

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 0072

100 SCOMM 9: HOUSE SPEC. COMM. ON PERMANENT FUND 1977-78

An alternative procedure would be to have the process start with the investment agencies presenting one-year and three- to five-year plans to the executive for presentation to the permanent committee by the end of the legislative session, i.e., by June 30. Then, the legislative committee would have a responsibility to respond to the executive drafts before the legislative session begins in the following January.

These timetables cover the planning function of the committee and agencies. They must be flexible enough to allow serious interchanges between the agencies and the committee. To allow even more flexibility, the committee should have the power to accept modifications of annual plans during the year, if circumstances change significantly. It should not have the power, though, to insist that plans be changed mid-year. Agencies must have free hand in implementing the plans once they are approved, without unexpected demands from the committee.

The annual review process is the central power of the committee, but even though it is important to have it thorough it must not be overly cumbersome to the investment agencies. The guidelines must leave much flexibility on specific investment choices for the agencies.

It is absolutely imperative that the oversight committee can only specify gross allocations to sectors of the economy and to

regions; individual investment decisions must be made by the individual investment agencies.

The committee also needs the power to require (not merely to request or receive) reports from all applicable agencies in the form and at the times stipulated by the committee. Establishing the proper form for the reports and when they are due is a duty of the committee (section 670).

We would suggest one more power for the committee which the present bill grants to the legislature: power to approve large investment projects, at least within a certain size range. The bill now sets \$1.5 million as the maximum investment size, which an agency (the Alaskan Development Bank) can make on its own (section 44.55.100(e)). It would be more efficient if the committee itself approved loans over this (or some other) size limit, measuring the potential investment against its own guidelines. The legislature could be required to approve all projects above a higher amount, after hearing the committee's recommendations. This would subject only the largest projects to a full legislative review and vote.

The limit (or limits) must be set to capture projects which will have major impacts on the Alaskan economy or large segments of it. Is \$1.5 million realistic? It seems quite low to us. We should set the limit(s) by consulting such sources as the Institute

for Social and Economic Research's "Man in the Arctic Project"; Arthur D. Little's sectoral analysis of Alaska; experienced Alaskan bankers; and various state commissioners.

Sec. 24.20.660. STAFF. The legislative audit division shall provide staff reasonably necessary for the conduct of the committee duties.

This committee is going to have such important and time-consuming tasks that it will need a strong and highly-qualified staff. Without this, either the review and approval process will become a mockery of the legal intent, or the agencies involved will be unnecessarily burdened in dealing with a poorly-run or unsophisticated process. Can the legislative audit division provide all the staff needed by the committee? Will the committee still be able to hire (through the audit division) the outside expert counsel it will need? It should be able and required to use, on a retainer basis, counsel like the Frank Russell Company (which is financial advisory to very large investment funds evaluating the performance of hired money managers), White Weld (which advises the Saudis on the use of their oil revenues), and experts in public investment analysis and long-range growth projections.

We suggest for the committee's consideration a small, separate, high-powered central staff for the committee with appropriate

technical support in critical areas such as (a) evaluating the performance of money managers for the trust function; (b) evaluating the overall long-term economic prospects of the economy and the need for intervention by the development function; and (c) the cost effectiveness of both the development function and the leading edge research and development function for renewable resources.

Perhaps the legislature should appropriate separate operating funds for the committee from either (1) the general fund, or (2) from the annual income of the various parts of the Permanent Fund itself. (The committee might simply submit a budget request to the legislature, whichever of these should be specified in the legislation.)

oh [If the legislative audit committee remains the oversight committee's staff source, this section should at least stipulate that the oversight committee can request certain full-time and retained counsel be allocated for its use.

Sec. 24.20.670. DUTIES. The committee shall

(1) report to the legislature its recommendations relating to the confirmation of suggested appointees to the permanent fund board of trustees, renewable resources development fund commission, and the development bank;

(2) annually review the long-range operating plans of all agencies of the state which perform lending, borrowing or investment functions;

(3) review quarterly reports from the permanent fund board of trustees, renewable resources development fund commission, and development bank policy board;

(4) present a complete report of investment programs, plans, performance, and policies of the permanent fund board of trustees, renewable resources development fund commission, and development bank policy board to the legislature within 30 days after the convening of each regular session.

Powers are what the committee may do; duties are what it must do, using its powers.

As mentioned above (Sec. 24.20.650), the description of the review timetable belongs here; it is the most important duty of the committee and is a thorough elaboration of the present part (2) of this section.

Duty (3) seems fine, but why does it only apply to the divisions of the Permanent Fund? Couldn't it apply to all agencies under the committee's review? As suggested above (Sec. 24.20.600), the legislature must add any agencies beyond the Permanent Fund and renewable resources fund which it wants the committee to oversee. Once they are placed within the committee's mandate, all of these duties should apply to them as well as to the Permanent Fund and renewable resources fund.

Duty (4) could be revised to include the committee's guidelines and all agency plans approved by the committee. Again, it seems more appropriate that it apply to all agencies within the committee's mandate. The 30-day limit fits with the suggestion we made above, that any plans not yet approved should go to the full legislature for action on January 31. Hence, the committee

would send all unapproved plans to the legislature after 30 days of the session, as well as all approved plans. (Are we correct in assuming that the legislative session begins on January 1?)

Four additional duties should be added to this section:

"(5) set reporting requirements for the applicable agencies' ["applicable agencies" should be defined in Sec. 44.55.170] annual reports and any other reports the committee needs from the agencies"

The legal description of this duty should stipulate that the reporting requirements must (a) be set to measure compliance with the committee's guidelines and each agency's short- and long-range plans; and (b) include how well each agency has met the targets set in its plans. These targets must be along the three general dimensions suggested above (sec. 24.20.650): financial, general economic, and social. The financial reporting will include conventional performance measures used by private firms, e.g., return on investments, growth in operations. The economic and social reporting will include the measures suggested above (again, Sec. 24.20.650). The committee should also stipulate analytic procedures for agency programs and large individual projects. We can draw on the experience of international and European development banks (especially Sweden's Statsföretag) to design these.

"(6) do long-range economic projections for the state to be used to establish the committee's annual and long-range guidelines"

Such a task will require that the committee have on retainer econometric modeling consulting services such as those provided either by the Institute for Social and Economic Research's "Man in the Arctic Project" or the Commission of Commerce and Economic Development.

"(7) establish criteria consistent with its own guidelines for review of investment projects ^{and} ~~it must~~ approve or reject, in accordance with sec. , ^{after} including public hearing(s) ^{have been} held in the area(s) where the project would have significant economic impact." [This applies to our suggestion that the committee, not the legislature, be required to approve projects over a certain size, or preferably, within a certain size range. The legislature would have to approve larger projects.]

For this third additional duty the committee will probably want to require that the agency involved provide it with certain information on the potential investment project. In this way, the committee can draw on the expert staffs of the operating agencies, rather than having to hire comparable professionals. This duty would fall within the committee's power to require agencies to report to it in a specified form.

Finally, one more duty should be added to the bill: (8)

each year, on January 1, the committee must recommend to the legislature what percentage of the year's nonrenewable resource revenues should be directed to the Permanent Fund, between 25 and 100 percent. The committee must base its recommendations on its own economic analyses, projections, and guidelines; including consideration of the inflationary effects of the revenues' uses. The statute must also include that, until the legislature votes on the annual percentage (this power we suggest be added to the bill's section 37.13.030), the preceding year's percentage applies to the current year's revenues. /

Sec. 24.20.680. RECORDS. The committee shall keep a complete file of all reports presented to it and all reports presented by it to the legislature or any legislative committee.

No comments; it is fine as is.

CHAPTER 13. ALASKA PERMANENT FUND. [Chapter is not reproduced here; refer to pages 4 to 10 of WORK DRAFT PAPER.]

The trust function of the Alaska Permanent Fund now looms very large in importance in the overall scheme of things. So I have asked one of the leading consultants in advising foundations and corporate pension funds how to structure and plan their large investment resources to comment pro bono in some detail on this function.

Gary Bergstrom is principal consultant to the Ford Foundation at the present time, in assisting them to redesign, restructure, and rethink their investment policies with regard to their \$2 billion endowment. In many ways I think that the Ford Foundation's resources are comparable not only in quantity but also in quality to those of the Alaska Permanent Fund. His comments to me are appended in a separate memorandum.

I would like to make a few fundamental overall comments to the committee to suggest the care with which I think we need to approach this section:

First, it seems to me a reasonable proposition that the moment the oil is removed from the ground and converted into cash it begins to lose value.

Second, in general the history of state investment management and money management to date is one in which performance often has been substantially below that of the private money management of large pension funds or endowments. On the other hand, there are several key states that have established a very high state of the art in investment and money management, including Minnesota, Wisconsin and Oregon.

Third, the state of the art of endowment and investment management has been changing extremely rapidly in recent years.

Fourth, it seems to me to be absolutely critical that the

Alaska legislature bring to the creation of the trust function the very highest current state of the art of investment management in order to be true to the constitutional mandate of the Alaskan voters.

Fifth, it seems to me to be incumbent upon the committee to make the fullest use of the good state experience of Minnesota, Wisconsin and Oregon and that of private money managers such as Bob Greeley of White Weld, Terrence Magrath of the Fidelity Organization, and Gary Bergstrom in order to be sure that this section is as carefully crafted as the creation of the oversight committee, the development function, and the leading edge research and development function.

Finally, perhaps it might be helpful if the phrase "the Alaska Permanent Fund" were used to deal with both the trust function and the development function. In turn it might be useful to refer to "the Alaska Investment Fund" for that 5/6 of the Permanent Fund's resources which go into the trust function; and conversely, to refer to the ~~Alaska Development Bank~~ *Alaska Enterprise Investment corporation* for that 1/6 of the resources of the Permanent Fund which go into the development function.

CHAPTER 55. ALASKA DEVELOPMENT BANK.

This entire chapter needs to be ordered more logically, as the other chapters are. The sections should be in an order

similar to the following: creation; funding; purpose; policy board creation, etc.; investment committee creation, etc.; then powers of each; duties of each; types of eligible investments and criteria for selecting them (probably one section for direct investments and one section for investments in community development organizations); boiler plate (conflict of interest, definitions, etc.).

Sec. 44.55.010. CREATION OF BANK; FUNDING. (a) There is created the Alaska Development Bank. The bank is a public corporation and government instrument in the Department of Revenue but has legal existence independent of and separate from the state. The exercise by the bank of the powers conferred by this chapter is considered an essential governmental function of the state.

