

SCOMM

#9: 22



*THIS SHOULD WAIT
UNTIL BANK IS CREATED.*

Arthur D. Little, Inc. ONE MARITIME PLAZA · SAN FRANCISCO CALIFORNIA 94111 · (415) 981-2500

July 7, 1977

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue
Pouch SBL
Juneau, Alaska 99801

Dear Mr. Edenso:

*They're offering org. planning
function - why not just have P.F.
avail. for growing sectors. As then
inexp. or pub. policy Board will
implement? Who decides which will
to penetrate.*

1-8883 (Revised)

Arthur D. Little, Inc., is pleased to submit this proposal to provide economic development advice to the Department of Revenue and the State Investment Advisory Committee. We view this as an exciting opportunity to be "present at the creation" of what could emerge as one of the more momentous economic development mechanisms so far conceived. We appreciate having had the opportunity to participate in a number of State Investment Advisory Committee meetings and to meet with interested parties within the Administration and the Legislature regarding the possible scope of our services and the need for assistance in defining economic development analyses appropriate to the Permanent Fund.

We have prepared this proposal on the basis of: meetings and discussions with various people in Alaska; an examination of previous as well as current studies focused on the compilation of data and the analysis of economic activity and industrial development in Alaska; and our knowledge in the broad area of economic development, both domestic and international. We believe we have the necessary combination of experience and professional skills to assist you in developing the necessary economic information and analysis required for initiation of the Permanent Fund.

Our proposal is divided into the following sections, reflecting our understanding of your requirements:

- Background
- Sectoral Analysis
- The State of the Alaskan Economy
- Purpose and Scope of the Study
- Methodology
- Work Program
- Management Organization and Staffing
- Cost, Duration, and Billing Procedures

Arthur D Little Inc

July 7, 1977

-2-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

We have made a diligent effort to respond to your needs on the basis of our professional judgment as to the appropriate manner in which to conduct this project. Should you wish modifications of our work program, we hope that we will have the opportunity to jointly review your needs in order to make the necessary changes in our response.

We believe that Arthur D. Little is unusually well qualified to meet the needs of Alaska in the area of economic development, including analysis and development of recommendations. We base this belief on the following factors:

- Members of the Arthur D. Little staff who will be assigned to this project have recently conducted or are completing assignments of a similar nature. Such studies provide us with a good background for evaluating the suitability and appropriateness of potential economic sectors.
- Staff assigned to this project have operational as well as consulting experience with public agencies and public entities which have as their primary concern appropriate economic development and facilitation of this development through various financial mechanisms. We are experienced both in the area of public policy and of industrial and economic analysis.
- Our Western Regional office in San Francisco specializes in regional planning and industrial development projects. We have assigned to this project senior personnel with excellent credentials in the area of industrial development.

BACKGROUND

Based on existing best estimates, between now and 1985 Alaska's share of North Slope, Prudhoe Bay, and other Outer Continental Shelf (OCS) oil and gas production can be expected to exceed \$7 billion. In addition, the possibility exists for additional state income from the extraction of coal, iron ore, and other minerals. With this large potential revenue from non-renewable resources flowing in at an increasing rate over the coming period, it becomes necessary to determine from a public standpoint the optimal ways to best utilize this income.

Arthur D Little, Inc

July 7, 1977

-3-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

Until now, the majority of the oil-related revenues have gone into the state's General Fund. While these revenues have provided for much-needed improvement in services and facilities provided by the state, a saturation point has probably been reached in terms of the ability of state government to absorb much additional revenue on a current operating basis. This will be underscored by the significant increase in state revenues following the start of the flow of oil through the pipeline.

Last November the Alaskan voters overwhelmingly approved the concept and the creation of the "Alaska Permanent Fund." Simply put, the concept was to provide a means of collecting at least a portion of the ongoing non-renewable resource revenues and placing these revenues in a permanent fund where the revenue capital would be maintained (the concept of permanence) while the income from the fund could be utilized for various purposes. This action was taken in anticipation of the fund's providing a sound basis for ongoing economic development beyond the period of non-renewable resource extraction.

Along with the passage of the referendum on the Alaska Permanent Fund, the ongoing State Investment Advisory Committee was expanded with additional citizen members reflecting a wide range of viewpoints to consider the questions of the structure and organization of the proposed Permanent Fund. Over the past few months, the investment committee, in association with its consultants, has developed draft legislation detailing the proposed management and organization for the Alaska Permanent Fund.

Quoting from Section 37.13.020, "Purpose of the Permanent Fund," House Bill 298, one version of the proposed legislation, provides an indication of the thrust of the goals of the Permanent Fund:

- "(a) The purpose of the Permanent Fund is to provide a means of conserving a portion of the state's revenues from mineral resources to the ultimate benefit of present and future generations of Alaskans. The revenues so conserved shall be invested in income-producing investment which will provide further benefits to present and future generations of Alaskans,

- "(b) Further benefits may be derived from the use of the Permanent Fund to:

Arthur D Little, Inc

July 7, 1977

4

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

- “(1) Assist the diversification of the economy of Alaska by making sound investments in Alaska’s renewable and non-renewable resources.
- “(2) Seek to smooth the cyclical pattern of growth of the Alaska economy.
- “(3) Encourage and assist the participation of private capital from both within and outside Alaska in private enterprises of benefit to Alaskans”

The Permanent Fund, at least as envisioned in the legislation under consideration, will be both a savings bank as well as a development bank. The draft bill provides that:

- Half the revenues derived by Alaska from its mineral resources will be put into the Permanent Fund. At a minimum 40% of the fund’s balances must be put into “investment grade securities.”
- As much as 30% of the remainder of the Permanent Fund will go to providing long-term investment capital for expansion of private sector economic activity in Alaska when sufficient capital is not available from other sources.
- No more than 30% can go to public works for community development projects for municipalities and public entities within Alaska.

Thus, a significant amount of revenue will be available to the Permanent Fund for purposes of providing investment capital for existing and potential economic activity within the state.

Having agreed upon the concept of the Permanent Fund, it becomes important to determine on what basis and through what set of criteria will financial assistance by the Permanent Fund in economic development projects be determined. As in any capital budgeting decision, typically, the fund will be faced with a set of proposed projects whose cumulative financial requirements exceed the Permanent Fund’s financing capability at that point in time. Given this budget constraint, the question is then how to allocate scarce investment resources among a set of proposed projects.

July 7, 1977

-5-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

In addition, the State of Alaska has historically been utilized as a resource base for the rest of the United States and to some extent Japan. Today it remains an economy primarily devoted to the extraction of both renewable and non-renewable resources with little value added from the processing of such resources. Pipeline activity has been a significant short-term boost to the state economy over the last several years, but it may well leave behind little residual long-term economic activity because of the relative "thinness" of the Alaskan economy. This would once again confirm the "boom and bust" characterization of the Alaskan economy.

SECTORAL ANALYSIS

At least in concept, the creation of the Permanent Fund, with its ability to supplement and complement the existing commercial banking activity in Alaska with the capacity to provide long-term loans and/or equity participation on a development basis, could well be an important mechanism for diversifying the economy and providing for greater utilization of Alaska's resources within Alaska.

