

ALASKA LEGISLATURE HOUSE SPECIAL COMM. ON PERMANENT FUND 1978-80

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banks for cooperatives, for example, usually limit facility loans to not more than 60 to 40 percent of the value of the security offered by the cooperative, and expect the balance to be financed by the association's permanent or long-term capital. This is fine for a wealthy cooperative that has built up sizable membership equity, but it is not very helpful to low-income cooperatives whose members by definition have no equity and, therefore, whose cooperative is ineligible for a loan from the bank for cooperatives.

It is for this reason that I have argued strongly in my memorandum to the committee of July 11, 1977 that the community development provisions of the Alaska Permanent Fund legislation should provide for equity investment as well as debt and guarantees, just as with productive private enterprise.

Other Domestic Models

The pattern for establishing and operating the Farm Credit system is paralleled in other major American financing systems such as the Federal Home Loan bank system. In each instance there is one initial large public capital stock purchase by the Treasury, which starts the system. After that the system pays its own way except for relatively small periodic appropriations to cover non-recoverable infrastructure and social overhead

capital costs. Eventually the Treasury stock is repaid and completely replaced by user-owned stock. For example, the initial \$75 million of Treasury stock that started the Federal Home Loan bank system in 1933 was fully retired by 1950, just as was the Farm Credit system.

With strong debt to equity ratios most of these same systems have been able to raise the substantial body of their capital on the private market through secondary marketing operations with strong paid-in equity capital backup.

FIGURE 1.

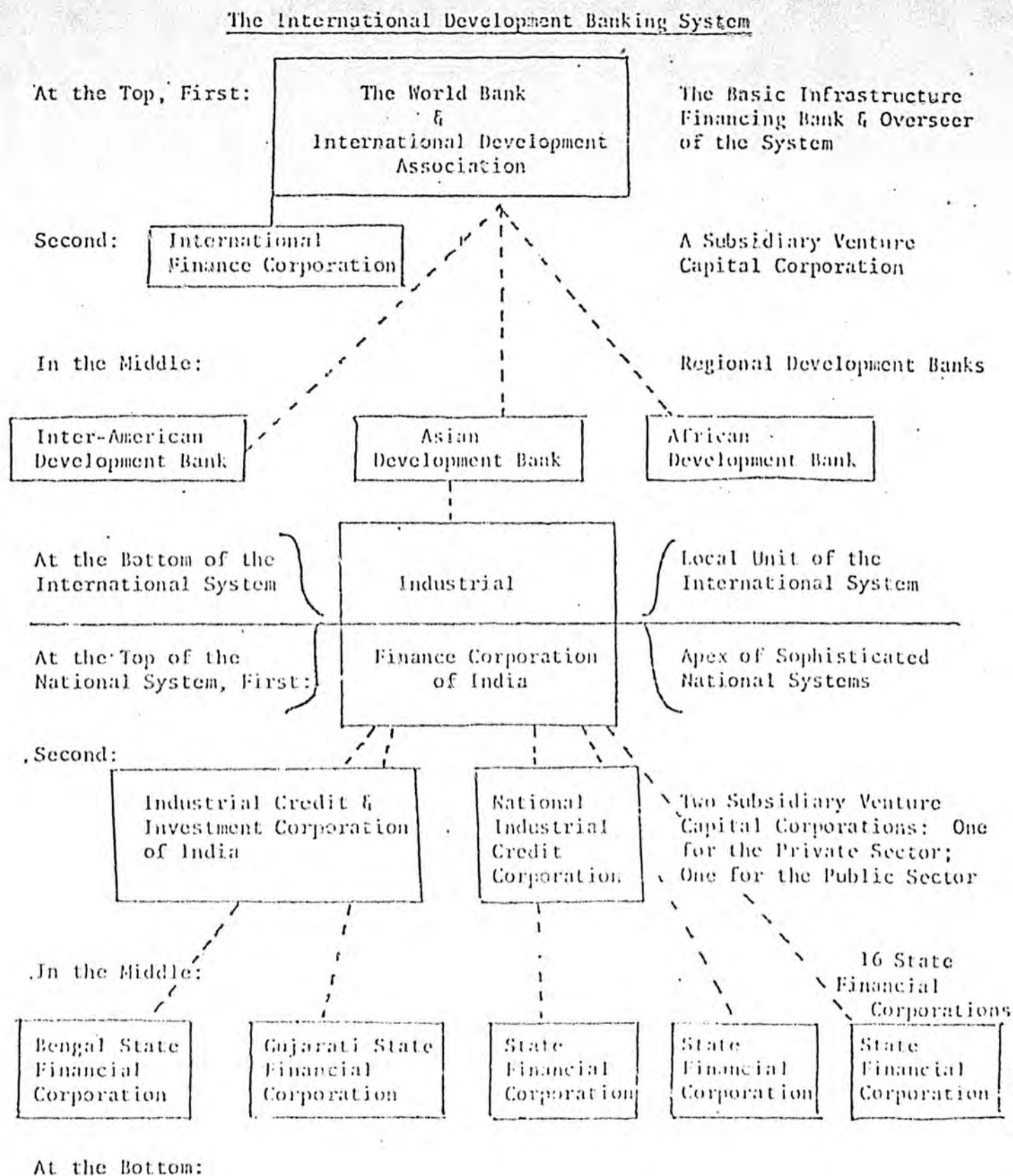
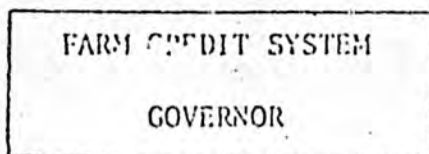


FIGURE 2

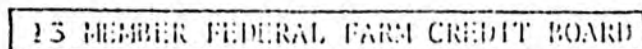
THE FEDERAL CREDIT SYSTEM

CENTRAL



Appoints

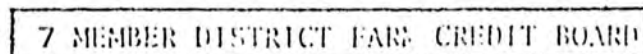
CENTRAL



12 appointed by
Pres. from nominee
of each district, one
by Secretary of Agriculture

REGIONAL
GEOGRAPHIC

(1 for each of 12 Districts)



REGIONAL
FUNCTION

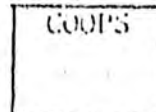
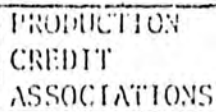
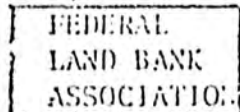
FEDERAL
LAND
BANK

FEDERAL
INTERMEDIATE
CREDIT BANK

BANK
FOR
COOPS

2 elected from
each "avenue", one
appointed by FCS
governor

LOCAL
FUNCTION



"First Ave." "Second Ave." "Third Ave."

The Boards of Directors of the Federal Land Bank Associations, Production Credit Associations, and Cooperations are elected by member farmers.

In Summary: A Range of Options for Regionalization Available
to the Alaska Permanent Fund

The experience of domestic and international development banks points out that the Alaska Permanent Fund has a number of specific options that might be used for purposes of regionalization. Specifically, the Alaska Permanent Fund might make local regionalized investments through: independent regional or local development banks or corporations; affiliates; subsidiaries; user-owned local institutions; branches; or some flexible combination of the above developed on an ad hoc basis. Each of these will be briefly referred to below.

Independent regional or local development banks or corporations: The World Bank and the European Investment Bank are both examples of institutions which primarily operate by making loans to and through independent regional and local intermediaries. Analogously, the Alaska Permanent Fund might make all regional investments to or through Alaskan regional and local community development corporations.

Affiliates: The French Crédit National finances its regional development through affiliated Regional Development Corporations. It has a substantial although not controlling stock interest in each of these SDRs. The predominant equity interest is held by local financial and development institutions with a greater sensitivity to local needs and conditions.

Subsidiaries: To the best of our knowledge, no development banks within the United States or overseas operate through their regional development programs through wholly-owned subsidiaries. On the other hand, many development banks, including the World Bank and the D.G. Bank, do use wholly-owned subsidiaries in order to undertake specialized functional financing activities such as equity investment.

User-owned local development banks or corporations: As we have extensively documented, the Farm Credit System, the Federal Home Loan Bank System, the British Columbia Central Credit Union, and the D.G. Bank are all institutions which are user-owned at both the regional and central level by local, cooperatively-owned development banks.

Branches: The Federal Reserve System and the British Finance for Industry are two central financial institutions which operate their regional activities through branches.

A flexible, ad hoc approach: The National Enterprise Board and the Canada Development Corporation are two large national development banks which have taken a needs-oriented ad hoc approach to regionalization. The National Enterprise Board, for instance, has recently established branches in Liverpool and Newcastle in order to get a better sense for how they could intervene in regional economic development. The Canada Development

Corporation has a sole branch in Vancouver in order to be more responsive to the regional economic development needs of western Canada and is undertaking its venture capital program through investments in affiliated privately-owned venture capital companies.

Our purpose in this regionalization paper, as in each of the sections of this second report, is to suggest a number of options which can then begin to be tailored to fit the specific purposes, needs and political economy of Alaska in designing the Alaska Permanent Fund. Based on the response of the legislature, this paper may also raise a number of follow-up questions which deserve further attention.

III. THE PROBLEM OF ACCOUNTABILITY

AN INTRODUCTION TO THE ISSUE

The question of assuring the accountability of the Permanent Fund management to the electorate, legislature and executive to carry out its public purposes is probably the single most important issue before the Special Permanent Fund Committee. In this final section of the report, we begin to suggest some measures by which the management of public enterprises such as the Alaska Permanent Fund may be held accountable for their performance. Because this is such a central issue, our aim in this section is simply to introduce the problem and begin to suggest some of the options available to ensure public accountability. We will detail some of the tradeoffs involved and cite specific cases from domestic and international experience.

It is important to point out at the beginning that the record is generally not a good one. In more cases than not, public accountability has been sacrificed for market efficiency. The task of overseeing the Permanent Fund to ensure that its public purposes are carried out will not be an easy one. Our sense is that this introductory discussion will raise many more questions that the Committee will want to consider between now and December 31, 1977. By "accountability" we mean the effectiveness

of the mechanisms by which the government seeks to assure that the managers of a public enterprise invest public resources in order to maximize the benefits to the ultimate providers of the funds. In the case of the Permanent Fund, those providers are the people of Alaska.