(b) One-sixth of the receipts of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses allocated to the permanent fund shall be paid directly into the bank until a total of \$100,000,000 has been paid in.

Part (a). The wording referring to the Bank's relation to the Department of Revenue should be identical to that describing the Investment Fund's relation with the Department (sec. 37.13.040). One of the phrases should be changed. Which wording is better: "within but not of the Department . . ." (37.13.040); or "in the Department . . . but has legal existence independent of and separate from the state" (44.55.010)? The phrase chosen should also be used in the renewable resources fund chapter. Also, should the sentence with the phrase ". . . considered an essential government

function . . ." be added to Sec. 37.13.040 and the renewable resources fund chapter?

Part (b). This part is fine as far as it goes, but it needs more detail. What is the minimum amount of paid-in capital the bank must have before it begins operations? We suggest \$50 million. We also need to have projections showing when the bank's portion of the oil revenues will reach \$50 million and \$100 million. These are needed before the December 9, 1977 committee meeting.

*also no law
the activities until
AEIC has
written up
operating
regulations and
submitted for
review by
committee*

Two additional parts could be added: Part (c). The law could stipulate that income derived from the bank's use of the paid-in capital will be retained by it, until tapped by the legislature (as we suggested in sec. 37.13.010, part (3)). That is, the bank is not required to pay dividends to the state. (This is the way the European Investment Bank and Germany's KW [Kreditanstalt für Wiederaufbau] operate. The Statsföretag in Sweden does pay dividends to the national government, when its performance warrants such payments. It did have an initial grace period, though, when no dividend payments were required regardless of the institution's performance.)

*return
earnings
to AEIC*

Part (c). Differential requirements must be established statutorily for the bank's equity and debt activities. These could be set in this section or below in section 44.55.090. For

equity, the bank should not be allowed to leverage its resources at all, so no reserve requirements are needed at all. The leveraging of funds used for loans or loan guarantees and the required reserves are discussed in Sec. 44.55.090 (b) (4), because that current section already refers to leveraging limit. The reserve requirements for guarantees are now set in Sec. 44.55.100 (b).

The key point here is that differential reserve requirements and differential leveraging requirements need to be stipulated for different uses of funds such as equity investment or debt lending or guarantees; or for different qualitative uses of funds such as productive enterprise or community development.

Sec. 44.55.020. ALASKA DEVELOPMENT BANK POLICY BOARD. (a) There is established the Alaska Development Bank Policy Board, consisting of the commissioner of revenue, the commissioner of commerce and economic development, the commissioner of community and regional affairs, or their designees, and six members to be appointed by the governor and confirmed by a majority of the members of the legislature in joint session. Two members shall have broad experience in investment finance, one member shall represent organized labor, and three members shall represent local communities.

(b) The six appointed members shall serve for six-year terms, and they may be reappointed. Terms shall be staggered. Initial terms shall be two members serving for two years, two members serving for four years, and two members serving for six years. Members continue to serve until their successors are appointed and confirmed.

(c) The chairman of the governing body of the renewable resources development fund serves as chairman of the policy board but is not a voting member.

(d) A majority of the policy board members constitutes a quorum for the transaction of business by the board. Decisions of the board shall be taken by a majority vote, including not less than a majority of the appointed members. The board shall hold at least one public meeting each year.

(e) Members of the policy board receive \$ _____ per meeting day if they attend the meeting and are entitled to per diem and travel allowances as are provided by law for members of state boards and commissions.

Part (a). The balance on the board seems fine, but perhaps we could stipulate more exactly the qualifications of the appointive members. One finance expert could have "broad experience in equity investments"; the other, "in medium- or long-term industrial lending." Also, the community-level representatives could be more precisely defined to make sure they cover a range of interests. At least one could represent a municipality. Another might be from a native regional corporation. The third could be someone involved in and with extensive experience in community development. Or is there some other type of local group that should be specifically mentioned--a large community versus a small community, perhaps? One in a less-developed area?

Part (c). The chairman should not be the chairman of the renewable resources fund. Perhaps the chairman could be appointed by the Governor from the six "public" board members (excluding the labor representative and the two finance experts). The chairman should probably serve "as chairman at the pleasure of the Governor." *agree*

Part (d). All of the board's meetings can and should be public, except those which deal with specifically defined confidential

matters. These exceptions should include discussions of the qualifications of present or potential members of the bank's investment committee.

Part (e). What is the payment to be? Are the public members (including the state officials) to receive it? (If it is \$250 per meeting, each meeting could cost the bank \$2250 plus per diem and travel expenses.)

How often must the board meet? Perhaps it should be required to meet at least once per quarter. This could be added to this section or to 44.55.040 (Duties of the Policy Board).

Sec. 44.55.030. REMOVAL AND VACANCIES ON BOARD. (a) The governor may remove a policy board member from office by and with the consent of a majority of the members of the legislature in joint session. The joint session shall be held within 10 days from the date of removal if the removal occurs while the legislature is in session or within 30 days of convening of the legislature if the member was suspended. If the legislature is not in session, the governor may suspend a member of the policy board for cause. Upon suspension, a board member may not participate in policy board business and may not be counted for purposes of establishing a quorum. A suspended member shall continue to receive his salary as a board member until the legislature in joint session consents to his removal. If the legislature refuses to consent to his removal, the member shall be reinstated to his position.

(b) A vacancy arising on the policy board shall be filled by appointment by the governor and confirmation by a majority of the members of the legislature in joint session, and an appointee to fill a vacancy shall hold office for the balance of the term for which his predecessor on the board was appointed. If a vacancy arises on the board while the legislature is not in session, the governor may appoint an interim board member who shall exercise all powers and receive the salary of a permanent board member until such time as the legislature in joint session fails to confirm the interim member's appointment.

(c) A vacancy on the policy board does not impair the authority of a quorum of the board to exercise all the powers and perform all the duties of the board.

Part (a). Shouldn't the phrase "for cause" be added after "from office" in the first sentence?

Sec. 44.55.040. DUTIES OF THE POLICY BOARD. The policy board shall

(1) select and appoint the president and other members of the Alaska Development Bank Investment Committee established in sec. 50 of this chapter;

(2) annually review and approve long-range operating plans, the budget for the forthcoming year, and the financial plan for the following years;

(3) have responsibility on behalf of the bank for relations with the general public, legislature, executive branch, local communities, and interest groups concerning all things excepting only those matters that are the responsibility of the investment committee;

(4) review quarterly reports from the investment committee concerning investment decisions and investment supervision, but the board may not impose an investment decision upon, or override an investment decision of, the investment committee;

(5) review, consider and approve policies;

(6) establish an audit committee, consisting of the commissioner of revenue and other members of the policy board to be designated by the commissioner, which shall select independent outside auditors, and receive all audit reports.

Part (2). Change to "annually review and approve annual and long-range (three- to five-year) investment plans for bank." These are the plans that are submitted to the oversight committee.

After the above phrase, we could add something like "these plans must comply with requirements set by the legislative oversight committee (correct name and legal citation) and take into account that committee's guidelines."

Part (3). We could add the phrase "including negotiating with the legislative oversight committee for approval of the bank's annual and long-range plans."

Part (4). This section should also include annual reports, according to standards set by the legislative oversight committee.

Part (5). Articulate types of policies: according to dimensions used in the bank's annual and long-range investment plans, and any other dimensions the policy board chooses, so long as the policies do not stipulate particular investment projects the investment committee must finance.

A Part (7) might be added: negotiate with the executive or legislative branch and accept or reject proposals for the bank to administer certain programs or investment projects for the state.¹ The funding for these programs and projects would come from appropriations or other funds from the state, not from the bank's own funds; and the program or project would be administered according to guidelines set by the executive and/or the legislative branch and accepted by the policy board. The board would be required to consult with the investment committee before making such an agreement.

This agreement could involve such things as interest subsidy programs for certain types of investments, special infrastructure investment projects, or concessional loan programs. It would be very similar to the arrangements that Germany's Kreditanstalt für Wiederaufbau (KW) has with its national government. It has several

¹ Bill 298 had a similar clause: it allowed the legislature to appropriate funds for subsidizing investments "which are of such high priority that special terms and conditions are appropriate."

advantages: (1) the government can take advantage of the bank's expert staff; (2) the bank can supplement its own programs with those subsidized by the state, offering more to its clients and closely integrating its programs with those of the state; (3) state subsidies are explicit and can be targeted to certain types of investments; and (4) the subsidies are covered by outside sources, not the bank's. The Alaska Development Bank, like Germany's KW, might choose to use some of its own surplus funds to provide its own subsidies for certain types of projects, though. This is the bank's choice, though; the state cannot force it to do so. (This choice by the bank could, however, be subject to the approval of the legislature.)

Sec. 44.55.050. ALASKA DEVELOPMENT BANK INVESTMENT COMMITTEE.

(a) There is established the Alaska Development Bank Investment Committee, consisting of the president and four members appointed by the policy board. No member of the policy board may be a member of the investment committee. Members of the investment committee shall be persons of recognized competence and wide experience in investments, finance, and other business management-related fields. Members may be reappointed and continue to serve until their successors are appointed. The president and members shall serve for four year terms. Terms shall be staggered. Initial terms shall be one member serving for one year, one member serving for two years, one member serving for three years, and one member and the president serving for four years.

(b) Four members of the investment committee constitute a quorum. Decisions of the committee shall be taken by majority vote.

(c) Members of the investment committee are in the exempt service under AS 39.25 and receive an annual salary equal to that of a commissioner of an executive department.

Part (a). The president may be a member of the investment committee, but the way it is structured now he must be a financial expert with no skills or understanding of public investment in general, or community development. At least one member of the committee should have such skills and perhaps the president should be required to be so, specifically. Also, the president should serve "at the pleasure of the policy board." Where are procedures to cover removal or vacancies on the investment committee? Also, where are the president's powers and duties articulated? Sec. 90 of Bill 298 did this. We needn't include as much detail in this bill, but we should at least include that the president is responsible to the policy board for the management and staff of the bank. We could use wording from 298: "sole responsibility of organization, appointment, dismissal and remuneration of all other staff."

Based on experience in Connecticut and elsewhere, this committee should have different divisions for the different types of transactions it must review: at least one for equity and one for debt. These could be subcommittees and act in behalf of the full committee, subject to the committee's overview. (The entire committee could choose to vote on any particular investment.) The president could serve on both subcommittees. This structure is similar to that used in some European development banks.

With the subcommittee structure, the full committee would probably have to have more members, at least seven so that four could serve on each subcommittee, the president voting only in case of a tie on the subcommittees. If subcommittees are used, the skills of their members (and hence, those of the full committee) must be specified more exactly.