One way of establishing a mechanism for budgeting and allocating scarce investment resources among alternative opportunities is to prepare a sectoral analysis of the Alaska economy to identify those sectors, industries, or portions of economic activity that appear to have the greatest payoff in the long run for Alaska in terms of diversification, income distribution, and the various other economic goals the state might develop. This sectoral analysis would provide an overview of the economy, linking both the existing sectors and those that might exist in the future to the overall markets within the U.S. economy as well as the international one, particularly the Pacific Rim economies. By focusing investments in those sectors of the economy that are likely to have long-term markets and meet state economic goals, it is most likely that the investments will provide long-term gain for the Alaskan economy.

Referring again to the proposed legislation to establish the Permanent Fund, "sectoral analysis" has been identified as one important means for the fund to determine what projects it will finance and in what manner. Included in the section "Duties of the Policy Board" is an element relating to the annual review and approval of long-range operating plans based on sectoral analysis of the Alaskan economy.

Further, in the section entitled "Operational Principles," various guidelines are provided for the operation of the public corporation. In addition to establishing the "prudent person rule of investment," this section requires that the particular project or investment being considered be able to stand on its own in terms of financial productivity. Should the Permanent

Arthur D Little, Inc

July 7, 1977

-7-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

The relative thinness of the Alaskan economy reflects the fact that so much of the consumer goods as well as a good portion of the industrial requirements are imported, indicating tremendous leakage of Alaskan income to the lower 48 and elsewhere. Recently in Alaska, the distribution of wage and salary employment, a measure of economic activity, has been roughly in the following proportions (this excludes self-employed workers, which exclusion would tend to understate, among other things, the fishing component of the Alaskan economy):

● Mining (including oil and gas extraction)	3%
● Contract construction	17%
● Manufacturing	5%
● Transportation, communication, public utilities	10%
● Trade	16%
● Finance, insurance, and real estate	5%
● Services	16%
● Government	29%

The above figures indicate the dependence of the economy on government — federal, state, and local. Contract construction representing 17% of recent total wage and salary employment is obviously distorted because of pipeline construction and related activities. Mining, even including oil and gas activity, provides only a modest proportion of the wage and salary employment in the Alaskan economy. Thus, even with recent pipeline activity, sectors important to increasing the amount of income retained within the Alaskan economy remain small. In fact, in the period from 1970-1975 manufacturing employment actually grew very modestly and stands at no more than 9000-10,000, primarily in fish processing and forest product activities.

Excluding government employment, the Alaskan economy relies in greater or lesser amount on the following activities:

Mineral exploration, development, and production, including fuels and metallic and nonmetallic materials. Here the possibility exists for expansion in a number of areas. It appears that the coal potential along with petroleum natural gas can provide an ongoing thrust to economic activity.

Fisheries. With the passage of Public Law 94-264 extending the U.S. Conservation and Management zone to 200 nautical miles, fishing is still in a period of flux. It can be anticipated that at least some portion of the yield of groundfish currently going to Russian and Japanese

July 7, 1977

-8-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

ships, will go to Alaska either through actual participation in the fishing or some payment mechanism. In addition, the traditional catches of the Alaskan fishing industry – salmon, king crab, snow crab, shrimp, and halibut – will continue to provide a basis for possible expansion of this sector.

Forest products. This sector, in which the current demand is primarily for pulp for both the lower 48 as well as Japan, reflects the sensitivity of the industrialized economies to materials competition. With the recent rise in oil prices, pulp has been substituted to some extent for petroleum-based fiber. The balance to be struck in the forest products industry in the future is unknown.

Tourism. Certainly in large measure a renewable resource, tourism has emerged recently as an important component of the Alaskan economy. Because its impact covers numerous sectors in a typical economy, it is difficult to measure. Whatever the combination of cruise ship, highway, ferry, liner, plane, and motor coach modes of travel, tourism will continue to grow over the next 10 years. Ways of insuring maximum returns to Alaska of tourism activity are still to be determined.

Agriculture. Agriculture – mainly eggs, potatoes, and milk – provides a modest contribution to Alaska's domestic needs. Similarly, truck farming surrounding the urban areas meets a modest part of the increasing demand in the urban population. Importation of food products from the lower 48 continues to be an important "leakage" out of the economy, and it can be anticipated that opportunities in this sector will emerge over time.

Where does the economy go in the future? Are there take-off possibilities based on capitalizing on resources, especially the renewable resources, of Alaska? Can this tremendous storehouse of resources and energy potential be developed with sensitivity to the compatibility of maximum utilization of renewable resources with the unavoidable use of non-renewable resources? These are the types of questions which a sectoral analysis of the Alaskan economy will begin to examine.

PURPOSE, SCOPE, AND APPROACH

As a beginning point for the ongoing economic analysis that will be required for proper project assessment by the Permanent Fund, this proposal is directed toward developing a structure and/or framework for evaluating proposed projects for investment. We have termed this a sectoral analysis – an examination of the Alaskan economy from a macro viewpoint, linking its current and potential outputs with those of the rest of the U.S. economy as well as

July 7, 1977

-9-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

Pacific Rim areas, to identify those long-term markets in which Alaska can most probably compete. Our work would also include an assessment of the internal Alaskan demand for various outputs, to identify areas where there is a possibility for "import substitution." In other words, given certain investment potential among various sectors of the Alaskan economy, what areas will have the greatest payoff to the Fund, balancing risk and return.

Our proposed work would identify the assets that would foster growth and the liabilities that constrain or inhibit development of particular activities in Alaska, and the mechanisms that might be used to remove or at least mitigate impediments in various sectors. To the extent that long-term capital will assist in removing impediments to development, clearly the Permanent Fund can well become an important mitigating measure.

The crux of our approach is to build upon existing studies, data compilations, and investigations of current activity in a manner which will maximize the involvement of the private sector as well as the public sector. This will assist in the identification of appropriate sectors in the evolution of economic diversity and stability within the Alaskan economy.

Specifically, our analysis would include:

1. An assessment of the long-term outlook for the U.S. economy as well as Japan.
2. An assessment of growth prospects for individual industries.
3. An assessment of the outlook for the Alaskan economy and industry:
 - a. Identification of influence of national, international, and state trends.
 - b. Identification of factors contributing to or inhibiting growth in Alaska-based industry.
4. Evaluation of major sectors of the Alaskan economy:
 - a. Resource extraction, such as petroleum and natural gas, other minerals, forestry, fisheries, and agriculture.
 - b. Manufacturing and processing, such as fish processing, other food processing, petroleum- and natural gas-related processing, and wood products.
 - c. Tourism

Arthur D Little, Inc

July 7, 1977

-10-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

- d. International and domestic trade linkages
- e. Energy
5. Identification of candidate industries for possible establishment in Alaska.
6. Preparation of sectoral analyses
 - a. Characterization of industry at national level.
 - Size
 - Location
 - Concentration
 - b. Historical development.
 - Major growth influences
 - c. Long-term growth prospects.
 - Macro economy
 - New products
 - New markets
 - Other considerations
 - d. Industry in Alaska.
 - Contributing factors
 - Inhibiting factors
 - e. Industry development and the Permanent Fund.
 - Consistency of goals
 - Recommendations for further action
7. Suggested project financial productivity measures.
 - a. Fund investment criteria.
 - b. Sector financial measures.
 - c. Initial sector priorities

The underlying goal of the above analysis is to utilize the revenues derived from non-renewable resources to achieve maximum use of renewable resources within the state.

