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PF: fiscal tools

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

M E M O R A N D U M   June 16, 1977

SUBJECT: Permanent Fund - Analysis of "Fiscal Tools"

TO: The Honorable Clark Gruening
Chairman
House Special Committee on the Alaska Permanent Fund

FROM: Richard Haggart
Research Analyst

This memorandum is in response to your request that we prepare:

1. A listing of the existing "fiscal tools"--state fiscal programs and debt instruments issued by the state--which are (or with minor modification could be made) eligible for investment of the Permanent Fund principal under the "income producing" criterion; and

2. An analysis of the "strengths and weaknesses" of each in terms of their appropriateness as components of a Permanent Fund strategy.

Basic to the problem presented us in making this analysis is the use of the term "fiscal tool" in the general outline prepared by the Division of Policy Development and Planning (DPDP), in their memorandum of May 6, 1977. Implicit in the concept of a "fiscal tool" is some idea of a job to be accomplished--clearly, a hammer is a "tool" but its utility--its "strengths and weaknesses"--can vary considerably, depending on whether the task at hand is brain surgery or house building.

Through this memorandum we have assumed that the "task at hand" for the Permanent Fund will be structured around some more or less explicit effort to shape the state's growth path. Consequently, we have used the terms "growth strategy" and "Permanent Fund strategy" interchangeably. In addition, many of our comments and observations regarding the "Permanent Fund" policy objectives are also applicable to the more general question of General Fund surpluses in years to come. And, in one sense, the "growth" impact effects of such General Fund surpluses may prove to be ever more critical in terms of state policy, because fewer constraints exist on how such money may be used.

Inescapable in this approach are some judgments about the sorts of growth strategies that are feasible (and thus worth analyzing) and the state's potential for general and sectorial economic development. The result is basically a "scenario" approach, based on a number of hopefully explicit assumptions. Obviously the analysis contained in Appendix II is only of limited usefulness if these judgments diverge significantly from those of the committee. The assumptions are as follows:

> Assumption No. 1: We assume that Alaska's long-run ability to sustain growth is limited, and that exclusive of Prudhoe Bay revenues, that limit is below growth rates which have occurred over the last decade.
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> Assumption No. 2: We assume that uncontrolled investment of oil revenues in Alaska will result in economic growth that will not be wholly self-sustaining if and when petroleum-related revenue begins to decline in the mid-1980's.
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> Assumption No. 3: Even if Alaska's non-oil economic potential were capable of being developed rapidly enough to replace oil revenues by the mid-to-late 1980's, such accelerated economic development would be undesirable from the standpoint of implicit social and quality-of-life objectives which are shared by most Alaskans.
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> Assumption No. 4: Within the limitations set forth above, we assume that the objective of the Permanent Fund will be to (a) promote that economic development which is self-sustainable after oil revenues begin to decline, and (b) which is not inimical to quality-of-life objectives shared by Alaskans (i.e. wilderness, enviromental and recreational values).
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> Assumption No. 5: Finally, we assume that to the degree that either Permanent Fund and/or General Fund revenues are in excess of the development objectives set forth in No. 4 above, that the excess revenues will be invested in a diversified and relatively riskless investment portfolio with the income accruing unencumbered to the General Fund.

The remainder of the memorandum consists of Appendices I and II attached. Appendix I provides a brief "laundry-list" of state programs which are eligible for Permanent Fund investment. Where possible, the descriptions and outline follow the format of the Executive Budget of the Governor. Appendix II contains a discussion of these programs by broad category, assuming that more specific programmatic analysis will be dependent on the assignment of more precise goals and objectives to Permanent Fund policy generally.

RGH:mo
Attachments

APPENDIX I

Specific State Programs Eligible for Permanent Fund Investment

In this part of the memorandum we briefly describe and comment on the state programs and activities which are potentially eligible for Permanent Fund investment support (i.e., they are "income producing"). A more generalized discussion of these program areas by type of activity appears in Part III of this memorandum.

