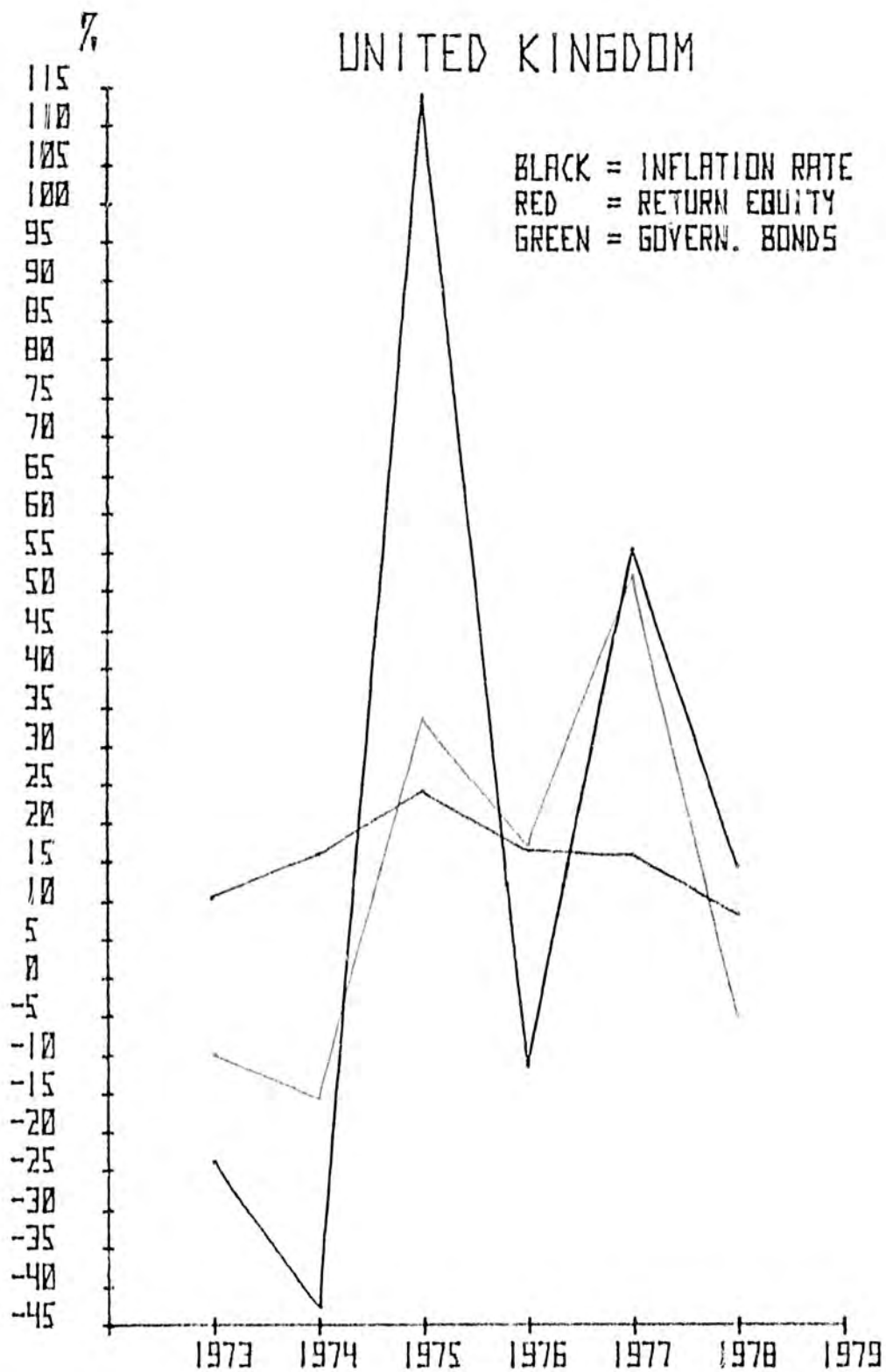


ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 86/2
598 SCOMM18: HOUSE SPECIAL COMM. ON PERMANENT FUND 1978-80



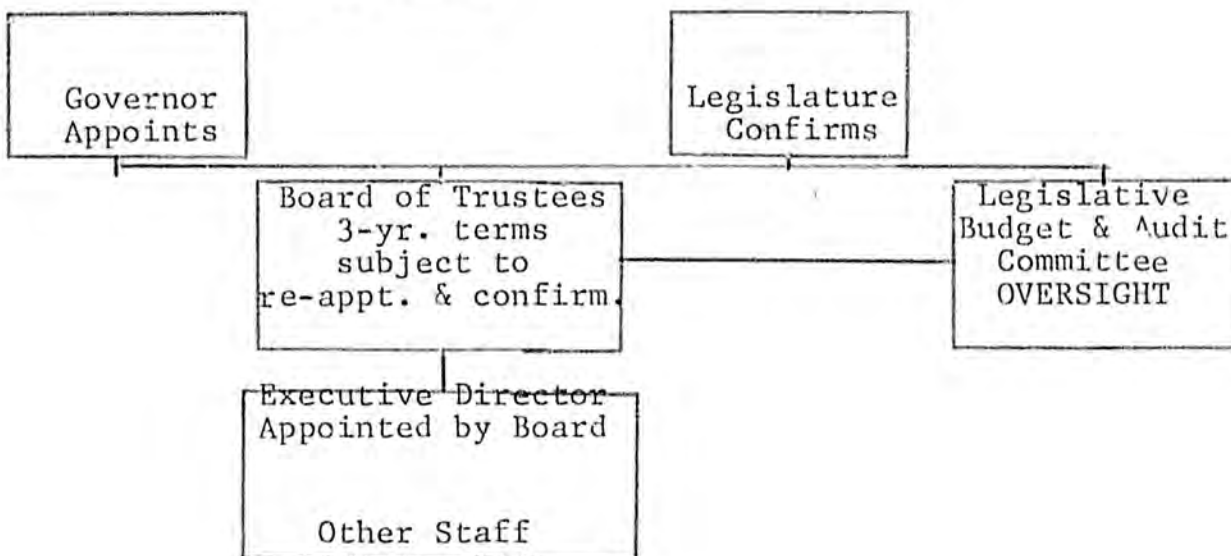
Comments

NOTES ON PURPOSES, ORGANIZATION, MANAGEMENT
AND REPORTING PROPOSALS IN HCS SB 161

PURPOSES

- Establish a means for legislative oversight of state lending and investment functions.
- Establish the Alaska Permanent Fund Corporation to invest and manage the principal assets of the Alaska Permanent Fund.
- A separate fund consisting of certain state mineral revenues.
- Used for income-producing investments which may include in-state investments that have a risk level and expected yield comparable to specified alternative investment opportunities and consistent with the prudent-man rule.
- Permanent: "1. Fixed and changeless; lasting or meant to last indefinitely" (Source: The American Heritage Dictionary of the English Language, 1970).
"1. Lasting or intended to last indefinitely without change; continuing in the same state or in the same place, stable, durable, abiding." (Source: Webster's New Universal Dictionary of the English Language, 1976).
- Accumulate sufficient income in the Fund to allow diversification of Alaska's economy and to insure that future generations receive benefits from development of the State's nonrenewable resources (Source: Joint Chairman's Report on CS SSHJR 39, March 24, 1976).

ORGANIZATION STRUCTURE



MANAGEMENT

- Policy decisions about permissible categories of investment would be made by the Legislature and included in statute.
- Decisions about trustee appointments would be made by Governor and Legislature.
- Operating decisions about the performance evaluation of the Corporation would be made by the Legislative Budget and Audit Committee.
- Operating decisions about the specific investments of Permanent Fund principal would be made by the Corporation staff, under direction of the Corporation Board.

REPORTING

- Alaska Permanent Fund Corporation (APFC) Board to submit quarterly and long-range investment reports to Legislative Budget and Audit Committee (LBAC).
- APFC Board to submit annual report to Governor, Legislature and the public.
- LBAC to report annually to the Legislature with recommendations for any needed legislation.
- Governor to report annually to the LBAC on capitalization levels and investment policies.

P. B. McDowell
March 20, 1980



Alaska House of Representatives



HUGH MALONE

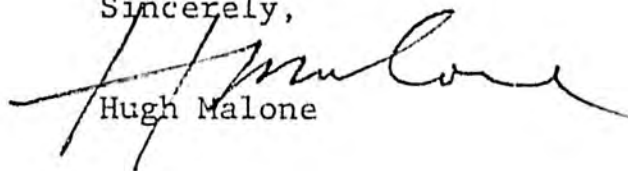
POUCH V
JUNEAU
99801

P. O. BOX 9
KENAI
99611

Dear Fellow Legislator:

Attached find two short executive summaries of reports prepared for the Department of Revenue. The authors, Drs. Coffman and Fry, spoke before the Permanent Fund Free Conference Committee on March 17 on their findings concerning capital shortages in rural Alaska. I hope that you will take the time to read through the papers and think about their implications.

Sincerely,


Hugh Malone

March 1980

CAPITAL SHORTAGE IN RURAL ALASKA
CONCEPTUAL ISSUES

Richard B. Coffman
City University of New York
and
Washington State University

-Draft-

I. Introduction and Recommendations

The main questions addressed in our study were:

1. Have imperfections in private capital markets caused a capital shortage in rural Alaska?
2. Have governmental policies caused a capital shortage in rural Alaska?

Our answers are:

To 1, yes. There is above average concentration in the banking industry in Alaska, which appears to have led to above average spreads between banks' deposit and lending rates of interest, and to less lending than would be found in a competitive market. However, this appears to be a state-wide problem, rather than one facing just rural Alaska.

To 2, yes. The State of Alaska has a number of policies which contribute to capital shortages. There are (a) state usury and loan interest ceilings, (b) the gross receipts tax on banks, (c) reserve requirements for state chartered banks, and (d) the many state loan programs.

These answers lead us to a third question:

3. What can be done to improve the functioning of Alaska's capital markets, and what role should the state budget surplus and the Permanent Fund play in the improvement process?