July 7, 1977

-11-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue



METHODOLOGY

The development of a sectoral analysis emphasizing identification of possibilities for vertical integration within the Alaskan economy to capitalize on existing renewable and non-renewable resources as well as expanding the availability of goods and services for the internal Alaskan economy requires a broad approach and a wide array of methodologies. The product of this proposed study is not just the output of a macroeconomic model; rather, it is the results of several flows of analyses coming together, leading to the identification of sectors appropriate for consideration by the Permanent Fund for project investment – sectors that are either represented currently in the Alaskan economy or are likely candidates for inclusion in the economy over the next few years. This would include vertical integration in terms of the processing of both renewable and non-renewable natural resources, as well as consideration of ways to reduce the leakage out of the domestic economy. For instance, over the next few years certain thresholds may well be reached within the economy, permitting the establishment of business activity that heretofore could not viably compete because of such factors as lack of economies of scale, sufficient domestic market, etc.

An important aspect of our approach and methodology is the utilization of our ongoing economic advisory service. Over the past several years Arthur D. Little has offered a variety of programs to both public and private clients focusing on the growth prospects for the U.S. economy and, most importantly, individual industries within the sectors. Currently a team of analysts is charged with assessing the performance of the U.S. and international economies and the implications for industry growth. Prominent in this ongoing effort is Arthur D. Little's large-scale input-output model of the U.S. economy, which characterizes the interface between the macroeconomy and individual industries, incorporating technological changes, new products, material substitutions, etc. As part of this effort we closely monitor the economy and developments in areas such as:

- Consumer spending.
- Business capital spending.
- New building activity.
- Fiscal and monetary policies.
- International trade activities.
- Worldwide economic conditions.

Through these activities, Arthur D. Little maintains close awareness of developments in more than 220 individual industries (see Appendix A). This provides us with a large, comprehensive, consistent, and detailed (four digit industrial classification) industry information system for

Arthur D Little, Inc

July 7, 1977

-12-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

problem solving – in particular, identification of likely sectors of growth in the Alaskan economy. This information system, embodying the analyses and insights of a large body of Arthur D. Little expertise, is carefully managed and continually updated.

WORK PROGRAM

To achieve the purposes of the project, we propose to undertake the following tasks:

1. Characterization of existing conditions,
2. Assessment of the present Alaskan economy,
3. Determination of the domestic/international markets related to outputs of key sectors of the Alaskan economy,
4. Preliminary analysis of the comparative locational advantage for Alaska by major sector,
5. Intersectoral cost/benefit comparison and development of investment criteria, and
6. Suggested sectoral priorities for the Permanent Fund.

Task 1 – Characterization of Existing Conditions in Alaska

To establish a consistent set of baseline information for determining suitable sectoral investment focuses and developing economic development strategies, we will first initiate a reconnaissance program to bring together relevant information on the existing situation within Alaska. This will cover existing studies and ongoing research including relevant data and analysis from the numerous affected public agencies in Alaska as well as private sector sources.

To complement the review of existing published data and analyses, we will conduct a structured interview program with appropriate persons primarily in the private sector in the major areas of activity in the state. This program will provide additional background on issues we consider it necessary to address and on the current nature of economic activity, and will also provide a preliminary assessment of the ability of existing Alaskan industry to compete in expanded markets.

July 7, 1977

-13-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

There are a number of studies in progress that provide information on the current state of the Alaskan economy; this includes both statistical information and "models of the economy." Among these basic sources of information are the following:

- Alaska Department of Commerce and Economic Development.
- Alaska Department of Revenue.
- Alaska Department of Labor.
- Governor's office, Policy Development and Planning.
- University of Alaska, particularly the Institute for Social, Economic and Government Research related to their "Main in the Arctic Program."
- Bureau of Land Management, quantitative models developed for assessing impact on the Alaskan economy of oil and natural gas development.
- Trade flow models developed both in the State of Washington and in Alaska linking the Alaskan economy to the Northwest portion of the lower 48.
- Other public agency information.
- The set of Regional Profiles prepared by the University of Alaska for the state and the Joint Federal-State Land Use Planning Commission for Alaska.

Our analysis of the availability of infrastructure and level of community development will be based upon information provided by the Alaska Department of Highways, the Alaska Department of Public Works, the U.S. Bureau of Land Management, and the U.S. Bureau of Indian Affairs, supplemented by local area information from the Alaskan Department of Community and Regional Affairs.

For specific sectoral information – i.e., historical measures of economic activity – we would utilize information from such entities as the Alaska Department of Natural Resources, Alaska Department of Fish and Game, the Division of Economic Enterprise of the Department of Commerce and Economic Development, the National Marine Fisheries Service, the Bureau of Indian Affairs, the U.S. Forest Service, and the Bureau of Mines.

July 7, 1977

-14-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

Task 2 – Assessment of the Present Alaskan Economy

To place Alaska in perspective, we will utilize the baseline information developed in Task 1 to prepare an assessment of the present Alaskan economy. This will include:

- Trends in economic indicators,
- Identification of structural relationships within the Alaskan economy,
- Delineation of regional economic activity in Alaska,
- Nature of economic development factors,
- Characteristics of the major sectors of the current economy,
- Level of infrastructure development, and
- Preliminary identification of constraints and impediments to future economic growth.

This assessment will be utilized later in this work program to compare Alaska's potential as well as development constraints with likely emerging markets within Alaska, elsewhere in the United States, and abroad. Labor supply and wage structure, transportation and communications, capital availability, utilities, tax structure, and existing markets will be included in our examination of development-related factors.

The major basic sectors of the economy, including resource extraction (e.g., petroleum and natural gas, other minerals), forestry, fisheries, and agriculture, plus the currently limited manufacturing and processing areas, will be characterized in terms of their long-term potential. Tourism – an activity that cuts across a number of sectors of the regional economy – will be quantified to the extent possible, and the sensitive factors in it will be identified. Energy development, including utilization of coal and hydro, the potential of geothermal, and the utilization of oil and natural gas, will be defined.

July 7, 1977

-15-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

Task 3 – Determination of Domestic/International Markets Related to Outputs of Key Sectors of the Alaskan Economy

We will utilize the Arthur D. Little economic analysis model which provides information (among other things) on the output from 220 industry sectors. (See Appendix A for discussion of the industry indicators and industry sectors included in this assessment.) This will be used as a take-off point for estimating 10-year demand for outputs of various industrial sectors and, in combination with the results of Task 2, will enable us to screen down to those sectors that represent possible expansion potential.

We note that, in addition to the utilization of information on the U.S. economy, along with information on trends in the Japanese economy, we will examine (again based on the information from Task 2) possibilities in non-basic sectors of the Alaskan economy such as the service, trade, and other areas that might represent important growth prospects. It is our feeling that there is a need for a blend of quantitative analysis with qualitative judgments regarding possibilities for expansion of some of the smaller sectors in the Alaskan economy for which local manpower and local resources can be utilized. To the extent possible, utilization of renewable resources will be stressed to enable the economy to reach a sustainable level of activity.

Task 4 – Preliminary Analysis of Comparative Locationa Advantage for Alaska by Major Sectors*

The results of Task 3 will identify on a preliminary basis those sectors both existing and potential that may offer the opportunity for expanded economic activity in Alaska. In this task we will utilize industry (or sector) specialists to determine on a pre-feasibility study basis the ability of Alaska to compete with other areas providing similar outputs or products. Having previously identified growth sectors, we will evaluate which of Alaska's characteristics operate to its advantage as an industrial location and which operate to its disadvantage. This will require knowledge of the sectors' resource input requirements, labor and capital requirements, and market distribution.