In some respects, the position of Alaskans in this enterprise is analogous to that of an investor in a private firm. The active investor gathers as much information as possible about the firm in which he invests. Using this information, he forms an independent judgment on appropriate management policies. He then seeks to have these judgments acknowledged and effected by participating in shareholders' meetings and by voting his shares. If, after these measures are exhausted, he is dissatisfied with managerial performance, he will seek to impose sanctions on the firm's operations by voting out management or, more likely, by withdrawing his money from the firm. In all these activities he is motivated by the principle of maximizing his benefit from the investment--his short-run money profit.

The benefit Alaskans expect from the Permanent Fund, however, is a good deal more complicated and long-lived than that sought by the private capitalist. Certainly, short-run financial results must be considered, but the idea behind the Alaska Permanent Fund is to convert non-renewable mineral resources into renewable

capital resources which benefit the Alaskan economy and Alaskans. These investments could generate many types of public costs and benefits. A small sample of costs Alaskans would seek to avoid includes degradation of the environment and social dislocation caused by the boom-bust nature of certain enterprises. Benefits might include wider participation of Alaskans in the management and wealth generated by business enterprises and the improvement of human services.

Experience has demonstrated that publicly-capitalized investment banks tend to operate solely under commercial profit-maximization criteria unless they are compelled to do otherwise through various forms of government direction and control. Our basic problems, then, are: 1) How is the substance of these directions to be determined? and 2) How are they to be enforced?

It is likely that no stable consensus can be reached on the proper mix of objectives for the Permanent Fund. Rather the Fund has many constituencies, each with different and often conflicting economic interests and with differential access to the political and economic means by which to have these interests effected.

To design the institutions surrounding the Permanent Fund as if the consensus mentioned above existed, as if it were the Fund's only task to interpret these objectives in its investment policy, may be virtually impossible, based on the experience of others.

Rather, the design of the Permanent Fund must provide a forum in which conflicts of interest can be aired and resolved on a continuing basis.

These conflicts are likely to arise at two points in the continuing operation of the Permanent Fund: first in the formulation of investment criteria and then in the application of those criteria. Those affected by these processes must have a chance to influence each of these sets of decisions. They must then have the means by which to review how these decisions are implemented.

In our investigations of the institutions profiled in Section I and other public enterprises we shall note, we have identified four stages in the accountability process. Two may be classified as forums in which the decisions mentioned above are made, two as means by which these decisions are implemented. In practice, these processes are carried on simultaneously.

Specifically, these stages are:

1) Setting of Goals and Priorities: The essential questions here are: Who sets the goals and how are they phrased in legislation, statutory directives, or guidelines?

2) Formulation of Measurement and Reporting Procedures: Goals are given operational substance by the establishment of measures to evaluate management performance. The issues here are: the relevance and quality of the measurements, the form in which

this information is presented, and who gets the information?

3) Governance: Public Inputs into Operating Decisions:

In most public enterprises, the elected government usually has a variety of formal and informal means of influencing day-to-day operating decisions. The enterprise's various constituencies also have such means. The important issues here are: Whose interests are made known to the Board? How and at what point in the decision-making process are they made known? What influence do they actually exert on the institution's operating decisions?

4) Operating Sanctions: What can an elected government do if it is dissatisfied with the results the management of a publicly-capitalized enterprise achieves? The most frequently available formal sanctions are the replacement of management and the withholding of funds from the agency. There are informal sanctions as well, such as publicity of mismanagement.

In the case of dismissal of management, the issues are: How and for what reasons can management be removed?

In the case of control of funds, some of the issues are: The source of funds and the conditions on which they are provided, who controls the funds once they are pooled for agency use, and the conditions under which the sanction of withholding funds can be exercised?

At each of the four stages, democratic elements of the

process must be traded off against the operating requirements of an efficient investment bank, i.e., the ability to make independent investment decisions and effect those decisions in a timely and flexible manner.

At each stage, outside control can range from zero to a level at which the operations of the agency are totally disrupted. Each level of control is characterized by a set of costs and benefits. In reviewing the four stages outlined above, we will present examples of mechanisms which have been used. They will be ranked from lowest to highest by the degree to which they effect management's deviation from standard commercial investment criteria. Finally, we will begin to suggest the nature and incidence of the costs and benefits of each strategy examined.

A. Setting of Goals and Priorities

Historically, the determination of goals and their definition in legislation has been the least important element in the accountability structure of public enterprise. In terms of enabling legislation itself, provisions for capitalization, organizational powers and management selection have had a much greater impact on the performance of these enterprises. The outcome of informal political and economic power struggles among the enterprises' various constituencies and principals has been more important to the active operation of development banks.

The goals of public banks are found in the opening sections of their enabling legislation. Seldom, however, do they represent the results of legislative deliberation. Bills are generally drafted by individuals who have some interest in the successful and continuing operation of the entity they are creating, and legislative attention is usually directed toward the operational aspects of the draft. In a few cases, the goals and objectives of development banks have been publicly debated, but, as in the case of the Canada Development Corporation, this does not assure that the public interest will be served.

The legislated purposes of most public enterprises tend to be more exhortatory than directive, legalisms intended to justify the use of public funds. In the case of authorities producing a good or service, the purpose is to do so efficiently; in the case of a public investment bank, it is to encourage the development of productive enterprise in the jurisdiction.

There are good reasons for leaving the statement of purpose vague, which have to do mainly with the legislative process: It is easier to build legislative consensus, easier to change operational direction to fit changing economic conditions, and harder to make small changes in language as the bill proceeds to enactment which substantially changes the intent.

Still, attempts have been made to formulate goals so that

they are useful as guideposts to management and criteria for managerial performance. Usually this entails relating goals to specific measurable achievements and administrative procedures in the legislation.

In most cases, the legislated goals of public enterprises or banks have had little bearing on their actual operations. This condition breaks down into two sets of conceptually separable experiences: In the first, management has found it convenient as well as legally and politically possible to evade its statement of purpose, undertaking operations for which the institution was not designed or refusing to undertake mandated functions. In the second, the statement of purpose has been so vague or founded on faulty analysis that the management has effectively been given a free hand.

Examples of the first type of experience occur most frequently in public authorities providing a good or service. Instances of selective adherence to statement of purpose arise in the history of the Port of New York Authority (PNYA). Established in 1921, the PNYA was charged with "developing terminal, transportation and other facilities of commerce." After a decade of unsuccessfully and unprofitably attempting to rationalize rail-sea connections, the Authority was allowed to acquire three motor vehicle bridges and the Holland Tunnel from other authorities.

These facilities were highly successful financially, and the Authority justified their continuing ownership of the bridges by claiming the revenues they generated were necessary to meet Authority bond contracts.

The PNYA used this same tactic in reverse in the Fifties and Sixties to resist public pressure to assume the ownership and management of the region's undercapitalized and unprofitable commuter rail system. Maintaining that the projected deficits of such operations would prevent them from executing bond contracts in good faith, the Authority's management withstood this pressure to undertake its mandated purpose for over a decade. A compromise was reached in the late Sixties when the Authority took over the most heavily-used portion of the commuter network in return for the approval of the Governor of New Jersey to use PNYA funds to build the World Trade Center. Many analysts view the Center as a speculative real estate transaction only peripherally related to the Authority's purposes. The commitment of substantial funds to the Center has in turn precluded the Authority's taking a significant role in the rail lines.

A similar instance can be found in the now-infamous case of Robert Moses' Triborough Bridge Authority. Its legislated purposes were solely to construct and operate the Triborough Bridge until it was paid off. However, through the imaginative use of

bonding power, bond contract drafting and the subtle use of clauses in the powers sections, the Authority's life and latitude in operations were enormously extended.

The statement of purpose for most public development banks fall into the second category outlined above: they are too inclusive to effectively direct managerial policy. The Canada Development Corporation is a prime case in point. In the CDC profile we noted how management's interpretation of the Corporation's goals threatened the achievement of the public purposes of the institution. This interpretation was permitted, however, by the CDC Act's statement of corporation objectives. These read:

"The objects of the company are;

- a) to assist in the creation or development of businesses, resources, properties and industries of Canada;
 - b) to expand, widen and develop opportunities for Canadians to participate in the economic development of Canada through the application of their skills and capital;
 - c) to invest in the shares or securities of any corporation owning property or carrying on business related to the economic interests of Canada; and
 - d) to invest in ventures or enterprises including the acquisition of property likely to benefit Canada;
- and shall be carried out in anticipation of profit and in the best interests of the shareholders as a whole."

These objects permit virtually any investment activity so long as it is profitable. They offer no priorities. More

importantly, only in the case of expanding investment opportunities do they provide an occasion for the application of quantitative measurements to some recognized standard of achievement. CDC's financial participation has led to the creation of only one new enterprise so far and has done little to open up investment opportunities for the greater number of Canadians. Yet this result is perfectly compatible with the Corporation's goals.

The British National Enterprise Board's statutory purposes, while broadly stated, are more amenable to measurement than CDC's and could thus become the basis of an accountability process. The purposes of the Board, as listed in the Industry Act of 1975, are:

- "a) to develop or assist the economy of the UK (or any part of the UK),
- b) to promote industrial efficiency and international competitiveness; and
- c) to provide, maintain or safeguard productive employment."

The first purpose is so broad as to accommodate any action the Board wishes to take within its extensive powers. The second two, however, are expressions of economic phenomena for which accepted empirical measurements exist. Industrial efficiency can be measured by cross-national comparisons of costs within sectors and the changes in profitability of individual firms; international

competitiveness by changes in the volume of export sales. The provision or maintenance of employment is similarly measurable, with differing degrees of sophistication.

The Community Development Finance Corporation Act goes one step beyond providing measurable goals by relating the goals to a specific set of problems described in the Act. Thus, the bill performs a clarifying function usually reserved to committee reports, and reduces the possibility of misinterpreting the goals in their implementation. The essential elements of the findings preceding the statement of purpose are:

- 1) that a substantial and persistently low level of employment and economic activity exists within certain areas of the state;
- 2) that it is beyond the ability of the government to correct these conditions solely through the exercise of regulatory power;
- 3) that it is beyond the ability of the private sector to counter these tendencies without capital assistance;
- 4) that Community Development Corporations have made substantial improvements in these areas, but cannot continue to do so without public provision of investment funds.

These findings all point directly to the purpose of the institution, which is to "increase the number of development projects in decadent substandard and blighted areas" through the agency of CDCs. The findings also militate against any alternative reading of the Act which might permit evasion of the administrative procedures outlined in the Act.

Such a specific set of findings, tied to specific objectives,

administrative procedures and reporting requirements, is one way of making the legislation statement of goals more meaningful.

