

ALASKA LEGISLATIVE COMMITTEES  
SUBJECTS /

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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?

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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

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.

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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).

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

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

## 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

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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

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

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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

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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~~ 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.

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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.

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It is therefore the last solution to be considered--only after having considered and either used or rejected all other forms of public intervention.

In designing the Permanent Fund as a development bank, there are four central questions we need to answer:

- \* First, what should be the limited goals of the Alaskan Permanent Fund within the framework of Alaska's overall economic development plan?
- \* Second, what should be the legal structure of the Alaskan Permanent Fund so that it is equitable and efficient in carrying out those goals, and yet accountable to the executive and legislature?
- \* Third, what board and staff management structure is best suited to carry out these goals?
- \* Fourth, what capital structure is necessary to ensure that the Alaskan Permanent Fund has the financial capability to achieve its purposes?

In addressing these questions, I have first approached the problem in general; then I have compared it particularly with the two drafts of the Alaskan Permanent Fund available to me, HB-298 and HB-300.

The comments that follow are intended to help clarify, or raise additional questions about, a basically sound draft document.

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In order to be sure that I understand the meaning of particular words and phrases in these draft bills, and perhaps to be of some assistance to you in making their meaning unambiguous, I've done a rather thorough exegesis of the key provisions. In all cases, I refer to the draft of HB-300, unless I particularly note HB-298.

A. What Should be the Limited Goals of the Alaskan Permanent Fund Within the Framework of Alaska's Overall Economic Development Plan?

Almost all development bank proposals are initially marked by three serious problems: confusion of goals, trying to do too many things at once, and assigning to the development bank responsibility for delivering more than it is capable of delivering. In considering any new development bank, we need first to remember that this new development finance institution, like any financial intermediary, can operate only on the supply side of the economic equation. Second, international and domestic experience make it clear that we should be precise in defining the goals of the institution and modest in our expectation of its impact on state, regional, or community economic development. Finally, if there are separate goals in terms of the cost or availability of capital, these separate goals should be implemented (as we shall see

in our discussion below) through separate arms of the development bank which are capable of differentiating risk, sources and uses of funds, and specialized management capable of achieving those specialized goals. In assessing the goals of the Alaskan Permanent Fund in light of these principles, it is most useful to look beyond the general purposes articulated in Section 10 to the more specific investment criteria in Section 40:

Investing Only in "Income-Producing Investments" (Section 10 and Section 40) is the single most important investment criterion of the Permanent Fund. Permanent Fund investment strategies should also be organized to bring private judgment, at private risk, to joint venture in most projects in order to ensure that the investments are soundly planned, managed and overseen. This key provision recalls our "First Principles," pages 7-11: public intervention through a development finance intermediary to stimulate economic development is warranted not because investment opportunities are unsound, but because from the standpoint of opportunity cost, the private market has opportunities to employ its resources at greater return or lower risk than, as a public purpose, the state may be able to afford. Moreover, as we noted earlier, the issue is seldom the cost of capital, but rather, its availability. Therefore the Alaskan Permanent Fund will rarely be warranted, as a development bank, in offering substantial below-market interest

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rates. The costs of capital, like state and local taxation, represent a very small percentage of the cost of production; and differential rates in the cost of capital seldom make the margin of difference in the economic viability of the enterprise. Yet the problem of the availability of capital for new technology development, or for small- and medium-sized commercial and industrial enterprise, or for community-based enterprise, is often a serious public policy problem.

Should it be determined that some form of subsidy is essential for certain large-scale infrastructure developments, or some community development or rural housing development projects, that subsidy should be provided by the General Fund, as our earlier discussion and Section 130 (4) suggest.

The rest of our analysis of the goals of the Permanent Fund is most easily done by a careful review of the three essential investment criteria for (1) investment-grade securities, (2) productive private enterprise, and (3) community development. This analysis conveniently fits our earlier discussion of potential investments for the Permanent Fund on pages 11 through 23.

1. Investment-Grade Securities:

Section 40 (1) provides that "At Least 40 Percent of the Resources of the Permanent Fund Shall be Invested in Investment-

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Grade Securities." (Section 10 (1)) This is a sound provision for two reasons (to which we have already made reference):

First, because development banks operate only on the supply side of the investment equation, it is not all clear what the capability of the Alaskan economy is to absorb Permanent Fund investments either for longer-term capital investment in productive private enterprises or for community development projects. Therefore, all capital which cannot be reasonably absorbed under those two categories should be invested in investment-grade securities. It is important, however, that a sufficient percentage of those investments be made in sufficiently liquid securities so that they will be available, when needed, for investment in productive private enterprises or community development projects. Second, this 40 percent investment in investment-grade securities not only "preserves the Permanent Fund's capital for future generations" (Section 10 (6)), but also acts as a kind of secondary reserve for the potentially high-risk investments in productive private enterprises and community development projects.

## 2. Investments in Productive Private Enterprise

Section 40 (2) provides that "The Permanent Fund May Invest Not More Than 30 Percent of its Resources to Provide a Reasonable Proportion of Longer-Term Investment Capital for Financing the

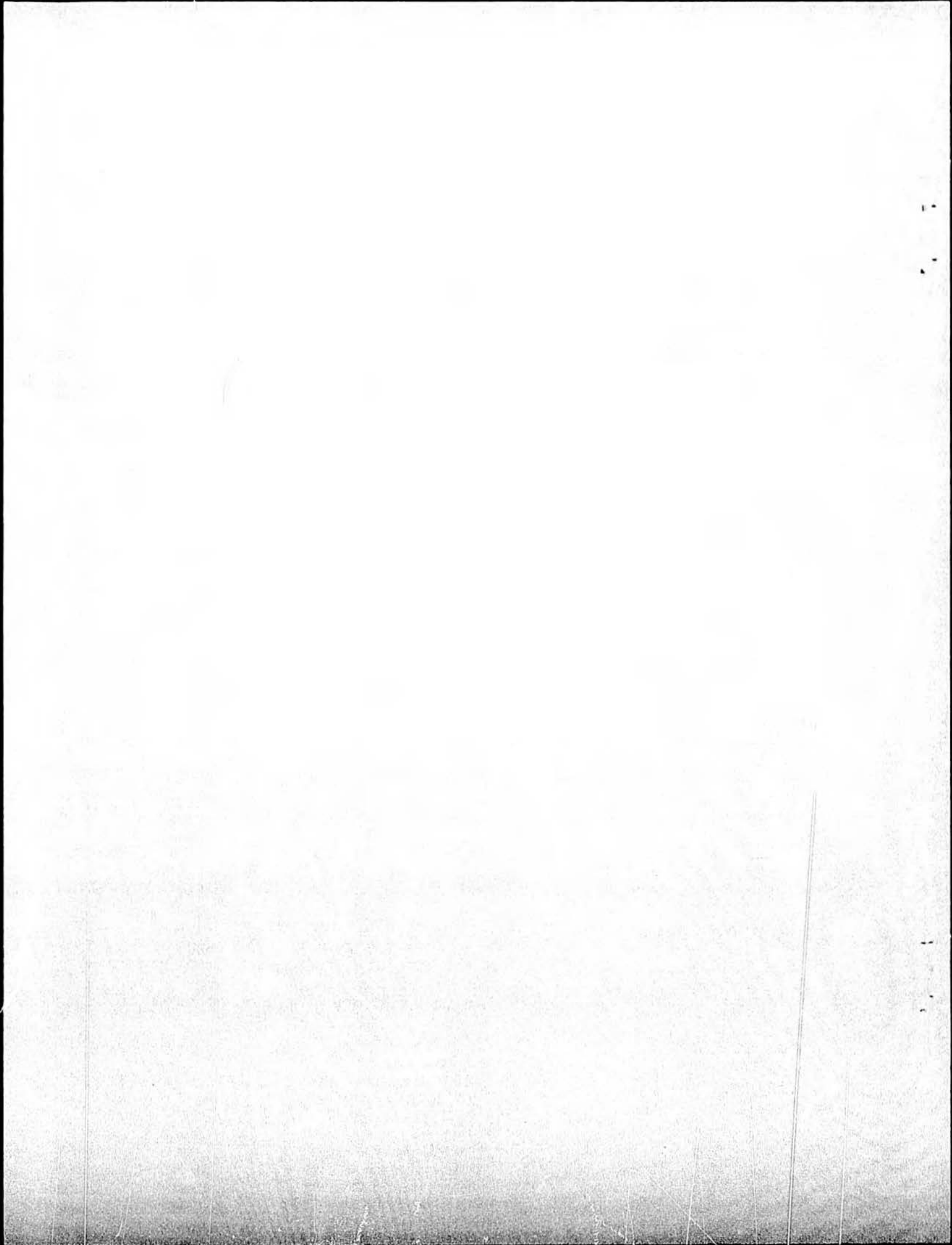
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Establishment, Improvement, and Expansion of Productive Private Enterprise Which Will Benefit Alaskans, and for Which Sufficient Capital is Not Available From Other Sources on Reasonable Terms. These Investments May Take the Form of Equity, Debt, or Debt Guarantees."