The key factors in the determination of the locational requirements of the potential sectors addressed will include proximity to suppliers and markets, availability of labor force, sensitivity to other input costs, taxes, infrastructure requirements, and related industrial factors. Ranking of the relevant importance of each of the above will be made for sector and industry types.

Arthur D Little Inc

July 7, 1977

-16-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

The candidate industries would be those whose locational requirements would be most closely met by Alaska as compared to other potential areas.

Task 5 – Intersectoral Comparison and Development of Investment Criteria

The results of Task 4 will provide an estimate of the likely ability of Alaska to compete in the identified sectors on a statewide basis. While the economics of a particular establishment might indicate potential for Alaska, for example, lack of development of infrastructure and related factors may hinder economic development in a given sector or industry. In this task we will examine on a subregional basis the likely distribution of future economic activity related to major sectors with the goal of identifying problems associated with, for example, infrastructure that would provide access or supply water or energy to the particular economic activity. This will enable us to make a preliminary ranking of appropriate sectors in terms of viability of a particular enterprise or establishment, and of the types of investment in infrastructure that probably would be required to facilitate development.

The results of this intersectoral comparison will be a preliminary set of investment criteria for establishing on a project-by-project basis the necessary types of information that will be required when a proposed investment comes before the Permanent Fund.

The project analysis based on certain investment criteria will differ from financing decisions in degree of complexity and in the breadth of its scope. The financing of projects requires an examination of the several methods of financing, such as debt, equity or combinations thereof and the terms and conditions of the financing instruments, and the project's ability, operating as well as financial, to provide a return on an investment made in it. Typically this procedure will include an analysis of operating performance, return on capital ratios, and other financial ratios. On the other hand, to select investment opportunities, the Permanent Fund will view the particular financing decision as only one part of an overall strategy. An investment analysis requires the design of a methodology for measuring various projects, the use of sensitivity analyses, and the development of risk/return profiles on each project under consideration.

In this task, we will consider the following aspects of developing investment criteria for projects within various sectors:

July 7, 1977

-17-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

- The fund strategy is initially determined. This includes identifying the mix of projects desired in the fund, and their risk, return, and capital requirements. The choice of various projects will determine the financial structure of the fund and will define the overall level of risk the fund will be able to support. A "hurdle rate" refers to this risk level whenever a project is considered as a potential investment.

In the evaluation process of choosing among projects one key assumption is that investment decisions will most likely be made under a capital rationing situation. This means that the fund itself will be limited in size and that if presented with several "attractive" investment opportunities, the selected process must decide upon only a subgroup of the total array of possibilities.

- For evaluation purposes, each project must be analyzed according to such criteria as the net present values (NPV) of earnings it proposes to achieve within a specific timetable. The fund will value this proposed stream of earnings according to the amount, timing, and opportunity costs it is likely to incur. These costs represent the opportunity foregone on the next most profitable investment.

Other measurements of projects exist, such as the payback method which analyzes the number of years required to return the original investment — the far simplest method. Payback criteria, however, do not consider income beyond the payback period. Therefore, if the fund portfolio is to be viewed as an ongoing source of cash, attention must be given to events beyond the one project's payback period. This necessitates a long-term fund strategy.

Thus, an objective of the fund strategy will be to select the combination of investment proposals that provides the highest net present value subject to any constraints for the period. To determine the NPV of a project, the appropriate discount rate will have to be selected. The discount rate must be in line with the hurdle rate, must consider an opportunity rate, should include an inflation factor, and most importantly must reflect a risk factor. For a project within a particular sector, its financial productivity should bear a relationship to the long-run characteristics of the industry in which the project is located.

Arthur D Little Inc

July 7, 1977

-18-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

- Once the rate is set, and the NPV computed, a sensitivity analysis should be undertaken to examine how volatile the variables are that determined the projected stream of earnings. If a company has a performance history against which variables can be verified and adjusted, this task is much simpler. If, on the other hand, the fund is presented a proposal for a new project with untested characteristics, the exercise of assigning probabilities to the variables becomes more difficult. The sensitivity analysis provides another tool of measurement and helps define more clearly the risk level of the project.
- The risk analysis of an investment decision does not simply entail measuring the risk of a project relative to its potential return. A particular project's risk must also be judged against that of other investment opportunities and most importantly against the overall risk of the fund itself. This means that the project should at best complement the fund's risk level. This can be accomplished, for example, by fitting the project's risk level against other fund projects such as having the risk of a high risk/return balanced against a low risk/return project.

Task 6 – Suggested Sectoral Priorities for the Permanent Fund

To provide the decision-makers within the Permanent Fund with useful sectoral information against which to evaluate proposed projects, this task will focus on assigning priorities to sectors and/or industries that appear to justify possible public investment. We will suggest short-term as well as long-term priorities, based on not only market and resource use criteria but the state of development of the associated infrastructure necessary for the establishment of certain industries. For example, it might be that in the immediate future, certain projects that might be proposed within particular sectors may be in existing, developed areas where access to available labor and infrastructure is relatively easy. These projects may have more immediate public returns.

For long-term projects, it may be that investment might be required not only in the enterprise itself but in the infrastructure such as roads, utilities, etc., necessary to make it feasible. Thus investment in these projects, even though within promising sectors, may require greater investments over longer periods of time.

July 7, 1977

-19-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

In establishing these priorities we would anticipate the involvement of the committee to insure an understanding of the procedures that we would have gone through in arriving at these priorities.

MANAGEMENT ORGANIZATION AND STAFFING

I will be project administrator and maintain day-to-day administration of this case. My professional experience includes 10 years as a regional economist and industrial development specialist with Arthur D. Little, Inc., in a wide range of public and private projects. I will have major responsibilities in the assessment of the current Alaskan economy, in linking the long-term demands in the overall U.S. economy, and that of Japan, with the appropriate sectors of the Alaskan economy, and in developing investment criteria and ranking sectors for possible investment.

I have extensive experience in the development of criteria for location of industrial activity in metropolitan and rural areas both in the United States and in developing countries; much of my work has also involved identification of specific economic activities appropriate for particular areas. Domestically, my work in industrial development has included identification of target industries for regions in Kansas, Nevada, Pennsylvania, Oregon, Washington, and California.

Internationally, I have examined the prospects for expansion of particular economic sectors in the countries of Senegal, West Africa; Republic of South Korea; and in the developing economies of the South Pacific, specifically the Kingdom of Tonga and the island of Truk, in Micronesia. These studies have also assessed the benefits and costs associated with the development of the specific sectors.

Closely associated with me in this project will be senior Arthur D. Little staff members with extensive experience in the broad areas of regional economics and industrial development:

Cyril C. Herrmann — Dr. Herrmann will assume primary project management and implement overall contract and study policy. Dr. Herrmann has been a consultant with Arthur D. Little for 22 years, and has worked on many economic development projects. His domestic work has included studies in New England, Florida, and California. For several years he was manager of the Arthur D. Little "Operation Bootstrap" program in Puerto Rico,

Arthur D Little, Inc

July 7, 1977

-20-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

one of the most successful industrial development action programs ever established. He had similar responsibilities for industrial development programs in Egypt, Iraq, Honduras, the Phillipines, and several provinces in Canada. He is Vice President of the Urban Land Institute and Chairman of the Research Committee.