F. Formulation of Measurement and Reporting Procedures

Public accounting is an essential element of governmental control over the activities of a public enterprise. This exposure forces management to keep operations in line with what is expected of them, and this pressure can work in anticipation of government censure as well as retrospectively.

Overseers of the Alaska Permanent Fund are interested in the social as well as financial achievements of the institution. On the financial side, public enterprise must be held to the highest standards of financial disclosure now universally applied to private enterprise. On the other hand, universally recognized measurement and reporting procedures have not yet been developed for social impacts. Many of the items presented for consideration by Singer and Mollenkopf in "After the Oil is Gone" are not amenable to quantification or comparison with unlike outcomes. This problem is treated in that useful paper, and we will not discuss it further here. Rather, we will note some practices used by some development banks to measure non-financial results, and comment on their appropriateness to the Permanent Fund.

Finally, accounts are inherently incomplete in that they

show only what has already happened--and not always very accurately. If an institution is expending public money, it should be concerned with the social choices it faces and present these choices to its overseers. We will look at some of the attempts public investment banks have used to address this problem through cost-benefit analysis and various other types of projection techniques and discuss their applicability to contemplated Permanent Fund operations.

Financial Reporting

Given the geographic and cultural distance from the institutions we have noted, it is difficult to evaluate the accuracy or fairness with which they represent their performance in annual reports. It must be noted, however, that management of public as well as private firms is motivated to present its accomplishments in the most favorable light.

What, then, is presented besides the usual balance sheet, income and expense statement, and report of changes in capital? One of the most important and useful parts of the annual report, usually required by national corporation laws, is separate reports on the activities of subsidiaries, major loan recipients or subdivisions. Consolidated financial records may conceal cross-subsidations, multiple accounting of depreciation of a given

asset and, most importantly, the true cause of poor performance, whatever it may be. This has been the case with the Small Business Administration's loan guarantee program. For years, the high loss rate of this program had been attributed by the SBA to instability in the small business sector. Investigation of the program by the General Accounting Office, however, revealed that poor administration and intentional disregard of program guidelines were responsible for a large percentage of loan losses.

For the most part, the degree of detail in the reports varies by who gets them. Usually the funding source has privileged access. For example, the report of agency financial operations in Connecticut Development Authority bond prospectuses are much more thorough and scrupulous than the report which goes to the Commissioner of Commerce. Similarly, the British Cabinet Secretary overseeing the operations of the National Enterprise Board may requisition all operating records. Generally, the legislature and the public must accept annual reports prepared by the enterprise and occasional ad hoc investigative reports as their sole sources of information on the financial activities of the enterprise. In the institutions we have noted, these vary greatly in the detail and usefulness of disclosure--from vague accounts for CDC, to quite detailed accounts for NEB.

Social Reporting

Few of the investment banks reviewed make any use of social performance accounting. CDC, NEB, and EIB make no specific provisions for reporting even easily measurable social indices such as total employment of the firms in which they invest. NEB lists environmental impact and encouragement of worker participation in management as criteria for investment, but they provide no benchmarks, measurements or reporting schedule by which to evaluate projects, prospectively or retrospectively, along these dimensions. The Connecticut Development Authority reports total employment of the firms it finances, but this is an utterly inadequate measure of its performance in creating or maintaining jobs. As with all expenditures of publicly-raised funds, it is the marginal addition to some stock (such as employment) rather than the gross size of that stock which is the barometer of performance. Proposed CDFC economic impact indices, described in that institution's profile, are somewhat more sophisticated but still do not address the "with/without" problem in evaluating the benefits of social programs. In other words, would any of the benefits have been realized anyway even if CDFC had not made the investment?

Projections

Projections are necessary to evaluate investment projects,

especially when there are several competing for the same pool of funds. CDFC is contemplating a simple projection procedure: applying its social accounting procedures to the business plan projections of investment applicants. Thus CDFC will have a two-track set of projections--for both financial and social returns, both of which will be subject to post audit.

Cost-Benefit Analysis

More elaborate methods of project evaluation have been developed by the World Bank and its national affiliates. These address the divergence of market and social valuations of the costs and benefits which can be anticipated from various large-scale capital investment projects. These divergences are usually caused by such factors as monopoly domination of markets, state regulations and externalities. The method is essentially one of cost-benefit analysis in which all quantities are reduced to monetary terms, as described in John Mollenkopf's paper.

These types of analysis are expensive due to their enormous requirements for data and skilled analysis. Therefore, they are usually applied only to large projects such as capital-intensive industrial plants or infrastructure which require massive fixed investments. There are some institutional benefits to offset these expenses. Such studies are usually carried out by consultants

in cooperation with local officials and managers. Thus, some permanent, resident expertise in this kind of analysis can be developed. Also, data developed for one study may be used to analyze subsequent projects.

In summary, again, the record to date of detailed financial reporting by development banks is mixed, at best, and social indices are virtually nonexistent.

C. Governance: Public Inputs into Operating Decisions

The most important factors affecting the results achieved by public enterprises have been the structure and dynamics of the day-to-day decision-making. For each institution reviewed, there has been a complex web of attachments, interests and attitudes which are brought to bear on each type of operating decision. For each institution these circumstances are different.

We can begin to analyze this experience by identifying the groups of players involved in the operation of all public enterprises and the nature of the relationships between the groups. We will then explore examples of these relationships, focusing on elements of democratic or at least pluralistic control.

The four basic groups with whom we are concerned are:

- 1) Elected officials and their appointed ministers or secretaries: This group is usually (but not always) statutorily

responsible for the oversight of the public enterprise. Their degree of involvement in day-to-day activities of the enterprise is slight--generally by design. After all, the enterprise's very existence is premised on its carrying out social purposes without the full expenditure of effort by the government itself. Elected and appointed officials are lumped together here because their tenures tend to be coterminous.

2) The Board of Directors is usually the ultimate authority for all decisions concerning the sources and uses of funds and setting the overall strategy for the enterprise. They generally serve finite, overlapping terms which may or may not be renewable.

3) The Professional Staff carries out the policies of the Board, policies which they generally propose to the Board. Their initiative in promotion and competence in administration has the single greatest impact on the overall performance of the enterprise. Generally, they prepare the analyses on which the Board makes its decisions. Their attachments to the enterprise tend to be of longer standing than any of the other groups, a situation which enhances their power considerably. Also, they are closest to the enterprise's constituencies at all levels of decision.

4) Constituents: By constituents we mean those groups in the general public which have organized, regular dealings with the enterprise. These groups include firms which do business

with the enterprise either as clients or as providers of goods and services, citizen action groups, community development corporations, labor unions, etc.

The important relationships among these groups are:

a) Elected Government to the Board: Who appoints the Board? How is the tenure of the Board related to that of government officials? Are there government officials with voting power on the Board? Are there required consultations between members of the government and the Board?

b) Constituents to the Board: How are the interests of constituents represented to or on the Board?

c) Professional Staff to Board and Constituents: Whose interests does the staff tend to promote? Are they under effective control by anyone?

Relationship of the Government to the Board

With the comic exception of some of Robert Moses' one-member authorities, the Boards of public enterprises are appointed by the Chief Executives of the political jurisdictions in which they operate. The Chairman, if he is designated as such by the Chief Executive, generally serves at that official's pleasure and is often a cabinet member. Such is the case with most state development authorities. As pointed out in the CDA profile, this

situation carries costs as well as benefits. In addition to the benefits of coordination of Authority activity with executive promotional and overall economic policy, staff may be pressured to undertake loans which are politically useful, but financially unsound. In Maine, for instance, the Commissioner of Commerce, as Chairman of the Main Guarantee Authority, pushed through the approval of a guarantee on a \$12 million loan to a sugar beet processing factory. This enterprise quickly went bankrupt, and the state was able to recover only 15 percent of its money through liquidation. It was later discovered that the Commissioner of Commerce had financial connections to the project.

This situation (of top staff being subordinated to the Board) is reversed at the Massachusetts Bay Transportation Authority (MBTA), which services the metropolitan Boston area. There, the five-man Board is chaired by the Chief Executive Officer (CEO), who serves at the pleasure of the Governor. The other four directors serve simultaneous four-year terms coterminous with the Governor's. Their powers are limited and mostly advisory. Massachusetts' Secretary of Transportation, who framed these regulations, justified the authority structure by claiming it was necessary to provide "a stronger basis for holding the Commonwealth's chief executive accountable to the legislature and the people of the region and state for the use of the state funds for

the MBTA." This provision does make the CEO an easy target in times of crises. On the other hand, it tends to strengthen the Governor's ability to direct the agency when public attention is not directed towards it.

In Europe, especially in France, government representatives on the boards of public and mixed enterprises are generally granted veto power over Board decisions involving the raising or expenditure of capital. This power has usually been used to delay the implementation of controversial decisions until they can be worked out between the management of the enterprise and its supervising Ministry.

The relationship between the government and the public enterprise can take other forms. For instance, these might consist of required consultations for various types of transactions or activities, the submission of reports and auditing by some agency within the government designed specifically for that purpose. In general, these controls are seldom exercised. They do not play an important role in the operations of any of the institutions reviewed except the NEB. The relationship between NEB and the Secretary of State for Industry is described extensively in that institution's profile.

Relationship of Constituencies to the Board

The interests of an enterprise's constituencies are most effectively represented to the Board by direct membership on it. Frequently, the distribution of directors among constituencies is dictated by the enabling legislation. This is not the case with CDC, and all 19 of its voting members are business executives. Certainly this provides no counterbalance to the profit-maximizing policies of that institution's management.

The distribution of Board membership is usually designed to accommodate political conflicts which are anticipated to arise in the operation of the enterprise. Thus the NEB, which is charged with making nationalized industries more efficient, is composed of six representatives of business firms, three representatives of labor unions, and an economic consultant. Similarly, the Board of CDPC is composed of three cabinet secretaries, two financiers, three representatives of community development corporations, and a representative of organized labor.

While such an approach to Board composition seems to be a logical strategy for dealing with political conflict, the record of this strategy has been ambiguous or worse. In Yugoslavia, where workers, union officials, management and consumers' representatives sit on the Boards of industrial enterprises, most observers report that management practices have not changed signif-

icantly in the directions desired by the workers. In Germany, the similar Mitbestimmung system has long been recognized as an instrument for the cooptation of labor. The record to date of non-expert representation on the Boards of development banks is, unfortunately, filled with more hope than effect.