For fairly obvious reasons, the outline of this discussion follows the Executive budget--hence, debt service activities appear in several areas, depending on the program area being discussed. Finally, for purposes of this analysis no programs were included that would require major legislative modification in order to make Permanent Fund participation possible.

Category 1: Education

1. The Scholarship Loan Program provides loans to Alaskan residents for post-secondary vocational and academic training. The purpose of the program is to assist qualified Alaskans to secure a post-secondary education and to encourage them to remain in Alaska after completing their schooling. Up to $2,500 per year is available to undergraduates and up to $5,000 per year to graduate students. Loans must be repaid within six years of the termination of studies, and a maximum of 40 percent of a loan can be forgiven for five years' residence in Alaska after graduation. In fiscal 1976, 2,087 loans were made totaling $308~~,500~~.
3.8 MILLION

2. Debt service for education-related state bonding in fiscal 1976 totaled $13.0 million, and is estimated to be $17.2 million in fiscal 1977. Debt service costs under this category include payments on University of Alaska projects, general education which includes rural schools built with state funds, and payments on library facilities. Of the associated costs of debt service for education programs, all funding comes from the general fund with the exception of dedicated revenues from the cigarette tax which totaled $475,000 annually through fiscal 1976 and is estimated to increase to $500,000 in fiscal 1977.

Category 2: Social Services

1. Debt service on Pioneer Homes totaled $765.9 thousand in fiscal 1976 and is estimated to increase to $900.7 thousand in fiscal 1977.

Category 3: Health

1. Debt service for health care facilities for fiscal 1976 totaled $705.8 thousand. For fiscal 1977, debt service costs are estimated to be $1,170.9 thousand and to increase in fiscal 1978 to $1.7 million.

Category 4: Natural Resources Management and Environmental Conservation

1. The Fisheries Enhancement Revolving Loan Fund is designed to support loans to non-profit organizations or individuals for the development of hatcheries. The Department of Revenue is required to purchase all loans made under this program. To date, the program has made only one loan, to a regional organization, totaling $1.4 million. In addition, officials in the Department of Commerce and Economic Development indicate that "prospective" loans (meaning loans which have been extensively discussed, but have not necessarily been applied for) total about $3.5 million--two individual loans totaling about $500,000 and one large regional loan of $3 million--and that the FY 1978 total could go as high as $10 million.

2. Debt service for this category totaled $3.5 million in fiscal 1976 and is estimated to increase to $4.7 million in fiscal 1977 and $5.8 million in fiscal 1978. Sub-categories under this category of debt service include fish and game facilities, water and sewer, parks and recreation, and forest fire protection.

Category 5: Public Protection

1. Flood control and national guard facilities debt service under this category totaled $629.000 in 1976, and is estimated to increase to $737.5 thousand in fiscal 1977 and $743.8 thousand in fiscal 1978.

Category 6: Administration of Justice

1. Correctional facilities debt service under this category totaled $888.6 thousand in fiscal 1976, and is projected to increase to $959.5 thousand in fiscal 1977 and $953.1 thousand in fiscal 1978.

Category 7: Development

1. The Municipal Bond Bank Authority is an independent public corporation established by the 1975 legislature to assist communities in Alaska to develop needed public facilities by marketing general obligation bonds. The bond bank will purchase these bonds and offer its own revenue bonds to the public bond market. The revenue bonds will be secured by the credit of the municipality as well as by a bond reserve fund appropriated by the legislature. In fiscal 1977 it was estimated that the authority will sell bonds in the amount of $25 million.

2. The Division of Business Loans has the responsibility of administering five revolving loan funds and two public corporations: the Small Business Revolving Loan Fund; the Tourism Revolving Loan Fund; the Commercial Fishing Revolving Loan Fund; the Child Care Facilities Revolving Loan Fund; the Water Resources Revolving Loan Fund; the Alaska State Development Corporation; and the Small Business Development Corporation. The five loan funds enable qualified businesses and public utilities in their respective areas to obtain long-term financing for the primary purposes of developing, expanding or modernizing their operations. The Department of Revenue must purchase all loans made by the division. In addition to this, the division maintains for the Alaska State Development Corporation a loan portfolio in excess of $3 million as well as an investment portfolio exceeding $3.5 million. This corporation, however, is inactive and will dissolve in 1983. Finally, the Small Business Development Corporation grants loans in participation with the federal Small Business Administration under the "502" programs. These loans are high risk development loans and the SBDC portion is five percent of the total loan. According to state officials, the SBDC has not made a loan for two years, although one for "about $50,000" is now under consideration.