Harry Foden — Mr. Foden will join with Dr. Herrmann in providing policy guidance and project review. Mr. Foden's experience in economic development work for Arthur D. Little extends over a 20-year period. Within the United States he has directed studies for states, municipalities, and public utilities, including New York, Pennsylvania, Mississippi, Massachusetts, Illinois, Indiana, and South Carolina. Overseas he has been involved in economic development work for Iraq and currently is engaged in such studies in Saudi Arabia. He is an Executive Group Member of the Industrial Council of the Urban Land Institute and a member of the American Industrial Development Council.

Vincent Ficcaglia — Mr. Ficcaglia is a senior staff economist whose work is concentrated in the areas of industrial and regional development and applied quantitative economics. Over the past several years he has directed numerous studies employing econometric and other quantitative techniques. In particular, he has utilized Arthur D. Little's input/output model of the U.S. economy to address questions related to the impact of various public policy measures and new industrial developments upon national, regional, and local economies.

Donald Tatzin — Mr. Tatzin is a regional planner and economist specializing in the identification of economic sectors for regional and local economies. He is presently evaluating the type and magnitude of new industrial and related activities associated with the effects of Alaskan Outer Continental Shelf development on Puget Sound and the State of Washington.

Richard Goodale — Mr. Goodale is a financial specialist with Arthur D. Little, concentrating on investment opportunities and financial analyses.

Christopher Krebs — Mr. Krebs is an economist and social analyst with special interest in community and regional economic development and public policy formulation. Of particular relevance to this project is his recent work for a major U.S. air carrier regarding the trade linkages and communities of interest between the United States and Japan, focusing particularly on the impacts on the Pacific Northwest economy.

In addition, as appropriate, technical specialists knowledgeable in particular sectors will be called on to provide in-depth assessments of markets and competitive positions within these sectors. Their resumes and those of the project team members are attached.

Arthur D Little, Inc.

July 7, 1977

-21-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

COST AND DURATION

It is our understanding that this work is to be completed within six months. Assuming an early August start, work could be completed by the first of February during the next legislative session. By early October we would be able to provide an interim report to you and the committee relative to the preliminary sectoral analysis. We will also submit monthly informal progress reports indicating work done to that time.

The final report could be presented in January, with the final report in 20 copies and a reproducible master copy provided at the beginning of February.

For the work outlined we propose that you authorize a fixed price of \$98,000 to cover professional services and expenses. We have estimated that the following levels of effort by task will be required:

Task	Professional Service and Expense
1	\$ 6,500
2	8,000
3	18,000
4	41,000
5	14,500
6	10,000

Invoices will be submitted monthly according to the following schedule and will be payable upon receipt:

Arthur D Little, Inc.

July 7, 1977

-22-

Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

Invoice Date	Amount
End of Month 1	\$15,000
End of Month 2	15,000
End of Month 3	15,000
End of Month 4	15,000
End of Month 5	15,000
End of Month 6	15,000
Submittal of Final Report	8,000

GENERAL PROVISIONS

Our work for clients is conducted on a confidential basis, and we will treat information developed hereunder in accordance with our established professional standards.

Since announcement to the public of our working relationship, either while it is in progress or afterward, might be mutually beneficial, we will discuss with you any opportunities we see in this area. Of course, the details of any such announcement would be confirmed in writing by both parties.

Our work will be on a best efforts basis. We trust the results will meet the objectives sought, and we have assigned to the work professional personnel having the required skills, experience and competence. In any event, our liability for damages direct or consequential resulting from this work will be limited to the amount paid us hereunder.

Any change in this agreement shall be confirmed in writing. This agreement shall be interpreted according to the laws of the State of California.

Our agreement may be terminated on 30 days' written notice by either party, or within such lesser time as we may find necessary to conclude the work currently under way and summarize our findings for you. In that event, you will be responsible only for the professional services and expenses which have been committed to that time.

Arthur D Little, Inc

July 7, 1977

-23-

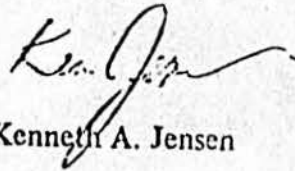
Mr. Jim Edenso, Deputy Commissioner
State of Alaska, Department of Revenue

1-8883

ACCEPTANCE

We look forward with great interest to working with you on this project. If this proposal meets with your approval and you would like us to proceed, please sign and return the enclosed copy within thirty days. Should you have any questions or wish more time to consider our proposal, please let me know.

Sincerely yours,



Kenneth A. Jensen

KAJ:gac

Approved for Arthur D. Little, Inc.

By *Ed C. De Budey*
Authorized Contracting Officer

Accepted for State of Alaska, Department
of Revenue

By _____

Title _____

Date _____

OVERALL ANALYSIS TO BE
PREPARED FOR EACH SEPARATE
PROGRAM RELATED TO COMMUNITY
DEVELOPMENT

What should be the relationship between your agency or program and the Permanent Fund? In your narrative discussion your analysis should address, but should not be limited to answering the following questions:

Do you believe that the availability of capital from the public sector is critical to the continuance of your program? Can capital be provided by the private sector? If private sector financing is not available, why not? What is the economic and/or social advantage (if any) of public rather than private sector financing?

Considering that 25 percent of oil revenue may be placed in the Permanent Fund and 75 percent may be placed in the General Fund (thereby making the General Fund potentially three times as large as the Permanent Fund), is it more or less advantageous from the state's point of view to meet your capital needs from the Permanent Fund?

Do you believe that the existence of the Permanent Fund will enlarge or diminish the scope of your program? Explain. Do you envision consolidation of your program with another? Do you foresee the potential for your program to absorb others?

If you believe that the Permanent Fund should participate in financing your program, should it do so as a lender or as an equity partner? As a lender what are the probable risks involved and the probable earnings (rate of return)? As an equity partner, what are the risks and the probable rate of return on investment.

Do you have a 15 year operating and/or capital funding plan? (If you do, please attach a copy to this report.) If you do not have one, when will you have one?

5

ADDITIONAL SPECIFIC QUESTIONS DIRECTED
TO CERTAIN STATE OFFICES/AGENCIES

TO BE ANSWERED BY:

ALASKA STATE HOUSING AUTHORITY

ALASKA HOUSING FINANCE CORPORATION

OFFICES RESPONSIBLE FOR GOVERNMENTAL HOUSING
(REAA - PUBLIC SAFETY - OTHERS)

OFFICE RESPONSIBLE FOR HOUSING FOR THE ELDERLY

OFFICE RESPONSIBLE FOR PIONEER HOMES

OFFICE RESPONSIBLE FOR VETERANS LOANS FOR HOUSING

1. What is your projection of total need, to be satisfied by your program in terms of housing units and dollars, for the following time frames:

FY 1979-1983

FY 1984-1988

FY 1989-1993

If possible, stratify the answer to the above by types of housing and geographical area. What percentage of the total need will be met by your program or activity?

2. What do you estimate or propose the source of the capital dollars required to fund your program to be? In what amounts?

General Fund appropriations?

General Fund capital appropriations for leveraging?

Leverage loan dollars borrowed from Permanent Fund?

Other borrowed funds from Permanent Fund?

Sale of investments to Permanent Fund?

Other Funds (specify)?

(Indicate amounts required by type of funding source in year groups FY 1979-1983, FY 1984-1988, FY 1989-1993.)