Each of the above underlined phrases is sufficiently important to warrant individual comment:

"Not More Than 30 Percent" suggests a reasonable and realistic upper limit of risk in terms of the availability of public development capital subject to demonstrated real demand for it. It is never possible to be rigorously precise in measuring the capital gap for publicly-needed capital. Development banks are best constructed to meet a reasonable demand and then organized in such a way that they are demand-sensitive, so that if there is a demand there is capital available. If such capital is not available, there is of course the alternative of adjusting the balance in investment-grade securities.

"A Reasonable Proportion" suggests that the Permanent Fund should not invest other than in collaboration with private financial intermediaries. Federal, state and local as well as international experience strongly support the idea that the public development bank investment is likely to be more sound if it is made on a joint venture basis with the private market.



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the private market is generally quite capable of filling this need. Second, the state has limited capability to influence short-term cyclical changes in worldwide markets or federal fiscal or monetary policy (in this regard, I trust the phrase "seek to smooth the cyclical pattern of growth of the Alaskan economy" (Section 10 (2)) refers to long-term redress of cyclical problems in the Alaskan economy resulting from overdependence on nonrenewable resources, and does not refer to short-term business cycles). Third, it is only in the longer-term capital markets that any capital gaps critical to overall state economic development arise.

"Establishment, Improvement and Expansion": Pages 11-21 of this paper, I outlined three kinds of investment opportunities where the establishment, improvement or expansion of sound, income-producing, productive private enterprises of benefit to Alaskans may not have sufficient private capital available on reasonable terms or conditions. These three kinds of investments include:

- \* sound 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 coincident with other available risk opportunities;
- \* the development of new technologies essential to the refining and production of value-added manufacturing of

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renewable or nonrenewable resources in Alaska before export; and

- \* support for the retention and expansion of medium- and small-sized business enterprise by ensuring access through commercial and savings banks to adequate intermediate and long-term expansion capital.

In each instance, there needs to be a rigorous analysis of the economic and financial soundness of the sector, the reasons for lack of adequate private market capital availability (if it, in fact, exists), and the relative benefits and returns, costs and risks of public intervention through the Permanent Fund.

"Productive Private Enterprises" appropriately requires that investments only be made in financially sound enterprises which are also income-producing, job-producing, revenue-producing, and contributing in real economic terms to the Alaskan economy.

"Which Will Benefit Alaskans" is a vital phrase requiring that the investments made in enterprises that are not only financially sound but also in which the economic benefit to the residents of Alaska is greater than their economic cost to the state. This critical issue will be discussed in detail under "Legal Structure and Accountability," pages 59-67, below.

"Not Available from Other Sources on Reasonable Terms" is also essential to ensure that any public investments made by the

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Alaskan Permanent Fund are complementary to the private marketplace and supplement private capital because of the public benefit derived by the residents of the state. However, as we have already noted, such collaboration between public and private capital must be reasonable and fair on both sides.

"Equity" is essential to the creation of new enterprises and new technologies, as well as to the expansion of substantial, large-scale enterprises which are necessary to the diversification of Alaska's renewable and nonrenewable resources.

"Debt and Debt Guarantees" are the modes of investment most necessary to collaborative support with commercial banks, savings banks and credit unions in increasing the availability of intermediate and long-term expansion capital to medium- and small-sized enterprises.

### 3. Investment in Community Development

Section 40 (3) provides that "The Permanent Fund May Invest Not More Than 30 Percent of Its Resources 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."

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Again, I want to amplify the meaning and corroborate the soundness of underlined phrases in light of regional and community economic development experience in the United States, Canada, Europe, and Third World countries.

"Not More Than 30 Percent" is an important limitation for two reasons, which my own work in community economic development has often made painfully clear: First, community development finance is very high-risk investment activity. Second, there is a serious problem in finding a sufficient deal flow of projects which are sound both financially and in terms of their community economic impact. Part of this is a market problem and part is a management problem. Low-income areas, by definition, have a more limited capability to support economic activity. Therefore, heavy emphasis should be placed on the development of community projects with a strong export market, which generate stable, steady jobs in the local community by importing sales revenues from outside the community. Finding adequate managerial talent is a far greater impediment to community economic development than finding adequate capital. The Permanent Fund has the tough responsibility of ensuring that community development projects are adequately managed as well as adequately funded. It must help mobilize that management capability as well as capital.

"Reasonable Proportion" is also a phrase with particular

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importance to community development activities. First of all, it suggests that in every instance the Permanent Fund should be joint venturing either with a municipality or with a regional or local community development corporation or cooperative which would put up a significant amount of the financing. I have already noted Alaska's unique opportunity to co-venture with regional corporations.

It also suggests joint ventures with private entrepreneurs. Some of the most successful community development efforts in the lower 48 today involve creative financial and managerial collaboration between community development corporations and private investors--the Kentucky Highlands Investment Corporation, the Delta Foundation, Harlem Commonwealth Council, and Bedford-Stuyvesant Restoration Corporation. All of these models and the history of their experience deserve the careful attention of the legislature in designing the Permanent Fund's community development investment structure.

"Longer-Term Investment Capital", or "patient money," is essential for successful community development projects. The need for extensive managerial assistance, for developing markets over a long term, for infrastructure investment, all add to the cost and to the time frame over which community development projects are likely to have a profitable payout. Often, the private market

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is willing to put up the short- and intermediate-term financing if municipalities, public community development corporations and the Permanent Fund provide sufficient longer-term equity and debt financing.

"Community Development Projects" would (based on the experience of community development organizations in the United States and overseas) encompass at least three major categories of activity: export industry, local commercial and housing services, and social overhead capital and infrastructure development. To the extent that the Permanent Fund participates in any of these three areas of activity, it must meet its essential goal of investing only in income-producing projects.

In the case of social overhead capital and infrastructure development, a subsidy will be necessary either from the General Fund or from a local municipality or public community development corporation.

Similarly, commercial and housing services essential to local community development will also be somewhat precarious in terms of the capability of developing a substantial cash flow, given the relatively low income of the local service area. In order to put together a sound overall package, it may be necessary for Permanent Fund investments to be paired with subsidized grants from the General Fund or from local municipalities.