3. The Department of Commerce and Economic Development through their Division of Veterans Affairs maintains a Veterans Affairs Revolving Loan Fund for the purpose of making loans to qualified Alaska national guardsmen and veterans in the State of Alaska. These loans may be used to purchase, refinance, build and remodel homes, farms, businesses and multiple dwellings. In addition, a qualified veteran may be granted a loan for education, fishing, mining or personal use. At the present time, the program has about 3,200 outstanding loans. In fiscal 1976, 1,500 loan applications were approved, totaling $55 million. It is projected that 1,160 loans with a value of $54 million will be approved in fiscal 1977, and a total of 1,480 loans valued at $30 million is projected for fiscal 1978.

4. The Department of Commerce and Economic Development through its Agriculture Division maintains the Agricultural Revolving Loan Fund which provides a source of long-term, low interest loans to promote a rapid development of agriculture as an industry throughout the state. Sources of credit usually available to farm enterprises are not available in Alaska due to the generally unproven potential for profitable operation. In fiscal 1976, 67 loans were made from this fund for a total of $700,000. It is projected that 92 loans totaling $1,500,000 will be made in fiscal 1978. As of fiscal 1976, the program had outstanding 126 loans to 222 separate clients.

5. The senior citizen housing development program provides loans and grants to municipalities, housing authorities and other non-profit local sponsors to stimulate new housing construction and for rehabilitation of existing units for senior citizens. Fund revenues are provided from a $7.5 million general obligation bond issue approved in November, 1976. To date, no loans have been approved, and program activity is limited to grants.

6. Debt service items in the development category cover remote housing bonds, water and harbor facilities bonds, natural disaster recovery bonds, and port facilities bonds. Total debt service costs for these categories in fiscal 1976 total $826,000. and are expected to increase to $2.7 million in fiscal 1977.

Category 8: Transportation

1. Debt service costs of the transportation category include general obligation bonds for highways, marine transportation, and aviation. In addition, revenue bond debt costs for fiscal 1977 will be accruing on international airports. Total debt service costs for the general obligation bond categories in fiscal 1976 totaled approximately $16.6 million. These are projected to increase to $19.3 million in fiscal 1977.

Category 9: Housing

The state of Alaska maintains housing programs in two major areas: state owned and operated public and low cost housing programs, operated by the Alaska State Housing Authority (ASHA), and a program of state supported financing for low- and moderate-cost private sector housing development via the Alaska Housing Finance Corporation (AHFC).

The ASHA was established in the late 1940's to provide increased availability of low- and moderate-cost housing for Alaskans, with specific reference to veterans and persons engaged in "national defense activities". In addition, ASHA is authorized to construct public buildings for the state or federal government. The low-cost housing program and the public buildings construction program are financed via bonds or other debt securities which the Authority is authorized to issue. The debt is totally secured by the properties involved, and involves no pledge of the state's credit.

While ASHA's activities in the state were at one time substantial, the Authority now is concentrating virtually exclusively on the development of public housing programs. Consequently, ASHA officials estimate that urban renewal activities will be entirely phased out by the end of 1977, and the Authority has also requested a termination of its public buildings program. While ASHA has the authority to issue bonds and notes on its own credit (no state guarantee of the loans is made), in fact, little of this type of financing has occurred (with the exception of the public buildings program which involved approximately $108 million in bond issues between 1966 and 1974). Currently, ASHA receives over 99 percent of its funding from the federal government, chiefly from the Department of Housing and Urban Development. The Authority has borrowed from the state in the past, but according to Authority officials, the Department of Revenue will not make short-term loans to ASHA except where federal guarantees exist. The lack of bonding activity of the Authority for housing construction reflects the lack of credit-worthiness of public housing projects. In the judgment of the Authority, such bonds would be essentially unmarketable. At the present time the ASHA is responsible for management of 1,970 housing units in the state, including 747 units of remote housing constructed via a special 1971 legislative appropriation and general obligation bond issue--the only significant increment of state funding other than short-term Department of Revenue loans, in recent years.