This is very critical, because the skills required for analyzing productive enterprise and those required for analyzing community development projects are quite different, even though both are income-producing.

For community development projects, the investment committee could be required to have a special screening committee to screen community-based projects according to community development criteria approved by the policy board. Should the policy board appoint this screening committee? If so, it should be added to its duties above (Sec. 44.55.040).

Part (b). If the committee remains at five members, a quorum of four is fairly stringent. Do we want this? If the committee is enlarged, what should a quorum be? What about a quorum for the suggested sub-committees?

Part (c). It appears that all investment committee members are full-time employees. First, is this necessary? Experience in other development banks shows that they may be paid on a per meeting basis. (The Connecticut Development Authority uses this technique.) If the committee is enlarged, as suggested above, should all members still be full-time employees? I doubt it.

Second, if they are full-time, why are their salaries set as state employees? They are bank employees, not employees of the state, and the policy board should be able to set their salaries (or per-meeting rates). Also, if used, would the state salaries stipulated here be high enough to attract the talent needed on the investment committee? I doubt it.

Sec. 44.55.060. DUTIES OF THE INVESTMENT COMMITTEE. The investment committee has sole responsibility to approve all investment proposals.

The duties of the investment committee must be articulated here. If not, at least we need to add that they must operate in accordance with the bank's annual and long-range plans approved by the policy board and the oversight committee. Also, their liability for their investment decisions should be stated (or waived) here. Must they be bonded? Many development banks bond their boards, either as individuals or as a group. Should the policy board also be bonded?

Sec. 44.55.070. BUDGET. The development bank is subject to the provisions of the Executive Budget Act (AS 37.07).

What does this section mean? Should not the Bank be funded by its own income? We could use this section to state that the bank is required to be self-financing and that the legislature may but is not required at any time to appropriate funds to the bank to meet the bank's obligations. This provides an escape

Yes, but its operating budget still should require legislative approval - but perhaps only by oversight committee.

valve, but does not in any way obligate the legislature--a technique used in other states. Unfortunately, I am not clear about what the provisions of the executive budget act are, and therefore what its consequences are for the Alaska Development Bank, based on the experience of other state-funded development banks around the world.

Sec. 44.55.080. PERSONNEL OF BANK. The policy board and investment committee members and officers and staff of the development bank are in the except service under AS 39.25.

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Fine as far as it goes, but where is information on the bank's staff? It should be included here and/or above, as suggested in Sec. 44.55.050 (a): the president is solely responsible to the policy board for the hiring, firing, and remuneration of all staff and counsel.

Sec. 44.55.090. PURPOSES AND POWERS OF THE BANK. (a) The purpose of the bank is to provide a means of conserving a portion of the state's revenues from mineral resources to the ultimate benefit of present and future generations of Alaskans. The revenues so conserved shall be invested in income-producing investments which will provide further benefits to present and future generations of Alaskans. Further benefits may be derived through use of the bank to

- (1) assist the diversification of the economy of Alaska by making sound investments in Alaska's renewable and nonrenewable resources;
- (2) seek to smooth the long-term cyclical pattern of growth of the Alaska economy;
- (3) encourage and assist the participation of private capital, from both inside and outside Alaska, in private enterprises of benefit to Alaskans;

(4) promote the investment of public and private capital for community development purposes;

(5) supplement private investment when sufficient private capital is not available on reasonable terms and conditions and when other state or federal financial assistance is not available.

(b) In carrying out the corporate purposes of the bank, the policy board has power to

(1) adopt, alter and use a corporate seal;

(2) prescribe, adopt, amend, and repeal bylaws;

(3) sue and be sued in the name of the bank;

(4) borrow funds, and in that connection furnish such collateral or other security as it determines, except that bank borrowing may not exceed one-half of its paid-in capital;

(5) guarantee obligations of another corporation or legal entity in order to facilitate their sale;

(6) enter into agreements necessary or convenient in the exercise of its powers and functions;

(7) acquire, hold, use, lease, sell or otherwise dispose of property of any kind, real, personal or mixed, or any interest in it;

(8) contract with state, federal and other agencies to develop needed information and analyses;

(9) do all acts and things necessary, convenient or desirable to carry out the powers granted or implied in this chapter.

(c) In carrying out the corporate purposes of the bank, the investment committee has the power to

(1) invest, in such form as it considers appropriate, including without limitation, by purchase of the capital stock of, or the lending of money to, projects, except that any investment in the capital stock of or other ownership interest in such project may not exceed 49 per cent of the capital stock of, or other ownership interest in, the project, and no loan or other investment in the project by the bank may exceed 90 per cent of the cost of the project unless, in the judgment of the committee, additional amounts must be loaned to protect the interests of the bank;

(2) deposit bank funds, or invest bank funds in such obligations as it may determine;

(3) buy and sell securities the bank has issued or guaranteed or in which it has invested;

(4) purchase currently sound evidence of indebtedness from the tourism fund, the agricultural revolving loan fund and the small business development loan fund if the loan was made after the effective date of this Act and if the loan meets the criteria of sec. 100 of this chapter;

(5) do all acts and things necessary, convenient or desirable to carry out the powers granted or implied in this chapter.

As mentioned above, this section should precede most of the above sections.

Part (a). Purposes seems fine.

Part (b).

(2) Add to end: "for the bank's operations" (not just the policy board's operations).

(4) This section sets a very conservative maximum debt to equity ratio of 0.5 to 1. We agree that the bank should have a conservative one, but we can draw on the experience of other development banks to set it. The Canada Development Corporation has a debt limit of 40 percent of its paid-in capital, but it makes very high-risk investments. (Remember, this debt can only be used for the bank's lending and guaranteeing activities, not for its equity investments. We have already made this requirement, above in 44.55.010 (c).)

The European Investment Bank offers more relevant experience. According to its corporate rules, it can make guarantees plus loans up to 250 percent of its paid-in capital. In practice, it maintains a ratio of equity to debt of around 1.3 to 1, because its accumulated reserves are so high. This conservative ratio helps it have privileged access to European debt markets. The Statsföretag Group in Sweden had a ratio of 1.6:1. We must very carefully set a maximum ratio allowed for the bank. (With so much

paid in capital, the bank may never borrow more than one-half of paid-in capital, but we should set a sensible limit for a sound financial structure.

We must also decide whether to set minimum reserve requirements for guarantees and loan defaults. Here we must also draw on the experience of similar development banks.

In this or an additional section we should unambiguously state that the state of Alaska is not responsible for the bank's liabilities. Experience with other American development banks shows how critical it is to put this in writing. "Moral" obligations are no longer very popular and certainly the state should leave no doubt in investors' minds.

(6) We could add here, "including agreements for project or program administration for the state of Alaska, according to conditions mutually agreeable to the bank and the state." We already discussed this possibility above, 44.55.040 (7).

Part (c). (1) We have several comments on this section:

a. The way it is now worded, the committee can make loans of any term, secured or unsecured. Is this what you intend? If not, the limit should be added or in sec. 44.55.100. In any event, this section should probably be amended so it reads, "in accordance with other requirements of this chapter", to acknowledge the entire section 44.55.100 and the necessity to comply with the approved plans.

b. Based on experience in many American development finance banks, this section should set a limit on the percentage of a loan the bank will agree to make and the percentage of the project costs the loan can cover. For example, some states make loans up to 90 percent of a mortgage, which can cover up to 90 percent of project costs. These percentages usually vary by loan use (e.g., land and plant versus equipment). The limits are set for three very important reasons: (1) they help the development bank leverage its funds; (2) they ensure that risk is shared with other lenders and with the borrower; and (3) they ensure that there is an extra check on the bank's loan decisions by at least one outside source.

Some states have limits as low as 40 percent of loan amount on 90 percent loan coverages. We recommend setting a maximum of no higher than 90/90 for plant and 80/90 for equipment. We should consider going lower, though. Also, if working capital loans are also made, we must set limits for them.

I would counsel against making working capital loans, for three essential reasons: first, there is no major capital gap here; second, the commercial banks are quite capable of making these loans and there is no reason for the state to compete with them; and third, we need to develop all of our financing mechanisms in basic cooperation with the private market and a system on the longer-term equity and debt financings which they are not so able to make.

c. This is actually a corollary to the above point: similar limits must be set on loan guarantees made by the bank. Again, some of the best state guarantee programs have limits of 40 percent on the share of a mortgage they will guarantee.

(2) this section could be amended to stipulate that it refers to surplus bank funds; that these funds should be deposited or invested according to the prudent-person clause; and that they or a portion of them must remain liquid enough to be activated for use according to the purposes of the bank.

Sec. 44.55.100. INVESTMENTS. (a) In making investments, the investment committee and staff shall exercise the judgment and care under the circumstances then prevailing which a person of ordinary prudence, discretion, and intelligence exercises in the management of his own affairs taking into consideration the probable income from the investments as well as probable safety of principal.

(b) An amount equal to at least 150 per cent of all guarantees by the bank shall be invested in investment-grade securities.

(c) The investment committee may invest not more than 50 per cent of the resources of the bank to provide a reasonable proportion of longer-term investment capital for financing the establishment, improvement, and expansion of productive private enterprises which will benefit Alaskans, and for which sufficient capital is not available from other sources on reasonable terms. These investments may take the form of equity, debt, or debt guarantees.

(d) The committee may invest no more than 50 per cent of the resources of the bank in financing a reasonable proportion of the longer-term investment capital needs for community development projects of municipalities and public corporate entities and private dwellings in Alaska for which sufficient financing is not available from other sources on reasonable terms. These investments may take the form of debt or debt guarantees.

(e) The committee may not invest more than five per cent of the resources of the bank or \$1,500,000, whichever is less, in a single project unless the legislature has approved the investment by concurrent resolution.

(f) The committee may not undertake any financing for which, in its opinion, sufficient private capital could be obtained on reasonable terms.

(g) The committee may not assume responsibility for managing any enterprise or project in which it has invested and may not exercise voting rights for that purpose or for any other purposes which, in its opinion, properly is within the scope of managerial control.

(h) The committee shall only undertake its financing on terms and conditions which it considers appropriate, taking into account the terms and conditions normally obtained by private investors for similar financing, the requirements of the enterprise or projects, the risks being undertaken by the bank, and the participation of other investors.

(i) The committee may seek to revolve the bank's funds by selling its investments to other investors whenever it can appropriately do so on satisfactory terms.

(j) The committee shall seek to maintain a reasonable diversification in its investments.