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Only in the case of export industry, in which local residents are employed in enterprises which sell to a "foreign" market outside the local area, is the likelihood of a strong, income-producing investment most assured.

"Municipalities" are essential co-venturers with the Permanent Fund where social overhead capital and infrastructure investments are required.

"Public Corporate Entities" I take to include regional and local development corporations and cooperatives.

"Private Dwellings" has a strange ring. The implication seems to be that individual local businesses are excluded from direct financing by the Permanent Fund for community development projects but local individual homeowners are not. Based on experience in the lower 48, serious consideration ought to be given to financing local housing development through a community development intermediary as well.

"Debt or Debt Guarantees": This is a serious flaw in the design of the Permanent Fund. The Permanent Fund should be free to make equity investments in community development, as well as in productive private enterprises. The experience of the most successful community development organizations in the United States confirms this judgment. The essential financial ingredient of successful CDCs is their ability to make equity investments

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in enterprises in order to have adequate control and in order to ensure that they are soundly and patiently financed.

Alaska is in a somewhat exceptional position, with many substantially funded regional community development corporations which can take much of the equity position for community development projects on a joint venture basis with the Permanent Fund. Nevertheless, such pioneering state community development banks as the Massachusetts Community Development Finance Corporation, with their capacity for making equity investments in community development as well as for handling debt and debt guarantees, deserve careful consideration by the Alaskan Permanent Fund. This power need not be used frequently, but it is essential that it is available to the Permanent Fund.

B. What Should be the Legal Structure of the Alaskan Permanent Fund So That It is Most Equitable and Efficient in Carrying Out Its Goals, and Yet Accountable to the Executive and Legislature for Achieving Its Public Purposes?

We have already noted that the great virtue of development banks is their ability to operate at a relatively high level of efficiency and market sensitivity. This strength, however, is counterbalanced by the tendency of development banks to operate more conservatively than public policy may warrant and (sometimes)

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to be designed with insufficient executive or legislative oversight. Care at this early stage in the design of the Alaskan Permanent Fund can help to ensure that the strengths of the Fund as a development bank are maintained while its weaknesses are minimized. I cannot emphasize too strongly the importance of integrating the Permanent Fund into an overall economic development plan. It is but one of many tools for achieving--and sustaining--a sound economy in Alaska.

Section 20 properly structures the Permanent Fund as "a public corporation of the state and an instrumentality of the state within the Department of Revenue that has a legal existence independent of and separate from the state. . . ." Section 90 "exempts" the Permanent Fund "from the provisions of the Executive Budget Act," Without knowing the particulars of the Executive Budget Act, I presume that this provision frees the Alaskan Permanent Fund board and staff to make decisions with regard to investing principal and whatever portion of income is necessary either for administrative overhead or for reserves without annual executive or legislative approval. Finally, Section 100 places "the president, officers, and staff of the Permanent Fund in the exempt service."

It is absolutely essential that the Permanent Fund, if it is to be efficient in carrying out its public purposes, be free to

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hire the highest caliber professional staff at competitive world-wide market rates--free of the constraints of Civil Service and of either political or bureaucratic manipulation. Similarly, the policy board of the Permanent Fund must be able to reward its president and staff for successful performance according to market standards, and fire that president and staff at will. Placing the personnel in the exempt service is essential to sound operations. Similarly, placing the Permanent Fund "in but not of" the Department of Revenue and making it exempt from annual approval of its investment decisions is also essential to its efficiency, PROVIDED THAT there are careful controls built into the statute of the Permanent Fund which ensure complete annual reporting and review of the investment activities of the Permanent Fund by both the legislature and the executive. This annual reporting and review must include both the financial soundness of its investments and their economic impact, and provisions must be defined which ensure that the investment planning of the Permanent Fund is consistent both procedurally and substantively with the overall economic development planning of the state.

In this regard, I prefer the language of Section 60 (10) in HB-300 over the comparable language in HB-298. The policy board should be required by statute to "present a complete report of investment programs, plans, performance and policies to a joint

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meeting of the Senate and House Finance Committees of the legislature within 30 days after the beginning of each session." It should not read merely "prepared to present."

The independent professional judgment that is essential to making tough investment decisions and the resulting market sensitivity of a well-structured public development bank such as the Alaskan Permanent Fund is, as I have noted, a conservatizing influence over time. It requires a more sophisticated form of accountability than simple financial accountability. Some form of dual accounting is called for. First, there must be simple accounting, according to conventional financial standards, of the ability of the Alaskan Permanent Fund to make prudent investments and receive an appropriate return on that investment. Because the Alaskan Permanent Fund is capitalized by a dedicated investment of public revenues, this public investment requires, however, an additional public measure of return on investment in terms of the external benefits to the economy as well as the internal rate of return to the development bank itself. Some of these external benefits can be measured as the fiscal return to the state in both reduced social overhead costs and increased tax revenues. There are serious technical problems in properly assigning both costs and benefits, but this is an area in which considerable pioneering is essential if we are to determine whether or not our

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projections for the Fund's economic impact and financial soundness have in fact been met.

I suggest, therefore, that Section 150 be amended to provide for an annual report which accounts for economic impact as well as the financial soundness of investments made by the Permanent Fund. This economic impact accounting should incorporate operational principle number 8, which requires that "the Permanent Fund shall analyze the economic and other effects of an investment decision, by including the effects on employment, income distribution, environment, health, social and other factors.

The Inter-American Development Bank and the World Bank have developed techniques of cost-benefit analysis which have some limited applicability to Alaska and which are summarized in most useful detail in "The Appraisal of Development Projects: A Practical Guide to Project Analysis with Case Studies and Solutions," by Roemer and Stern. It should be recognized, however, that because the Alaskan economy is part of the wide open and fluid American economy, it will be much more difficult to isolate the costs and benefits of Permanent Fund investments. For better or worse, unlike Zaire or India, Alaska does not have its own currency or tariff laws.

More appropriate to your purposes are some of the techniques now being pioneered in Massachusetts with the Community Development

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Finance Corporation, in which all investment decisions and all auditing of those investment decisions are made on a two-track line of analysis: the first track includes traditional projections and accounting for financial soundness; the second track includes projections for economic soundness. In this system, the staff must report to the investment board its projections of primary and secondary employment and fiscal benefits at the same time that it reports its projections for financial viability. The investment review board must then specifically find that the project meets standards of both economic and financial soundness. The monthly, quarterly and annual reporting of any enterprise financed must also note whether both sets of projections have or have not been met. In turn, the annual reporting of the Community Development Finance Corporation to the executive, legislature and public must account for the performance of its investments on both tracks.

I want to reemphasize that the techniques for economic impact accounting have not been well developed, but that is all the more reason for us to make a commitment to improve the sophistication of those techniques given the awesome financial responsibility in undertaking such projects as the Alaskan Permanent Fund. I would be happy to share with you in more detail some of the standards and procedures which are now being developed.

Two other forms of public accountability deserve further

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consideration by the Alaskan Permanent Fund committee--provisions in keeping with the movement toward both "sunshine" and "sunset" laws.

Sunshine Provisions: Section 190, which provides for public access to information, does not yet properly articulate, in either draft, the appropriate boundaries for "sunshine" on the one hand, and for confidentiality and discretion on the other. Two matters require the utmost confidentiality: the financial records of an individual private enterprise, and the personnel actions of the Permanent Fund itself. Those matters should be dealt with in executive session and in full confidentiality regarding individual records. All other policy actions of the investment board should be taken in public meetings of which a public record is available. The results of individual financial reviews and personnel actions must be available in summary form to the public--including the basic terms of any financial arrangements that are concluded.