The Role of Staff

The staff of a public enterprise generally outlasts its directors. Like most bureaucracies, it tends to operate in its own best interest. This is an area of public affairs which is virtually undocumented, but Jameson Doig's article on the PNYA provides some substance for the average social scientist's suspicions.

The Authority's top management is appointed by the Board and can serve indefinite terms. During the Sixties, the average length of company experience among the top staff officers was 30 years.

Realizing the threat to PNYA solvency posed by public pressure to acquire commuter lines, Doig reports that the staff orchestrated an elaborate resistance which included lobbying of the state legislatures, both directly and through favored contractors, wide-scale publicity campaigns and influencing a purportedly independent study committee formed by the state legislature to investigate the problem.

Such overreaching may be countered by the imposition of civil service or other personnel and conduct regulations on the staff. This tactic has its costs, since sufficiently skilled personnel will not be attracted by civil service salary scales and may be put off by complicated hiring procedures. The Connecticut Development Authority has experienced this difficulty. So has SBA in much more severe fashion. The real power in SBA resides in the regional officer positions, which are appointive. The regional financial officers may override loan decisions made at lower levels. Lately, there have been several documented cases of political uses of SBA funds by persons in the regional offices over the objections of the district level loan officers.

Professional staff competence is the most important element in determining the performance, financial and otherwise, of all the development banks reviewed for this report. For the most part, the top staff consists of men experienced in banking who have been able to transfer their experience and judgment to the public sector with considerable financial success. In general, they tend to reject the idea of being bound by the social consequences of their investments, claiming the institution will accomplish nothing unless it maintains its financial credibility. Statements to this effect have been made publicly and privately by the executive directors of CDC and CDA. The directors of EIB

and NEB have explicitly pledged themselves to the accomplishment of social goals, such as the rationalizing of industry and the provision of employment opportunities. So far, however, they have not discovered a framework for bending their organization's energies to those purposes.

D. Operating Sanctions

There are essentially two types of operating sanctions which can be imposed on the management of a public enterprise. One is the removal of responsible personnel; the other is the control of the flow of funds to the enterprise. These sanctions are imposed only after an enterprise's problems have reached crisis proportions.

Removal of Personnel

In public enterprises, the government can remove Directors only, usually only for cause. Where such action has been taken or threatened, it has usually been in response to evidence of financial failure or personal abuse of corporate power on the part of Directors. This is the case with current investigations of the private use of Authority facilities by Directors of the PNYA. Edward King, former Chairman of the Board of the Massachusetts Port Authority, was removed by Governor Dukakis for policy reasons. King had been openly antagonistic towards citizens' groups seeking

a noise-prevention curfew on Logan Airport, which was one of the key factors. This is, however, the exception that proves the rule.

Control of Funds

There are two basic types of capitalization for public enterprises. One is essentially private. Investment funds are raised through the sale of securities backed by the revenues of the bank and often guaranteed or leveraged by the tax revenues of the political unit of which it is a subdivision. The second is the direct provision of tax revenues to the enterprise under various conditions set by the government. Our investigation provides no clear indication of which type of financing is the most effective in holding an enterprise financially or socially accountable. However, we will review the evidence before us for each type.

Private Market Finance

The experience of PNYA and the commuter lines has demonstrated that reliance on the bond market--even the claim of such a reliance--can be used by an Authority to delay or refuse action on a potentially desirable and widely demanded social project.

On the other hand, recent experience of public authorities has discredited the frequently-heard claim that dependence on the

bond market imposes "market discipline" on the management of public enterprise. For example, by the time the New York state legislature refused to bail out the Urban Development Corporation in February of 1975, the agency had run up over a billion dollars in debt it could not cover from operating revenue. It was estimated that the state would have to put up \$240 to \$320 million simply to complete projects UDC had left unfinished. Investors had counted on the political power of UDC's management and had largely ignored its internal finances once the Corporation had been cleared by the rating agencies. The arbitrariness of this particular system is well-documented by John Peterson in The Rating Game.

Still, the use of bonds can work and can effectively redistribute capital if the institution is prudently managed. This is the case of the European Investment Bank and B.C. Central, whose financial operations are described in the profiles section. CDA's Umbrella Bond Program is another good example of the redistributive possibilities of using private market finance. Here, the Authority performs the function of evaluating the prospective risk and return of lending to small- and medium-sized firms for institutional and individual investors in market securities. It has thus opened up a hitherto untapped source of funds for its borrowers. Ultimately, the market discipline of this system is under-

mined by the extensive backing the state offers the program. Its success to date has been due primarily to high-quality management.

Financing Through Tax Revenues

Control over the provision of state revenues to public investment banks ranges from nil to finicky. At the bottom of the scale is CDC, to whom the Canadian government has provided a block initial capitalization of nearly \$300 million. This policy has assured CDC's virtual freedom from any type of control or accountability.

At the upper end of the scale, NEB's investment funds are provided on an annual basis, and their release must be justified to the Secretary by three-year plans covering both financial and non-financial aspects of the firms designated to receive funds. So far, the Secretary's office has shown little regard for the social aspects of NEB-financed enterprise.

The Small Business Administration relies on periodic Congressional appropriations to finance its lending and guarantee operations. This method of funding imposes costs in that it is cumbersome and time-consuming. Theoretically, it should yield benefits in terms of increased oversight of agency operations. However, the sheer number of loans SBA makes and the complexity of the decentralized administration of the program have made

Congressional oversight impossible. As we have noted, as late as 1974 it was assumed by the SBA's observers that its high loss rate on guaranteed loans was due to chronic instability in the small business sectors. A 1975 study of a large sample of SBA loan records revealed that many guarantees were made for reasons other than to finance the expansion of small business facilities. Over 20 percent of the loans guaranteed were used to pay off existing debt, and of these about one-quarter were to firms which did not meet minimum standards of creditworthiness.

Contrasting the NEB and SBA experiences, one might reasonably conclude that executive oversight may be more rigorous than legislative oversight.

CDFC's capitalization demonstrates a compromise between the lack of control inherent in CDC's capitalization and the complex, potentially disruptive day-to-day supervision of NEB's flow of investment funds. CDFC has been granted a modest, non-renewable sum of \$10 million which it may use as it sees fit within the administrative process laid out in the legislation. The legislature, in providing this form of capitalization, has essentially recognized the experimental nature of the program. If this experiment turns out to be successful, on financial, political, or social terms, the state legislature may choose to augment the original capitalization. The technical details and consequences of CDFC's capitalization are fully explained in its profile.

The problem with most financial sanctions is that they come into play only after the damage of mismanagement has been done. Continuous governmental control over an enterprise's flow of funds imposes costs in terms of limiting public bank's investing flexibility. The benefits, in terms of use of funds which corresponds to government policy or statutory mandate, have not yet materialized in practice.

E. Conclusion

The problem of holding public enterprises accountable for their performance is largely unsolved. Total accountability is neither possible nor efficient; public supervision itself is costly, and it can damage as well as promote performance in the public interest. The contribution of specific institutional structures and prescribed administrative procedures is largely unpredictable.

The workings of accountability systems is further complicated by the fact that public enterprises themselves control information on plans and operations. Past experience has shown that concerned officials have had to undertake extraordinary measures to get enough information to understand what is really going on in these enterprises. If this kind of vigilance were constantly maintained, the purpose of having the public enterprise

would be undermined. Generally, public enterprises are set up to relieve the government of a portion of the costs of administering some area of responsibility which, like assistance to productive economic activity, should generate enough surplus to finance the institutions set up to pursue this purpose.

On the financial side, the success of public banks has depended for the most part on the honesty and competence of their staff. Most public financial institutions rank high on these dimensions when compared to state-owned industrial or service firms. A set of acknowledged reporting conventions and simple criteria of success exist for the financial operations of public banks. These have been developed in the private sector and transferred intact, through the importation of management, to the operations of public financial institutions. As assets and profits mount, management's position becomes more secure, its decisions less open to question and influence by the government and its various constituencies.

On the other hand, public banks have been relatively unsuccessful in taking the social consequences of their activity into account. It must be said that they face substantial problems in doing so even if they are committed to the effort. First, reporting conventions and performance criteria are at a primitive stage of development and are subject to a great deal of controversy.

Second, management tends to be unfamiliar with what has been done in the field.

Social costs and benefits generated by an enterprise are distinguished from the phenomena that show up in its balance sheets mostly because they are not given a money value in the market. Still, the realization of these benefits or the minimization of costs requires that money be spent or that certain income-generating activities be restricted. This is a form of redistribution of the economic product of the enterprise which requires a political decision on the form the benefits and costs are to take and how they are to be distributed.

Therefore, the Permanent Fund must provide a forum in which the range of choices can be exposed and conflicting interests heard. It must then provide a means by which to assure that the decisions reached are carried out, especially when this implies a deviation from conventional commercial practice. Here the record of public enterprise is, to date, unfortunately quite uninformative. In such an enterprise, the framers of the Alaska Permanent Fund must follow their state's tradition; they must be pioneers.

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Appendix
to
Final Report
of
The House Special Committee on the Permanent Fund

VOLUME I - Transcripts, Minutes

- Rep. Clark Gruening, Chairman
- Rep. Terry Gardiner, Vice Chairman
- Rep. Ernie Haugen
- Rep. Russ Meekins
- Rep. Bill Miles
- Rep. Leo Schaeffer
- Rep. Rick Urion

These transcripts were taken from tape recordings. They have been edited for the purpose of clarity. The original recordings are in the possession of the committee and may be heard upon request.

PRESENT: Clark Gruening, Chairman; Terry Gardiner, Vice
Chairman; Bill Miles, Russ Meekins, Leo Schaeffer;
Hugh Maline; John Rader; George Hohman.

TUSSING: I am not going to read the paper, nor am I going to go through it point by point. Frankly, it is is a little too heavily steeped in jargon and it is hard for me to get back and read it through a couple of weeks after I have done it and exorcise all of the economist catch phrases and financial catch phrases.

GRUENING: Arlon, give us a little bit of your background. There may be a few people who haven't heard of you.

TUSSING: I know almost everybody here. If they don't know me, maybe it is their hard luck. I am a adjunct professor of economics at the Institute of Social and Economic Research at the University of Alaska. I have been connected with the university in one way or another for eleven years. With the short study requested by Representative Gruening to cover some of the background of economic issues that the committee felt had not been really treated before the committee got into looking at the organization in terms of the permanent funds. I have read Dr. Daniel's paper, and let me assure you that until this morning I had never met him and we did not cooperate or collude in any way. So I found nothing in his paper that I could disagree with and a great deal I could

agree with.