(k) The committee shall only consider investment proposals after the applicant for an investment has submitted a detailed proposal to the committee's staff and the staff has prepared a written report recommending the investment after a study of its merits.

(l) The committee shall analyze the economic and other effects of an investment decision, including the effects on employment, income distribution, environment, health, social and other factors. The committee shall be sensitive to the views of affected local communities and shall include an analysis of those views in proposals for large investments.

(m) The committee may guarantee qualifying loans made by financial intermediaries in order to facilitate investment by the intermediaries in specific enterprises or projects whose individual financing requirements are not, in the opinion of the committee, large enough to warrant its direct supervision.

(n) The committee shall provide for operational and performance evaluations (post-audits) of its investments and investment programs and report the results to the policy board.

(o) Nothing in this section prevents the investment committee, in the event of actual or threatened default on any of its investments, actual or threatened insolvency of the enterprise in which the investment has been made, or other situations which, in the opinion of the investment committee, threaten to jeopardize the investment, from taking such action and exercising such rights as it may consider necessary for the protection of its interests.

Part (a). The prudent-person clause should not apply to the Alaska Development Bank's activities. It must invest in income-

producing projects, but it is supposed to maximize benefits to the Alaskan people, financial and nonfinancial.

A sharp distinction must be made between the extremely rigorous money management standards which must be applied to the trust function of the Permanent Fund and to the less rigorous but nevertheless income-producing standards that must be applied to the development function of the Alaska Development Bank. The standards of the Alaska Development Bank should be much closer to those of the World Bank, or the European Investment Bank, or the Inter-American Development Bank, or the Connecticut Development Authority and the Community Development Finance Corporation. Each of these institutions is required to make income-producing investments and to live within their own balance sheets, but they are not required to make the same return as the private market. It is not necessary for them to make that same internal rate of return, because their external return to the state of Alaska more than compensates for their lower internal rate of return.

Part (b). See our comments above, Section 44.55.090, Part (b) (4).

Part (c). Does this 50 percent mean half of all equity investments and half of all loans? What exactly does it apply to: debt plus equity together or separate? This section should make clear that these are direct investments, loans or guarantees for

projects in contrast to those of Part (d). Are developers eligible as project owners? Experience in other states strongly suggests that project owners must be project users. (This must be worded very carefully.) Joint ventures or participation loans with community development organizations also fall within Part (c).

Part (d). Again, what exactly does this 50 percent apply to? Also, the section should include equity as well as debt and debt guarantees.

This entire section must be given far more detail on the function described. The bank is to use 50 percent of its resources to invest in community development organizations (CBOs)--not directly in community development projects nor in private dwellings. CBOs must be defined here or in Sec. 44.55.170. Does it include municipalities, any regional development organizations? What community development bodies are eligible? How must eligible bodies be structured? What is their board structure? Who do they represent? What types of financial instruments must they use? What types of projects do they support? All these questions must be answered. Fortunately, several other states, especially Massachusetts with its CDFC, have already grappled with the questions and we can learn from them.

In my judgment, this was the least well developed section of HB 298 or 300. Those drafts were quite muddy in defining what

was a legitimate community development organization or a legitimate income-producing project. It might be useful to refer back to my comments on pages 54-59 of the July 11 report and be sure that we use the highest current state of the art of community development finance in articulating this section of the proposed House bill.

This section (or section m, below) should also allow the bank to also have a sort of "global loan" program, similar to that of the European Investment Bank. The Alaska Development Bank could lend to regional development corporations so they, in turn, could lend according to criteria set by the bank. This would be similar to Sec. 120(9) in Bill 298. For further background, see pages 92 to 116 of my second report to the committee, dated 9/14/77.

Part (e). We have already suggested that \$1.5 million may be too low a limit. See our comments, above, sec. 24.20.650.

Part (g). Why shouldn't it be able to exercise voting rights as any other equity investor in a project? It has already been limited to a minority ownership in any project. Also, the limit to "not assume responsibility for managing . . ." appears to conflict with Part (o), below. It should be able to do this temporarily, if its own investment is threatened. In fact, in order to be a prudent investor, it must.

Part (l). We should stipulate here that the analysis should

be in accordance with the reporting procedures set by the oversight committee. It must include social and economic analysis as well as financial. The standards for both need to be spelled out.

Part (m). See our comments in Part (d) above. Why shouldn't the bank also be allowed to make loans to such intermediaries? If so, how large can the loans be and must they be participation loans? What types of financial intermediaries are eligible? What criteria must they use in making the investments or loans? How small are these investments or loans (i.e., what is the meaning of "not . . . large enough")? Shall this be left up to the committee or be stated in the legislation?

Sec. 44.55.110. INITIAL DETERMINATIONS. Before beginning its financing operations, the policy board shall render a detailed report to the legislature which shall

(1) define the renewable resource industry sectors which need financing for expansion of existing projects or the development of new projects;

(2) define the size and nature of projects which are feasible for bank financing;

(3) determine specific projects which are feasible for bank and private financing;

(4) determine the availability of private investment capital for the projects it determines are feasible;

(5) forecast the capital requirements of the bank for the first three years of its operations.

Good, but this report should be sent to the executive branch's economic development staff and the legislative oversight committee for review and comment before it is sent to the legislature. Must the legislature approve it?

Sec. 44.55.120. REPORTS AND PUBLICATIONS. The policy board shall publish an annual report to the governor, legislature and the public. Each report shall include financial statements audited by independent outside auditors, a statement of the amount of money received by the bank from each source during the period covered, a statement of bank investments, a description of bank investment activity during the period covered by the report, an analysis of economic and other effects of investment decisions including, but not limited to, the effects on employment, income distribution, environment, health, social and other factors, and any other information the policy board believes would be of interest to the governor, the legislature and the public. The bank may also publish such other reports as it considers desirable to carry out its purpose.

Add ". . . according to the standards set by the legislative oversight committee. . . ."

Sec. 44.55.130. CONFLICT OF INTEREST. (a) Members of the policy board and investment committee are subject to the provisions of AS 39.50.

(b) Members of the investment committee shall disclose their financial interest in an investment proposal and disqualify themselves from voting on any investment proposal in which they have a financial interest. The committee may not make an investment in any project or enterprise in which officers of the bank have a financial interest. Members of the policy board are prohibited from all attempts to influence the investment committee, its president or staff in the discharge of their ordinary operating duties. All officers of the bank in the discharge of their offices owe their duty entirely to the bank and no other authority.

We aren't sure what the provisions of AS39.50 are, but we assume they are standard conflict of interest restrictions.

Why is the policy board prohibited from influencing the investment committee? The policy board shouldn't be allowed to influence individual investment decisions, but the essence of their role is to "influence" and guide the actions of the bank's investment committee and staff. See comments in July 11, 1977 report.

Sec. 44.55.140. POLITICAL ACTIVITIES. The members of the policy board, members of the investment committee, and officers and staff of the bank may not engage in partisan political activities. The resources of the bank may not be used to finance any partisan political activities.

Sec. 44.55.150. PUBLIC ACCESS TO INFORMATION. Information in the possession of the bank is a public record, except that information which discloses the particulars of the business or affairs of a private enterprise or investor is confidential and is not a public record. Confidential information may be disclosed only for the purposes of an official law enforcement investigation or when its production is required in a court proceeding. These restrictions do not prohibit the publication of statistics presented in a manner that prevents the identification of particular reports, items, persons, or enterprises.

Sec. 44.55.160. TAX EXEMPTION. The bank is exempt from all taxes and assessments in the state. All security instruments issued by the bank, their transfer and their income are exempt from all taxes and assessments in the state.

These three sections are fine; no comments on them, at least not yet.

Sec. 44.55.170. DEFINITIONS. In this chapter

- (1) "bank" or "development bank" means the Alaska Development Bank;
- (2) "board" or "policy board" means the Alaska Development Bank Policy Board created by sec. 20 of this chapter;
- (3) "business enterprise" means a private corporation, firm, partnership or sole proprietorship;
- (4) "committee" or "investment committee" means the Alaska Development Bank Investment Committee created by sec. 50 of this chapter;
- (5) "renewable resource project" or "project" means property of a business enterprise used in connection with
 - (A) making, processing, preparing or producing in any manner goods or products of agriculture, fisheries, or forestry; or
 - (B) outdoor recreation.

More definitions are needed. "Productive, private enterprise" (44.55.100 (c)): does this include manufacturing, commercial, service? If so, how are each of these terms defined? How are community development organizations defined? (See questions, above, 44.55.100 (d).) How about "investment grade securities" (44.55.100 (b)) "Applicable agencies" for the oversight committee could be defined here, too.

We must comb through the bill to make sure all other ambiguous terms are clearly defined. Fortunately, we have many other pieces of state legislation to draw on for good suggestions for many of the definitions that we'll need.

Sec. 4. AS 39.25.110 is amended by adding new paragraphs to read:
(21) members of the policy board and investment committee, and the president, officers, and staff of the Alaska Development Bank;
(22) members of the board of trustees, the executive director, and staff of the Alaska Permanent Fund Board of Trustees.

Sec. 5. AS 39.50.200(9) is amended by adding new subparagraphs to read:
(NN) Alaska Development Bank Policy Board and Alaska Development Bank Investment Committee;
(OO) Alaska Permanent Fund Board of Trustees.

Sec. 6. This Act takes effect immediately in accordance with AS 01.10.070(c).

Fine; no comment on these three sections now.

We suggest that two additional sections be added to the draft.

Addition A: High Noon Provision

(This section would apply to entire Permanent Fund and renewable resources fund, so it could be added right before or after Sec. 37.13.030.)

After 9.5 years, the operations of the entire Permanent Fund should be subject to a fundamental review by a joint executive-legislative commission. Half the members could be appointed by the Governor, the other half by the speaker of the house and the senate president, jointly. Total membership could be about fifteen. The odd member could be the Governor or some outsider on whom the governor and the legislative leaders agree.

This commission would begin its review 9.5 years after the Permanent Fund is created. It would review the Fund's achievements, how effectively it was implementing its purposes, and whether those original purposes were well chosen to benefit Alaskans. After six months, the commission would report to the governor and the legislature whether the Fund should continue operations and, if so, with what modifications. The commission's report would also be available to the public.

The commission would have a small staff funded by an appropriation, approved by the legislature, from the Permanent Fund's retained earnings.

It is critical that this "high-noon provision" be incorporated into the enabling legislation, so there is some mandatory and fundamental review process of the institution once it is fully operational and has a track record. We have found that many similar institutions have drifted away from their original purposes or outlived their original usefulness. Without some automatic trigger for a fundamental review, they continue indefinitely. Their management has a stake in preserving them and inertia is on their side. Even such a commission review may not be able to swing an existing institution back on course, but at least it has a fair chance of doing so.