Sunset Provisions: While these are, in principle, a good means of holding public development banks accountable for their actions, they present certain practical problems, in that development banks by their very nature are investing assets and creating liabilities which will not mature until perhaps twenty or thirty years into the future. This is not an insurmountable

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problem; the sun of the Federal Reconstruction Finance Corporation (RFC) set in 1958, at which time its assets and liabilities were assumed by the Small Business Administration. Nevertheless, I suggest not a predetermined "sunset" date for terminating the Alaskan Permanent Fund, but rather what I would call a "high noon" provision.

The "High Noon" Provision: After the Permanent Fund has had a chance to get off to a good, strong start--say, after an interval of ten years--at its high noon of financial and economic activity, I suggest that it be subject to a fundamental review by a joint executive and legislative commission in order to determine whether or not its performance equalled its promise. The establishment of such a commission should, at the end of nine and a half years of activity, be required by statute now. The commission should be required to report to the executive and legislature on the tenth year anniversary of the Permanent Fund. Included in the commission's findings would be recommendations for the continuation of the Permanent Fund, subject to various modifications, or its termination.

Accountability to Local Communities: This is a sensitive issue, handled differently by different states, depending on the history and custom of different jurisdictions. Massachusetts, for instance, has a three-hundred-year history of strong local

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home rule which requires virtually all state actions to be locally approved. Connecticut has precisely the opposite tradition.

The language of the Permanent Fund bills seems to make three implicit distinctions:

Because the Permanent Fund can only finance a "reasonable proportion" of community development projects, there seems to be an implication that there must be a municipal or regional or local development corporation sponsor.

Section 130 (8) specifies that the Permanent Fund generally "shall be sensitive to the views of affected local communities . . ." and specifically "shall include an analysis of those views in proposals for large investments." The implication is that investments in medium and small "productive private enterprises" need not bear such an analysis. The key questions are: What is "large"? And, do these phrases reflect Alaskan state-local custom?

C. What Board and Staff Management Structure is Most Efficient for Carrying Out These Goals?

Generally speaking, I find the structure and responsibilities of the Permanent Fund policy board, the investment committee and the president to reflect appropriate international, national and state development banking experience.

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In the above section on legal organization and accountability, I have already noted the critical importance of establishing the managerial independence of both the boards and staff of the Permanent Fund so that they are able to produce according to market standards and to be independent from daily political or bureaucratic interference.

Structure of the Permanent Fund policy board (Section 50):

The structure of the Permanent Fund policy board is good. It is small enough to be effective and yet large enough to represent a balance of interests. The two/seven balance between members of the executive and public members is good. The public members should be "confirmed by the legislature in joint session," in the manner of advice and consent for major executive positions in the federal government.

If the Alaskan governor serves a four-year term, the consequence of staggered four-year terms for the seven public members is to give an incumbent governor assured control of the board during the third year of his or her term, subject of course to legislative confirmation. This arrangement has both advantages and drawbacks. If the Permanent Fund is to be an integral part of an overall development plan for the Alaskan economy there must be some mechanism by which the president and the policy board are a part of that planning process and operate within an overall development plan. On the other hand, the efficiency of the

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Permanent Fund requires some independence from the executive. On balance, the provisions in HB-300 seem appropriate given the stipulation of confirmation by the legislature, and removal only "for cause".

Given the small size of the policy board, the requirement of a two-thirds quorum is particularly important to ensure an active and vital policy group in which a substantial number of the members are consistently present.

I would suggest that you consider some mix of users among the seven public members of the policy board. One user might be a representative of a municipality, another might be a representative of a regional or local development corporation, another might represent a major primary sector of industrial activity, and one might represent a distributory sector, especially in the community or regional development area. The financial community is appropriately represented on the investment committee, but users might well be similarly represented on the policy board.

I also suggest that you reconsider the soundness of having the president serve as the chairman of the policy board. The president has sufficient power as the chief executive officer. It is more common development banking practice for the chairman to be a widely-respected public member, either appointed from among the public members to serve as chairman at the pleasure of

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the governor or to be chosen by the policy board itself. Having the chairman serve at the pleasure of the governor, drawn from the public members, is one method for helping to integrate the Permanent Fund's planning into state development planning. In any event, for the protection of both the president and the institution, I suggest a separation of the chairman's and the president's functions.

Also, in my judgment, all meetings of the policy board should be public, particularly in light of the fact that the policy board does not itself make specific investment decisions. Only the personnel actions of the policy board with regard to the president should be held in executive session, and then publicly announced.

The provision in HB-300 to pay policy board members \$250 per meeting day, as well as per diem and travel expenses, is a good one. The policy board function is enormously important, in which the members carry great responsibility. It is common practice to pay private board members a fee for performing that function; the same should be true of a public development bank such as the Alaskan Permanent Fund.

The Duties of the Policy Board (Section 60) are well drawn. The distinction between your policy board and investment committee is remarkably similar to the distinction between the policy

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board of the Massachusetts Industrial Development Authority and its subsidiary investment review boards.

It may be wise to point out in precise language that the policy board cannot impose an investment decision upon, or override an investment decision of, the investment committee. It can only determine, on a periodic post-audit basis, that investment decisions made by the investment committee were within the overall annual operating and financial plan approved by the policy board.

The Structure and Duties of the Permanent Fund Investment Committee (Sections 70 and 80) are also quite sound. Here I think it is not only appropriate but essential that the president of the Permanent Fund serve as chairman of the investment committee. I would suggest, however, that at least one of the members of the Permanent Fund investment committee have "recognized competence and wide experience in" community economic development.

The Structure and Duties of the Permanent Fund President (Section 90) are also generally well articulated, although there are a few matters here which call for some clarification. For example, I wonder if I am the only one confused by the apparent contradiction between a Permanent Fund president to serve for "a term of five years," while at the same time serving "at the pleasure of the policy board." In my judgment, the Permanent

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Fund can only be effective if in fact the president is subject to employment at the "pleasure of the policy board."

Similarly, the provision in Section 170 which states that "members of the policy board are prohibited from all attempts to influence the investment committee, president, officers and staff in the discharge of their ordinary operating duties. The president, officers and staff of the Permanent Fund, in the discharge of their offices, owe their duty entirely to the Permanent Fund and no other authority," seems to me to confuse the respective responsibilities of the policy board, investment committee and president, rather than clarify them.

Finally, I am pleased that this generally good draft recognizes the importance of empowering the president of the Permanent Fund with the sole responsibility for "the organization, appointment, dismissal, and remuneration" of all other staff. The policy board wants to be able to hire and fire a president who is then held wholly accountable for all of the other operations of the Permanent Fund.

The Provisions for Technical Assistance in Section 160 are another area in which I would suggest some reconsideration by the Permanent Fund committee. This provision, however well intended, runs counter to my own experience in designing development banks. In fact, in all recent development bank legislation I have

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drafted, we have specifically prohibited the development bank from "providing financing for pre-investment activities including feasibility studies." The reasoning behind this prohibition is simple: we want to hold separate the developer function from the banker function. If the development bank invests in its own pre-investment feasibility studies or technical assistance there is a tendency on the part of the development banker to become prematurely "married" to what may turn out to be an unsound idea.

On the other hand, this kind of technical assistance is essential--particularly for many regional and local community development projects. Therefore an alternative solution has been to create a separate technical assistance agency which is specifically in the business of using "soft" tax dollars rather than "hard" investment dollars to make these pre-investment studies and then to bring the developed proposal to the development bank for an arm's-length banker review. Section 160 deserves further thought and review in light of this experience.