Our answer is that the state has the power to do a great deal to improve Alaska's capital markets. We suggest the state consider:

- (a) abolishing all interest rate ceilings;
- (b) abolishing the gross receipts tax;
- (c) abolishing the 20% reserve requirement for state banks;
- (d) passing a new Small Loan Act;
- (e) abolishing all state loan programs.

We believe these actions would bring capital market efficiency in Alaska at least up to the national average, and perhaps beyond. We thus see no economic reason for the state to be involved in the loan business, and no need to view the

state budget surplus and the Permanent Fund earnings as pools of loanable funds. We thus suggest:

- (f) that the budget surplus, for the most part, be distributed to Alaskans;
- (g) that the Permanent Fund be managed to maximize the yield of its portfolio.

We further suggest that:

- (h) the state subsidize people, not capital if the true concern is income and wealth distribution in rural Alaska;
- (i) the state subsidize houses, not mortgages if the real issue is a socially unacceptable standard of housing in rural Alaska;
- (j) the state Business Loan Program be evaluated;
- (k) if the Alaska Housing Finance Corporation stays in existence it be required to promote innovative lending by buying price level adjusted and graduated payment mortgages;
- (l) the state substitute a consumption tax for the income tax, effectively reducing the Federal income tax burden on Alaskans.

II. Conceptual Issues in the Capital Shortage Problem

We will now turn to an explanation of our conclusions and recommendations. First, I will discuss conceptual issues. Next, Dr. Fry will report on our empirical study of Alaska's capital markets. The conceptual issues are as follows.

Some basic terms must be defined. First, there is a distinction between real capital and financial capital. Second, capital can be considered as either a stock or a flow. A major distinction is between positive (market, economic) shortages of capital, which are defined in terms of the workings of free, efficient markets, and normative (social) shortages of capital, which are defined with reference to individual and group norms and values.

We will begin with the concept of a well functioning market. This is a market of many borrowers and lenders, none of whom have any power over terms and conditions of

loans. Equilibrium of supply and demand in this market will determine the interest rate and the amount of capital loaned and borrowed. This result will be economically efficient.

A positive (market, economic) shortage of capital is defined as an amount of capital less than would be found in a well functioning market. There are many potential causes of such capital shortages. These include:

1. temporary shortages due to changes in market supply and demand. In a free market the interest rate will soon adjust to eliminate such shortages.
2. permanent shortages due to interest rate ceilings. Interest rate ceilings make it illegal for interest rates to rise to eliminate shortages and thus can perpetuate shortages.
3. shortages due to monopoly power. A monopolist will find it in his interest to restrict lending and raise interest rates.
4. shortages due to the nature of infrastructure capital. Private capital markets will generally produce too little infrastructure capital because private investors cannot capture the wide spread public benefits produced.
5. shortages due to government created risk and uncertainty. Too little capital may be produced as private investors react to uncertainty about future taxes, regulations, and restrictions.
6. shortages due to taxes and regulation. Taxes and regulation which raise the costs of lending will tend to reduce the amount of lending and capital formation.
7. shortages due to lack of market mechanisms to deal with risk. If firms cannot insure against various types of risk, they will reduce the amount of investment undertaken.

This concludes our list of varieties of positive shortages. We now turn to the concept of normative shortage. The normative (or social) shortage is generally defined in terms of perceived "needs". If less capital than "needed" is produced by the market, then a shortage is perceived by those who have defined the needs. The needs concept is criticized by economists because (a) it is subjective, and the perception of needs varies from person to person, (b) it

ignores overall resource constraints, and (c) it ignores costs.

There are many potential sources of perceived normative shortages. These include:

1. shortages due to differences in borrower characteristics. Capital markets will discriminate among borrowers on the basis of amount of collateral and equity, evidence of business ability, and credit history. Those discriminated against may perceive a shortage of capital.
2. shortages due to transactions and information cost differences among borrowers. Capital markets will discriminate against borrowers presenting high information and transaction costs. Those discriminated against may perceive capital shortages.
3. shortages of capital confused with shortages of income. People who are poor lack capital among many other things. However, their basic lack is one of income and wealth, and giving them more capital is only one way to increase their income and wealth.
4. a shortage of capital confused with a shortage of work. Those who stand to benefit from large scale construction projects - workers, suppliers, transporters - often see a lack of such projects, and characterize this as a capital shortage. However, there is no economic shortage here unless there are available benefits which would generate net benefits.
5. a capital shortage confused with a shortage of subsidies. Government loan programs which offer subsidized interest rates or loose credit tests will face many eager demanders. But there will always be too few subsidies to meet this demand. Further, as government terms and conditions become seen as the norm, people will start to believe there is a shortage of private capital on reasonable terms.

This concludes our listing of varieties of normative shortages.

III. General Policy Considerations

Our specific policy suggestions have already been listed, and will be discussed in more detail in Dr. Fry's presentation. However, here at the end of this discussion on conceptual issues some general comments on policy are in order.

First, when positive capital shortages are found "the cure should fit the disease". That is, if a capital shortage has a specific cause then that cause should be attached directly. Unfortunately, though, government has a tendency to discover a problem, then pick a solution which expands the size of government and its role in the economy, whether or not that is the best solution. If capital shortages in Alaska are due to government policies, then the best solution is to alter those policies, not to get the government more deeply into the lending business.

Second, many attempts have been made by governments around the world to stimulate economic development by subsidizing capital in particular, and private enterprise in general. Unfortunately, many of their policies have had the unintended result of destroying profit-seeking, market oriented firms, and of creating in their place subsidy-maximizing firms. The subsidy-seeking firms will produce anything, anyway, anywhere, so long as it gains them a subsidy. When the subsidies end, these firms fade away, and it is discovered that no viable economic base has been created, despite all the resources used up and all the activity undertaken.

March 1980

INVESTMENT CAPITAL IN RURAL ALASKA

MAXWELL J. FRY

University of Hawaii

SUMMARY

1. Findings

(a) There is no evidence of any economic shortage of physical capital in rural Alaska.

Were there an economic shortage of physical capital in rural Alaska, then unexploited investment opportunities which would yield above-market returns must exist. The current perception of residents of rural Alaska and outside observers is that profitable investment opportunities are lacking in rural Alaska. We have found no evidence to contradict this view.

The best indication that unexploited profitable investment opportunities are not abundant in rural Alaska comes from the performance of the ANCSA (Alaska Native Claims Settlement Act) regional and village corporations. The conclusion must be reached that the 12 regional corporations and 205 village corporations have failed to locate unexploited profitable investment opportunities in rural Alaska. Corroborative evidence is also provided by the Small Business Administration's (SBA) activities in rural Alaska.

Rural Alaska has not witnessed rapid economic growth precisely because of the lack of profitable investment opportunities. Apart from the census division of Barrow, above-average population growth during the 1970s has occurred only

in Alaska's urban and contiguous rural areas, i.e. Haines, Matanuska-Susitna, Seward and Valdez-Chit-Whittier.

(b) Rural Alaskans may not be able to borrow as much as urban Alaskans because they have less wealth.

White families in the United States possess three to four times more net wealth than minority families at any given level of income. If urban and rural Alaskans hold the same proportion of their wealth in the form of deposits, the deposit holding differences will reflect differences in wealth.

Excluding public bank deposits, deposits of all kinds (bank, S & L and credit union) averaged \$5,910 per urban Alaskan and \$2,082 per rural Alaskan in 1977. However, this difference needs to be interpreted with considerable caution. For one thing, there is a substantial volume of banking by mail. The United Bank of Alaska claims that 65 per cent of its accounts are mail accounts. Furthermore, many Alaskans are known to bank out-of-state, particularly in Seattle.

Nevertheless, this three-to-one difference is consistent with the hypothesis that urban Alaskans may well possess three times the wealth of rural Alaskans at similar levels of income. The further implication about differential borrowing abilities is clear. Rural Alaskans may be able to borrow only one third as much as urban Alaskans, since ability to borrow is limited by the borrower's own equity in the prospective project.

(c) There is no evidence that financial institutions discriminate against rural Alaskans.

One can certainly live further from a bank in rural Alaska than would be possible anywhere else in the United States. Nevertheless, population per bank branch is not substantially higher in rural than it is in urban Alaska. Furthermore, the population per bank branch in rural Alaska of 3,609 is considerably lower than it is for the United States as a whole - 5,062. Even in states permitting statewide branching, as does Alaska, there are 4,868 persons per bank branch. Total per capita deposits in rural Alaska are only 37 per cent of the value of per capita deposits in urban Alaska. Deposits per rural branch are 47 per cent of deposits per urban branch. On these bases, Alaska has an above-average supply of bank branches even in its rural areas.

Economies of scale exist in the banking industry. Hence, unit costs of banking should be higher for rural than for urban branches of Alaska's financial institutions, since rural branches are much smaller than urban branches. These higher unit costs might be met in four ways: (a) Lower deposit rates of interest and higher service charges; (b) Higher loan rates of interest; (c) Fewer banking services; (d) Lower profits.

Deposit rates of interest, even on large certificates of deposit, and service charges are uniform across all bank branches in Alaska. Loan rates are not differentiated on a regional basis, nor are the credit standards applied to loan applicants.

Rural branches offer fewer services than urban branches. However, the branch banking system enables all clients to obtain specialised help and consideration - impersonally and with some delay - from head office. This solution is evidently viewed as a poor substitute for personal contact and local decision making autonomy.

It seems that rural branches are indeed less profitable than urban branches. This conclusion was corroborated by bankers interviewed during this study. For example, it was claimed that the National Bank of Alaska could never build its existing branch network if it had to start from scratch again today.

It was alleged by various interviewees that bank branches simply sucked deposits out of rural Alaska to Anchorage. Loan distribution data are unavailable. However, the Community Reinvestment Act of 1977 obliges regulated financial institutions to service the credit needs of the communities in which they are chartered to do business. Federal financial supervisory agencies are required to enforce this law. Responses from the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board indicated that all regulated financial institutions in Alaska had complied with the Act.

In conclusion, we could find no evidence that private sector financial institutions in Alaska discriminated against residents of rural areas.

(d) Government creates capital shortage in rural Alaska through subsidised credit.