Housing other than public housing is primarily the responsibility of the Alaska Housing Finance Corporation created in 1971. The Corporation makes or buys mortgages on low- or moderate-income housing, insures mortgages, makes home improvement loans, and makes loans for other associated costs of home ownership for qualified persons, or developers, including downpayments. To finance its activities, the Corporation is authorized to issue bonds and notes. In addition, income from the Corporation's activities (interest payments and insurance fees) is retained for operations. As of November 30, 1976, the Corporation had approximately $166.9 million in outstanding bonds and notes, and an additional $9.2 million in notes payable to the state of Alaska (as with ASHA, these short-term loans are made by the Department of Revenue to the Corporation). Of the bonded indebtedness outstanding, the Corporation issued $50 million in FY 1976, and anticipates issuing a further $75 million in bonds during FY 1977 and FY 1978. As of November 30, 1976, the Corporation's activities had assisted approximately 4,000 people obtain home financing, and they estimate that the FY 1977-78 bonding program will assist an additional 1,500.

Finally, the state has established 13 regional native housing authorities with powers essentially similar to those of the ASHA. They do not, however, have the authority to engage in the public buildings program or to participate in urban renewal activities. Like ASHA, virtually all money for these activities is provided by the federal government, and state participation is minimal and limited to insured short-term loans. According to state officials, none of the corporations have sold bonds.

Category 10: Energy and Power Development Authorities

A recently enacted, and still nascent, program is the Alaska Power Authority. The Authority is an independent body, designed to promote development of hydroelectric and fossil fuel power sources for domestic Alaskan usage. The Authority is generally empowered to issue bonds and notes to finance power development activities in the state, with the debt being secured by the projects themselves or by the earnings of these projects.

The Alaska Power Authority's funding sources are the Power Project Revolving Fund, appropriated initially by the legislature, as well as receipts from the sale of bonds or notes, which are not subject to legislative appropriation. As currently constituted, it appears that the legislature could appropriate money directly from the Permanent Fund (or allocate Fund resources by legislative direction) to the Revolving Fund, or could legislatively direct the Fund to purchase some or all of the debt securities issued by the Authority. Obviously, the greater the contribution made by the legislature to the Revolving Fund, the less the requirement for the Authority to issue debt. Conversely, minimal appropriations to the Fund would necessitate issuance of debt securities by the Authority.

Presently, the Authority is still in the formative stages and has, as yet, issued no bonds. Power Authority officials estimate that initial organizational work will be complete by October 1, 1977, and that the Authority will then be able to evaluate specific projects and financing proposals.

The state also has authorized the creation of regional electrical authorities to develop adequate, safe, and reliable electric power sources in rural or economically depressed areas. The authorities have the authority to sell bonds, but according to state officials none have done so due to poor credit ratings of the prospective facilities. One association (Tlingit-Haida) has secured long-term financing from the Rural Electrification Administration, U. S. Department of Agriculture.

Category 11: Toll Bridge Authority

The Alaska Toll Bridge Authority, created to provide for the analysis of feasibility and establishment of toll bridges upon public highways, is inactive. There are, to the knowledge of the Department of Highways, no toll bridges in the state of Alaska.

APPENDIX II

This portion of the memorandum contains a general analysis of the use of fiscal mechanisms in conjunction with overall Permanent Fund policy, and where possible, analyzes the strengths and weaknesses of various approaches.