Intervention in the Case of Default: The apparent contradictions between Section 130 (2) (3) and Section 130 (b) need to be resolved so the management of the Permanent Fund has full power to protect its investments, including the exercise of voting rights.

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D. What Capital Structure is Necessary to Ensure that the Alaskan Permanent Fund Has the Financial Capability to Achieve These Purposes?

The capital structure of a development bank is intimately tied to the goals of the institution. Different kinds of management and different kinds of capital are both required in order to carry out the different purposes. Both international and domestic development finance experience makes it emphatically clear that for the very reason we don't want venture capitalists to make unsecured inventory loans and for the very reason we don't ask commercial bankers to make thirty-year, fixed-asset land, plant and equipment loans, we need to keep the risks, managements, and funds of the development bank separate to carry out separate tasks. Thus, the World Bank Group, for instance, separates the International Finance Corporation (an equity investing vehicle) from the World Bank itself (a market-rate debt vehicle) from the International Development Authority (a subsidized, below-market granting and lending vehicle). In Massachusetts, the Technology Development Corporation and the Community Development Finance Corporation, which are both high-risk equity and venture capital vehicles, are capitalized, managed, and insulated from each other and from the operations and risks of the long-term secured lenders such as the Industrial Finance Agency. In public development

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finance as in private finance, the terms, the cost, and the character of the sources of funds must match the uses of the funds.

It is for this reason that I suggest that operational principle number 9 which empowers the Permanent Fund to "make investments in financial intermediaries . . ." might be more precisely defined to isolate several compatible but operationally distinct tasks on a functional basis. Specifically, I suggest that the business plan of the Permanent Fund consider the possibility of establishing separate subsidiary financial intermediaries to carry out several possible specific functions of the Permanent Fund, including:

a technology development corporation to invest in technologies which would reduce the cost of value-added and refined production of both renewable and nonrenewable resources in Alaska;

an intermediate and long-term financing agency to collaborate with commercial banks and savings banks in providing debt and debt guarantees in support of greater intermediate and long-term capital for medium and small-sized enterprise;

a community development finance corporation to co-venture with regional and local community development corporations and municipalities in providing equity as well as debt and debt guarantees to finance income-producing community

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development projects particularly in lower-income and rural areas of Alaska; and  
a central development bank for locally-owned cooperative banks which would be initially capitalized by the Permanent Fund but eventually repurchased by local cooperatively-owned user banks in order to support rural and community development in outlying areas of Alaska.

Each one of these four areas of activity would have its own investment review board appointed by the policy board (much like the investment committee) with persons of "recognized competence and wide experience" in the specific investment area. Their chief executive officers would be directly appointed and directly responsible to the president of the Permanent Fund, but the day to day decision-making would be the province of the investment review board and the staff of the subsidiary institutions. The policy board, the investment committee, and the president would retain the same direct power over these subsidiaries that any private corporation holds over its subsidiaries. As the Central Bank gradually became owned by its users, this authority in time would pass from the Permanent Fund to the users.

Two major areas of activity would be directly retained by the Permanent Fund:

First, those productive private investments which are of

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such a large scale and such a relatively high risk as to be beyond the capability of the private market acting alone;

Second, large-scale infrastructure investments deemed critical to the overall development of the Alaskan economy. Any subsidies necessary to finance the infrastructure, however, would be borne by the Alaskan General Fund rather than the Permanent Fund. Operational principle number 4, Section 130, implicitly suggests that any subsidies would be made by special appropriation of the legislature. I think that additional consideration might be given to the retention of income on investments by the Permanent Fund for a third purpose beyond overhead and reserves--that purpose being the explicit provision of subsidies for specific kinds of social overhead capital investment, community development, and infrastructure development. A specific prior authorization by the legislature should be required before the income of the Permanent Fund could be released to those purposes by the policy board.

Section 130 (8) could also be used to create subsidiary financial intermediaries on a geographic basis to encourage some more sensitivity to the needs of lesser-developed regions in Alaska. In our highly complex political economy, it is not necessary that capital mobilization and decision-making take place at the same level. This has been amply demonstrated in the

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operations of the Federal Home Loan Bank System and the Farm Credit System at the federal level. Similarly, there are increasing numbers of development finance intermediaries at the state and local level which operate on a decentralized basis so that decision-making is more sensitive to local conditions. Local investment decision-makers will be better able to assess the risk, service the risk, monitor the risk, and deal with problems of default than a more distant investor. International, national and private market financial experience supports this concept.

Finally, my limited exposure through memoranda to the existing thirteen revolving loan funds now operated by the Alaskan state government suggests that they might be more efficiently managed as subsidiary development finance intermediaries under the overall policy guidance of the Permanent Fund. This is another matter that calls for further review.

The Provision for Reserves in Section 120 is a good start which does not go far enough. The legislature should consider establishing specific differential reserves for different kinds of equity, debt or debt guarantee activity. For instance, reserves for community development equity investments by the Massachusetts Community Development Finance Corporation are projected to be 100 percent. Similarly, no state has established long-term industrial debt guarantee programs without limiting the

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state's exposure through a ceiling on reserves in ratio to total guarantees outstanding.

The Provision for Borrowing Powers in Section 40 is a very important provision in terms of the future growth and development of the Permanent Fund. The dedicated oil revenues initially capitalizing the Permanent Fund's equity base at \$2 or \$4 billion should be compared to the capital base of the World Bank or the Canada Development Corporation. If the Permanent Fund is soundly managed, the opportunity to leverage additional equity or debt in worldwide money and capital markets on top of that equity base is substantial, as has been the experience of the CDC (in equity markets) and the World Bank (in international bond markets).

# MEMORANDUM

*Donald*  
*Tom*  
*FYI*

RECEIVED  
AUG 17 1977

TO: Fran Ulmer  
Director  
Division of Policy  
Development & Planning

DATE : August 17, 1977  
POLICY DEVELOPMENT  
TRAINING

FROM: Jim Edens *[Signature]*  
Deputy Commissioner  
Department of Revenue

SUBJECT: Proposed Contract Between House  
Permanent Fund Committee,  
Department of Revenue and the  
Institute of Social and Economic  
Research

The proposed contract is attached for your information and comments.

Generally, the Department of Revenue views the proposal as a "shotgun" approach to addressing some of the problems and issues related to the Alaska Permanent Fund.

Specifically, Clause I (A) is felt to be information that is currently being evaluated by the Senate Permanent Fund Committee (evaluation of State Loan and Investment Programs, past and present). The Department does not feel that this proposal should duplicate an existing effort.

Clause I (D). This activity and research is currently being undertaken by the Department of Revenue in two areas; a. The Division of Research is actively pursuing fish hatchery feasibility studies and has nearly completed its effort. b. The proposed Arthur D. Little, Inc. contract will address investments in the sectorial analysis studies. It is felt that this part of the proposal would also be duplicative.

JE:ba

DRAFT

CONTRACT BETWEEN  
STATE OF ALASKA  
DEPARTMENT OF REVENUE  
AND  
UNIVERSITY OF ALASKA  
INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH

The parties of this agreement are the STATE OF ALASKA, DEPARTMENT OF REVENUE, on behalf of the Legislative Committees on the Permanent Fund, hereinafter referred to as the "Department", and the UNIVERSITY OF ALASKA, INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH, hereinafter referred to as the "Contractor".

THE PURPOSE OF THIS AGREEMENT is to provide the Legislature and the State with expert economic information on the expected effects of selected permanent fund management strategies.