GRUENING: I might just introduce the committee. I am the chairman of the House Permanent Fund Committee and sitting next to me is George Hohman, the chairman of the Senate Committee on the Permanent Fund. Two members of the Senate committee are here in attendance, the president of the Senate, John Rader. At the end of the table, Senator Pat Rodey, from the Senate. On my left, from the House, is Representative Terry Gardiner who is vice chairman, and Representative Bill Miles. Going down on the right side, Representative Russ Meekins and Speaker of the House Hugh Malone who is not a member of the special committee, but has an interest in the Permanent Fund.

TUSSING: Let me emphasize one issue in particular which is mentioned in my paper but does not have---does not really focus on as much as I would like to focus on. That is that the investment policy of the Permanent Fund will have far less influence on the rate and shape of economic development in Alaska than the amount of money in the general fund and the way the general fund money is spent. For one thing, the general fund is going to be much larger than the Permanent Fund according to the kind of numbers we are talking about, as far as revenue dedications to the Permanent Fund.

A Department of Revenue projection issued in February of this year, assuming a 25% contribution revenue to the fund projected in 1985 Permanent Fund balance of \$1.8 billion and a general fund

balance in the same year of \$6 billion, as based on the projections of existing programs and the anticipated gross rate in state spending. That \$6 billion is surely not going to accumulate in the general fund. There is going to be enormous pressure to spend it. But the general fund---the money available in the general fund will be much greater than the money available in the Permanent Fund. For another reason the general fund will have more influence is that its expenditures in general move directly into a spending stream in the state's economy through payrolls and procurement while the Permanent Fund money, much of it will be invested outside and, as I will explain in a moment, probably all of it will be in effect invested outside no matter what the investment policy the Permanent Fund is.

Thirdly, the Alaska demand for Permanent Fund investments is extremely low. There is very little additional demand in terms of potential income earning projects which can be funded by the Permanent Fund which would not be funded through existing financial sources and much of my paper is devoted to this. An examination of the question of whether or not there is a capital shortage or not---in other words whether or not the existing financial institutions are sufficient mechanism to bring capital into the state.

My conclusions are this: Major industrial ventures in Alaska, and this includes ventures in fish processing, mining

timber, major agriculture developments, major tourist operations, are very adequately served by existing financial institutions. That there is no financial obstacles to their continued rapid development in the state. The obstacles that exist tend to be problems of resource location and marketing regulatory problems including state leasing and permitting and federal leasing and permitting. But they are not financial problems, for the kind of large industrial venture that would significantly diversify the state's economy, or the kind of large industrial venture that would be piggyback on our oil and gas industry like petrochemical. These investments will be made by large national or multi-national corporations drawing on their regular sources of finances. For those that are independently developed within Alaska, the new ventures with new enterprises, there are a large variety of institutions in the capital market that are interested in the financing required investment.

I will give an example of this from my personal experience and involved in a new fishing port in a remote totally undeveloped site in Western Alaska. The preparatory work putting together of the land leases and getting the engineering design on the port facilities had just barely begun and we have made no public announcement of this, yet within a few weeks after this started we had been approached by three major outside banks---one New York bank, one California bank and one Canadian bank, who were very interested in putting together a financing package for this venture which is

just a beginning of a conception. All of these banks have specialists to deal in Alaska and there is no lack of information to prevent them from going and looking for more information and looking for investment opportunities. They are as aware of anybody in Alaska or as aware as the managers of the Permanent Fund of the opportunities that the expansion of U. S. National Fisheries jurisdictions and the growing world demand for protein and the opportunity that it will create for bottom fisheries and other fisheries in Alaska. One of these major New York banks has a specialist who is heading up a whole team dealing with these problems specifically.

Another experience we had was that directors of the new firm were immediately inundated with approaches from friends who had invested and who were looking for places to put venture capital. High risk, high potential return ventures with large tax write offs. People come in and say I have got \$29 million I have to place during this tax year, or I have got a problem. They want a potential rate of return but most of these big development ventures aren't terribly sensitive to the small differences and the amount they pay per capita. A major venture, a big venture, that where there are millions of dollars involved, those millions of dollars can carry a great deal of investment research and exploratory work on the part of either the ultimate investor or the financial intermedior, the insurance companies or brokerage houses.

So my conclusion with respect to major industrial venture, not only is there no problem, no specific problem, but that Permanent Fund investments in these ventures will essentially displace capital that would come in from the outside. So from the point of view of impact, the point of the impact in Alaska's economy, or the impact in diversification of Alaska's economy is going to be very little. A concentration on these ventures might on the other hand affect the security of the quality of the loan portfolio of the Permanent Fund because, in a sense, you are putting all your eggs in one basket called Alaska and the very thing that may make your regular revenue fall may make these investments in Alaska enterprises particularly risky.

Move on to another area in which the Permanent Fund probably has no role and no particular effect, and that is the commercial loans in the urban areas of Alaska. There is no capital shortage here. The existing financial institutions, the commercial banks, thrift institutions, factors, mortgage brokers, etc. and both the commercial and residential, it is the same way in Alaska as in the rest of the country---there is no substantial interest rate differential between Anchorage and communities of comparable size in the rest of the United States. There seems to be a greater availability of loan money, partly because the people in some of the outside financial institutions have a great faith in Alaska because the growth is assured. There is no problem, there is no capital shortage to be filled by the Permanent Fund in the area

of equipment financing, the kind of item trucks, construction equipment, generators, compressors, aircraft, etc., which are movable where the financing is available from vendor to manufacturer, from equipment financing companies, from banks and smaller units from credit unions and the like. No matter where you are in Alaska, if you need a backhoe and you've got something useful to do with it, and a prospect of some income, you can finance a backhoe. There is no capital gap for the Permanent Fund to fill here. The question of utilities and other utility type interest subsidy investments is often raised and I see quite a bit of talk about the Permanent Fund providing credit to the Alaska Power Authority or to the Susitna project. This could be done but it is another incident where the Permanent Fund would probably simply be displacing money that would be available from outside. If the Susitna project is viable, if it can prove that it can pay its debts or can be financed conventionally, and the reason that---there are several reasons why the Permanent Fund should probably not be involved in financing the long term debt of the Susitna project.

First is that the Alaska Power Authority can issue tax exempt bonds, while at the same time the Permanent Fund can invest in taxable corporate bonds, for example, or federal securities that get a higher rate of return than the Alaska Power Authority or any solidly based Alaskan utility would have to pay. It makes no sense for the Permanent Fund to be

getting a low rate of interest on its investments than it can get in the open market while at the same time the Alaska Power Authority doesn't get any break on the cost of capital.

Now, conceivably, the Permanent Fund could be used as a source of equity capital for joint ventures. However, going through most of the major categories of the capital market in Alaska, these are either areas which are adequately served by the existing financial institution or ones in which the Permanent Fund could probably not make a useful contribution anyway.

One area does stand out as an area of opportunity and in this very preliminary survey it seemed to me that the one capital market that is not serving its constituents well is that serving small community business, medium size business in the small communities and in the Bush in Alaska. The urban commercial banks in Alaska just don't reach out far enough. The cost of information gathering, of servicing loans, the cost of collections and repossessions, foreclosures, resale and things are just too much. Outside institutions don't deal with them. The demand is too sparse. So the tourist oriented business or a local store or a small locally owned fish processing venture or something on that order may not be able to borrow, or, for that matter, to obtain any sort of capital on terms comparable with a similar venture---a venture with similar early expectations in a major community. And so I think there is an area in which the state could look at the formation of regional development. Probably a statewide development bank would be too

big and would be too far from the---the problem in the Bush and the small communities have people on the scene oriented to problems of the particular community. I would suggest looking at the possibility of setting up a state-chartered regional development bank in each of the regional corporation areas and working together with the regional corporations, or having the regional corporations participate in these rural development banks, but having a professional management supervised by the Permanent Fund using Permanent Fund money. The problem here is that I doubt whether the aggregate demand for capital from all of these banks would be greater than forty or fifty million dollars at the present time. A great number of people in smaller communities in the Bush who feel that they are not well served by the existing banking system. But the total amount of real business they would generate is relatively small and you are not talking about billions of dollars---you are talking about tens of millions most likely. Just think of what it is in the Calista region which has induced the Calista Corporation to put its money outside of the region. How much potential private investment that could be locally developed does exist? How much opportunity is there in the Calista region? It is nothing like the kind of funds we are talking about with the Permanent Fund. So I would say by and large the potential role for the Permanent Fund money in altering the shape or

character of Alaska's economy on a business-like basis is rather small.

I go on to say the Permanent Fund is not a very promising tool for short economic stabilization. I am not sure how many people really think that it could be but I've heard it referred to as something that could feed money into the economy in a slump period and slow down the investment activity in a boom period. Now as far as dealing with the regular business cycle that lasts two or three years, there is a number of reasons why Permanent Fund is not a promising tool.

In the first place, its impact is less and slower than that of the general fund. The impact of the Permanent Fund investment policy is going to be very, very minor compared with what is done with the general fund. The general fund expenditures are direct injections into the state's economy. They occur now and secondly because Permanent Fund investments---many of them will simply be displacing capital which would otherwise come in but there is another fundamental problem that, even if these were not ---even if these previous problems were not involved, there is another problem that would probably make it impossible to use the Permanent Fund or general fund appropriations for that matter as a significant stabilizing force. That is by the time it takes the management to recognize that we are in an overheated boom situation that something out to be done about, we may well be approaching a turning point. So it takes some time to recognize something ought to be done. Then you have to implement the policy. And by the

time the loans are made and the people or concerns who receive those loans start paying construction workers, it is very likely that we are going to be on the other part of the cycle. But the effect of the Permanent Fund---or for that matter the effect of the legislature---trying to use the capital budget as a stabilizing device is that you are going to zig when you ought to zag.

There is a very good persuasive case on the part of some economists that the federal reserve has been more often ---that the effect federal reserve policy nationally has been more often wrong than right. We could build a business cycle model of the Alaska economy and give legislators in the--- give them say \$4 billion on a computer to play with. We will start the thing off at 1964 after the earthquake and see whether there is any---see what you can do on the basis of the effect on unemployment, building starts, on gross products if you have gross products, and things like that. See what happens as you try to influence the economy with this. My intuitive guess is that it would create---no matter what you did trying to do it would create oscillations in the economy that wouldn't have existed before. I just don't think that it can be done.