TO BE ANSWERED BY:

ALASKA POWER COMMISSION

1. What is your projection of capital dollar needs over the next fifteen years, to fulfill the needs for power in Alaska? Structure your analysis in terms of five year increments (FY 1979-1983, FY 1984-1988, FY 1989-1993). Indicate the need for regional power, rural (bush) power, municipal and private power generation within organized units of government. What percentage of total statewide need will the Commission satisfy?

2. Where should the capital funding for these projects come from:
 - General Fund appropriations?
 - General Fund capital appropriations for leveraging?
 - Leverage loan dollars borrowed from Permanent Fund?
 - Other borrowed funds from Permanent Fund?
 - Sale of investments to Permanent Fund?
 - Other funds (specify)?

TO BE ANSWERED BY:

DEPARTMENT OF TRANSPORTATION

1. What is your projection of capital dollar needs over the next fifteen years to fulfill the following needs:

Ports & Docks

Small Boat Harbors

Airfields

Municipal Mass Transit

Local Roads & Trails

Major Highways

Ferries & related facilities

(Indicate other capital dollar needs by five year time blocks --
FY 1979-1984, FY 1984-1988, FY 1989-1993.)

2. Where should the capital financing for these projects come from?

General Fund appropriations?

General Fund debt (G.O. Bonds)?

Loans from the Permanent Fund?

Equity investment by the Permanent Fund?

Federal Funds?

Municipal Government Funds?

Other funds (specify)?

BACKGROUND INFORMATION

ALASKA PERMANENT FUND INTERIM ACTIVITY

Alaska
State
Legislature

Governor

Comm. of Revenue
and
State Investment
Advisory Committee

Administrative
Working Group
Alaska
Permanent Fund

Economic
Diversifi-
cation

- . Dept. of Commerce & Economic Development
- . Dept. of Revenue
- . Dept. of Labor
- . Governor's Office
- . Dept. of Natural Resources
- . Div. of Policy Development & Policy
- . Dept. of Fish & Game

Savings
Account

- . Dept. of Revenue
- . Dept. of Commerce & Economic Development
- . Div. of Budget & Management
- . Dept. of Administration

Community
Development
Investments

- . Municipal Bond Bank Authority
- . Dept. of Community & Regional Affairs
- . Dept. of Revenue
- . Dept. of Transportation
- . Dept. of Administration
- . Div. of Budget & Management
- . Div. of Policy Development & Planning
- . Dept. of Commerce & Economic Development

Public
Information
and Input

- . Div. of Policy Development & Planning
- . Dept. of Revenue
- . Dept. of Community & Regional Affairs
- . Governor's Office
- . Dept. of Commerce & Economic Development
- . ~~Dept. of Fish & Game~~

- Dept. of Justice

ALASKA PERMANENT FUND WORKING GROUP

The Governor appointed the Department of Revenue as the lead agency for the administration in the development of the Alaska Permanent Fund. Further, the Governor appointed the State Investment Advisory Committee to aid the State in the development of the Alaska Permanent Fund (the S.I.A.C. is statutorily mandated to advise the State on investment policy). It is the recommendation of the Department of Revenue that the proposed administrative Alaska Permanent Fund Working Group report to the State Investment Advisory Committee in order to continue the rapport already established with Alaska's various interest groups. The purpose of the Working Group will be to develop recommendations on policy for the S.I.A.C. based on public input and State agency programs.

The Division of Policy Development and Planning will be responsible for coordinating the efforts of the Working Group. It will monitor report preparation and distribution to all agencies. Each agency will be responsible for the preparation of reports and subsequent presentation to the Working Group. The Division of Policy Development and Planning and the Department of Revenue will be responsible for jointly preparing a final report to the State Investment Advisory Committee.

The membership of the proposed Working Group be comprised of the following:

Department of Revenue/Commissioner's Office

Department of Commerce & Economic Development/Commissioner's Office

Department of Community & Regional Affairs/Commissioner's Office

Department of Transportation/Commissioner's Office

Department of Administration/Commissioner's Office

Department of Labor/Commissioner's Office

Department of Natural Resources/Commissioner's Office

Department of Law/Attorney General's Office

Department of Fish & Game/Commissioner's Office

Governor's Office/Kent Dawson

Office of Budget & Management/Ron Lind

Division of Policy Development & Planning/Director's Office

Alaska Municipal Bond Bank Authority/Dave Rose

The Working Group should be sub-divided into the following categories for participation purposes:

- a. Public information and input
- b. Community development investments
- c. Savings account
- d. Economic diversification

Task assignments will be made at the first meeting of the Working Group. Each assignment should take into consideration each agency's major area of activity and expertise, e.g., Community and Regional Affairs be assigned in the community development area; Division of Policy Development and Planning for agency coordination (circulating reports for comments, deadlines, etc.), and so on.

Specific Questions to be Addressed by the Alaska Permanent Fund Working Group:

I. Public Comment and Information Input

How should the Alaska Permanent Fund monies be invested?

A. Investments in the private sector.

If the Alaska Permanent Fund is used to stimulate development in the private sector, a number of questions should be asked of the public. The following are questions which may be presented to the public for consideration:

1. Investments in capital intensive sectors versus investments in labor intensive sectors.
2. Investments which subsidize project development through interest rates lower than market rates of interest.
3. Investments at market rates of interest.

4. Investments to diversify the economy in order to eliminate seasonal effects of certain industries, implement new industries, and to broaden the State's recurring tax base.

5. Investments which minimize environmental impact.

B. Community development investments.

Some types of community development projects which need to be considered by the public include:

1. Housing.

2. Infra-structure development (to include utilities, transportation, communications, power development, etc.).

3. Financial assistance to communities through providing trust, guarantee, and other types of agreements for municipal securities.

Questions which need to be asked pertinent to community development include:

1. What kind of housing: single family, multiple, large housing development projects (condominium development)?

2. Would there be a limitation on infra-structure development assistance?

3. Should there be a specific amount allocated for community development projects?

C. Savings account.

The savings account concept means that the Alaska Permanent Fund could be either partially or wholly invested in the financial securities markets. This concept implies investments of the Alaska Permanent Fund monies in U. S. government securities, Baa securities, and other securities of a similar rating. The objective is to earn the greatest amount of income while minimizing the amount of risk in order to insure the preservation of the Permanent Fund. Questions to be presented to the public include:

1. What percentage of the Alaska Permanent Fund should be allocated to the savings account concept?

D. Alaska, Inc.

II. State Agency Data and Study.

A. Investments in the private sector.

Information concerning Alaska's economy may be useful in evaluating investment proposals submitted to the Alaska Permanent Fund. The development of a sectorial analysis of the State's economy to provide information to be used for evaluating investment proposals is an important aspect of the State agency and data area. Such questions as the following may be asked:

1. What sectors of the State's economy are more attractive for investment purposes?
2. What sectors of the State's economy should be considered for purposes of prioritizing investments from the Alaska Permanent Fund in the State's economy?
3. Should there be an allocated amount of Alaska Permanent Fund monies designated for investment purposes into a particular sector of the Alaska economy?

B. Community development investments.

1. Regional growth rates (actual, projected, limitations).
2. Projected housing needs.
3. Mutual options for community investments in the categories of electric power, utilities, transportation facilities, and communication.
4. An inventory of community investment opportunities.
5. An inventory of community credit characteristics.

C. Savings account (financial management and investments).

1. The State's investment management experience in the security market.
2. Investment management experience of other investment managers.