IT IS THEREFORE MUTUALLY AGREED THAT:

CLAUSE I. - STATEMENT OF WORK

(A)

- (1) The Contractor shall review the policies which guided investment of the large general fund balance that developed in FY 1970, and identify the extent to which those policies were directed at influencing the rate and direction of growth in the Alaska economy or sectors thereof. Reference should be made to (a) the stated or recollected intentions of policy makers; and (b) the actual fiscal strategies pursued, as determined under (A)(2) of this clause.
- (2) The Contractor shall determine the chronology of those investments or other general fund management actions that had or were expected to have a direct impact on the Alaska economy.
- (3) The Contractor shall estimate, to the extent published banking statistics and other economic data permit, the actual impact of the actions identified under (A)(2) of this clause, identifying the possible sources and degree of uncertainty associated with this estimate. Included with this estimate shall be (a) a discussion of any capital substitution effects inferred from the data; (b) an assessment of any income redistributions resulting from the investment policies; and (c) calculations of the state's opportunity costs as measured by the actual returns on "outside" investments earned during comparable periods.

- (4) The Contractor shall prepare and submit a written analysis of its findings under (A)(1) - (A)(3) above.
- (B) The Contractor shall review the "Alaska Inc." proposal embodied in HB 525-SB 384 (Tenth Legislature) and provide written estimates over a twenty-year period of the effects the proposal would have on (1) personal income; (2) levels of employment; (3) population; and (4) any other regional economic indicators that the Contractor may consider relevant. In making these estimates, it is recognized that assumptions will need to be made concerning, inter alia, future personal consumption and saving patterns. It is recognized that qualitative judgment will be the source of many of these assumptions; however, each assumption shall be made explicit, as shall the reasons for making it. In addition, the Contractor shall estimate and report in writing on comparable effects of (1) retaining earnings in the permanent fund; (2) using fund earnings to lower personal income taxes; and (3) spending fund earnings as supplemental general fund revenues.
- (C) The Contractor shall prepare a written report assessing the long-term economic and fiscal impacts of varying the amount of contributions paid into the permanent fund. Included in the report shall be an examination of minimum, maximum and intermediate levels of contributions to the fund and--assuming state expenditures consume the revenues remaining after permanent fund contributions--estimated impacts on (1) personal income; (2) population growth; (3) employment levels; and (4) permanent fund and general fund balances. In addition, the Contractor will devise a means for estimating contribution levels which would, by adjustment of appropriate co-efficients, leave sufficient general fund revenues to meet any legislatively pre-established level of real expenditure growth. Correspondingly, the contractor will also devise a means for estimating contribution levels that would generate sufficient earnings to accommodate predetermined proportions of the state's forecasted revenue requirements.
- (D) The Contractor shall prepare and submit a written analysis of the economic and fiscal impacts of permanent fund investments in two hypothetical projects from distinct sectors of the Alaska economy. One project would be state investments in hatcheries and stream enhancement, directed at increasing salmon harvests as outlined in the report, The Economic Feasibility of Private Non-Profit Hatcheries by F. L. Orth. The second project would involve an investment in a petro-chemical facility. The details of the petro-chemical facility will be prepared by the Contractor in consultation with the Project Director. For each of the projects, the Contractor will trace the impacts of the investment in terms of changes in employment levels, personal income, state and local taxes, and population.

# MEMORANDUM

TO: The Honorable Sterling Gallagher  
Commissioner  
Department of Revenue

Fran A. Ulmer, Director

FROM: Don K. Lehr  
Economic Policy Analyst  
Policy Development and  
Planning  
Office of the Governor

DATE: August 26, 1977

SUBJECT: Arthur D. Little  
Study

I appreciate this opportunity to comment on the Arthur D. Little proposal. There is certainly potential for obtaining a valuable product from such a study. Although all the areas of investigation suggested by ADL are of interest, there are some that appear particularly worthwhile.

I feel that the most important parts of the proposal are Task (4) Preliminary analysis of the comparative advantage for Alaska by major sector, and Task (6) Suggested sectoral priorities for the Permanent Fund. The recognition of the crucial importance of Task (4) is reflected in the allocation of over 40% of the total contract dollars to this item. The more detailed analysis of certain industries suggested by the preliminary work of Task (4) could be of great value in all State economic development efforts, in addition to providing a starting point for Permanent Fund managers. We would like to recommend increased emphasis on Task (6) which now receives approximately 10% of the total funding. In the case of sectoral analysis, the greater the industry specificity, the greater will be the value of decision makers. From previous discussions with you, I understand that the consultants will focus substantial attention on import substitution potentials of the Alaska economy and on the possibilities for small-scale technology. I would like to reiterate that I strongly agree with that focus for the study.

The strength of Tasks (4) and (6) is their emphasis in relating is that they relate specifically to Alaska (rather than national or international) conditions and markets. Although knowledge of overall market projections is necessary background for assessing the Alaskan position, a relatively small portion of the work effort should be expended in the general area described in Task (3). This is information already at the disposal of the consultant and should require no additional work. Further, to the extent possible it would seem cost effective to de-emphasize Task (1) Characterization of existing conditions and Task (2) Assessment of the present Alaskan economy. Much of this information presently resides with the State and most likely can be brought together in desired form for less than \$14,500.

Task 5, which emphasizes the development of investment criteria may be somewhat premature. The objective which the suggested criteria address is maximizing the rate of economic development. Under the State Investment Advisory Committee bill, several objectives are mentioned and it will be the responsibility of the Policy Board to refine and interpret these objectives, translating them into a policy framework within which the Permanent Fund managers will operate. Given that this translation and refinement cannot occur until the Policy Board is established, only standard textbook procedures (net present value, risk and sensitivity analyses) can be enumerated by the consultant. A much broader review and analyses process is currently being developed currently within State government - including within the Department of Revenue (reference your August 2 memorandum).

I hope these comments will be useful in your consideration of the ADL proposal. We are greatly interested in receiving copies of the final product!

DL/bb

SCOMM

#9:23

TO: Fran Ulmer  
Director  
Policy Development and Planning  
Office of the Governor

DATE: July 20, 1977

FROM: Tom Singer  
Senior Planner  
Policy Development and Planning  
Office of the Governor

SUBJECT: House Permanent  
Fund Committee/  
DPDP Coordination

HOUSE PERMANENT FUND COMMITTEE

Pending Research Proposals and Needs

Priority List

The following list is a summary of general research areas and needs identified in the consultant's reports to date. Hopefully, you and Clark can prioritize the proposals, assign them among the participating agencies and interests, and organize and coordinate staff efforts at drawing up more specific work plans. The subjects which I feel are most critical are identified by an asterisk.

General

Who

Staff<sup>1</sup>

*Clark's people will do this*

Subject

\*On-going list of specific suggestions for the enabling legislation which are presently buried in their reports.

Capital Markets and Economics

*Clark will send us contracts for comment*

Who

YSER

Subject

\*Study the capital availability gap in Alaska. What are the capital flows: loans by economic sector and geographical location; loan applications both denied and granted). (BD p. 15) (AT p.29)<sup>2</sup>

1. Staff includes committee staff, DPDP staff and legislative affairs.
2. BD is Beldon Daniels' report, AT is Arlon Tussing report. Page citations are included.

ISER

*ISER OR  
SOMEONE*

\* Study the capability of the Alaskan economy to absorb the capital supplied by the Alaska Permanent Fund. Also what is the relative sensitivity of various enterprises to capital availability vs. information vs. natural resource availability or quality vs. labor force quality vs. transportation vs. communication vs. energy costs vs. institutional environment, etc. (AT p. 4).