There is another problem. It is a practical, political one. That is, when the money is available, when you are in a recession situation, when the money is available there is

resistance to spending it. You are in a boom, no matter how high the rate of inflation and how great the pressures that boom is creating on public facilities. It is going to be very hard to get anybody, whether it's in administration, legislature or managers of the Permanent Fund, to say we ought to turn off the water when the revenue is more available than it has ever been before and the needs are growing by leaps and bounds because of this boom and population influx. If you are skeptical about that, look at what happened to all the talk about stockpiling of public works projects until after the pipeline construction is over. It just is not going to happen.

Nevertheless, the Permanent Fund can be an important long-term stabilizing influence. That long-term stabilizing influence as the main intention of the people in voting the Permanent Fund and the legislature for establishing one. That is the result of the fact that state spending is the main engine of growth in Alaska. It determines in the long run the level of employment and level of population and determines the needs for government service. The principal influence of the Permanent Fund on growth and on the size of the state's economy is the amount of money it takes out of the general fund.

The Permanent Fund is going to influence the rate of growth of the state's economy, but not on the supply side. It is going to have almost no impact on the rate of growth by the way it spends

money, or the way it invests money. It will have a gigantic impact in terms of the amount of money that is dedicated to the fund because, for every hundred million a year that goes into the Permanent Fund, there is a hundred million that is not in the general fund for current operations and for state capital expenditures or for current consumption. In the next decade or two, the legislature is going to determine the rate of employment and population growth in the state and it is going to determine the rate at which the need for state services increases by the way in which it spends the money. It makes some difference whether this money is spent in tax reductions, in transfer payments such as Alaska, Inc. or welfare, on regular operations of government or on construction.

It would be worthwhile to have a comprehensive fiscal model of the state's economy so that you can look at what the differences are, but the differences aren't as important as similarity. The more you spend, the bigger the economy is going to grow, the more population we are going to have in the state and the greater the need for state services are going to be a year or two or five years down the line. So the more money that is not available for this process today, or the more money that is not spent, the smaller the employment and population base and the smaller the needs will be.

What the Permanent Fund does and its principal function

and principal predictable function is that it slows down the development of the state by diverting money from current expenditure. There is hope that it creates enough income and it grows to the point where it can sustain the state expenditures that sustain the rest of the civilian economy of Alaska in those days after the oil money is gone or when the oil money levels off or when the oil money stops increasing in amount as fast as the perceived need for population are increasing.

So if you take this revenue bubble and put it in the future, you stabilize the economy. I have two final points on this. The eye of the legislature ought to be much more on the amount of money that goes into the Permanent Fund than it is now, and probably a little less on dividing up the---or deciding what kind of portfolio the fund should have. And that the 6%, say 25%, does not solve the problem, it does not---25% of the nonrecurring oil revenue going into the Permanent Fund does not do away with the revenue excess, nor does it do away with the use of this oil money to create here in Alaska an economy.

It is just not when the oil money runs down and the oil runs out, that will be a long time, but when the rate of growth of state revenue starts to slow down. So putting 25% just means you got 75% left there with an enormous growth in those years when you have got a lot of revenue and very little when the revenue stops coming. So it seems to me we ought to start thinking in terms of what kind of formula for contributions to the Permanent

Fund will stabilize or create stable growth over the long term in the general fund and to do this you have to get some view---have some philosophy of growth for the state. That is, how rapidly should the state's economy grow. As I said, the legislature is going to determine how fast the state is going to grow by the amount of the money spent.

So you need some sort of formula and it should not be a fixed percentage. It should be something on the order of after your studies have determined the 6% or annual rate of growth, the real value of the general fund expenditures is what you need to sustain the reasonable growth in the standard of living in Alaska and a reasonable rate of population growth.

So, as far as what needs to be known, the research ought to be done. I think the legislature ought to look very heavily at just what are going to be future revenue needs. What is the projected income from other sources. And just how much of that gap is going to have to be filled from mineral royalties. Assuming that Prudhoe is the last big field and put in some speculative reserves and making assumptions about the price of oil and the rate of other resource development, and you say at what point are current revenues not going to be enough to sustain the level of government, the level of population, the standard of living that we want to maintain, and that will

tell you at what point you are going to have to start drawing out of the surplus in the capital fund to maintain this economy. If people are lucky, the growth will have a sufficient momentum that you will have future oil discoveries and you can keep putting off that day of reckoning, so that you may never have to draw on the accumulative surplus, much less the capital. But the principle remains the same. The most effective use of the Permanent Fund is to control what is available in the general fund, to make less available now and more available in the future. What should be in the general fund probably is the most important to know in setting up the Permanent Fund.

GRUENING: Thank you very much, Arlon. As usual, you have raised a few questions.

TUSSING: In summary, I think most of the investments of the Permanent Fund in Alaska will simply displace money that will come from somewhere else. Now it is possible to increase investment of various industries by subsidization or making loans available cheaply. The problem is that most of the ventures that would take advantage of them are ones that would be viable in any case. Both Dr. Daniels and I made the point that most new ventures, their feasibility is not very sensitive to interest. I mentioned in here that a new venture probably that expected to be able to be

written off in five years or so, which means a growth cash flow is in 30 to 50% of investment capital, and when you have got to have cash flow of that magnitude, a couple percentage points difference from what you are paying for, capital is not a crucial factor.

Well, I admit there might be some cases---in fact I was going to---there will for certainty be some cases which a prudent Permanent Fund manager might reasonably deem to be a prudent investment and managers of other outside financial institutions might not. Those marginal cases are probably so limited compared to the number of---if you are going to cover those, you are probably going to be giving money at subsidized interest rates or giving higher leveraging to a lot of other people who don't need it, and in those other cases you are simply giving away potential earnings from the Permanent Fund and for the propose of backing out capital which would otherwise be there. There may be some such cases at the margin, but I am very skeptical, first, about how many there are, and too the volume in terms of capital demand, and secondly, the ability of the Permanent Fund managers to discern those. I would ask why it is if these are trustworthy investments that can earn a market rate of return and the risks are not too great, why it is that some combination of investors and lending ---why the promoters who are putting it together haven't been able to package it attractively enough that somebody will

finance it in view of the enormous diversity of capital market. As I say, there is the availability of the insurance company money in large amounts for wealth secured investments of the availability of high return---high cost, high capital for the others and there is everything in between, I would just ask the question in this case, why is it that the Permanent Fund manager thinks it is so much better than the investment and there may be some---there may be some---but most of them are limited by resources or by the local interest structure or something of that nature.

GRUENING: I think Terry has a question here.

GARDINER: I have got a couple. What is the advisability of the Permanent Fund financing the El Paso gas line?

TUSSING: Well, it seems to me that the talk of the Permanent Fund financing is a political gimmick to get some support outside. There may be some resistance in Congress, the federal loan guarantees and if the State of Alaska will undertake those guarantees, maybe the Congress or somebody...

GARDINER: Are you saying that...

TUSSING: Well, I said in the past, I am skeptical about financing

viability of any of the gas pipeline projects in standing on their own two feet. That is, there is an enormous danger that the full cost of service of moving the gas from Alaska to the lower 48 is more than the gas is worth in the lower 48.

If there is a national decision that we ought to have a gas pipeline from---how do you cover the risk of that possibility? The financial market---that is, the bond houses and the insurance companies who are lending other people money are not going to be satisfied with a three-to-one probability the thing is financially viable, let alone only one-in-three possibility. So people are trying to come up with ways of providing that backstop. Now the pipeline companies essentially propose the consumers provide that backstopping simply by rolled in pricing, which means that the gas utilities use the fact that they have got a lot of gas that they hang on old long term contracts at regulated prices lower than the value of the gas to---they use that to subsidize the fact that Alaska gas will go into the market at more than it's worth, more than the consumers are willing to pay. You have rolled in pricing and you have the so-called all events tariff where the gas utilities, the buyers of the gas, will sign a contract saying we will pay for it, no matter how much it costs, and even if it is interrupted. We will pay the debt service on the pipeline. We will guarantee the debt service and will sock our consumers

for that debt service by adding it to the price of the other gas they get, you know, the gas that doesn't come from us.

Well, the notion of a state loan guarantee is just another attempt to find a gimmick to---or another backup for the fact that these things probably will not stand on their own feet economically. Now if there is a national decision to build a pipeline, there will be the national federal government finding some way of guaranteeing the financing. If consumer guarantees are not enough, there will be federal loan guarantees---and I really can't see Alaska coming up with a proposition that it wouldn't guarantee the bond of El Paso is going to have any effect on national decision. In fact, we may well be setting ourselves up to be sandbags on this if the commissioner of revenue comes back here and says that Secretary Blumenthal and Governor Brown and these people are going to support El Paso if we do it. And you rush it through the legislature in a special session before September 1st and the president makes his decision for Alcan on September 1st. Then they come back and say, well you lost your virginity, now we want you to do the same for the Alcan line.

The Treasury Department has been saying all along Alaska is the principal beneficiary of the pipeline. Alaska ought to be putting in the loan guarantees. Alaska ought to take the risks. And now they have got you. But what have you got? You've tied up a lot of Permanent Fund money at a public utility rate of return in a risky

investment that---I want to know on these loan guarantee programs the seniority of the state's guarantee; that is, if the pipeline can't pay, if it's revenue can't pay its debt obligation, who is it---is it Alaska that gets stuck first, or is it somebody else? If Alaska is going to be hit at the bottom of the list; that is, if somebody else is going to be hit first, it is not going to have much effect on the cost of financing the pipeline in its feasibility. If Alaska is going to be hit first, we have got a very expensive continued liability on the Permanent Fund.

GRUENING: I would like to just follow that up with--- do you intend to follow that question up? I just wanted--- before we got off---there has been a rumor around that there is some plan to suggest the Permanent Fund get into financing the gas pipeline. But assuming there are some business risks involved, does that---would that reflect on the reason there is a cause that the producers or the lessees of that gas had not come forward to finance a line?