D. Other technical questions.

1. Legal meaning of "permanent" and "income producing".
2. Comparison of cost of administration of other State investment funds.

E. Alaska, Inc.

MODELS AND OPTIONS
FOR THE
ALASKA PERMANENT FUND:
FUNCTIONS, REGIONALIZATION AND ACCOUNTABILITY

Report Number Two
September 14, 1977

Belden Hull Daniels
Department of City and Regional Planning
Harvard University

Table of Contents

	<u>Page</u>
INTRODUCTION: Some Models and Options	1
I. FUNCTIONS	3
A. Alaska Ownership of Large Scale Alaska Enterprise	3
1. Canada Development Corporation	3
2. British National Enterprise Board	21
B. Expansion of Small and Medium Scale Productive Enterprise	46
Connecticut Development Authority	46
C. Community Development in Underdeveloped Areas	67
Massachusetts Community Development Finance Corporation	67
D. Regional Economic Development	92
European Investment Bank	92
E. An Alaska Central Bank Owned by Local Coopera- tive Development Banks	117
1. British Columbia Central Credit Union	117
2. Deutsche Genossenschaftsbank	133
II. REGIONAL MODELS AND OPTIONS	149
International and Domestic Patterns	149
International Models	151
An American Parallel: The Farm Credit System	153
Other Domestic Models	157
In Summary: A Range of Options for Regionalization Available to the Alaska Permanent Fund	161

Table of Contents (continued)

	<u>Page</u>
III. THE PROBLEM OF ACCOUNTABILITY	164
An Introduction to the Issue	164
A. Setting of Goals and Priorities	169
B. Formulation of Measurement and Reporting Procedures	176
C. Governance: Public Inputs into Operating Decisions	181
D. Operating Sanctions	189

MODELS AND OPTIONS FOR THE ALASKA PERMANENT FUND:
FUNCTIONS, REGIONALIZATION AND ACCOUNTABILITY

September 14, 1977

INTRODUCTION: Some Models and Options

My first report of July 11, 1977 raised many questions concerning the purposes, functions, sources and uses of funds, management and accountability of the proposed Alaska Permanent Fund, based on the accumulated experience of several hundred development banks over the last one hundred years.

This second report takes the next step, and provides a beginning look at a number of development banks whose experience and functions seem particularly relevant to potential public purposes of the Permanent Fund. In selecting development banks to analyze in detail, I have been guided by two factors: first, institutions which would compliment reports already prepared for the State Investment Advisory Committee by Price Waterhouse and White, Weld; second, institutions whose purposes and functions seem particularly relevant to key potential Fund goals.

Each of these institutions have been analyzed and compared in terms of: I. Purposes; II. Sources of Funds/Capitalization; III. Uses of Funds/Operations; IV. Management; V. Accountability; VI. Evaluation; and VII. Relevance to the Alaska Permanent Fund.

In addition to this look at functional models for the Fund, two key structural issues are outlined in some detail, based on domestic and international experience: regionalization; and accountability to the taxpayers, legislature, and executive. In both instances, a conceptual approach is developed out of a range of

domestic and international experiences. This experience and the conceptual framework will probably raise more questions for your further consideration.

Again I would like to note that as an outsider, I feel competent to suggest detailed operating experience which may be relevant to the Permanent Fund's purposes, but not competent to suggest what those purposes should be. There is an old Asian proverb which says that after one trip to India foreigners write a book, after two they talk in quiet whispers, after three, they say nothing at all. This is my second trip to Alaska.

It is with special gratitude that I thank my research associate, Mitchell Rosenberg, for his extraordinary care in helping to prepare this report. One of the pleasures of teaching and working is witnessing younger colleagues and friends grow in competence to encompass their vision. I wish Mitchell well in his year in Germany.

My sense is that this second report, like the first, will raise more questions than it answers. For this reason, I have noted it a "discussion draft", and look forward to responding to the further issues it raises.

I. FUNCTIONS

A. ALASKA OWNERSHIP OF LARGE SCALE ALASKA ENTERPRISE

1. CANADA DEVELOPMENT CORPORATION
Discussion Draft

September 14, 1977
Page 3

1. PURPOSES

The CDC is an investment bank operating in the private sector of the Canadian economy. Created in 1971 by an act of Parliament, its initial capitalization was provided by the Canadian treasury in the form of a purchase of over \$250 million in common stock. Such an institution had been proposed by government officials as early as 1958 in response to concern over the high level of foreign ownership and control of Canadian business. This condition, they felt, discouraged the development of native entrepreneurial talent necessary for economic growth and job creation. The proposed use of financial mechanisms to achieve such goals met with strong opposition from the Canadian business sector and allied politicians. When the CDC bill was passed after 15 years of debate, none of these social objectives were included in the institution's statutory agenda.

Legislative Goals

The three main objectives of the CDC summarized in the act are:

- 1) to help develop and maintain strong, Canadian-controlled and managed corporations in the private sector of the economy;
- 2) to widen the investment opportunities open to Canadians; and

3) to operate profitably, in the best interests of all its shareholders, public and private.

The investment policies by which these goals are to be achieved were left purposefully broad in the act in order to accommodate conflicting views of the proper role for the institution in passing the legislation and to provide maximum managerial discretion. This is similar in concept and language to the draft of the Permanent Fund developed by the Investment Advisory Committee. However, the "Objects" section of the act, various documents of the debate prior to its passage, and statements of company officials provide a clear picture of the CDC's investment criteria and their rationale.

Management Interpretation of Goals

CDC management interprets its role as a provider of the equity capital necessary to mobilize Canada's material, human and capital resources to bring domestic industry up to internationally competitive scale in the long run. The management's investment policies following from this view are:

1) emphasis on large, longer-range development projects, particularly those involving upgrading of resources, a high technological base or good potential for building a Canadian-controlled presence in international markets.

2) Profit potentials must be commensurate with perceived risk. This is the one criterion mandated in the act, similar to the current draft of the Permanent Fund. As a rule of thumb, the Board proposed targeting investment to sectors in which predicted growth exceed twice that of GNP. Acknowledging the long-term nature of their mode of investment, the directors declare, "CDC is prepared to be patient, recognizing that some of its opportunities will exist because others are unwilling or unable to wait through the years of earnings buildup."

3) CDC in a manner again similar to the current Permanent Fund draft, does not seek to duplicate or preempt activities in the private capital market. Thus it does not lend, debt capital, presumably being readily available to large-scale enterprises in the Canadian private market. It is, however, prepared to play a catalytic role in joint ventures with foreign or domestic investors.

4) CDC seeks controlling positions, through the purchase of voting stock, in the companies in which it invests--this in order "to take measures necessary to protect and increase the value of its holdings." Such measures connote input into top-level strategic and corporate planning decisions, not day-to-day management. The Permanent Fund draft is unclear on this point.

5) CDC seeks to concentrate its activities in sectors where Canada holds competitive advantage on an international

scale or can achieve such position through consolidation of markets.

6) Roles the CDC specifically rejects include buyer-of-last-resort for faltering firms, buy-back agency for foreign-controlled firms or high bidder in take-over contests where foreign firms are involved.

In order to pursue these policies, CDC has been granted a very broad range of powers. It may invest in any asset or security, promote companies, lend or guarantee funds. It may even invest in firms not carrying on any part of their business in Canada when, in the opinion of the Board of Directors, such investment would further the aims of the company.