ADL, ISER

*ADL*

This proposal should be coordinated with the above proposal. Study the possibilities which exist for primary, value added industrial activities in Alaska which can produce goods at competitive cost, and methodologies which are available for deciding 1) What are the underlying goods -market or financial- market reasons for the lack of private capital, 2) if they can be overcome through either alteration of the price (interest rate) or availability (terms) of money, and 3) the net benefit of such alteration. (BD p.11) (AT p.31)

ISER

*GALBY  
ISER*

For various scenarios of the expansion of different industries in Alaska, analyze the growth implications on State government and the economy. (AT p.35)

ISER, Legislative Affairs

*P*

Study the income effects of Alaska Inc. Study empirically the effects of spending the \$900 million from Prudhoe Bay. Study the Salmon/Bottom Fishery (like Delta Barley).

Fiscal Planning and Coordination With the Rest of State Government

Who

Staff, B&M

*Dna + L will  
expand on met + JWG  
Higgett's work  
DONTA*

Subject

\*Combine short-and long-term revenue projections (Revenue) and expenditure

projections (B&M), estimate the size of the surplus, and analyze the implications for State spending and the Permanent Fund.

Daniels

Study banking regulations and tie-in to Permanent Fund. (BD p. 35)

B&M, CED, DPDP

\*Study State loan programs and tie-in to Permanent Fund, and compare with SBA and EDA programs in Alaska. (AT p. 35)

Tussing

\*Develop appropriate contribution formula to Permanent Fund to smooth the growth of the General Fund. (AT p. 32)

Criteria and Constraints

Who

Subject

Staff

\*Develop loan criteria which embody the goals chosen for the fund by the Legislature.

Daniels

\*Study dual accounting and socioeconomic annual report-i.e., performance evaluation criteria based on criteria and goals. (BD p. 62)

Accountability

Who

Subject

CRA

Report on appropriate local input alternatives. (BD p.66)

DPDP Contract

Control and management study to be coordinated with Beldon's work.

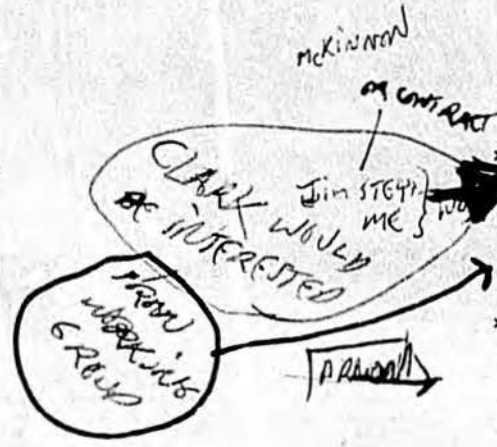
Structure

Who

Subject

Daniels<sup>3</sup>

1. Refine proposal to create: Technology Development Corporation Intermediate and Long-term Financing Agency



*I MUST CALL  
OUTLINE FROM  
BAYLOW - FOR CLARK  
MAYBE LETTER FROM*

*LATER  
W&B:W*

*CLARK WILL  
ASK BAYLOW  
FOR THIS*

*BAYLOW  
I DON'T*

*I CAN PUSH FOR THIS IN  
W.G. - W&B FOR  
SENATE'S  
WORK*

*KEVIN SWO*

*MC SWO*

*Clark, man, etc. meet with John, Mir, etc. for formal presentation + coord. need to firm up joint committee parties*

Community Development Finance  
Corporation

Central Development Bank

2. Decentralization Question for  
above.

3. General Discussion of  
Accountability in organizations  
around the world.

3. We understand Beldon is doing these three tasks.



for Bidden Daniels

TO: Fran Ulmer, Dona Lehr, Tom Singer of DDP

FROM: John Mollenkopf

CONCERNING: Reactions to Tussing, Daniels Presentations to  
Special Committee on the Permanent Fund.

The two consultants to the Special Committee on the Permanent Fund concentrated their testimony on the difficulties which face any State attempt to guide the economy's development, particularly when the attempt is made through capital subsidies. They stressed that the APF's most effective role will be to conserve the State's nest egg. They therefore argued that the APF should be organized in a conservative manner which would aim it at wealth management/conservation rather than such goals as economic diversification or enhanced Alaskan ownership (both of which are contained in the language of the APF constitutional amendment.)

It is my belief, however, that these two consultants were lead by their concerns to commit the APF to an excessively conservative stance. I would therefore like to summarize the argument as posed by Tussing and Daniels, state their conclusions, articulate the underlying assumptions on which these conclusions are based, and criticize them. In this process some alternative ways of thinking about the APF will become evident.

1. Summary of Tussing's and Daniel's argument.

The two economists made essentially similar points. They basically say:

- public capital cannot make economic expansion happen which was not already fairly likely. It facilitates, rather than initiates.
- the factors which do determine which types of economic expansion takes place, such as labor, raw materials availability, transportation infrastructure, and world market prices, are largely beyond the control of the State and the APF.
- "Likely" economic expansion will typically involve production organized by large multinational firms (e.g. ARCO) exporting to a world market. Such firms can tap worldwide capital sources (and therefore do not require funds from the APF).
- The only exception to this rule will be small Alaskan firms which produce for local consumption rather than export; such firms do not have access to adequate long term debt.

On the basis of these four observations, the two economists conclude: 1) that the APF cannot, and should not, complement or displace existing financial intermediaries to any great extent, since they are doing their job, but to the extent it does so should commit itself primarily to the strong activities of the multinationals and secondarily to the weak activities of small Alaskan businesses, and 2) that most APF funds should be invested on Wall Street more or less as a trust fund operation.

2. Comment on the assumptions which are critical to this line of argument.

While in and of itself this line of argument has its merits, it depends upon and entails some unstated assumptions which deserve close, and I believe critical, scrutiny. Let me describe them in turn.

First, this argument supposes that a multinational corporation-based, export-oriented economy is preferable to a more diverse, Alaskan-based economy which mixes import substitution, added downstream product processing, and local entrepreneurship with the more basic export activities. Or if the former is not preferable, it is inevitable.

Second, it evidently assumes that questions of accountability, whether of the APF or of the firms which it assists, is not crucial (since the APF is restricted to a passive financing function rather than an active entrepreneurial function.)

Third, to reach this type of conclusion the authors evidently feel that no significant economic alternatives are available to the State other than multinational exports of timber, oil, fish, or other raw materials.

Fourth, both authors assume in their testimony that the APF should invest its money only in directly productive activities, as opposed to indirectly productive investments in the preconditions for constructing an alternative economic future.

Each of these assumptions can be challenged on the facts. A little thought experiment might suggest why they should be challenged. Imagine that Alaska develops along the assumed trajectory: it deepens its dependence on major oil and gas extraction projects, adding minerals as well. It also develops major additional export activities in lumber and fish. The APF is largely invested in high grade stocks, but also makes substantial loans to help finance these developments. What then?

Alaska has become what might be called a resource colony. Its future will be tied to world market prices in the various commodity areas, and its fate will in part be determined by the entry of new, perhaps lower cost exporters. The chance of such exporters banding into some form of "OPEC" will be nill. Though these sectors will probably involve high-wage, unionized jobs for Alaskans, these jobs will be insecure. To the extent that the State engages in down-stream processing, these activities will be highly capital intense, utilizing capital goods produced elsewhere and technicians trained and migrating from elsewhere (and ready to migrate again to new technical work should Alaska falter.) The State's economy would even more than now depend on decisions made at corporate headquarters far removed from, and not terribly sensitive to, Alaska. In short, the State would have set itself up for the type of boom-and-bust cycle which characterized the gold mining era, with no more long-lasting benefit, and not much more economic diversification. Not only is this potentially an unwise course for the State's policy makers to plot, it controverts the constitutional language which established the APF. If I recall correctly, the amendment stressed goals like economic diversification and independence.