Addition B: Technical Assistance Subsidiary

This provision may not be needed at all; but if it is, it could be added as a section of chapter 55, perhaps after section 44.55.110.

This would be a subsidiary to the Alaskan Development Bank to provide technical assistance to community development organizations eligible for funding from the Bank. These organizations probably need technical assistance to be able to screen and choose viable investments in their communities and do feasibility studies on them. The assistance could be in the form of convertible grants; i.e., grants that would be paid back, if an organization's financial performance reached a certain level of success.

It is critical that this subsidiary (a) is arms-length from the Bank itself, so that it is not involved in choosing the organizations or projects the bank invests in; and (b) is funded separately from the investment part of the Bank, with an appropriation from the general fund or from the Bank's retained earnings (approved by the legislature). It could revolve its grant funds, if and when they were paid back, reducing its need for annual appropriations.

The subsidiary could be structured similar to an institution now being designed in Massachusetts to provide technical assistance to community development corporations. In addition to offering convertible grants to organizations, it could support a network between them so techniques, new skills, and experience could be exchanged. The network could also facilitate joint ventures between community development organizations.

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THINKING ABOUT THE ALASKAN PERMANENT FUND:
A CAUTIOUS APPROACH FOR ALASKAN POLICYMAKERS

July 11, 1977

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THINKING ABOUT THE ALASKAN PERMANENT FUND:
A CAUTIOUS APPROACH FOR ALASKAN POLICYMAKERS

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INTRODUCTION: A Sense of Limits

The Chinese character for the word "crisis" is a combination of two other characters--"danger" and "opportunity." This could well be the symbol for the Alaskan Permanent Fund. As an outsider to Alaska who has worked for the last eighteen years in development banking and for the last thirteen in community and regional economic development, I am awed by both the opportunity and the danger posed to Alaskans by the Prudhoe Bay oil revenues and the challenge of creating an Alaskan Permanent Fund. I agree with Arlon Tussing that this is "an absolutely unique situation," different from any with which I have previously dealt in Asia, Europe, or the United States.

This leads me, as an outsider, to be doubly careful: first, in a short period of time I can only begin to understand the Alaskan political economy; second, I do not want to be precipitous in proposing specific solutions for the Alaskan economy based on experience in quite different settings.

In this initial memorandum to you, therefore, it seems most appropriate for me to limit my observations to three matters:

First, I would like to suggest a way in which you as Alaskan

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policymakers might approach the problem of thinking about the uses of the Permanent Fund as one aspect of an overall Alaskan Economic Development Plan designed to prepare for the day when the Prudhoe Bay oil reserves are no longer contributing so handsomely to the Alaskan treasury.

Second, I would like to suggest for your consideration some general principles concerning the structure of the Permanent Fund as a development bank in terms of its purposes and powers, legal organization, management and capital structure, which have a general applicability irrespective of your particular goals for the Alaskan economy over the next twenty years.

Third, I would like to suggest a few specific ideas concerning the especially difficult tasks of community and regional economic development, based on the experiences of others.

In making these observations, I am mindful of your unparalleled opportunity to use these resources to build a strong, permanent economy through investments which produce both a reasonable internal rate of return on investment to the Permanent Fund, and a reasonable external rate of return to the economy as a whole and to the treasury of the state. On the other hand, I am equally mindful of the parallel danger that these resources could either be wasted through improper management or improperly employed in ways which create far greater distortions to the

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Alaskan economic base or to some of its specific sectors, regions and communities.

It is important for all of us to realize that the dangers of economic distortion are particularly acute in development banking. I realize that the use of the Permanent Fund as a development bank is only one alternative which you are considering. However, since development banking is my professional field it is the only alternative upon which I will comment.

Because development banking is a somewhat "trendy" idea these days, there is the very real danger of creating a development banking institution which is not sufficiently thought out. Some of the specific dangers include designing a development bank with conflicting goals, or with a capital structure which is ill-suited to carry out those goals, and/or with a management likely either to be inefficient or else unaccountable to public policy governance by the executive or the legislature. Even more serious, there is the danger of proposing a development bank to solve a problem which is not a financial one--that is, one in which the solution does not lie in either reducing the cost or increasing the availability of capital. If, however, the problem is in fact a financial markets problem, it may well be that it is caused by some existing form of governmental intervention which is seriously dislocating the financial marketplace. The least expensive

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solution in that case would be to remove the governmental regulation, rather than to create one more governmental development banking "gimmick."

Finally, there is a tendency to disregard or to misapply the vast body of multinational and national development finance experience that has accumulated in Third World countries and in Europe and Canada. It is my understanding that Price Waterhouse and White, Weld have given the state a systematic analysis of that experience.

When it comes right down to it, development banking is the most direct, aggressive, and high-risk form of public economic intervention. This suggests that it should be used with great caution. Your own experience with some thirteen state revolving loan funds would seem to confirm the fact that development funds created with high hopes often do not achieve the goals for which they were intended. What is called for, therefore, is a careful, step by step analysis of the nature of the specific economic problem before you. Then, after carefully weighing the relative costs and benefits of different options, you should select the most efficient, cost-effective solution--a solution specifically tailored to stimulate real economic development in Alaska.

As an outsider, I cannot determine what your economic goals should be. On the other hand, I can, perhaps, suggest a way of

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looking at the limited aspects in which the Alaskan Permanent Fund, as a development bank, can be a part of your overall effort to use the full resources of the Alaskan state government to help create a sound, balanced, broadly-based economy.

The following outline proceeds step by step through a series of questions which may help you review your design of the Alaskan Permanent Fund in terms of your economic goals over the next twenty years. These questions are divided into three units:

- * First, what is the nature of real economic activity in Alaska and Alaskan financial markets, and what is the current impact of federal and state governmental intervention on both real economic activity and financial markets?
- * Second, what are the different mechanisms which the Alaskan state government can use either to stimulate or retard the overall direction of the economy and the state's financial markets?
- * Finally, what are the limited ways in which the Alaskan Permanent Fund can be a part of such an overall economic development effort by the Alaskan state government?

Throughout this discussion, there is an emphasis on limits: the limits of any state government to affect overall state economic development; the limits of development banking to contribute

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to that overall economic development effort. If these limits are recognized and accepted, the likelihood of a soundly conceived and soundly implemented Alaskan Permanent Fund is much greater.

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I. THE NEED FOR A COMPREHENSIVE ALASKAN ECONOMIC DEVELOPMENT PLAN
WHICH RECOGNIZES THE LIMITS OF STATE INTERVENTION IN THE ECONOMY
AND THE APPROPRIATE USES OF A DEVELOPMENT BANK

First Principles

Before we begin to propose any specific form and function for the Alaskan Permanent Fund as one mechanism to help stimulate economic development, we need to have a conception of what is actually happening in both the Alaskan goods market and financial markets and what the present consequences of federal and state intervention are on both real economic activity and the flow of capital in the state. In order to do this on a current and ongoing basis, the Alaskan state government needs to establish a permanent economic development planning process which makes full use of the capabilities of both the public and private sector and the universities, and which develops a reasonable consensus about the forces at work in the Alaskan economy.

I would like to emphasize that there is nothing unAmerican about such a comprehensive, ongoing planning process. I am simply suggesting that the state of Alaska undertake the same kind of careful planning with regard to the husbanding of its capital assets as any American Fortune 500 corporation would do in order to profitably employ its resources. The tools have been admirably

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developed in the private marketplace; they are there, ready to be incorporated by a state willing to look upon itself as a public enterprise.

This planning process needs to be realistic about the limited capability of the state to affect either worldwide market forces or federal policy. These plans must also incorporate an understanding of the limited capability of any financial intermediary to affect the course of real economic activity.

Financial markets operate only on the supply side of the economic question. They cannot, by themselves, create a demand for economic activity that is not there. A critical question Alaskan policymakers will have to face and answer is: What is the capability of the Alaskan economy to absorb the capital supplied by the Alaskan Permanent Fund? Although I am not in a position to answer that question, I suspect that it will be some time before the Alaskan economy has the capability to absorb anywhere near the amounts of capital available to the Permanent Fund.

Moreover, the cost of capital represents only a very small portion of the cost of doing business. Other worldwide market forces and federal governmental actions far more profoundly affect the cost of production than the cost of money does. It is these worldwide market forces and governmental actions which we must attend to first. Two corollaries to this point deserve careful note:

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First, in very few instances is the cost of capital a serious impediment to sound economic development. There are, however, occasional circumstances where the scale of economic activity, or the location of that economic activity, or the relative risks and rewards of the economic activity, make the availability of capital for that activity virtually nonexistent from a private market standpoint. It is in these circumstances that public intervention in capital markets is appropriate, if stimulating that economic activity would significantly benefit the state economy and treasury. Since the question is one of availability rather than cost, in very few circumstances are below-market interest rates either necessary or appropriate for a public development bank. Examples of the kinds of economic activity which may be of real economic benefit to the Alaskan economy and treasury, but for which there may be insufficient available capital include: rural industrial and commercial development, housing development, the development of new technologies which reduce the cost of production in Alaska for either refining or adding value to Alaska's renewable and nonrenewable resources, and scales of enterprise which are either too small or too large for the private market to finance with a sufficient return coincident with risk. These examples will be analyzed in greater detail in sections below.

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A second consequence of the fact that this cost of money is not an important cost of production is this: seldom will lowering the cost of money on the supply side compensate for high costs of production in the marketplace. For example, a petrochemical industry in Alaska is apparently not now financially feasible because of the high costs of production. This problem cannot be solved by lowering the cost of money for petrochemicals through an Alaskan Permanent Fund.

However, lowering the cost of capital can encourage short-run economic activity which is in the long run essentially unsound--and which has a high likelihood of eventual failure.

In summary, a long-term Alaskan state economic planning process must filter out the large number of cases in which development is not dependent on the cost and supply of capital, and in which other public policies are less costly and more appropriate to the solution of the problem. Conversely, the planning process needs to define more precisely those situations in which the economic problem is indeed a financial market problem amenable to solution by Permanent Fund investment. Obviously, these tasks are two sides of the same coin.

In undertaking an overall economic analysis of Alaska and the limited ways in which the Alaskan Permanent Fund can affect overall economic development, I would like to suggest four key

investment areas for the Alaskan Permanent Fund which deserve much more detailed analysis; this analysis would seem to determine the extent to which real economic activity which is financially sound and of economic benefit to the state is now limited by the insufficient availability of capital at a reasonable cost. Two of the areas represent investments within Alaska, and two represent investments by the Permanent Fund outside of Alaska.