TUSSING: I don't see any reason why a producer should want to finance it. They are not in the gas business, they are not financial intermediaries and the cost of capital--- is maybe 20% or 25% after taxes. That is their opportunity

cost. Now why should they acquire a contingent liability against capital that can be invested that way but limits what they can do with it. The most they can get from money invested in the gas pipeline system is the public utility rate of return. The cost of the capital to them is much greater. ARCO cannot go out and borrow money as a public utility at the kind of rate the public utility can. If the income is not guaranteed the---proposing to set up companies to guarantee the gas pipeline their revenue, have consumer guarantees, etc. ARCO and Exxon didn't have any guarantee of revenue. And so, from their point of view, I would regard it as an outrageous suggestion. They are not going to---of the notion before the Federal Power Commission that they are going to be that enormous beneficiary from the sale of the gas. Who knows what the price is going to be and whether it is going to be a great boom. It is very minor compared with the oil revenue. If the president adopts the FCC's proposed pricing scheme, that is to price the gas at Chicago on the basis of the price of No. 2 fuel oil, to set the price at \$2.25 in Chicago and subtract the cost of transportation from it, the oil companies really don't have a great interest in building that pipeline, or in helping build the pipeline.

MEEKINS: Yeah, but on the other hand, if they are concerned about, you know, increasing the wellhead and the state's case would

be similar, there might be---really don't know---there might be a motivation of an extra benefit that guarantees a substantial portion of the debt would reduce not only the interest cost but the---maybe the debt equity ratio and that might possibly, I understand, decrease the---it would lower the cost of service and increase the wealth.

TUSSING: Well, it might be, but the people who are advocating this approach are those who were saying a few months ago that the cost of service would categorically have no effect on a wellhead price. As I say, when the figures came out showing that El Paso would result from the highest cost of service, they said, well the cost of transportation has no effect on the wellhead price. Now you have the same people turning around and saying, well now let's commit our Permanent Fund money to lower the cost of service to El Paso and we will more than get it back in increased wellhead price. For the same people to make both of them is not credible.

MEEKINS: I agree.

GRUENING: OK, if we can get off the reality gap...

MEEKINS: I have another question. You were talking about the various economic growth of...

...and so the question is, when you are looking at it, did you come across anything that you felt could create, whether Permanent Fund or not, could create economic growth in the state that would be real economic growth in the sense that it doesn't necessarily increase population in the state but increases real economic activity...

TUSSING: Real economic activity increases population. The mechanism is you create jobs and people come in to fill the jobs. There are people coming to Alaska and leaving all the time. It is not a question of attracting people. What happens is the higher the unemployment rate here the more of them leave after... It is essentially the same question. Now, what industries you get may affect---and others---you know, they may have a higher average wage, but of course that will affect if they have a relatively high component of skilled and technical personnel and professionals they will attract and---the people who are qualified for those. No, I don't see how over the long run you can have a large effect on the---you can't create any real economic growth in Alaska unless you know, economic activities---the rest of the United States.

Oh, economic growth is proceeding in Alaska at a very rapid rate. Alaska economy is growing faster than that of any other state in the country. We are increasing in the sense we still have the same unemployment rate, or greater, and, you know, the people

after the pipeline---know what our average incomes show, but basically, we have got a bigger pie, but it is the same pie. And so what I am saying---you know, that is why I say, can you create real economic growth in the sense that people might be better off here, but it is still the same amount of people.

Well, what is better off, to reduce the seasonality? I think part of the extreme seasonality in the economy comes from the weather in the first place, but it happens because people like it. They want to go outside in the winter and they don't like to work construction in the winter. And things like that. It may be you can stabilize by spending the money on salaried state employees to work the year round in nice comfortable office buildings. That is one way of doing it. And you get...

GRUENING: Are there any other questions?

RODEY: You mentioned the Permanent Fund and financing those projects that normal private institutions won't finance. How can you avoid what Mr. Daniels called---that is Permanent Fund getting all that bad debt portfolio. There seems to be a consistent danger we are going to face as we develop some scheme for investing money.

TUSSING: If you look at the history of development bank

type institutions, of special lending funds in Alaska, look at EBA, FBA, BIA loan programs, etc. If you instruct the managements to make loans only to those ventures that can't get money otherwise, you are asking them to invest in those who are, by definition, high risk ones, and you are going to have a lot of bad loans and portfolios. That is the way it is going to be. If that is alright---if this is the way of spreading the money around, well fine. When the money first started coming in, the government purchased all the land in a city and then sold it back to the people at lower prices. That is the way of getting money into the---it was an urban development program. If you want to get the money into people's hands, that is one way of doing it. You get a lot of---projects that can't get financing when you got too much money. If you are going to give it away, well there are all sorts of ways to do that.

No, I don't think you are going to avoid that. I would like to see a real audit of loan quality in the existing state revolving loan program. And what the real subsidy is. When you take into account---when you classify these loans the way the banks are suppose to classify their loans and write off the ones that are really no good and write down the ones that are only partially collectable and then add the administrative costs, and say what have we got from the agricultural---for the small business loan. It frightens me to set up a multi-billion dollar---without taking a

hard look at what went wrong with the other loan programs. And taking a hard look at all these EDA projects, the EDA financing of industrial parks, the BIA industrial park projects and infra-structure projects that we were supposed to encourage in rural areas.

GRUENING: Hugh, did you have any questions?

MALONE: Thank you, Mr. Chairman. In the report that you prepared for the committee, in discussing the accumulation of surplus balances in the state general fund, it states that one way to make use of general fund balance would be to reduce the personal income tax. It says that the analysis showed a significant reduction in the general fund balance of a highly stimulative effect by the increase of disposable income increased demand, but it says that if additional revenues would be generated it would not be sufficient to maintain constant per capita at government expenditures. General fund balance would be depleted more rapidly than initial calculations indicated. It concludes by saying if the Permanent Fund is interpreted as a fund to benefit Alaskans the expansion generated by the income tax---I believe that would be the reduction of the income tax---could be the worst possible use of the general fund money. The question I have is---the next page at the

bottom there, discussed an idea that has been brought up from time to time, the transfer of payment directly to individuals. That would provide an economic increase in private---my question is, would the same considerations apply to that transfer distribution of monies to some form of Alaska, Inc., would apply to an income tax cuts. That is to say that you would generate additional revenues but you generate government costs that exceeded those additional revenues in that you might have a case where the expansion generated could be the worst possible use of general fund money and would you care to comment on that?

TUSSING: OK, as I said before, we can model the different impact tax deductions of Alaska, Inc., welfare payments, increases in state operating expenses, and there would be significant differences because they will be distributed differently throughout the population by income level and by region and some would have larger impact outside the state than others and it would be worthwhile to compare them. What we are saying here is all of these things do have impact and those that feed cash directly into the economy might well have more impact---or likely to have a greater effect on the management of state services than on the secondary ability to adapt to the time at which you couldn't maintain the services of the population you created. You may be asking---you said one of these uses may be worse, probably should say among the worst, from the point of view of stabilizing the growth. It could apply to the others as well.

GRUENING: Mr. Malone.

MALONE: Thank you, Mr. Chairman. Generally, one of the ideas was discussed when the various legislation creating Permanent Fund was under consideration. One of the ideas was that there would be some sort of buffer against the decline in state revenues with the dropoff in production of mineral resources. Does that make any sense to save money for a rainy day, or is that only a question of considerations. Can you put that into perspective?

TUSSING: Alright, you can model the situation. Assume that the demand for state services is going to remain constant in per capita dollars and you can add to say---increase 2% a year and you are aiming for a population growth rate of 2% or 5% a year, something like that. Then you can put it into your model and can see how much revenue is necessary. Then you can project how much your regular taxes would maintain the same structure of personal taxes in the state, the nuisance taxes, the gasoline tax, etc., how much that rate---and how much you are going to need from supplemental sources which would be either current mineral leasing revenues or Permanent Fund income. For every rate of contribution in the Permanent Fund you can show where the lines are going to cross, the point

at which the growth of the amount---the current revenue plus Permanent Fund income wouldn't be enough to sustain that level of service. Now for some amount of Permanent Fund contributions you may find that that point never comes. That the Permanent Fund may---and that you will always be able to maintain---well, your rate of increase in state services may be growing at 5% a year and the Permanent Fund's spendable income may be at 7% or something like that. It is entirely conceivable. But you would get that result only with very large early contributions, trying to minimize the budget growth---trying to keep growth in the next decade to a very low level.

If you spend 75% of the oil revenues every year, you are going to get to the point where the state's economy and the state government can no longer sustain the needs created and get to that point much faster. The model is very useful for that. The model did some preliminary projections on the basis of 25% contribution on the basis of various assumptions as to what happens to the general fund, but you can put together whatever assumptions you want. You can test various formulas for Permanent Fund contributions and come out with a theoretical golden path, where each year you assure that at least for 20 years, maybe for 30 or 50 years, there is always enough surplus revenue in the Permanent Fund to meet the requirements of the growth. But that can be accomplished only on the basis of an assumption as to what your goal is for population growth or growth of state gross income.

GRUENING: Are there any further questions of Dr. Tussing?

RADER: Doctor, in regard to the trans-Alaska gas pipeline, you are saying that if it is a viable economic project that money would be available to us at a public utility rate through normal public utility sources throughout the United States. It is possible that Alaska, in order to get in its royalty gas to tidewaters the trans-Alaska line would have an interest rate---would be justified in financing a line which would not be financable at a normal utility rate in order to have that option of 25 years of recall of our gas?

I have no idea of what the value of that option is. But I am only assuming, first of all, that you could establish going in, that the ability of Alaska to tax and the ability of Alaska to---the desirability of keeping that option of tidewater availability of oil and gas. Is there room for argument that we could participate in that situation in a project that a New York investor would not be interested in?

TUSSING: It depends how much it is worth to you to get to tidewater.

RADER: How do you think of that 25 year option with the gas pipeline? What do you think?

TUSSING: I don't think it is worth very much, myself. I think that we are going to have a lot of oil and gas explorations in the Gulf of Alaska or Cook Inlet, and there are presently uncommitted gas resources in Southern Alaska. If the state builds a spur from an Alaskan highway pipeline to Cook Inlet, for example, it is much more likely that the gas would go north on that spur than south. It is conceivable the cost situations may change sufficiently to make the Inlet area or Prince William Sound an inviting area for industrial development, based on the gas. No study has yet indicated that that is in the offing. There is no evidence for it and there is no serious argument anywhere that there is a petrochemical or major gas using industry waiting to be established because of the availability of gas at tidewater in southern Alaska. Any sacrifice the state makes now, either in gas revenue or in Permanent Fund earnings, speculating on what is going to happen five years from now, is that thing that happens 25 years from now has got to be awfully big at compound interest to justify the sacrifices made now.