There is a plethora of subsidised loan programmes in Alaska. The interest rate is deliberately set at a rate below the market equilibrium. Demand therefore exceeds supply and there is unsatisfied demand. Those who are not satisfied may rationally prefer to wait in the hope of a subsidy in the future rather than borrow now at market rates of interest. Subsidised credit programmes create their own economic capital shortage - there is always a shortage of gifts.

To the extent that greater subsidies have been given to rural borrowers, there is a greater capital shortage in rural than in urban Alaska. Capital shortage created in this way can be eliminated completely simply by bolishing the subsidised credit programmes. The only other way it to meet all loan demands at the subsidised rate. This necessarily involves eliminating all private supply of capital in Alaska.

(e) Government lending replaces private lending in rural Alaska.

Unsubsidised state lending supplants an equal volume of private lending. In this case, the interest rate on state loans is the same as the rate on private sector loans. Therefore, total demand for loans will be unaffected by the introduction of a state loan programme. If a borrower chooses the state programme, the state must in turn borrow the funds with which to

supply the loan. The increased demand for funds by the state is offset exactly by the decreased demand by the private sector financial intermediaries. Hence, aggregate demand remains unchanged here too. With no change in direct and derived demand for funds, the quantity supplied, i.e. aggregate saving, will be unaffected too. If the pool of saving remains unchanged, an increase in state lending to finance investment must be exactly offset by a decrease in private lending to finance investment, since saving equals investment.

This crowding in by state lending programmes will not be complete if state lending is subsidised. In this case, there will be an overall increase in saving and investment. The tax exemption of interest on bonds sold to finance state lending programmes is a subsidy illustrating this point. For example, the AHFC can sell tax exempt bonds and lend on these funds in the form of mortgages at below market rates of interest. As a result, the aggregate quantity of loans demanded increases. To be sure, this raises the market rate of interest so that the tax exemption is financed in part by all other borrowers. The main point here, however, is that the higher market rate of interest elicits an increase in the quantity supplied, i.e. in saving. Hence, both saving and investment rise.

It is not just economic theorising which provides these results. As part of this study, borrowers from the State Business Loan Program were surveyed. Of those borrowers who had approached a private sector institution before obtaining a

loan from the State's programme, only one was actually denied a loan elsewhere. Seventy-eight per cent of these borrowers simply preferred the lower interest rate charged by the State.

The rapid expansion of public sector lending in Alaska has thwarted growth of the private sector financial institutions. Since there are economies of scale in financial intermediation, state lending has kept the private financial institutions' unit operating costs higher than they otherwise would have been.

(f) Regulation causes capital shortage in rural Alaska.

Reserve requirements for state chartered banks, the franchise tax, interest rate ceilings, selective credit policies, and the Small Loan Act hold financial intermediation in both urban and rural Alaska below its optimal level, inhibits innovative lending which is essential in today's inflationary climate, and produces an economic shortage of financial capital, particularly of the high interest, high risk variety.

Below equilibrium institutional interest rates hold financial intermediation between savers and investors below its optimal level. Higher real institutional interest rates increase incentives to save and to invest, and also raise the average efficiency of investment. This is so because financial intermediaries raise real returns to savers and, at the same time, lower real costs to investors by accommodating liquidity preference, reducing risk through diversification, reaping economies of scale in lending, increasing operational efficiency and

lowering information costs to both savers and investors through specialisation and division of labour. When real institutional interest rates rise, disintermediation falls and financial intermediaries can use their expertise to allocate more efficiently the larger volume of investible funds which is then forthcoming.

2. Recommendations

(a) Subsidise people not commodities if the true concern is income and wealth distribution in rural Alaska (p.19).

(b) Subsidise houses not mortgages if the real issue is a socially unacceptable standard of housing in rural Alaska (pp.17-19, 29).

(c) Repeal the usury law, Small Loan Act, franchise tax and reserve requirements. Allow finance companies to accept deposits (pp.60-74).

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(e) If the Alaska Housing Finance Corporation stays in existence, require it to promote innovative lending by buying

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(f) Evaluate the State Business Loan Program (p.90).

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Consultants

March 1980

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(i) Set the Permanent Fund management the sole objective of maximising the yield of the Fund's portfolio (p.99).

7 February 1980

Dear Borrower,

I am conducting a small study of the State's Business Loan Program for the Department of Revenue. The objectives are to find out how successful this program has been and what changes would improve it.

Your assistance would be of great value and much appreciated. Please would you help by completing and returning the enclosed questionnaire in the stamped addressed envelope provided. It should not take more than a few minutes and will be an important input in the process of improving this program.

Thank you very much in advance.

Yours sincerely,

Maxwell Fry

Maxwell J. Fry

- PLEASE CONTINUE ANSWERS ON BACK IF NECESSARY

SCOMM

#18:13

ECONOMIC CONSIDERATIONS
IN ESTABLISHMENT OF
ALASKA'S PERMANENT FUND

by
Arlon R. Tussing
Institute of Social and Economic Research
University of Alaska

for
Legislative Affairs Agency
State of Alaska

July 7, 1977

I. INTRODUCTION

The following report was prepared under a contract between the State of Alaska Legislative Affairs Agency and the University of Alaska Institute of Social and Economic Research. Its object was to explore some of the fundamental economic questions involved in establishing the structure and policies for the permanent fund authorized by a 1976 amendment to the Alaska Constitution. Research for this report was devoted mainly to an initial exploration of the question to what extent capital markets serving Alaska are reasonably efficient, and consisted largely of unstructured and unsystematic interviews with businessmen on both sides of those markets --- officers of financial institutions and other investors and lenders, and corporate officers and entrepreneurs in Alaska industries or with Alaska interests.

In line with the contract between the Legislative Affairs Agency and ISER, the study and report were to be "...in the nature of a general reconnaissance, and need not involve the collection or processing of original quantitative data." Among the tasks of the study, however, was to prescribe "the analytical and policy issues" which deserve further investigation in depth. A number of the issues raised in this report do warrant collection and processing of original data. In line with the report's terms of reference, I have not proposed final conclusions on any of the six interrelated questions set out in the contract, but have only attempted to explore and define them sufficiently to propose how the Legislature might proceed with such investi-

gations, particularly some quantitative testing of the hypotheses offered here.

Uses of the Permanent Fund

Public officials, "experts" of various kinds and voters generally have envisioned several different purposes for an Alaska permanent fund. The constitutional amendment which authorized the fund reflects a consensus that at least one-fourth of Alaska's non-recurring mineral leasing revenue should be excluded from the regular stream of state spending. A corollary of this consensus is that the fund should be profitably invested to give state government a permanent stream of revenue independent of current mineral leasing income and independent of economic conditions in the state generally. Because state government spending is a large part of Alaska's economic base (and will grow proportionately larger as tax and royalty income from North Slope oil begins to flow), the spending of income from permanent fund investments and their responding in Alaska's private economy could have a stabilizing effect on employment and income in the state.

There is little doubt that the operation of the fund would have the effect of reducing the immediate fiscal impact of oil and gas income and a stretching out and smoothing of its long-term impact, however the fund is organized and whatever its investment strategy. But the size of these impacts will depend on how much of the permanent fund's capital is invested or lent in Alaska and on what terms. Given certain assumptions about

the size and structure of the state's economy, the revenues committed to the fund, the yields of the fund's investments and the disposition of income from those investments, we can forecast its effect on the shape of long-term growth of state product, personal income, employment and per capita income. Some elementary projections of this sort have already been made by ISER under the Man in the Arctic Program.

Beyond this, there is little agreement on the proper purposes or the long-term effects of permanent fund investment strategies, and there has been little examination of the economic fundamentals which determine whether these purposes can actually be achieved by an instrument by the fund, or what its actual effects (intended and unintended) are likely to be. Apart from the purpose of delaying and smoothing the fiscal impact of non-recurring mineral leasing revenue, other goals that have been suggested for the permanent fund are to accelerate the growth of the state's non-oil economy and at the same time to expand state government's non-oil tax base.

In pursuit of this end it is usually assumed, and there seems to be a near-consensus in the unofficial statement of legislators, that permanent fund moneys invested or lent in Alaska be confined to creditworthy projects and enterprises, and at market rates and terms. If capital markets in Alaska (and in the United States) are workably efficient, however --- and my investigation so far suggests that they are --- investment of permanent fund moneys in Alaska will have exactly the same effect on the state's economy as investing them outside Alaska.

(The quality of the fund's investment portfolio may, however, be affected by the choice.) That is, permanent fund money would tend to replace the same amount of money that otherwise would have been provided from private financial sources.

Unless it provides capital subsidies, permanent fund activity will not accelerate growth of non-oil industry and thereby diversify the state's economy. If capital markets are generally efficient, moreover, non-subsidized permanent fund outlays would not tend to smooth out Alaska's business cycle or the growth rate of employment and population, even if there were no other fundamental difficulties (treated in part IV of this report) in using state investment policy as a counter-cyclical tool. In the absence of capital subsidies, any attempt to disperse economic activity or to foster rural industries will also tend to be futile if the absence of growth in rural Alaska or in particular small communities is a result of factors other than the failure of financial institutions to bring enterprise and investors together on mutually acceptable terms. If poverty or stagnation is caused by deficiencies in natural resources, the skills or attitudes of the labor force, transportation, communications and energy costs, or an unsatisfactory institutional environment, the permanent fund cannot cure these ills, nor even mitigate them unless it is treated as a source of capital available for investments which will not meet market tests.

II. CAPITAL MARKET EFFICIENCY

Every proposed strategy for Alaska's permanent fund depends

upon stated or unstated assumptions about the "efficiency" of national or international capital markets. The proposition that Alaska as a whole, certain regions of Alaska, or certain Alaska industries suffer a chronic capital shortage which can be remedied by permanent fund investment strategy amounts to saying that existing capital markets do not, in fact, function efficiently.

By "efficiency" in the capital market, we mean the ability of loanable or investible funds to move readily in and out of Alaska, among industries and among different kinds of capital instruments of different term and risk (common stocks, bonds, loans, etc.) in response to the differences in anticipated yields.