A. Potential Kinds of Investment by the Alaskan Permanent Fund Within Alaska:

1. Investments Which Contribute to a Sound, Balanced Alaskan Economy Less Dependent on Nonrenewable Resources and Government Spending

The Alaskan economy is, apparently, at the present time far more dependent on governmental spending than is the American economy as a whole. Moreover, much of the current primary economic activity in Alaska is dependent on nonrenewable resources which are being developed largely by outside interests, with the principal value-added activity taking place outside of Alaska. The result is primary economic activity which is particularly labor-intensive, seasonal, and cyclical. Therefore, economic planning should focus on those possibilities for creating primary, value-added industrial activity in Alaska which can produce goods at a cost competitive in worldwide goods market.

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In analyzing ways in which the Permanent Fund might contribute to a more broadly-based economy, it is useful to make two sets of distinctions: first, between income-producing and infrastructure investments; second, between income-producing investments which (from the standpoint of private market opportunity costs) appear to be too large for the private market to undertake and those which appear to be too small.

a. Potential investments too large for the private market

Given the increasing efficiency and scale of worldwide money and capital markets, you, as policymakers, need to consider whether or not there are sound potential investments in Alaska's renewable and nonrenewable resources which diversify the Alaskan economy but which are too large for private enterprise to finance on its own at a sufficient return competitive with other available risk opportunities. The \$9.7 billion investment by the oil companies in the Alaska pipeline suggests that there are few investment opportunities too large for the private market. In this instance, on a worldwide opportunity cost basis, the rewards as well as the risks to the investors were and are very great. However, there may be opportunities for the development of both renewable and nonrenewable resources in Alaska which are sound

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investments but which do not provide a sufficient return coincident with risk such as investments in petrochemicals or iron-ore reduction. Here, the Permanent Fund could joint venture with private enterprise in order either to reduce the risk or increase the return.

In analyzing the relative returns and costs of public intervention in such cases, at least four issues require the most careful calculation: What are the underlying goods-market or financial-market reasons for lack of adequate private market capital for the project? Could these obstacles be overcome by a public investment? Do the public benefits warrant the risk? If they do, can a public-private joint venture be constructed which does not disproportionately shift the risk to the Permanent Fund and the rewards to the private market?

The scale and efficiency of worldwide capital markets suggests that the private market is capable of undertaking any large-scale projects--if they are sound. If the private market is unwilling to risk it, the Permanent Fund should be extremely cautious in considering intervention.

Yet, there may be another question: Who should own the enterprise and reap its rewards? In this regard, the Canada Development Corporation is an important model for the Alaskan Permanent Fund, as it considers public intervention in such large

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investments, as well as when and whether ownership of such large-scale enterprises should become Canadian. The Canada Development Corporation, created in 1971 with an initial government investment of \$250 million, has since had the largest public equity offering in Canada's history (\$150 million in preferred stock sold to institutional and individual investors). It now has assets of \$1 billion and owns a number of formerly foreign-owned, large-scale enterprises. Depending on the standards by which performance is judged, it has had a mixed record; it is nonetheless worthy of your close scrutiny and consideration.

b. Potential support for medium and small enterprise

The second area in which, as a matter of public policy, it may be necessary for the Alaskan Permanent Fund to supplement private investment in order to stimulate more balanced economic development is in support for the retention and expansion of medium- and small-sized business enterprise by ensuring access to adequate intermediate and long-term expansion capital through existing commercial banks and thrift institutions. Because of the evolving nature of worldwide credit markets and the strictures of governmental intervention, such smaller firms have an increasingly difficult time securing adequate longer-term expansion capital.

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We are moving, world wide, to a multiple-tiered money and capital market. This phenomenon is not peculiar to any one jurisdiction such as Alaska, although it can have differential impacts in different jurisdictions depending on the nature of the local economy. The Massachusetts economy, for instance, is unusually dependent for its employment base on medium and small industry. Even its fastest growing high-technology companies (very profitable firms under \$100 million in sales which are growing at 20 to 40 percent per year) have considerable difficulty accessing sufficient amounts of either equity or intermediate and long-term debt, because of the structure, scale and efficiency of the private market and impediments (often unintended) created by state and federal intervention in both goods and financial markets.

It should be clearly understood that the problem is not the availability of short-term working capital. Commercial banks, finance companies and factors take good care of these needs. The problem is not price. Many of these ventures could be financed at above-market rates. The problem is that often the length of terms needed are too long for many commercial banks, yet the sizes of loans are too small for most insurance companies, and, finally, the nature of the industrial and commercial loans are beyond the competence of most thrift institutions.

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Federal S.E.C., I.R.S., E.R.I.S.A., bank, savings bank, and savings and loan regulations simply make matters worse. (State regulations do too, but since this is something you can do something about, state regulation is reserved for special discussion on pages 34 through 39, below.)

If you decide that some form of support for intermediate and long-term debt for medium and small commercial and industrial enterprise is warranted in Alaska, it is critical that any intervention by the Permanent Fund be developed in close collaboration with and through existing commercial banks, savings banks, savings and loan associations, and credit unions. This is essential for several reasons: If the state acts alone, the odds are much higher that it will make a bad loan, whereas acting through the local financial community, it can bring their money and judgment to bear, thereby reducing both the cost and the risk. Collaboration also strengthens and integrates the financial community more firmly into the local economy.

Once again, it is not necessary for the Alaskan Permanent Fund to reinvent the wheel. The single best state development bank providing longer-term credit support for small business in collaboration with banks is the Connecticut Development Authority, which has been steadily expanded and amended since 1958. Virtually every American state, Canadian province, and European nation

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has a similar, if less effective, intermediate credit facility. In development finance, as in medicine, one can learn a great deal from institutions which have not worked well. We want to avoid mistakes knowingly as well as emulate successful models.

c. Infrastructure investments

Potential infrastructure investments necessary either to provide access to natural resource development or to create the environment in which a profitable market investment can be made should only be made after careful economic analysis has in fact determined that, if those infrastructure investments are made, the costs of production and rates of return are such that the resulting economic enterprise is competitive in worldwide goods markets. The world is replete with examples of infrastructure investments made in Asia, Africa, or Latin America (not to overlook empty federally-funded industrial parks in Appalachia) in the hope that if they were made, real economic activity might result. In most instances, those were dashed hopes.

Although the Alaskan Permanent Fund may well be the most appropriate vehicle for making that infrastructure investment, any non-market costs should be borne not by the Permanent Fund but by legislative appropriations from the Alaskan General Fund.

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2. Investments Which Decrease Economic Disparities Between Alaskan Regions, Communities, and Demographic Groups

The second major area in which the Alaskan Permanent Fund can be a part of an overall economic development strategy within Alaska is in strategies to minimize the rate of increase in economic disparity among regions and demographic groups within Alaska. Note the conservatism with which I make that statement: I did not say eliminate the gap; I suggest for the time being that a more limited goal is more reasonable and realistic--simply to minimize the rate at which the gap widens. For instance, at the present time, the south central region of Alaska has 54.5 percent of the population and 63.2 percent of the gross state product. On the other hand, the Arctic and western regions have 16.3 percent of the population and only 8.8 percent of the gross state product. Although I do not have the precise figures, I suspect that those regional disparities have increased over the past ten years, and that without economic development planning and intervention on the part of the state, they will continue to increase at a faster and faster rate over the next twenty years. I would also guess that the 155,000 Alaskan citizens living outside the major cities are subject to more cyclical, more seasonal, and more labor-intensive industry than Alaskans employed in the principal cities and in the southeastern and south central regions.

If this growing disparity does exist, and a decision is made to use state resources to try to narrow the gap, there are specific community and regional development banking experiences in the United States and overseas which can be employed by the Permanent Fund to contribute to that goal. These experiences are described in greater detail below, on pages 54 to 59.

If the state makes such a policy decision, Alaska has a unique opportunity to organize a portion of the resources of the Permanent Fund specifically for purposes of joint venturing with the Alaskan native corporations in order to assist them in developing petroleum and natural gas resources on their land, as well as hard-rock mining, forest production, and fishery resources within their territories.

B. Potential Kinds of Investment by the Alaskan Permanent Fund Outside Alaska

As I have already indicated, I have not yet had access to the economic projections for Alaska of the state government, the Alaskan banking community, or the University of Alaska's Institute of Social, Economic and Government Research. Nevertheless, it seems a reasonable presumption that the enormous potential capital resources of the Permanent Fund are too great to be appropriately absorbed in investments in the above two categories if those investments are to be sound, income-producing investments.

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The important question then is: How might the balance of the funds be reasonably invested? I would suggest two potential categories of investment for the Permanent Fund outside Alaska:

1. Investments Outside Alaska Which Contribute to Overall Alaskan Economic Development

Areas of economic activity which deserve careful consideration include investment in the development of technologies which would decrease the production cost of either the removal of natural resources from Alaska or the refining of those resources within Alaska. Similarly, the Alaskan Permanent Fund might invest in the development of technologies which would add economic value to natural resources in Alaska before export.

This is another instance in which the Alaskan Permanent Fund may need to "supplement private investment when sufficient private capital is not available on reasonable terms and conditions." The development of these technologies may require investments by the Permanent Fund either within or outside Alaska. Because of changes in the structure of American capital markets over the past twenty years and because of changes in federal policy with regard to securities regulation, capital gains taxation, and the imposition of extensive new limitations on institutional investors, there is virtually no capital available in the United States

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today for start-up investments in new technologies or for investment in technological innovation outside of large multinational corporations.

If it seems reasonable, as a part of Alaska's overall economic development plan, to invest a portion of the Alaskan Permanent Fund's resources in the creation of locally owned technologies, once again, there are good development banking models for such technological investment. These include the thirty-year-old National Research Development Corporation (NRDC) in Great Britain, SOFINNOVA in France created in 1971, the Connecticut Product Development Corporation (CPDC) created in 1974, and the Technology Development Corporation now before the Massachusetts legislature.

2. Investments in Investment-Grade Securities

I have come to the issue of investing a significant proportion of the Permanent Fund's assets in marketable securities not from the vantage point of safety, but from the vantage point of development finance: it is simply unlikely that there will be sufficient income-producing demand for development finance in Alaska to absorb the full resources of the Permanent Fund. Therefore, having carried out its development banking function, the Permanent Fund will have to invest the remainder of its substan-

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tial resources in marketable securities. In addition, the investment of a significant portion of Permanent Fund resources in marketable securities will strengthen its financial integrity as a development bank.