The General Fund:

In our judgment, the General Fund is a relatively inefficient mechanism, generally, for dealing with projected short-term revenue surpluses. This criticism is apart from any specific problems which may exist for individual program areas. We believe this to be true because:

1. The political process tends to allocate total available revenues regardless of marginal utility and without systematic consideration of longer term economic and social consequences.

2. Existing fiscal mechanisms now funded through the General Fund were virtually all enacted during periods of revenue scarcity. Hence, these programs have an innate bias towards maximizing their share of fiscal resources, vis-a-vis competing programs (or, viewed in another context, the programs compete for available resources on behalf of their various constituencies within the state). In short, these programs and their managers in the state bureaucracy can be expected to seek the greatest slice of the available revenue "pie" that they can get, notwithstanding any constraints imposed by generalized "growth" or Permanent Fund policy objectives.

3. We do not believe it particularly sanguine to expect that future legislatures will constrain their own fiscal actions if surplus General Fund revenues exist. Again, we believe the pressures will be virtually insurmountable to distribute available revenues. The experience with the Prudhoe Bay lease sale revenues may be illustrative. In this instance, the state was able to "bail" itself out of an untenable revenue position with the in-place reserves tax. No such alternative is visible on the fiscal horizon, once oil production related revenues begin to decline.

Consequently, we believe that holding large revenue surpluses in the General Fund is likely to prove to be the <u>least</u> effective method of managing the state's short-term revenue surplus, <u>if</u> there exists in the minds of the committee an alternative long-range goal towards which these funds should be committed.

Should this line of reasoning be accepted, then it follows that the General Fund should be the recipient of only those funds which will not be detrimental to the long-run growth objective as set forward in Permanent Fund policy. Clearly, the more ambitious the eventual objective of the Permanent Fund, the less will be the year-to-year contributions to the General Fund from oil revenues, and the greater will be the contributions to the Permanent Fund, or other specific objectives.

Specific Programs Within the General Fund:

Loan Programs: The state maintains loan programs to promote a variety of interests, ranging from promotion of business enterprise to Senior Citizen Housing and Child Care Facilities. Before considering the potential effectiveness of these programs, several points emerge concerning loan programs generally:

1. Unlike most other programs contained in the General Fund, loans are interest bearing investments, and hence, potentially eligible for backing by the Permanent Fund directly. Therefore, the question of what division should be between the Permanent and General Funds in terms of the overall revenue "surplus" is not directly applicable.

2. However, under current law there is no requirement that the Permanent Fund purchase such securities, nor is there any provision allowing Permanent Fund monies to be used for funding such programs directly (assuming this mechanism were legal).

3. Finally, there is no current provision of law requiring any coordination between ongoing state objectives (as exemplified in the loan programs and their statutory objectives) and the investment objectives of the Permanent Fund. The matter of coordination will be discussed further below.

While investments of Permanent Fund money in state loan programs is superficially attractive (and in fact is attractive in some aspects), several problems exist which should be considered:

1. Since state loan programs are intentionally subsidized to promote the specific areas covered by the programs, the Permanent Fund would earn a lower return on invested capital then would otherwise be the case.

2. One answer to the problem of differential rates of return between state issued loans and market rates has been suggested within the Department of Revenue. This approach would involve using the State Treasury as a secondary market for state sponsored notes or mortgages which were financed at the subsidized rate by the Permanent Fund. The Treasury would then repurchase the notes at a discount rate that recognizes the difference between the subsidized rate and the market, thus effectively reimbursing the Permanent Fund for the differential. In essence, then, the capital resources of the Permanent Fund would be available for support of state sponsored loan funds, while the interest subsidy burden would continue to be borne by the state. In any event, some provision making up the interest rate differential would seem to be appropriate.

3. Such a program as outlined in No. 2 above, however, could easily result in growth impacts that are not easily predictable, or controllable. Currently, the amount of state loan monies are rather closely controlled by the appropriations process--in FY 1976 the state issued loans totalling only $56.8 million. Unless controlled by Permanent Fund legislation, access to the Permanent Fund as a capital vehicle could result in a ballooning of state loans, at only marginal increases in carrying costs (because the only appropriated cost to the state would be the interest differential subsidy payable to the Permanent Fund).