The most important elements of capital market efficiency are mobility, cost and information. Legal limitations on the flow of loanable funds can clearly reduce capital market efficiency as defined here (though there may be good social reasons for the restrictions). An example of a legal restriction on the mobility of capital for social reasons, the federal government limits the rate of interest payable by banks and thrift institutions on savings deposits, in order to channel funds to, and reduce interest costs for, the residential mortgage market (but it also restricts the funds available to savings institutions). The fees of brokers, underwriters, lenders, and "finders" of venture capital, and taxes such as capital gains and stock transfer taxes also increase the cost of moving funds from one investment to another. A lack of competition can both erect barriers to capital mobility and increase transactions costs.

The element of capital market efficiency most often held to be deficient in Alaska is information. If funds are to move easily and at competitive rates of return from areas or industries with cash flow surpluses to those with excess demand for capital, entrepreneurs must know where equity and debt money is available and on what terms, and potential investors or lenders must have the means to appraise the earning capacity and risk of the ventures they are asked to underwrite.

Capital mobility, transactions costs and the adequacy of information are all a function of market size and diversity (which is in turn a function of market size). A region with large and diversified capital demands will attract a large number of financial institutions of different kinds, who will serve as intermediaries between entrepreneurs and investors or lenders. They will compete among one another for business, thereby lowering capital transactions costs to ultimate borrowers and lenders. And most critically, they will make it their business to understand the industries and kinds of enterprises they serve and their local and regional economies, thereby increasing market information necessary to evaluate individual ventures.

This issue has important implications for the permanent fund's investment strategy. If capital markets serving Alaska business are workably efficient, permanent fund moneys dedicated to Alaska investment will have no impact on the aggregate level of investment (and thereby the rate of economic growth), the industrial structure, or on the profitability of investment in Alaska, unless

these moneys are offered on subsidized terms. Loans from the permanent fund at market rates would simply displace private capital that would otherwise be available at the same rates.

The only material result might be a reduction in the diversity--and thereby safety--of the permanent fund's own investment portfolio because it would be imprudently concentrated on Alaska issues and unduly sensitive to business fluctuations special to the state.

If, on the other hand, institutional barriers to capital movements, excessive fees or taxes on capital transactions, or inadequate information result in a shortage of capital for Alaska ventures at normal market terms, then it will indeed make a significant difference to Alaska's economy how much of the permanent fund is allocated to investment within the state. The conclusion that investment strategy would, in fact, make a difference need not necessarily carry with it the implication, however, that the difference would be great, or cost-effective or even in the right direction. To the extent there are demonstrated inefficiencies--barriers, costs or ignorance--in Alaska's capital markets, it may well be cheaper and more effective to remedy those problems directly rather than to offset them with permanent fund investments.

The paradigm (pattern of concepts and theories) of capitalistic finance presented in business school textbooks is one of efficient capital markets. Within the terms of this paradigm, it is very unlikely that Alaska could suffer a chronic capital shortage. Outside investors and lenders, in their search for

the highest rates of return consistent with a given degree of security, would make an effort to discover investment opportunities in the state, while entrepreneurs with Alaska interests would shop the world's capital markets for venturers or lenders of funds on appropriate terms. Whatever lack of information existed about capital sources, the particular industry, Alaska's institutions or business conditions, or regarding the particular firm could be remedied at a price, and at least for large ventures, that price would be relatively small compared to the funds involved. A variety of financial intermediaries and investment services would compete with one another to bring together borrower and lender or entrepreneur and investor, and to furnish either side with needed information. This competition would increase capital mobility and lower both transactions costs (the spread between the yield to lenders and the cost to borrowers, for example) and the cost of information.

Capital market efficiency is obviously a relative matter. The mobility of funds is seldom totally unfettered; there are almost always fees and taxes or other transactions costs; and information itself comes only at a price and is never perfect. The relevant questions here are to what extent and for what regions and industries in Alaska are capital markets significantly less efficient than elsewhere in the national economy and to what extent, if at all, can the investment strategy of the permanent fund remedy or offset these inefficiencies.

Alaskan Capital Markets

In my conversations with businessmen inside and outside of Alaska, it appeared that bankers and officers of financial institutions generally, officers of large corporations, successful real estate developers and the most successful entrepreneurs in contracting, tourism and fishing tended to "believe in" the efficient markets paradigm and conduct their businesses as if it were an accurate view of the world. It is true that several of them spoke of a national "capital shortage"; the reference is to the aggregate effect of high taxes and inflation, and few of the businessmen in these categories seem to believe that there is a shortage of investment or debt capital peculiar to Alaska or to their own industries. The officers of banks, finance companies and other money market institutions believe that their companies actively seek out investment opportunities in Alaska and consistently denied that they insisted on higher rates of return or greater security for Alaska issues. Two West Coast bankers active in Alaska stated a belief that it was probably easier to place large issues generated by their Alaska correspondents than comparable issues from California or Washington State because of the widespread confidence in Alaska's wealth and continued industrial growth. Two corporate officials made a similar observation, one of them alluding to the "glamor" of Alaska investment.

Officers of national or multinational corporations in petroleum, mining and fish processing indicated that for them, the procedures, problems and costs involved in the financing of Alaska

ventures were for all practical purposes identical with those for financing comparable ventures in the Lower 48 or in other politically stable advanced capitalist states. Their own sources were national and international, and their ability to raise funds rested in part on the overall strength and reputation of the company, and in part on their ability to communicate to potential investors and lenders the reasons (resource base, engineering cost estimates, market factors, etc.) why they themselves believed that the proposed Alaska investment was sound. One successful developer scoffed at the notion of an Alaska information gap: "Information, salesmanship--that's what business leadership, what you call entrepreneurship is all about. It's your job as a developer to get all the information your banker needs into his hands. Make him as confident about your project as you are yourself."

Many small businessmen including, it appears, most prospectors, inventors, independent merchants, and operators of hotel, restaurant and other tourist-related businesses outside of Anchorage, and some contractors do not, however, believe in the efficient markets paradigm. I heard many complaints about treatment by banks and finance companies and a feeling that "the system" is biased against small businessmen and against Alaskan enterprise. I heard anecdotes purporting to show that even Alaska banks favor outside-owned businesses. Many persons in this group expressed a hope that the permanent fund could correct this bias and make more funds available for ventures like their own. It was especially noteworthy to me

that most state and federal civil servants in the economic development or business assistance field expressed views more consistent with the capital shortage paradigm than with that of efficient markets and believed that government should provide more financial assistance to private industrial development in Alaska. Whether or not these sentiments express an accurate view of the way in which the economy and financial markets operate, it seems likely that it is a more representative view than the more sophisticated textbook, "big business" view of capital markets, and constitutes a substantial political constituency for an activist policy by the permanent fund's managers.

In preparing this report, I encountered several instances where entrepreneurs or corporate managers were working on financing a fisheries, mining or tourist venture, a shopping center or a residential subdivision. Those in this group who seem to accept the efficient markets paradigm regarded it as the essence of their own job as a developer or manager to assemble and integrate the necessary information on resources, markets, costs, economic and environmental regulation and to draft credible profit and loss projections and pro forma financial statements acceptable to their corporate boards or to outside investors or lenders.

A common situation among small and medium Alaska business enterprises seems to be a rate of growth (with sales increasing at 20 to 100 percent per year) that leads to a need for additional fixed and working capital far outstripping internally generated

cash flow. It is "obvious" to the owners and operators of these businesses that money borrowed to sustain this growth would earn a very good rate of return, but that there is never enough credit available. Businessmen in this situation seem to express two strikingly different attitudes toward their own "capital shortages." Those who operate by the efficient markets paradigm (and these seemed generally to be the most successful) expressed their problems objectively in terms of necessary cash flow and debt-equity ratios acceptable to lenders, while there were others who attributed their cash crunch to the institutional incapacity of financial institutions to serve their kind or business, or to the laziness, ignorance or malice of particular lenders.

It is clear that there are widely contrasting perceptions among Alaska businessmen and others about the adequacy of financial institutions and the supply of capital to Alaska ventures. Curiously, the distribution of these perceptions seems to be bimodal; that is, they cluster at one extreme or the other with only a scattering of individuals in the middle. Perceptions also seem to be highly correlated by industry and by size of enterprise.

In general the bigger the firm, or the faster it is growing, the more satisfied its spokesmen are with existing capital markets. Without exception, representatives of large financial enterprises doing business in Alaska and of large national and multinational corporations spoke as if they believed in efficient markets and, without exception, they rejected the notion that lack of informa-

tion, high transactions costs or institutional barriers created a capital shortage in Alaska or in the industries with which they are connected or whose financial needs they serve.

On the other hand, hardly any local merchants, service industry operators or tourist business operators outside of Anchorage and Fairbanks, and hardly any entrepreneur or developer who was still trying to put together his first "big deal" (capitalized at \$1 million or more), believed that financial institutions operated efficiently or fairly, and most of them felt that Alaskan enterprise was at a substantial disadvantage compared with firms in the same business elsewhere. As I mentioned before, almost every public official interviewed believed that there was an Alaska capital shortage that could, and should, be treated by application of government money. Anchorage and Fairbanks merchants, contractors and real estate developers seem to fall into both groups, as do operators of independent businesses connected with forestry, fisheries and mining.

The time and resources available for preparing this report did not make it possible to separate perceptions and ideology from reality. Each group's perceptions were supported with convincing anecdotes. Nevertheless, most of the correlations between attitude and situation were predictable, and the perceptions surely contain a measure of self-interest and self-justification. Officers of financial institutions who have the job of searching out and appraising investment opportunities are likely to believe

that their jobs are useful and effective, and they are unlikely to emphasize the problems of those kinds of enterprise that they do not serve (and which may not, in fact, be served well by any sector of the capital market). And it is not surprising that public officials feel that government financial and technical assistance (like economic regulation) is essential to a healthy business economy. But among businessmen, are the first group satisfied with the status quo because it served them well, or are those who accept, understand, and work easily within the status quo the people who are for that reason most likely to succeed as corporate managers and entrepreneurs?