In point of fact, it appears that there are sources of entrepreneurship in the State which, unlike the large corporations, do not have access to sufficient capital, which could produce import substitutes for the local market and which could also further process renewable resources like fish or timber. It also appears that the APF might well focus on removing or reducing the barriers which confront Alaskans, but not the large corporations, as they attempt to market goods over long distances. Examples include public or user-owned fish marketing organizations, lumber mills, etc. (If it is true that factors other than capital constrain Alaskan economic growth, then the State and the APF can locate and address these constraints rather than merely accepting them.) In other words, each of the implicit assumptions in the chain of argument advanced by Tussing and Daniels can and should be given serious scrutiny. The failure to do so commits Alaska to an economic development strategy which it may come to rue.

To conclude: the world provides models both of countries which adopted a commodity export strategy and came to regret it (Cuba and sugar, Chile and copper), and countries which decided from the outset to import substitute, stress local entrepreneurship, and use public capital to help local businesspeople market effectively (Japan and Israel stand out in this respect.) While it is possible that Alaska's export commodities will enjoy an unlimited boom which would permanently postpone the due bills for that type of strategy, such an outcome is far from guaranteed. If it does falter, no matter how well APF funds are invested they can do little to compensate. If, however, they are used to build up a more diverse and self-sustaining economy, they will have left something solid behind after the oil has been pumped away. At the very least this alternative is worth serious exploration.

July 19, 1977

TO: Hon. Clark Gruening, Chairman, Special Committee on the Permanent Fund, Alaska State Legislature

Ms. Fran Ulmer, Division of Policy Development and Planning,  
Office of the Governor

FROM: John Mollenkopf, Public Management Program, Stanford Graduate  
School of Business *John Mollenkopf*

CONCERNING: The Accountability Issue for the Alaska Permanent Fund

As all of us know, one of the most important issues facing the legislature as it seeks to define the Alaska Permanent Fund's organization and goals is the issue of accountability. The Permanent Fund represents one of the most important steps the legislature will take; it is a unique opportunity. How the responsibility for this step will be shared is both a sensitive and important problem. What is the best way of thinking about it?

The problem of how, and to whom, the Permanent Fund is to be held accountable, can be broken down into two parts. First, it is important to be as clear as possible about what one means by the very term. To whom is the government to account for its actions? At what level of decision? What specific mechanisms will make accountability possible? Secondly, the specific animal we are talking about, basically an economic development bank, will have its own distinct characteristics, some of which will help and some of which will make accountability more difficult. What are these specifics? What can we learn from economic development funds which have been held up as models in order to improve the Permanent Fund's responsiveness?

A. The overall issues.

Government bureaucracies tend to develop various constituencies which help them do their job more easily and provide the political muscle to keep their funding going at budget time. Some of these constituencies are client groupings (defense contractors, for example), while others are interested bystanders, legislative purse-holders, or the like. As the relationship between government agencies and their constituencies hardens over time, bureaucracies become vulnerable to criticisms of unresponsiveness, lack of accountability, and resistance to change or guidance. Devices which were originally created to help the agency be responsive, such as advisory committees, may even become a means for further insulating an agency from broad public input. In attempting to design a responsive and accountable public organization, therefore, one cannot focus simply on specific mechanisms, but must also take into account the broader structure of interests which surrounds a given agency.

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To get accountability, one must think through not only what happens at the top, but how decisions are made all the way through the organization. It not only matters who gets on the Permanent Fund Board, or to whom that Board is obliged to report, but how the inside of the Fund is organized. The Fund of necessity will have to make important tradeoffs among alternative objectives. How these decisions get made (and therefore how the Fund determines who it will be responsive toward) will depend on who makes these tradeoffs, whether advocates for both sides are present, and the like. If this aspect is left out of the organizational design, such decisions will be made by default. The Fund might, for example, spend most of its money on large capital projects simply because their proponents ask for larger sums of money and know where to make their pitch. But would this really be the "right" allocation? In order to assure that the Fund is both accountable and responsive, such problems have to be taken into account in the Fund's design. While it may be a relatively small agency, and perhaps in some sense more efficient than other types of grant-making agencies, it will inevitably have some bureaucratic characteristics which will raise the question: to whom is accountability owed?

In the Permanent Fund's case, a number of key actors are involved. Fund management itself will follow professional norms in its attempt to invest its funds. The legislature will wish to guarantee that the Fund pays sufficient attention to the diverse constituencies which it represents. The executive wants to use the Fund as part of an overall economic development and public revenue-maintaining strategy. The banking community wants to assure that the Fund acts as a complement, rather than as a competitor to, its activities. In- and out-of-state potential loan recipients are primarily interested in public assistance in their pursuit of private return, while labor, the fishing industry, the mining industry, and other economic interest groups will each want to see that their interests, if not advanced, are at least not jeopardized. Impacted communities affected by Fund decisions may want to have some influence, as will individual citizens, who wish to enjoy the benefits of economic growth while protecting and enhancing the Alaskan lifestyle.

The problem of the Fund's accountability thus revolves around how to include, and balance, each of these constituencies most appropriately. What "appropriate" turns out to mean naturally depends on what goals the people of Alaska, through their legislators, choose for the Fund. It is probably safe to say that the Fund will have an obligation, however strong or weak, to respond to each of these constituencies. The costs and benefits of alternate organizational designs for this pattern of accountability can be substantial. If the Fund is closed off to all but a few constituencies, it may act speedily, but at the cost of planting the seeds both of future conflicts and a skewed investment pattern. If, on the other hand, the interested parties are all included and balanced off in the process of making decisions, considerable grief may be avoided. The cost may come if disagreements preclude timely and aggressive decision-making. The legislature will want to weigh this balance carefully. Like the founders of the United States, it will be solving a problem of constitutional design.

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The key problems in designing accountability into the Alaska Permanent Fund may thus be summarized under three headings:

1. What are the key constituencies to which the Fund rightly owes some degree of responsiveness?
2. Where, in the Permanent Fund decision-making process, can attention to the concerns of these constituencies best be fit in? How can they be balanced without excessively hindering positive action.
3. What specific mechanisms, ranging from advisory boards to social/economic impact reports to legislated investment criteria, to direct policy-making legislative oversight, can most appropriately be used to assure accountability to these constituencies?

B. The Permanent Fund's specific organizational context.

Banks are well known for their mystique. Finance is a realm not particularly accessible to the common man. While public access to information, and participation in decision-making processes, are important in any case, they will be particularly important for the Fund. With the accountability problem as described above in mind, it will be important to try to learn from other models which have been held up as successful development funds. How well would they work in the Alaskan setting? Are they really accountable? Can we learn from their shortcomings? Consultants have mentioned the British Columbia Credit Union, the Canadian Development Corporation, the Connecticut Product Development Corporation, the Massachusetts Community Development Finance Corporation (not yet operational) and the soft-money side of the World Banks as such examples. Other less successful experiences, such as the Small Business Administration, also come to mind.

We need to ask of these models the following types of questions: to whom have these organizations been accountable? whose goals, as a result, have they tended to maximize? is this experience one to be replicated in Alaska, or modified? have disputes arisen over their responsiveness, and what has been their result? By answering such questions, it should be possible to rank these model organizations according to how well they might represent Alaska's constituencies, and what modifications might be indicated. By investigating them, it would be learned how other jurisdictions have chosen to solve the trade-off between responsiveness to diverse constituencies and the need for sufficient agreement to act on sound investment opportunities.