Finally, even if the Permanent Fund has only its minimum capital base of \$2 billion, it will be not only one of the world's largest development banks, but a sizeable financial intermediary by any worldwide standard. It will be sufficiently large-scale to operate in the worldwide money and capital markets as a major lender, investor, and supplier of capital. It must therefore have the most able management that money can buy, capable of operating with both prudence and profitability in such sophisticated markets.

To sum up, I want to underscore two major points: first, as a capital-supplying development bank, the Alaskan Permanent Fund cannot create real economic activity; it can only support economic activity for which there is a genuine market demand but an insufficient capital supply.

Second, the Alaskan state government has other tools within its economic arsenal which it should use as a part of an integrated, overall economic development plan to stimulate the economy; the Alaskan Permanent Fund is one of the tools which can contribute to that overall economic development--a tool with its own inherent limitations.

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Before we consider in detail the goals, structure, and strategy most appropriate for the Alaskan Permanent Fund, I would like to outline my sense of the other tools which the Alaskan government should employ in contributing to overall economic development for the state. If Alaska's expenditure policy, tax policy and regulatory policy are not honed into a single, coherent, economic development policy, the capacity of the Permanent Fund to affect positively the economic diversification of the state will be severely curtailed, and its own investments jeopardized.

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II. USING THE FULL RESOURCES OF THE ALASKAN STATE GOVERNMENT
TO PLAN FOR AND CONTRIBUTE TO A SOUND, BALANCED ECONOMY

In planning state government intervention to stimulate economic development, I suggest an order of battle which considers expenditures policy first, tax policy second, and administrative regulation designed to stimulate the flow of private capital third, before considering a public investment. If a public investment is then deemed necessary, I suggest a careful consideration of tax expenditures and administrative grants before finally deciding to create a development bank such as the Permanent Fund as a vehicle for carrying out that economic development policy. Each of these four points are discussed below.

A. The Role of State Expenditures in Stimulating Economic
Development

State expenditures can either be an investment in the creation of real economic activity in the state or, as is more often the case, state expenditures can represent both a disincentive to real economic activity and a disinvestment from real economic activity.

This misuse or use of state expenditures for economic development is compounded by the general proposition that state

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expenditures rise to meet state revenues. This has certainly been the case in Alaska since 1969, and is a principal motivation for the creation of the Alaskan Permanent Fund. The principle, however, is universal; in Massachusetts, the level of state expenditures (and therefore the level of taxes) rose from 26th out of 50 states in 1958 to an unenviable third in 1977. The result in Massachusetts today is to drive industry and real economic activity out of the state because Massachusetts is simply too expensive a jurisdiction in which to do business, relative to other parts of the U.S. and the world.

There is, however, a unique aspect to Alaskan state expenditures which is shared by no other state in the United States. Simply speaking, Alaskan government is the economy. Combined federal, state and local government expenditures account for 40 percent of the state's employment--a figure nearly twice as high as that for the United States as a whole. Thus, as Arlon Tussing has pointed out, governmental expenditure in Alaska is the driving arm of the state's economy.

This is fine so long as there are revenues to support the expenditures. Massachusetts is again a case in point: Today Massachusetts wage earners and corporations are being asked to support an enormously high level of unplanned and unproductive expenditure which was rather widely distributed in the space-

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technology boom of the 1960's, but which are now being imposed at an increasingly high tax level on a shrinking economic base.

For individual states like Massachusetts and Alaska which cannot print money or set up tariff barriers in the manner of the federal government, there is a limit to which expenditure policy can be used as a means of stimulating the economy. Because the Prudhoe Bay oil reserves are finite, and will not always be the principal revenue producer for Alaska that they are today, it is essential that the state's General Fund as well as its Permanent Fund be invested in ways which will create real economic activity and a strong permanent tax base. In this regard it is useful to think of tax revenues as forced savings that have the same "potential" as private profits for creating productive enterprise through investment. If tax revenues are not used to create a productive public investment in this way, the state will have made a disinvestment from the economic marketplace which might have been more productively employed if the capital had not been removed from private savings by taxation.

I would like to suggest that the Permanent Fund represents a unique and bold opportunity to rethink not only the function of a state government as a stimulator of overall economic activity, but also the very structure of state government as a public enterprise. We have already noted that the state planning process

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should incorporate corporate planning techniques in which the revenues and assets of the state as a public enterprise are invested in order to increase future income flows and the future asset growth of the state. I would like to carry that idea one step further. I would like to suggest that we view the structure of state revenues and expenditures as similar to the income and expense statement of a corporation. In this analogy the annual dedication of revenues to the Permanent Fund is the retained earnings of the Alaskan people. The Permanent Fund itself represents the net worth of Alaskans as a part of an overall balance sheet for the Alaskan state government and its constituents.

If we think about the relationship between the General Fund and the Permanent Fund in this way, the task of state government on an annual basis is to expend its General Fund in ways which will contribute to an increase in revenues and therefore lead to an increase in annual net retained earnings which can be put into the Permanent Fund as a constantly increasing net worth.

Similarly, the task of the Permanent Fund is to invest those net retained earnings in ways which will contribute over time to an increased revenue flow to the state. This suggests a constantly increasing net retained earnings on current account (the General Fund) and a constantly increasing capital base for the economy on permanent account (the Permanent Fund).

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Seen in this light, all state expenditures from the General Fund must be as productive and qualitative as those made by the Permanent Fund, and the two must be part of the same planning process. Otherwise, one will cancel the economic impact of the other.

Finally, the net retained earnings flowing into the Permanent Fund are an equity base which can leverage substantially greater short- and long-term liabilities from the worldwide capital market, as does the World Bank. The following crude income and expense statement and balance sheet for the state as a public enterprise suggests these ideas graphically.

THE STATE AS A PUBLIC ENTERPRISE

Income and Expense Statement

<p>Annual State <u>Income</u> from Individuals, Businesses, and Oil Revenues</p>	<p>General Fund Current Social Overhead <u>Expenditures</u> and Infrastructure Investments</p>
	<p>Permanent Fund <u>Annual Retained Earnings of the People</u>; Annual Contribution to Net Worth for Future Investment</p>

 Balance Sheet

Current Assets

 Current Liabilities:
 Annual Expenditures
 for Social Overhead

Fixed Assets

 Long-Term Liabilities:
 State Bonds to Finance
 Infrastructure

 Permanent Fund
 Long-Term Bonds

 Permanent Fund Net Worth

B. The Impact of Tax Policy on Alaska's Economic Development

Alaska is in a unique position with regard to its revenue structure in that the vast bulk of its revenues are not derived from taxes borne by individuals or businesses native to Alaska. A serious future problem, however, is whether Alaskan residents and resident businesses will be able to support through tax revenues an expenditure level generated during the salad days of high oil royalties and other natural resource taxes. Massachusetts once again is an unfortunate illustration of the fact that although expenditures rise to meet revenues they do not automatically decrease when a revenue base begins to shrink or disintegrate. Given the fact that the oil revenues to Alaska are "temporary," if the tax burden in the future is not to fall abruptly

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and harshly on residents and resident business of the state, expenditure levels must be controlled now. For, although it is clear that expenditures are the driving force in the expenditure-revenue connection, in a highly competitive worldwide market, the level of taxation is the factor of state policy which most discourages private market investment in individual states.

Once again, Alaska is unique in relation to other states in that it has relatively low individual and business tax (because of the current high level of state income from oil revenues). Should the situation dramatically change, however, as it has in Massachusetts, primary industry which can locate elsewhere will do so.

In order to understand the impact of the level and structure of taxation on economic development, it is important to dispel two myths and underscore one reality.

Myth 1: Tax Incentives Offered by State Governments to Private Business Do Not Stimulate Economic Development. Rather, They Represent a Gift or Equity Grant Directly to the Private Business. A review of the economic literature and business experience demonstrates that tax incentives granted by state governments are too small to affect the business judgment of corporations. Thus, since the tax avoider would have made the business investment in any event, the result is simply to grant, as a gift

to the business firm, tax revenues which the state would otherwise have collected. The business firm incurs no expense it would not have chosen to incur anyway, but receives additional income in the form of tax forgiveness. This represents a direct contribution to the net income of the business firm.

Since tax incentives represent a direct transfer of otherwise collectible state revenues to the private firm, it is easy to understand why business groups are highly supportive of such tax incentives.

Tax incentives are simply a beggar-thy-neighbor contest between states, in which each state seeks to outbid its neighbor without affecting any real economic activity.

Myth 2: The Level of Corporate Taxes is Not a Significant Real Factor in Stimulating Economic Activity in the State.

First, all corporate taxation represents a very small cost of doing business. Second, 50 percent of corporate state taxes are paid for by the federal government as a deduction against federal taxes. Third, in most instances, corporate taxation acts as a sales tax--that is, it is passed on to the consumer. For example, the Alaska oil royalties and taxes are directly passed on to the consumer; moreover, they are not borne by Alaskans. In fact, most primary industry anywhere

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tends to be export industry and passes on its corporate tax to consumers throughout the world, whereas distributive industry passes its corporate tax to local consumers. This inhibits economic development only to the extent that the incidence of taxation unduly raises the cost of living, and hence the cost of labor, in the state.

Reality 1: The Critical Aspect of State Tax Policy as It Affects Economic Development is the Level of Personal Taxation, Its Impact on the Cost of Living in the State, and Therefore on the Cost of Labor in the State. Labor is the single largest cost of production for any business enterprise. (This is clearly true outside of Alaska, but once again I hesitate to jump too quickly to the conclusion that what is true elsewhere is automatically true inside Alaska. Alaska's harsh climate, enormous internal distances and difficult terrain, as well as great external distances from world markets may mean that other costs of production are disproportionately higher in Alaska than in other parts of the world, and that labor represents relatively a smaller proportion of the costs of production.) Therefore to the extent that state taxation significantly increases the cost of living and hence the cost of labor, it significantly increases the cost of doing business in the state.

Again, the level of taxation is only significant to the

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extent that the industrial or economic base of the state is at all footloose. Obviously, the entire distributive sector of the economy is dependent on primary industry and is essentially a captive of the state economy. Similarly, to the extent that basic industry is dependent on natural resource development, it too is a captive of the state economy. The level of state taxation on natural resource development will affect economic activity only to the extent that it bids up the cost of production and therefore the price of the product beyond a competitive world market price.

Once again, Alaska is in a unique position--quite different from that of, say, Massachusetts, which does in fact lose a substantial amount of its industry just over the border to New Hampshire because the basic differential costs between the two states are the levels of state taxation.