My own provisional conclusions on the issue of capital market efficiency are as follows, but they are subject to modification on the basis of a quantitative study of attitudes and actual workings of the financial system in Alaska:

1. Investors and entrepreneurs, would-be lenders and would-be borrowers alike believe that the existing capital market institutions are adequate to finance large industrial or commercial developments in oil and gas, mining, petrochemicals, fisheries, timber, trade, and tourism anywhere in Alaska. I have found utterly no reason to doubt this consensus, and see no way in which the permanent fund could improve on the mobility of capital, transactions costs, or the information made available to investors by the sponsors themselves and through existing financial institutions.

It follows, therefore, that the permanent fund's investment activity in these areas will not significantly influence the profitability or growth of basic industry in Alaska unless loans are made at less than current market rates or under less secured terms (e.g., more highly leveraged, lower coverage rates, less collateral) than is customary. If the permanent fund invests in Alaska industrial ventures at market rates and terms, therefore, it will divert private capital elsewhere that would otherwise be attracted to the venture. In short, there is no need and no useful function for permanent fund investment in major industrial or commercial enterprise in Alaska, unless there are grounds to subsidize that enterprise.

2. Despite the disagreement of those who do not believe in the efficient markets paradigm, the working and fixed capital requirements of residential and commercial real estate developers, contractors, retail and wholesale merchants and purveyors of services in Fairbanks and Anchorage are being served by existing banks, thrift institutions, finance companies, mortgage brokers and the like, in exactly the same way and at approximately the same rates and under the same conditions as in other communities throughout the nation.

Some businessmen will always have grievances against their bankers (and many Alaskan businessmen have some gruesome yet convincing tales to tell) or against the financial system gen-

erally. But Anchorage and Fairbanks banks do compete aggressively for business customers, and some of the "atrocious" stories can be attributed to understandable disagreements over the creditworthiness of a particular borrower or venture rather than a systematic failing of the system. Again, apart from any argument that a particular line of business or kind of investment ought to be subsidized, there seems to be no case for the permanent fund or one of its subsidiaries to enter the commercial capital markets in these communities. I am not certain at this point how well these needs are being served in other urban places in Alaska.

3. Several alternatives exist for financing the purchase or lease of standardized machinery used in business, including motor vehicles, construction equipment, aircraft, boats, electrical generators, compressors, machine tools and the like. Commercial banks, finance companies, credit unions, manufacturers and vendors all offer some kind of financing for this kind of chattel, and one or more of these forms of financing seems to be available to creditworthy borrowers in any Alaska industry or location. Higher servicing and collection costs do tend to limit borrowers in the more remote areas of Alaska to higher interest rate alternatives, but on balance this reflects not a failure of the market to reflect true costs but the opposite, it does not constitute a case for permanent fund involvement in the install-

ment credit business, unless there is also a case for a capital subsidy to rural enterprise generally.

4. The general feeling of local businessmen in small communities and rural areas of Alaska is that they face a genuine capital shortage and that they are at the mercy of one or two financial institutions that are indifferent to their aspirations or the facts of their business situation. There seems to be some merit to these complaints. Lending in small towns or the bush is exceptionally expensive, however; the cost of investigating and servicing small commercial, real estate and installment loans and lease purchase contracts and the like, and the costs of collection, foreclosure, repossession and resale can easily exceed the potential earnings from loan fees and interest. These excess cost burdens, together with unfamiliarity with local conditions, understandably make the statewide (Anchorage and Fairbanks) banks and other financial institutions reluctant to provide capital even for the larger locally-owned development, such as resorts, hotels, apartment houses, fish processing plants, etc., and where they do make loans they are willing to finance a smaller portion of total investment. In these cases, governmental participation or guarantees (EDA, SBA, Farmer's Home, Alaska Veterans loans, etc.) have often been essential to obtaining conventional private financing. This portion of the demand for capital in Alaska may then be a legitimate area for permanent fund activity.

In sumamry, it appears that most attempts of the permanent fund to serve as a development bank for Alaska would duplicate

functions that private financial institutions (backed up in many cases by other governmental assistance programs, e.g., FHA, Farmer's Home, VA, etc.) perform or are capable of performing adequately. At this stage in my investigation, I have been able to identify only one function in which a new public financing source might function better than the current machinery of the private capital market, and that is in provision of commercial credit and financing of small and medium scale industrial and commercial enterprises in small communities and rural areas.

III. SUBSIDIES AND SOFT LOANS

Diversification of Alaska's economy is widely regarded as a desirable goal for state policy and as a proper purpose of permanent fund strategy. The benefits argued for such a policy are reduction of economic fluctuations and creation of a permanent employment, income and revenue base not dependent upon oil and gas or other exhaustible resources. The line of reasoning in the previous section of this report suggests that the existing concentration of Alaska economic activity by region tends to reflect real resource location and cost factors (such as transportation expense and small market scale) rather than capital market failures. It appears that a reduction of existing barriers to capital mobility and improving information flows would not necessarily accelerate the rate of development in Alaska fisheries, agriculture or tourist industries, for example, or in rural Alaska generally.

Making capital more readily available at lower rates to Alaska enterprise generally could be expected to increase investment in all sectors of the state's economy, but there is no reason to believe that it would influence the concentration of investment in the desired direction, that is, in favor of economic diversification or geographical dispersion (if the latter is indeed a desirable objective). Lower capital costs would likely have their biggest impact precisely where development would proceed most rapidly in any event. If investment activity is already concentrated in oil and gas-related activity, fish processing and in Anchorage residential and commercial real estate development, that is probably where more abundant, cheaper capital would go. There is a strong confirmation of this proposition in the investment behavior of the rural-based regional and village corporations.

Making capital cheaper and easier to obtain will undoubtedly have one effect which may be regarded as counterproductive; business will be given an added incentive to substitute capital for labor and the state's economy will tend to become more capital intensive than it otherwise would be. If investment policy is to be in any way directed toward "job creation," it must be highly selective and not simply a matter of lowering capital costs across the board.

If the legislature deems it desirable to influence private investment in Alaska in the direction of greater economic diversification by means of permanent fund investments, it will have to authorize the fund's managers to make loans to the favored

types of venture on terms other than those of the private market. There is a serious question, however, how many new ventures will be made feasible simply by a reduction of interest rates on borrowed capital below customary rates. There is in fact good reason to believe that investment demand in new speculative industrial, agricultural or tourist-related development are relatively insensitive to interest cost. This is because private investors are not likely to commit their own equity to such ventures unless they have a prospect of recovering their total investment in five years or less. Such an outcome requires an annual cash flow equal to 30 to 50 percent on total investment, a situation in which two or three percentage points interest expense is seldom crucial. More important parameters are the standards for the creditworthiness of the venture and requirements for equity and collateral. In other words, it is likely to be more critical for a new venture in fish processing or tourism whether it can borrow three-fourths rather than two-thirds of its total requirements, than it is whether the interest rate on that loan is 9 or 12 percent.

In this situation, subsidized loans by the permanent fund can without question have an influence on the shape and direction of economic growth in Alaska, and that influence will be greater the greater the proportion of permanent fund moneys devoted to the favored types of enterprise. The form the subsidy is likely to take to make it effective, however, will not be (and should not be) lower interest rates, but rather a

relaxation of lending standards to enhance the availability of funds. One danger here, even if the legislature deliberately authorizes the fund's managers to make such loans, is that the nature and the degree of actual subsidy may not begin to appear for many years, until it begins to show up as defaults on principal and interest payments. This danger will be aggravated if, as is often the case with governmental loan programs, there is not a rigorous policy of classifying problem loans and of promptly writing off those which are uncollectable. Banks and thrift institutions are required by law and regulation to do this, but even there the requirement is only very loosely implemented or enforced, because lending officers are reluctant to expose their own imprudence in making bad loans or to write down the capital position of their institutions.

In any event, there is sure to be some opportunity for the permanent fund to influence the sectoral and geographic direction of economic development in Alaska by manipulation of credit terms. The most aggressive (and in conventional terms, imprudent) lending policy cannot, however, create an industry where resources, markets, skilled labor and other requisites are missing, and the fund's managers should never become so "soft" as to finance enterprises whose promoters are not taking a substantial risk themselves, or which do not have convincing prospects of long-term viability.

The most relevant model of a development bank for Alaska is not the IBRD (the World Bank) or the regional development banks, but the International Development Agency, the World Bank's "soft

loan" subsidiary. If the permanent fund is to direct the shape of economic growth in Alaska, it will not be through normal commercial investments on normal commercial terms, but through a postponed or hidden subsidy in the form of higher loss rates in future years. This is not the appropriate place to judge the desirability or assess the ultimate beneficiaries of capital subsidies directed at changing the structure of Alaska's economy, but the Legislature may well wish to assure that those implicit subsidies are not totally hidden, by setting out (or requiring the fund's managers to set out) explicit and rigorous standards for the granting, servicing, classification and writeoff of soft loans, and by requiring a rigorous annual audit of the fund's loan quality.

There is another dimension to the capital subsidy issue which the Legislature should keep in mind as it authorizes any soft or subsidized loan program under the permanent fund. Granting credit at terms more liberal than the market will almost certainly make some enterprises viable that would not otherwise be so, but it is difficult to draw lending standards in such a way that other ventures which would be viable anyway do not receive a windfall that serves no social purpose. This consideration suggests a policy that might be adopted toward the soft loan program --- that loans under this program be made at rates perceptibly above market rates (as is appropriate to the greater risk). If my earlier observation is correct that speculative investment in Alaska is more sensitive to the degree of leveraging permitted than to interest rates as such, higher interest rates would

screen out some of those enterprises which did not need assistance from the fund and would at the same time help build up a reserve for loan losses to offset the subsidy aspect of the program.

IV. COUNTER-CYCLICAL INVESTMENT

There are several possible concepts of the permanent fund as an economic stabilization device for Alaska. The one basic concept of the fund on which there is a near-consensus is that it is to be regarded as a savings account for a "rainy day." That is, Alaska's government is about to experience an extraordinary surge of income from oil and gas royalties that is not likely to be sustained. Since petroleum revenues will not only be the main source of general government income but will for some time be a principal support for the private economy and the main engine of economic growth, the permanent fund would be used to reduce the injection of income into the state's economy during the boom phase, and then the income from investing these revenues would be used to sustain state expenditures and their fiscal impacts after the boom has ended.