Consequently, if the committee chooses to utilize any or all of the state's existing loan programs as investment vehicles for Permanent Fund money, we believe adoption of a policy which would make such investment levels contingent on annual appropriations would be appropriate. It is also possible that some absolute limit or percentage limit be placed on the amount of Permanent Fund money invested in state loan programs. Without such limitations, the loan programs are likely to emerge as sources of "easy money", siphoning large and very possibly inappropriate amounts of Permanent Fund money into the programs.

A final and extremely significant point should be addressed if the committee chooses to allow use of some Permanent Fund money to support state loan programs: the matter of coordination between existing state programs, and prospective investment and development activities of the Fund. An obvious example would be the Fisheries Enhancement Loan Fund (a current state loan program) and any prospective fisheries development investments which might be made by the Permanent Fund itself (either independently, or as a reaction to some legislative direction in the Permanent Fund legislation). Since the two programs (one actual, the other prospective) are seeking the same ends, it would seem to be in the best interest of the state to insure that investment and development decisions regarding the state's fisheries be made in a coordinated manner--which potentially would not be the case, since at least some of the Permanent Fund investments may well take place outside of direct legislative review. This problem may be become even more severe if the impact of such impending programs as the Renewable Resources Fund are included in the considerations--it is entirely conceivable that prospective investors in Alaska could have at least three, and possibly more, major state funding sources available to them, only one of which would be accountable to the legislature in terms of appropriations.

Capital Improvements Projects and State Bonds

One alternative fiscal vehicle that must be considered is utilizing the Permanent Fund as a major purchasing agent of state bonds, and thus financing at least portions of the state's capital improvements via the

Fund. This course of action has the advantage of internalizing the state's bonding activity, and turning long-term repayment obligations (if the bonds are sold in the open market) into long-term revenue sources (as repayments are made to the Permanent Fund). In our judgment, however, this is a relatively inefficient form of fiscal self-discipline--which is not to say that inefficient self-discipline may not be better than no self-discipline at all under some sets of assumptions.

However, there are clear inefficiences and dis-economies associated with setting up the Permanent Fund as a state or municipal bond purchasing authority. Chief among these is the differential in the rate of return that the Permanent Fund would earn under such a system. Thus, the choice would essentially be between purchasing tax exempt state or municipal debts at lower rates (due to their tax exempt status), and forgoing the higher rates that are attainable in high grade corporate or even federal securities. Since the Permanent Fund is a state entity that pays no taxes, the advantage of investing in tax exempt debt is lost. At the present time, high grade tax exempts are paying about 5.5%, while similar grade corporates yield about 8.15%--the difference, if the Fund were to invest in state debt instruments, would be a clear loss to the state.

Perhaps the best argument in favor of avoiding Permanent Fund purchase of state tax exempt debt lies in the area of avoiding distorting effects on the state's growth rate. Put most simply, reliance on the national capital markets provides ongoing discipline of the state's fiscal affairs that is relatively immune to short-term political considerations. Major purchasers of the state debt instruments are fully capable of analyzing the state's ability to repay debts, especially in the light of declining oil revenues beyond 1986 or 1987. Hence, any temptation the state government might have to issue excessive amounts of debts will be tempered by the market's reluctance to accept such debts, in the form of rising interest charges as such relatively risky indebtedness increased. Conversely, of course, utilization of the Permanent Fund as a debt purchaser would run the very real risk of having the state issuing debt in excess of the non-Permanent Fund economy's ability to adequately service and retire. Under such circumstances, the Fund or portions thereof, could be dissipated by inefficiently overdeveloping the state's capital improvements sector, beyond that level which the national debt markets would normally permit. This situation differs from potential misuse of excess money in the General Fund only because the principal and some interest will be repaid to the Permanent Fund--however, the potentially distorting effects on the state's economy and growth rate would be very similar. And, as was noted earlier, some real impact on the value of the fund would occur because of the interest rate penalty the Fund would suffer if forced to finance state and municipal debts.