At present, therefore, Alaska has some margin of taxing freedom, given its relative isolation, its relative dependence on the governmental sector, on natural resource basic industries and on a captive distributive sector. However, should Alaska's long-term economic plan require the development of a value-added basic and secondary industry, it will become much more subject to shift-share competition between the states.

As with expenditure policy, Alaska stands out in comparison with other states in that its tax structure does not appear to

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discourage economic development. However, as Alaska moves toward a diverse, stable economy, the influence of its taxation policies on economic activity will probably become much greater and more like that of states in the lower 48.

C. Regulatory Policy as It Affects State Economic Development

In analyzing the impact of state regulatory policy on economic development, it is important to distinguish between real economic activity in the goods market and financial activity in the financial markets.

On the one hand, state environmental policy, land use policy, transportation policy, energy policy and labor policy all involve regulations which affect the real costs of doing business in the state. Often the costs imposed on economic enterprise are not the costs of the policies themselves but the cost in lost time due to the procedures by which the policies are implemented. It is often possible for a state to reduce the cost of a regulation through a change in process without modifying its substance.

On the other hand, the impact of state regulatory policy on state-chartered, privately-owned financial intermediaries directly affects the flow of capital to enterprises in the state. This issue is central to the question of how to design and structure an Alaskan Permanent Fund. In line with the aim of invoking the

most efficient, cost-effective solution which involves the greatest return and the least cost or risk, a public policy which would achieve economic development goals through administrative stimulation of the flow of private capital rather than through public investment would appear to be more cost-effective. Two critical issues require careful consideration here. First, is it a realistic possibility to shift the flow of private assets through administrative action in ways which respect the sometimes conflicting goals of prudence, profitability, and economic public policy? Second, if it is, is such a solution actually in the public interest?

There are two principal ways in which public administrative intervention might be able to shift the flow of private financial assets in order to carry out a public purpose while still meeting the tests of prudence and profitability: the first is to change the rules of the regulatory game; the second is for the government to act as a public entrepreneur to create a new financial intermediary which will be either initially or eventually privately owned.

1. Changes in the Regulation of Asset Management of Privately Owned Financial Intermediaries in Order to Stimulate Economic Development. First, let us look at state chartering and regulation of financial intermediaries such as life insurance

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companies, commercial banks, savings banks, savings and loan associations, and credit unions. Initially, states chartered these financial intermediaries in order to contribute to the development of the economy of the state and its communities. As these financial institutions suffered collapse and failure in various recessions and depressions over the years, states became less concerned with how the assets were invested in economic development than with protection of liabilities due depositors.

I suggest that a review of ways in which state regulation could be amended to stimulate the flow of assets is a very fruitful avenue for further exploration. Such a review should be undertaken in close collaboration with the financial industry itself, for there are many ways (as we have found in Massachusetts) to modify regulations affecting asset management that are mutually attractive to both the state and the financial institutions themselves.

In Massachusetts, by way of example, we discovered that only one Massachusetts corporation, Gillette, was an eligible investment for the \$25 billion state-chartered thrift industry. Through a collaborative process of Massachusetts industry, the thrift institutions, the banking commission, and the legislature we have now amended those regulations so that all Massachusetts corporations above \$25 million in sales are eligible for investment. We

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did this in ways which protected depositors, provided a profitable return to the financial institutions, and did not compromise the availability of the assets of these institutions for housing development.

2. State Government as a Public Entrepreneur to Create a New Financial Intermediary Either Initially or Eventually Privately Owned. A second way in which the state might stimulate the flow of private capital to further economic development goals is for the government to act as a "public entrepreneur." This means the creation of a new financial intermediary which is either initially privately owned, or initially has some public capital, but eventually becomes wholly privately owned.

From a private market standpoint, there may well be sufficient return on investment coincident with risk if only such an institution could be put together at a sufficiently aggregate scale. Such a private development finance intermediary may well provide risk-pooling and information and transaction cost pooling that is diseconomic for any single existing institution. Yet, it may not be worth the cost for a single private financial institution to undertake the promotion of such a new development finance intermediary.

In such circumstances, the government may undertake the formation of the private institution as a public entrepreneur in

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order to benefit from the public externalities of increased jobs, increased individual and corporate tax receipts, and reduced welfare and other social overhead costs. That is precisely our recent experience in Massachusetts in entrepreneuring the \$100 million Massachusetts Source Corporation, to be owned wholly by the Massachusetts insurance industry, and the Central Development Facility, to be wholly owned by the Massachusetts banking industry.

The key public question is: Will the institution be accountable to produce not only its private return on investment, but the public return as well? The answer lies in careful legislative chartering of the institution to ensure that there is adequate reporting and legislative oversight so that its activities may be monitored to see that the public purposes are achieved.

One Example: An Alaskan Central Bank for Local, Cooperative Banks and Credit Unions. One such institution which might contribute to rural community and regional economic development in Alaska would be an Alaskan central bank for existing rural unit banks or new cooperatively owned full service deposit institutions chartered by residents of small towns in the state. . . If the central bank of such a network is well designed, is able to borrow in international markets, and has very strong management, yet is owned by its member local institutions, it can be a vehicle to supply whatever capital is demanded locally to meet

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housing, commercial and industrial development. Local sensitivity to local needs and how to meet them is coupled with sophisticated management and capital access at the central state level. Good models for such institutions exist as close as the British Columbia Central Credit Union, and as far away as the German D.G. Bank. Both institutions are models of local initiative and cooperative ownership coupled with centralized managerial and capital efficiency. They have provided the model for the recently constituted Central Development Facility in Massachusetts.

Similarly, the U.S. Federal Farm Credit System provides the model for the creation of a network which is initially publicly capitalized but which over time is purchased by the users themselves. The Farm Credit System was initially 100 percent federally owned and is now 100 percent owned by individual farmers and ranchers working through local cooperative institutions throughout the United States.

In summary, I strongly urge a careful review of existing state regulations with regard to asset management of state-chartered financial institutions, and a collaborative effort with those institutions to determine if there are ways in which the state might either modify regulations or act as a public entrepreneur to create a new privately owned financial intermediary which, under discreet legislative oversight, would contribute to the overall economic development plan of the state at no cost to the treasury.

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D. Choosing Among Kinds of Public Investment: Which is More Equitable or Efficient, a Public Investment Made Through the Tax System, or Made Through a Grant or Subsidy Administered by the State Bureaucracy, or Made Through an Investment in a Development Bank?

Finally, before we leap into a detailed consideration of the Alaskan Permanent Fund as a development bank, it is important to realize that a public investment in economic development by the state of Alaska could be made in any one of three different forms, each of which has different consequences in terms of its relative efficiency and equity. They are:

(1) Tax incentives, more properly called tax expenditures, such as an investment tax credit, in which the legislature chooses to forgo tax revenues in order to try to stimulate capital investment in either a particular location or a particular scale of enterprise or a particular sector of economic activity;

(2) Grants and subsidies administered by bureaucrats such as the ten revolving loan programs now existing in Alaska, in which the legislature appropriates funds to the executive to be funneled by bureaucrats in order to try to stimulate particular kinds of economic activity in particular areas; and

(3) Independently chartered public development banks such as the proposals for the Permanent Fund, which are capitalized by

a public investment, authorized by the legislature, and administered by the independent board and a professional staff.

Each of these three forms of public investment has different consequences from an equity and efficiency standpoint in terms of their capability to carry out their specific public purpose.

Tax Expenditures, for instance, are subject to very limited governmental oversight. Once established by authorization of the legislature, they require neither annual appropriations by the legislature nor executive management. They do, however, cost the taxpayers as much as a similar program financed by an administered grant through annual appropriations. Tax expenditures are thus a favored form of public investment by special interest groups and most private enterprise, especially since their application is initiated by the tax avoider rather than by the legislature or executive. Most academic analysts agree that their economic impact is generally questionable from an efficiency standpoint, in that the tax expenditure is generally too little and too late. Moreover, from an equity standpoint, tax expenditures tend to favor rich individuals and corporations over poor individuals and small businesses, especially those located in depressed areas.

Grants and Subsidies administered by the state bureaucracy, on the other hand, are often criticized because they require too

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much legislative and executive oversight. Administered grants may be more equitable in that they are accessible to smaller enterprise, lower-income persons, and poorer regions of the state; however, academic and entrepreneurial analysis agree on the relative inefficiency of this form of public investment, which usually operates with little or no sensitivity to the marketplace and a very high administrative cost. Given this inefficiency, even the equity argument is weak, because the designated public purpose is often not carried out.

It is my understanding that the ten existing state revolving funds, which would fall into this category, have recently been subject to just such criticism. I would suggest that, as a part of Alaska's economic development planning, the revolving loan funds be carefully reviewed in order to determine if in fact they are carrying out their public purposes. I would further suggest that serious consideration be given to shifting their operation from that of a bureaucratically-administered revolving loan fund to development finance intermediaries which might be operated as subsidiaries of the Alaskan Permanent Fund.

Finally, Development Banks, such as the Farm Credit System at the federal level, or state housing development finance authorities at the state level, tend to operate at a relatively high level of efficiency and market sensitivity, but may suffer from

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more conservatism than public policy warrants and from insufficient executive or legislative control.

At this point I do not propose to make any absolute judgment about the relative equity or efficiency of any of these three forms. Rather, you need to recognize that each of these forms of public investment has its own relative costs and benefits which need to be carefully weighed in making specific decisions about a specific kind of public investment to carry out a specific public purpose. In different circumstances each of these forms will be more or less efficient or equitable in contributing to a specific piece of the overall economic plan of Alaska.

III. STRUCTURING THE ALASKAN PERMANENT FUND AS ONE TOOL
IN ALASKA'S OVERALL ECONOMIC DEVELOPMENT PLAN

If we decide that the Alaskan Permanent Fund operating as an Alaskan development bank is one appropriate mechanism for dealing with certain aspects of Alaska's overall economic development, our task then is to structure the Permanent Fund so that it does what we want it to do.

It is worth reemphasizing that we cannot even consider this task until we have decided that:

- * the economic development problem to be addressed is not a problem in the goods market, but a problem in financial markets;
- * it is not a problem created by some existing form of public intervention which should be undone;
- * it is not a problem which is best solved by administrative regulation of the flow of private market financial assets; and
- * if there is to be a public investment, it is not a problem best solved by a new tax expenditure or a new bureaucratically-administered grant or subsidy program.

As noted in the beginning of this memo, development finance is the form of economic intervention that poses the highest risk.