It has also been suggested that the permanent fund could help even out short-term business fluctuations in Alaska, or maintain long-term economic growth (as measured by the growth of state product, real personal income or employment) at some optimum rate. Such stabilization policies could in principle operate through varying appropriations to the permanent fund, working through the fiscal impacts of general fund expenditures;

through varying the permanent fund's rate of new lending in Alaska, working through the fiscal impact of investments supported by these loans; or with both appropriation and investment policy. The basic principle is simple: when the state's economy was booming, larger appropriations would be made to the permanent fund (thereby reducing revenue available to the Legislature for general fund outlays) and/or a smaller proportion of permanent fund assets would be invested within Alaska. When the state was in a recession, the flows would be reversed: less revenue would be appropriated to the permanent fund and more to the regular capital and operating expenses of state government, and/or the permanent fund would inject more investment money into the Alaska economy (presumably by selling off non-Alaska investments in its portfolio).

There are, however, both conceptual and practical problems with using the permanent fund as a stabilizing device on any more sophisticated basis than is implied by the "savings account" notion. One of them has been identified previously --- to the extent that existing financial institutions make up a reasonably efficient capital market, the volume of unsubsidized loans or investment the fund makes in Alaska may not have a significant effect on economic activity in the state.

Even if there were significant capital market deficiencies which gave permanent fund outlays a real effect on aggregate investment in Alaska, or even if the fund had a policy of subsidizing Alaska business (thereby expanding the level of investment

beyond what it otherwise would be), it is still not obvious whether a policy of varying state expenditures or permanent fund investment in response to economic conditions would in fact reduce business fluctuations in the state, increase them or be on balance neutral. The crucial question here is the relationship between our ability to forecast economic conditions or recognize cyclical turning points, and the time it takes for a change in appropriations or in lending policy to show up in unemployment rates or rates of economic growth.

Some very gross economic changes, such as the buildup and decline of pipeline construction activity, obviously could be anticipated and their fiscal effects projected with some degree of confidence. But the Alyeska pipeline is likely to be historically unique in size and specific gravity in the state's economy. Future ups and downs are more likely to be the resultant of a number of smaller influences, many of which (general business confidence, for example) cannot be mapped out in advance and are difficult to quantify even retrospectively. If booms and recessions often cannot be recognized clearly until after they have been with us awhile, and their turning points recognized only after they have passed, it is also true that significant delays are inevitable between the recognition of a new trend, the fiscal action that is appropriate and the actual movement of new dollars into (or out of) the private economy. Depending upon the relative lengths of the various lags, attempts to stabilize Alaska's economy or smooth its growth rate might be successful, but it seems equally likely that state fiscal policy would zig when it

should be zagging, that the amplitude of the business cycle would thereby be increased, or even that the permanent fund's intervention could create oscillations in the state's economy where otherwise there would be none.

It is not obvious which of these outcomes would in fact result from an attempt to use the permanent fund as a stabilizing influence. The effect would depend in part on whether it was appropriations, lending or both which were being varied, and what economic indicators were being used to trigger policy changes. A business cycle model could be developed which would simulate the behavior of Alaska's economy under the influence of various decision rules.

Intuitively, I expect that such a model would show that the various lags in recognizing trends and implementing policy, and in the actual economic impact of that policy, would preclude using the permanent fund to offset economic fluctuations with a term of less than about three years. If the fund is to be useful as a stabilizing device, it will probably be only as an instrument to regulate growth rates in very gross terms and only in the very long run. If, for example, the social impacts of a continuing growth rate in employment below 2 percent per year or above 8 percent were determined to be unacceptable, the legislature might conceivably key permanent fund appropriations or investment policy to the average growth of employment in Alaska over the previous five years, with the understanding that no individual year's growth is ever likely to be on track because of the fund's policies, and that excessive growth in one year might be offset by

stagnation in another, or vice versa. It is likely, in other words, that long-term stability in growth rates might be achieved at the expense of greater instability in the short run.

The practical problems in establishing a stabilization policy for the permanent fund are political and administrative. If permanent fund appropriations (and their complement, operating expenditures from the general fund) are to be varied, it is the Legislature which would have to vary them. While there would be little difficulty persuading the executive branch to propose and the Legislature to authorize increases in capital and operating expenses during a recession if money is readily available to be committed, it may be too much to expect a sharp reduction in outlays to offset an economic boom in the state, particularly when revenues and "needs" have both been increasing at exceptional rates precisely because of the boom. The fate of the state government's announced interest to "stockpile" public works projects until the end of the Alyeska construction boom should be instructive on this point. It is not clear, moreover, that the managers of the permanent fund would be immune from similar pressure with respect to their lending and investment policies, if they were granted the discretion to alter those policies according to economic conditions in the state.

V. PUBLIC ENTERPRISE

Another suggested use for permanent fund moneys is to finance public works projects. The works most often proposed are hydro-electric plants and fisheries improvements such as hatcheries and

habitat enhancement. These two examples are of course quite different; electrical generating facilities can be and usually are self-supporting from the sale of power. The principal reason for governmental investment in such facilities, ideology aside, is the exemption from federal taxes of the income of a public utility and of the interest it pays on its debt. This very consideration suggests that revenue bonds of the Alaska Power Authority or other governmentally owned utilities would not be an appropriate permanent fund investment, because the permanent fund (whose own income is tax exempt) could be expected to earn a higher rate of return from investments in taxable federal or corporate bonds than the Power Authority would have to pay in interest on its own tax-exempt bonds, assuming that the securities were equally rated. This consideration does not, however, necessarily foreclose the permanent fund from providing all or a part of the equity component of Power Authority capital (and in earning a rate of return appropriate to the risk taken by an equity investor), or from providing a guarantee of Power Authority bonds, or from subsidizing electric power development.

The crucial characteristics of some public works, such as hatcheries and habitat improvement, is that they cannot be financed conventionally. Benefit-cost analysis may well show that the new benefits to society exceed the capital and operating outlays, but the burdens and the benefits may not fall on the same people, and it may be impractical (or impolitic) to collect a user charge from the beneficiaries. In the case of these fishery-related investments, however, costs could be allocated at

least roughly among the beneficiaries through a surcharge on fishing licenses, entry permits or raw fish taxes. If such capital improvements are not to be funded this way, however, they seem more appropriate subjects for general fund appropriations than as "investments" by the permanent fund.

VI. ISSUES FOR FURTHER INVESTIGATIONS

This report has identified a number of questions whose answers are crucial if the Legislature is to develop appropriate policies for operation of the permanent fund. At most, however, the author has been able to give only tentative answers to these questions. The following is a list of issues that warrant further investigation, together with some discussion of methods and sources.

1. Capital market structure, costs and efficiency. A survey is necessary of the number, size and aggregate Alaska activity (e.g., loans made, loans outstanding, loans being serviced) for various institutions in the financial market, with offices both inside and outside of Alaska. Questionnaires and interviews would be used to determine the relative weight of each of these institutions in financing different industries in Alaska and their policies regarding various types of Alaska business.

A survey is necessary to determine just what is the price of money in Alaska and how does this price (together with other credit conditions) differ from those elsewhere in the United States. A large body of aggregate data comparing Alaska conditions with those in other states is available in the commercial bank call reports; some information is available by major loan

categories (real estate, commercial and installment). The absolute level of these rates is less indicative than their relation to rates in other Western states and particularly the trend of any Alaska rate differential. Any differences in other loan terms (for example, requirements for compensating balances) would have to be based upon questionnaires or systematic interviews with lending officers.

Similar questions can appropriately be asked about differences in the rates and conditions for various categories of credit as between the urban centers of Alaska, and small communities and rural areas. The quickest approximation to an estimate of geographic differentials could be obtained by comparing loan statistics for the outlying branches of statewide banks with those of their urban offices. A hypothesis that deserves investigation is the proposition that retail credit markets are more competitive and more efficient than "wholesale" markets in Alaska. If this is the case, channelling the permanent fund's Alaska lending through existing financial institutions could result in large, unearned windfalls to the banking system without significantly benefitting Alaska borrowers. It would be instructive to see what happened to the "spread" between the interest cost of public deposits to Alaska banks and their interest earnings on real estate loans, for example, as a result of the Alaska preference provision in management of the state's North Slope bonus money. A similar question can be asked about the actual effect of the state's purchases of residential mortgages, after loan fees are taken into account.

2. Demand for investment and for loanable funds. A sample survey and detailed case studies should be undertaken of the financial structure and the procedure of financing fish processing plants, hotels and other relevant investment projects in Alaska. The contrasts, if any, in structure, procedures, costs of capital for individual components of financing (interim construction, working capital, etc.) should be noted and the appropriate implications drawn. The importance of capital financing costs to overall project costs is an important element in judging the potential sensitivity of investment demand to interest rates.

The investment demand schedule for individual industries ought to be investigated. The question here is to what extent will a reduction in the interest rate to a particular group or for a particular purpose result in an increase in the level of investment. The question is difficult to answer generally because the shape of the curve relating investment outlays to interest rates will differ for each subcategory of investment and will be affected by a large number of other factors. Builders of national econometric models have spent much time trying to specify investment demand functions with only limited success, however. The data base modeling Alaska investment demand is very limited because there are almost no satisfactory statistics that can be used as indicators of investment activity, with the partial exception of residential construction. The more productive approach would be to model individual projects--even fictional projects--in the way the Delta barley project was analyzed.

3. Aggregate impacts of different policies toward permanent fund appropriations and investments. The percentage of eligible funds that should be channelled into the permanent fund is of central importance. Not only will the future growth of the state's economy be determined to some extent by the choice of eligible permanent fund investments, but perhaps more importantly, it will be determined by the amount of money remaining in the general fund for unrestricted use. Specifically, Department of Revenue analysis of state revenues presented in February, 1977, projected a permanent fund balance of \$1.8 billion in 1985 based upon a 25 percent contribution rate. The same source projected a general fund balance in excess of \$6 billion in the same year. Increases in spending above the historical pattern of state government expenditures would have a downward effect on the total remaining in the general fund, but the balance can be expected to remain substantial.