The gas on the North Slope probably should not come to tidewater in southern Alaska. There is very likely to be a big surplus of gas in southcentral Alaska, the Gulf of Alaska, lower Cook Inlet, out the chain, etc. and it is going to be extremely difficult to market.

The trans-Alaskan gas pipeline is an idea, it is a vision, it's very little else in terms of the prospect for further development. It is a big payroll boom and that's why it is so attractive. Do we want another big payroll, big construction boom for the difference between the El Paso and Alcan in terms of the payroll. How much are we to pay?

How much is it worth to pay to get gas directly to Glennallen. Wouldn't it be a lot cheaper to give them the money to haul propane in for free, or something like that? I know how much it is worth but a lot of this discussion takes it completely out of economic reality. It has become a religious thing and I don't know how much it takes.

GRUENING: Now that we are into religion, can we get back to Permanent Fund? Do you have any other questions?

RADER: I have a couple of others, if I could, Mr. Chairman. During the discussion of Permanent Fund, it has been brought up from time to time that Permanent Funds can be used as a vehicle. You touched on this during your discussion and I apologize for not having read your paper. I assure you I will. It has been suggested that the Permanent Fund be used as a vehicle to handle the transition of Alaska non-renewable resources to renewable resources and I assume inherent to that would be that we would take the Permanent Fund and use it to

subsidize what would apparently be non-economic agricultural products or fishing ventures perhaps on the Continental Shelf and the 200 mile limit or something else, I don't know. To use---I don't know really---I am not one of those who made that argument. It was made that this fund could be used as a vehicle to get us from a non-recurring resource revenue to a recurring resource revenue. Do you really see that?

TUSSING: How long are we going to subsidize them and compare the cost of continuing subsidy to just how much income you could bring in by investing that money at the highest rate of return and using it to sustain normal state activity. I am no more sure than you are what the people who talk about this mean. I would like to see what kind of venture and what kind of subsidy is involved. Suppose the Permanent Fund contributes free half the money to establish a processing plant for bottom fish. Over long term the operating cost---or the revenue to cover the operating cost and the depreciation---are you going to just keep feeding in money from somewhere to keep that project going if it's not otherwise viable, and if you have to do that what do you want it for? Does this make the state's economy any less precarious than it was based mostly on oil? I don't quite understand the argument myself.

RADER: I don't either. I thought maybe...

TUSSING: Let me say, I have faith in the ability of the fish processing industry and of Alaska-based fisheries to grow and make enormous investment in the next two or three years or in the next five or ten years, and there is virtually nothing that can stop this aside from state and federal regulatory policy, but the pace and shape of that development is not going to be determined by the cost or availability of venture capital. That will be there if the projects can show that they are worthwhile. There may even be too much because there are a lot of Japanese and Korean companies who are writing down and writing off their previous investments in processing plants back home and who will want to get involved at almost a non-economic basis in Alaska industries and may want to get a foothold now and will invest at less than, you know, it thinks a prudent investor might hesitate at. That is true, we have another source of capital in the native corporations who have been doing that, too.

RADER: A different line of inquiry. Have you given any thought as to the governmental structure that you would recommend? You and I are both aware to some degree at least of our past, in the way we handled the past lending activities and whether they have been economic. I am like you. I have some question about the management ability of some of our agencies. Have you given any thought as to how the fund should be structured

for an executive and legislative oversight but with a view towards insulation from legislative pressures and public pressures, etc.?

TUSSING: Not enough to spend time on my prejudices.

RADER: That concludes my question.

GRUENING: Thank you, Senator Rader. Are there any further questions of the committee? Representative Meekins.

MEEKINS: Dr. Tussing, you were talking about providing some loans for small and medium enterprises in the rural area and that private institutions don't provide the capital needs there. Is it your view that in order to do that that we would have to set up regional development banks or some sort of development banks and that that wouldn't be possible or preferable to work through the financial institutions?

TUSSING: Well, I think most investments in Alaska should be done with or through or in partnership with existing financial institutions. I haven't given a great deal of thought to how this would be structured, but I would see the regional development banks being formed in some sort of cooperation between the Permanent Fund and existing financial institutions and the regional corporations. For example, they might joint venture, which would be utilizing the services and get money from the existing financial institutions. Might guarantee them and sell bonds---have a correspondent relationship---there is just many ways of doing it and I simply haven't devoted a lot of thought to its structure. It will be a

difficult problem. It is not an easy thing to work out.

GRUENING: On that line, Mr. Belden Daniels, who is our next witness, will give a little more thought to that. Are there any further questions from the committee? I want to thank you very much for a very thought provoking presentation. Thank you. I would like to call our next witness because I would like to wrap most of this up today. I think he is in the audience. Mr. Belden Daniels from Harvard University has submitted a very, I think very, comprehensive report and I would like to hear your initial comments, Belden. You have a resume here that looks pretty impressive. I know you are pretty modest and maybe you could summarize it for us.

DANIELS: Thank you, Clark. I am a lawyer, a former international banker. I teach development finance at Harvard and I am actively involved in putting development banks together in a number of places in Asia, Europe and in the United States. That provides me with a very good point of departure because I suppose that in the last 18 years of working in development banking and in the last 13 years or so in working specifically with regional and community economic development problems that I have read several hundred development banking acts and draft bills and I participated in drafting and having passed and funded a dozen or so myself.

I begin with a very strong feeling of genuine excitement about the quality of work which the State Investment Advisory Committee has already invested in this issue and which the consultants for the state, Price Waterhouse, White Weld and Bob Richards here in Alaska, have contributed. It is much easier for someone in my position to offer refinements and additions and clarifications on a draft which I think is essentially very sound. I am speaking specifically about House Bill 298 and I think somewhat improved version of that House Bill 300, which are the two that I have looked at in some detail.

I have about eight points, if I could kind of quickly go down them and make them fast, and then open it up to your discussion as much as possible. I guess I want to say one or two more preliminary things. I confess to being somewhat overwhelmed by both the potential size and scope of the Permanent Fund and also by the size and nature of the Alaskan economy in relation to your population base and I feel very cautious about wanting to be too quick in making judgments about the relevance of my own experience in many other parts of the world because, as Arlon Tussing has point out, you are faced with an absolutely unique situation. There are really no comparable situations in my experience in either Asia or Europe or in the United States which combine the particular concentration of extraordinary resources, capital and natural, in such a vast area with such a limited population. So I would like

to reserve the ability to be somewhat tentative in---as an outsider in offering too much advice and council about how you should proceed here.

I do think that there are at least three major areas in which that experience is relevant to you and useful to you; that is, the world wide experience is relevant and useful to you, without presuming what your goals are. And they get, Senator Rader, to some of your questions.

One, I think there is a way that you can look at your problems or your opportunities---a great deal of learning with regard to structure that is worth your careful consideration and I am mindful that having read all of the minutes of the Advisory Committee and the reports of your previous consultants, that through Price Waterhouse and White Weld you have had a rather thorough consideration of lots of that international development banking experience.

In the third area that I would offer some comment on, related to Representative Meekins' question, is the specific applicability of regional and community development experience to some of the structural problems that you are facing. The title of my paper I believe in very strongly and that is that I would urge caution on all of you in several levels. One I think, it is very important for all of us to recognize the very real limit on the capacity of any state government to influence profoundly the course and direction of economic

development within its boundaries and this is one of the areas which Arlon and I certainly share---one of the many areas in which we share a common kind of sense of caution.

Secondly, I think that all of us need to be extremely cautious in anticipating too much impact on the economic development of the state from the Permanent Fund. And, in my eight points that I would like to make, Clark, I think I can bring out the specifics of that in, I hope, at least quick conference. The punchline, of course, in suggesting this caution with regard to the role of the state in economic development and the role of Permanent Fund in economic development is that you have the opportunity of enormous scale, either to waste these tremendous capital resources that you have or to husband them very carefully, both in terms of the maintaining the value of the capital itself and invest in ways which will at least marginally contribute to the overall economic development of the state.

Point One: No development bank, no financial intermediary, can create any economic activity that isn't there in the first place. Development banks and any financial intermediary operate only on the supply side of the economic equation. If there is real economic activity for which there is not available capital, then the intervention of the Permanent Fund can affect that positively and can add economic value to the state. But if there isn't a market, if there aren't sufficient---if the costs of production are too high, the intervention of the Permanent Fund is not going to

affect that at all. Specifically, it is my understanding that at the present time petrochemical industries is not viable on a world-wide basis. The cost of production of petrochemicals in Alaska are too high to be competitive on the world-wide market. Now that may change and then maybe things that will lower those real economic costs. But there is nothing that the Permanent Fund can do to intervene in order to lower the costs sufficiently to compete in the world-wide market. Now that is very, very important, I think, in terms of lots of thinking about the Permanent Fund.

That means, for instance, in terms of Point Number Two, that subsidies are not the issue. We have a very interesting case in point in Massachusetts right now where we have very rapidly growing, high technology companies, between \$50 and \$100 million in sales, that are between 20% and 40% profitable and growing, and growing at the rate of 20% to 40% a year, which have a great deal of difficulty accepting capital in either equity or debt form for their needs. But these companies could be financed on Master Charge, and I think that that is a critical idea. In fact, there may be circumstances where you want to increase the price of capital in the Permanent Fund because it discourages non-economic activity and you want to discourage all of the dogs that will be attracted to the Permanent Fund if there is subsidy available. The issue is the availability of capital.

Point Number Three. The general fund is far more important--- and I am saying this in emphasis to Arlon's point---the general fund is far more important in terms of its impact on the overall economic development of the state than the Permanent Fund. I devote time to this in my paper, and I don't want to repeat any of that now, but the issue of expenditure policy, tax policy and regulatory policy will more profoundly affect economic development than the Permanent Fund. But the key punchline in Point Number Three is that you have got to operate your expenditure policy, your tax policy, your regulatory policy, and the use of the capital resources of the Permanent Fund as part of a coherent economic development effort in the state. If you don't the opportunities for sound investment on the part of the Permanent Fund will be less, the jeopardy of Permanent Fund investments in the state will be greater, and the likelihood of your general expenditure policy through the general fund and your investment policy operating against each other, I think, are very great. I suggest that there is extraordinary opportunity right now for the State of Alaska to think about a coherent overall economic development approach that recognizes the limits of all of its policies, individually and collectively, to affect the economic development of the state, but still is operated in combination, will have a much greater impact than operated separately. Just a simple illustration.. A couple of the issues that I have had the pleasure of talking about the last couple of days is from some of the native corporation areas