The possibility of such a large general fund balance requires that the choice of the percentage of oil revenue dedicated to the permanent fund reflect the expected impacts of the uses of the general fund balance as compared with the impacts of administration of that money through the permanent fund.

For example, one way to make use of the general fund balance would be to reduce the personal income tax. The ISER MAP analysis shows that this would indeed cause a significant reduction in the general fund balance. At the same time, it would have a highly stimulative effect on the private sector as the increase in

disposable income stimulated private sector demands. Employment and population would increase. Additional revenues would be generated, but these would not be sufficient to maintain constant per capita government expenditures. Either the level of services would have to decline or the general fund balance would be depleted more rapidly than initial calculations indicated, or both. If the permanent fund is to be a buffer against the depletion of the general fund, or is interpreted as a fund to benefit Alaskans, the expansion generated by the income tax could be the worst possible use of general fund money.

The growth implications of any constant percentage permanent fund contribution needs examination. Lumpy additions into the general fund caused by lease sales on state lands may be accompanied by bursts in general fund spending activity by the state. This erratic behavior could result in uneven growth and its problems. A formula for permanent fund contributions, which minimizes fluctuations in the general fund, might be a more appropriate rule than a fixed percentage.

Projections of the state fiscal position are important in the formulation of permanent fund policy in another way. Knowledge of what is happening to the general fund can determine permanent fund objectives. A large general fund balance, for example, tends to reduce the force of the argument that certain industry should be stimulated because of the tax base it provides.

The MAP model can be of assistance in the formulation of permanent fund policy in this regard because it can be used to project "futures" under varying assumptions of general fund policy given a "neutral" permanent fund. The state model can be used for this purpose.

A related issue is what policy should be established with regard to disposition of interest from the permanent fund. It is important not only what uses should be made of permanent fund interest but to a certain extent, what should be the target interest rate considering the uses of the interest. That is, if the interest is not put to good use, there should be relatively little concern with a high interest rate.

The basic issue, however, is whether the interest should be returned to the general fund without strings, should remain in the permanent fund for some period, or should be distributed to Alaska individuals who, in a sense, become the owners of the permanent fund.

The implications of each alternative on the growth of the economy and its fiscal condition will be considerably different. Reinvestment in the fund would have minimum impact in the short run. Transfer to the general fund would result in increased expenditures on state and local government which would have a stimulating effect on the economy with the impetus on increase in public sector activity. A transfer payment directly to individuals under some form of Alaska, Inc., project would provide an economic increase with a private sector impetus.

All of these kinds of expenditure programs can be analyzed with the MAP model framework. For this kind of analysis, which attempts to provide a picture of the relative impact of alternatives, specific program details are not necessary. The qualitative impacts would be the same regardless of whether a specific dividend amount were paid out as Alaska, Inc., payments or the available interest on the fund were distributed in that fashion. Here also, the state economic model can be used.

On the assumption that permanent fund investment will somehow be directed to the growth of certain industries, there is also a need for econometric simulations of the effects of expanding various Alaska industries on the state's economy as a whole, particularly on its employment and tax base.

4. Performance of soft loan programs. There are a number of existing state loan programs directed to social and economic development objectives. In general, they have loaned money at lower than prevailing commercial interest rates (but not necessarily at less than the state's "opportunity cost" of money). The actual quality of these funds' portfolios is unknown, however, and the actual rate of subsidy taking into account prospective future loan losses cannot, therefore, be determined. A systematic study should be made of this issue and its implications explored for administration of any soft loan program under the permanent fund.

Similar studies would be useful with respect to federal loan programs such as EDA and SBA, particularly concerning their Alaska activities. The experience and performance of International Development Agency programs and subsidized loan programs of other nations and states would also suggest problems which might be expected from any Alaska soft loan program established under the permanent fund.



Alaska State Legislature

House

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528 W. 5th Ave., Suite 270
Anchorage, AK 99501
2 September 1977

Professor Barbara Bergman
6700 Selkirk Drive
Bethesda, Maryland 20034

Professor Donald Gordon
2201-9500 Erickson Drive
Burnaby, British Columbia V3J 1M8
Canada

Dear Professors:

We are happy that you will be able to take part in our symposium on the economic issues that arise with different investment goals for the Alaska Permanent Fund. Actually, no wide exposure of the issues has yet taken place.

I find it useful to group them under two broad headings: What is the long-run purpose(s) of the Permanent Fund and where should it be invested?

As for the first, the major argument made for the Fund as it went before the voters was that it would slow the growth of the budget, which had risen 400% since the North Slope oil lease sale in 1969. It was further argued that the Fund would be a savings account for a rainy day or, more commonly, that it would replace oil revenues as they declined. This latter aim has lead some to consider placing a ceiling on budget growth such as holding spending constant in real per capita terms, with all or part of the other revenues to go into the Permanent Fund.

It was also hoped, often by the same people, that the Fund could restructure Alaska's economy --- diversifying it, reducing its cyclical and seasonal nature, and bringing down unemployment, especially among the Native and other rural populations.

Clearly, all these purposes are consistent with the language of the constitutional amendment that principle be used for "income producing investments". Just as clearly, dividing the Fund among the public (on the basis, say, of residency) has been ruled out.

It should be noted here that Fund earnings are to be sent to the general fund "...unless otherwise provided by law..." To date, the unusual proposals have included one by the Governor to pay 50% of the earnings to residents on the basis of every five years in

Alaska, one to pledge earnings (and principle) as security for state and local debt or even the loans of rural credit unions, and one (private suggestion) to provide an annuity to Alaskans reaching age 55 based on their years in the state.

Where to invest the Permanent Fund seems to be the question of whether a developing economy (isolated, with leakage of an estimated 64¢ on the dollar, but mostly literate and skilled), based largely on a depleting resource (transfer payments from the oil and gas industry), and having few apparent options for some time should have a policy of government intervention. In short, a policy of loans at the going market rates, or subsidized loans, or even subsidized infrastructure loans (which may be possible in some cases) versus a policy of free trade.

The discussion thus far has been cast in the catch phrases listed below and not all of them are strictly economic, of course.

Invest here to:

- Offer home, business, and personal loans on preferred terms
- Remove gaps in the existing, especially rural, capital markets
- Create jobs, diversify the economy, etc. (but at market rates)
- Enlarge the private tax base
- Increase Alaskan ownership and control of business

Invest Outside to:

- Have greater safety of principle and higher earnings (given the failure rate of new businesses and the problems of present state loan programs)
- Reduce population growth (congestion, increased demand for public services)
- Avoid influence-peddling
- Maintain the quality of the environment
- Reduce inflationary pressures
- Allow benefits for a wide cross-section of the public

With best wishes, I am,

Sincerely,

James B. Rhode
AA to Rep. Cowper, Chairman
House Finance Committee

Professors Bergman, Gordon Con't.

3

cc: Rep. Hugh Malone, Speaker of the House
Rep. Clark Gruening, Chairman, Special House Committee
on the Permanent Fund
Rep. Steve Cowper, Chairman, House Finance Committee
Mr. Mike Doogan, AA to Rep. Gruening
Dr. George Rogers
File

PETER B. McDOWELL

61 KNIGHTSBRIDGE
LONDON SW1X 7RA

9th February 1977

Dear Jim,

I spoke with Jim Edenso yesterday concerning several suggested revisions and was pleased to learn that discussions of the enabling legislation are moving ahead. Jim also mentioned that Hugh is strongly supporting a carryover until 1978, following public hearings in the interim. This, of course, would defer making the Fund operational until mid-1978. We then discussed the subject, and I told him I would write you a private letter along these lines.

As we have discussed many times, it occurred to me that there might be a "third way". There seems to be a "third way" to both let the Fund get started, assuming of course that it is important to not delay the time at which the Fund begins to have an impact on self-determination by Alaska on the pattern of investments in the state, and carry out the interim hearing process. This would be to move the legislation through this year, and direct the interim hearings to gather grass-roots input about sectoral priorities and specific investment opportunities.

This would complement the more scientific sectoral analyses that should be prepared simultaneously. The results of both would then be merged by the Fund to produce the first long-term investment program proposed to the Policy Board.

As we observed during the SIAC process, public input in the early meetings was not concerned with technical structure matters, but rather with sectoral priorities and potential specific investments.

Mr Jim Rhode

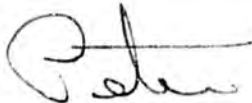
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9th February 1977

It would be most useful to develop a state wide consensus on those matters, which combined with a scientific analysis, would provide one of the best possible bases for the future investment program.

I hope these personal thoughts are useful. Please share them with Hugh and Clark if you like.

Sincerely,

A handwritten signature in cursive script, appearing to read "Peter". The signature is written in dark ink on a light background.

PS When can I expect to see you in London?

WHITE, WELD & CO.
INCORPORATED

ONE LIBERTY PLAZA
91 LIBERTY STREET, NEW YORK, N. Y. 10003

THEODORE P. SWICK
FIRST VICE PRESIDENT
212/285-2153

CABLE ADDRESS "WHITEWELD"

December 9th, 1977

Mr. Clark Gruening, Chairman
House Permanent Fund Committee

Since the House Special Committee on the Permanent Fund is in the final stages of structuring legislation for consideration by the 1978 legislature, it is time to consider the use of the income of this "Permanent Fund".

The provisions of the Permanent Fund Constitutional Amendment include that "the income from the Permanent Fund shall be deposited in the General Fund unless otherwise provided by law". According to the best estimates of the Department of Revenue, the minimum amount (25%) of the funds received as mineral lease rentals, royalties and other payments will result in an accumulation by 1985 of some \$1.8 billion. The investment income from that amount, at an average 7% rate of return, would produce approximately \$126,000,000 in any one year. As the Permanent Fund continues to grow, its increased capital will provide additional annual income in excess of the aforementioned figure, however, for the sake of perspective, the ensuing discussion will be confined to the \$126,000,000 projected income.

If the estimates are correct as to the principal accumulated in the Permanent Fund by 1985 at a 25% rate, the remaining balance accumulated in the General Fund should amount to some \$5.4 billion. The effect of the addition of \$126,000,000 to such an accumulation would increase the 1985 accumulation by approximately 2%. Such an increase is minimal in relation to a General Fund accumulation of the magnitude as anticipated.

Therefore, the income of the Permanent Fund should be dedicated to doing more than just adding a small increment to the General Fund. Even though it may eventually return to the Permanent Fund, it should be channeled into projects with revenue producing capability that provide benefits for the majority of Alaskans, and simultaneously allow for long-term financings at the lowest possible interest rate.

The House Special Committee, during the conduct of public hearings, has received many proposals for the use of Permanent Fund's income. Many of these proposals appear to be meritorious from numerous points of view. However, in turn, many of these same proposals would seem to be better responded to through

-2-

the actions of the legislature and addressed through the General Fund as opposed to the Permanent Fund's income.

Essential to the lifestyle of all modern societies is the availability of electric power. Advocates of no growth, modest growth, rapid growth or controlled growth all share a need for power. The availability of power often determines whether desirable economic growth can take place. The cost of such power is of course, an important element. All other things considered, the cost of power influences the future direction in any modern society.

Whether power generation occurs through capital-intensive projects (hydro-electric) or fuel-intensive projects (coal or gas-fired) its financing is generally through issuance of long-term debt. Production costs of hydro are generally stable since the fuel (water) costs are practically non-existent. Production costs of coal or gas-fired facilities are subject to continually escalating costs of the fuel necessary for the electric generation.

Long-term debt sold for the construction of either type of facility, without regard to the operation and maintenance expense of each, must be amortized through the service of debt; principal and interest payments annually until the debt is extinguished. The total cost of the debt service is affected by the rate of interest which investors demand for the long term loan of money.

A 40 year debt instrument in the amount of \$100,000,000, bearing an interest rate of $6\frac{1}{2}\%$ will require a level debt service (principal and interest) of \$7,069,400 annually to liquidate the debt. If the interest rate is $5\frac{1}{2}\%$, the annual debt service requirement is \$6,232,000. This represents a difference of \$837,400 per year and over a 40 year period involves a saving of \$33,496,000.

Since debt service is a major factor in determining the rates users must pay for electric usage, the rate of interest at which a debt instrument is financed is a significant element in the total cost to the consumer. Bonds payable solely from the revenues of the utility are judged by investors on their credit-worthiness. The more credit-worthy, the lower the interest rate, the less credit-worthy, the higher the interest rate.

Alaska possesses many sites which are suitable for hydro-electric generating facilities. However, in some instances, these sites are not located near the population centers which require the power generated. Due to its topography, long-range transmission lines bringing power to the load-centers are often not feasible. In other instances, the best development of such capital-intensive projects may require large-scale projects which in the near-term, produce a surplus of power. Smaller scale generation facilities using coal or gas-fired power production are required in those areas without large load demands or without good potential hydro sites. The fact that the latter use a precious commodity which is non-renewable is not the point. If the power is needed, it must be produced. Nevertheless, if the project can be financed at a lower interest cost, a benefit will accrue to the user through a lower cost of service.

It is suggested that the future power needs of Alaskans can be delivered at a lower cost whether such power is provided through hydro or fossil fuels. The ability to affect the interest rate on whatever long-term project is financed, can accomplish this. The following paragraphs suggests how this can be done without depriving the Permanent Fund of other uses of its income.

The income from the Permanent Fund will be derived from "investment grade" securities and as such represents a highly reliable and secure cash flow. This annual cash flow can be dedicated to assuring that principal and interest requirements on bonds issued to construct revenue producing power projects are met in the event of a revenue short-fall from the revenue producing project. The effect will make it possible for the revenue bonds to receive a high credit rating and high evaluation in the market place which will result in a significantly lower cost of borrowing for the project construction. At the end of a given period, (debt service year or monthly), income from the Permanent Fund dedicated to the revenue bonds debt service requirements not needed is released to the General Fund or for any other purpose directed by law.

The dedication of Permanent Fund income to revenue bond debt service would not be accomplished in the legislation itself, but rather in a "guarantee agreement" between the Permanent Fund and the entity issuing the revenue bonds and the "guarantee agreement" would actually appear on the face of the debt instrument. From the investor and rating agency point of view, if the guarantee is in the legislation it is legally subject to change by succeeding legislatures. If the guarantee is in an agreement as part of the revenue bond issue it is dedicated for as long as the bonds are outstanding.

It must be assumed for the purpose of this guarantee arrangement that the Permanent Fund will receive 25% of the oil and gas income because of the terms of the Constitutional Amendment. Based on that assumption, estimates (by the State) of the size of the Permanent Fund in 1985 will be \$1,800,000,000.

A reasonable assumption of 7% income from investment produces an annual cash flow available for guarantees of \$126,000,000. An annual cash flow of this magnitude, assuming a 6% interest cost on guaranteed bond issues, will support approximately \$1,800,000,000 of bonds.

The various projects to be supported by the guarantee would be financed by revenue bonds of any state agency or any subdivision of government in Alaska for electric generation and transmission. Each bond issue would capitalize interest during construction and fund its own debt service reserve to conform to the demands of the market for such bonds at the time of financing.

The act providing for a guarantee should be broad in form. The covenants relating to, and provisions of, each project will be structured into each bond issue.

There might be some merit in including in the act certain findings and directives to the Board of the Permanent Fund, but it probably is more appropriate for the Board to outline its own guidelines as it relates to such guarantee on bonds of projects to be financed in its administrative rules and regulations. By this is meant, for example, considerations by the legislature in its deliberations leading to the approval of a project such as economic need, economic feasibility, geographic locations, social benefit, impact on locality, etc.

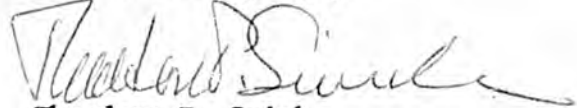
A draft of a bill has been provided to your committee which would, subject to redraft to conform to custom, constitutional requirements, the Permanent Fund Act and language usage in Alaska, creates the mechanism for such a debt guarantee program. A brief analysis of this draft follows.

- Section 1. Creates the mechanism by authorizing the Board of the Permanent Fund to enter into guarantee agreements. Limits the guarantee to income only. Provides for agreements with any entity of state or local government. Provides guarantee of principal payments, sinking fund payments and interest but prevents use of Permanent Fund income for optional early retirement of guaranteed debt. Limits the guarantee to electric generation and transmission. Leaves the details of guarantee agreements to the Board of Trustees.
- Section 2. In effect limits the amount of debt that can be guaranteed. This adds to the credit-worthiness of the guarantee from the lenders point of view. Depending somewhat on the actual portfolio of investments in the Permanent Fund, it is important to consider whether or not to limit the total of guarantees to something less than 100% of the Fund income. This could be done in the Act, which does not happen in this draft, or it could be a policy matter of the Board of the Fund.
- Section 3. Provides that the guarantee article appear on the debt instrument which clearly establishes that it survives as long as the bonds are outstanding. This definitely is stronger and distinguishes the guarantee from any similarity to the so called "moral-obligation" pledge.
- Section 4. Provides that a guarantee agreement can be entered into on the debt of projects only after approval by the legislature. Part of the thrust of this section is in contemplation of a centrally controlled State-wide power development plan that considers the needs and best interest of all of Alaska.

Sections 5 & 6 These sections are simply "boiler-plate" provisions.

The draft bill clearly does not contemplate any subsidy of electric costs to energy consumers. However, there is no prohibition that any subsidy to energy users deemed to be appropriate by the State can be accomplished by the legislature through appropriation from the General Fund or other sources which would not interfere with the value of this guarantee program to finance the capital costs of meeting the power needs of Alaska.

Respectfully yours,

A handwritten signature in dark ink, appearing to read 'Theodore P. Swick', with a long, sweeping horizontal line extending to the right.

Theodore P. Swick

TPS/vmr

The Role of the Permanent Fund in Alaska's Future



**A Preliminary Report by
the House Special Committee
on the Alaska Permanent Fund**

There will be a public discussion of goals of the Permanent Fund beginning at 10:00 a.m., September 15 in Room 402 of the State Court building. If you wish to present testimony, please contact the Committee at 528 West Fifth Avenue, Suite 270, Anchorage, Alaska 99501. Phone: 276-3433.

Special Committee on
The Alaska Permanent Fund
(907) 276-3433
528 W. 5th, Suite 270
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Members
Rep. Clark Gruening, Chmn.
Rep. Terry Gardiner, V. Chmn.
Rep. E. J. Haugen
Rep. Russ Meekins
Rep. Bill Miles
Rep. Leo Schaeffer
Rep. Rick Urion

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I Introduction

An overwhelming majority of Alaska voters approved an amendment to the state constitution in November 1976 which provides that at least 25 percent of certain state nonrenewable resource revenues be placed in a permanent fund. The amendment requires that the fund's "principal shall be used only for those income-producing investments" the legislature designates as eligible for permanent fund money. The amendment also provides that income from the investments will go into the State's General Fund (where all other revenues and taxes are deposited) unless the legislature designates that income for other purposes.

In 1978 the Tenth Alaska Legislature will consider several different proposals for management and organization of the fund and use of the fund's earnings. Three bills introduced in the 1977 session were referred to the House Special Committee on the Alaska Permanent Fund. Our task is to find out what Alaskans want the fund to achieve and to recommend legislation for a permanent fund that can best attain those goals.

The intent of this report is to inform Alaskans about the Alaska Permanent Fund—how it evolved, present management, possible future roles, and investment and management options for

its principal and earnings. This report also allows committee members to state what they feel are the main issues to be resolved in the permanent fund enabling legislation.

We hope that you will take the time to study this booklet, jot down your comments and questions as you read, and send us your views by filling out and mailing the questionnaire on the back cover. You may obtain further information about the Alaska Permanent Fund by calling or writing:

House Special Committee
on the Alaska Permanent Fund
528 West 5th Avenue, Suite 270
Anchorage, Alaska 99501
Phone: (907) 276-3433

Above all, please watch for and participate in the public meetings and forums on the Permanent Fund to be held throughout the state beginning in September. If we have your comments by then, we can incorporate your ideas in the Public Forum program. Legislators will attend each forum to discuss the Permanent Fund, answer your questions, and find out what you want your Permanent Fund to be.