II. SOURCES OF FUNDS/CAPITALIZATION

Authorized - CDC is authorized to issue 200 million common shares without nominal or par value, of which the first 30 million were subscribed by the Canadian government from 1971 to 1975 at prices averaging slightly over \$10 a share. The company is further authorized to issue up to \$1 billion in preferred stock with such convertibility, voting and interest features as the Board determines. CDC is under no statutory debt limit. Management has chosen a target level of 40 percent of paid-in capital, a conservative policy designed to compliment CDC's risk-oriented

investment policies. This scheme indicates a potential capitalization of \$5 billion.

Capitalization Goals

CDC wishes to finance further investment through the public issue of shares. Its aims in so doing are:

- 1) to decrease the government share of ownership to 10 percent within 10 years. The government currently holds 65 percent of all CDC stock outstanding.
- 2) to offer opportunities for equity investment in Canadian industries to Canadian investors. Political support is an expected by-product of such a policy.

Reliance on public support reinforces the profit criteria for investment, since continued growth will depend on investors' perception of CDC as a safe and profitable investment.

Actual History of Capitalization

1971 - CDC was originally capitalized by the Canadian government's purchase of 25 million shares for a price of slightly more than \$250 million. The government increased its holding incrementally over the subsequent four years until it held about 30 million shares valued at slightly more than \$300 million in 1975.

1974 - CDC placed 10 million non-voting redeemable preferred

shares with institutional investors. These preferred shares sold for \$10 and carried a dividend of 5 3/4 percent. The proceeds of this issue were used, in part, to pay off bank debt incurred to finance start-up operating costs. The shares are redeemable at the option of the holder or CDC after five years.

1975 - CDC marketed 1.5 million preferred voting shares to some 20,000 individual, institutional and governmental investors. These shares sold for \$100 and carried an 8 percent dividend. They were convertible for 10 shares of common stock with further share bonuses for early conversion. They are redeemable at the option of the holder or CDC after five years. This was the largest public stock offering in Canadian capital market history.

Despite CDC's profit orientation, its performance has not yet inspired sufficient investor confidence to support the subscription of common stock on the basis of capital gains alone.

In 1975 CDC also issued about 950,000 shares of common stock to the Canadian government as the final \$10 million payment for the Crown Corporation, Polysar.

Outstanding debt of wholly-owned subsidiaries stood at \$250 million at the end of 1975.

III. USES OF FUNDS/INVESTMENT OPERATIONS

CDC has used its funds primarily to invest in established

businesses either through buying the enterprise outright or through purchase of a significant portion of its outstanding securities. CDC's holdings in 1975, by industrial sector, were as follows:

Petrochemicals - CDC acquired Polysar Ltd., a manufacturer of rubber and petrochemical products, from the Canadian government. The negotiated price for the Crown corporation was \$62 million plus \$10 million if certain profit targets were met. As of year-end 1975, Polysar's assets were \$602 million. In 1975, CDC, through Polysar, joint-ventured with Canadian banks to finance the construction of the Petrosar naphtha cracking plant, a \$575 million, world-scale facility.

Mining - In 1973, CDC acquired, through tender, 30.2 percent of the stock of Texasgulf, Inc., the American-based energy and mining firm. At the time of this acquisition, 68 percent of Texasgulf's earnings were generated by enterprises located in Canada.

Oil and Gas - In 1975, CDC acquired 60 percent of the Canadian assets of Tenneco. These assets include gas and oil processing plants and vast areas of oil, gas and bituminous tar producing properties. These assets are valued at \$135.0 million.

Health Care - CDC has purchased several drug companies and research facilities in an effort to build a consolidated Canadian-

owned complex in the health care field. The flagship firm of Connlab Holdings Ltd. is Connaught Laboratories, a research facility formerly attached to the University of Toronto. Since the consolidation of these companies in 1974, Connlab has shown steady losses.

Venture Capital - CDC's directors have acknowledged the crucial role of financial support for technological innovation in economic development. They have not found it appropriate, however, to undertake the complex and time consuming services of venture capitalists themselves. Instead, CDC has purchased large amounts of stock in three existing venture capital firms, leaving their management free to administer the newly expanded funds. These firms invest in a wide variety of enterprises at the conceptual or early development phase.

Pipelines - CDC has advanced \$3.8 million to a consortium planning the construction of a North-South natural gas pipeline.

Looking over CDC's investments, it is apparent that they meet the institution's criteria of being in sectors where Canada holds a comparative advantage (natural resource extraction and processing) or which have experienced high growth (medical supplies and equipment). Unfortunately, statistics which would permit an estimate of CDC subsidiaries' presence in their respective sectors are not available. We can, however, get some idea of the

impact of these investments on the extent of Canadian control of these sectors by comparing 1968 statistics on total assets, Canadian and foreign held, in major sectors which appear in a 1973 government report on foreign investment in Canada to CDC's current holdings.

In 1968, assets employed in the petroleum/natural gas sector totaled \$9.2 billion, of which Canadians held \$3.7 billion (38 percent). Even given growth in this sector between 1968 and 1973, CDC's Petrosar undertaking is a sizable net addition to Canadian holdings in this sector. None of CDC's other undertakings have nearly so large a quantitative impact.

IV. MANAGEMENT

The Corporation is managed by a Board of 21 Directors drawn mostly from the business community. While the government holds over 50 percent of the stock, two Deputy Ministers are ex officio Board members with no voting power. The government may choose to appoint four Directors rather than casting its ballots at Shareholders' Meetings. Such power has not been exercised to date. The government has stated both publicly and privately that it does not intend to interfere with the affairs and management of the Corporation.

The Board's policies are administered by a highly profes-

sional central staff of twenty. Subsidiaries' production decisions are to be made independent of CDC input. The staff was kept small to encourage flexible response to problems. Specialized matters are often referred to consultants.

V. ACCOUNTABILITY

The CDC act, elements of Canadian corporate law and the political climate in which the Corporation was implemented combine to leave the CDC Board and staff in virtual total control of company operations and investment.

Legislative Accountability

By statute, CDC is not subject to Parliamentary oversight. Parliament's latitude for intervention is restricted to voting changes in capital authorization and certain exceptional by-laws concerning CDC's objectives. Given the Corporation's immense initial capitalization, it is unlikely that Parliament will have the opportunity to exercise any constraints on CDC short of closing it down.

CDC is not a Crown Corporation, i.e., a public corporation formed under the Canadian Financial Administration Act "that is ultimately accountable, through a Minister, to Parliament for the conduct of its affairs." Although it is publicly capitalized, it

is subject to no ministerial oversight or control. Rules governing disclosure for Canadian corporations have been widely attacked for being unduly lax; these are the accountability standards to which CDC is being held.

Executive Accountability

The federal government does hold a certain amount of de facto power through rules governing the distribution of shares. No association, a term defined operationally by the Board, may hold more than 3 percent of the outstanding voting stock. The federal government may hold 10 percent. Therefore, its voting position may always be dominant, given an absence of block coalitions. However, the government has chosen to maintain a hands-off stance towards CDC operations. Investment policies and priorities, for example, were set by the Board with no government input. With its current holdings, the government could exercise control through the removal of Board members, but has chosen not to do so.

The government has eschewed other control mechanisms which have been applied to mixed enterprises in Europe, where this kind of structure has a longer history. These mechanisms include having government officials as voting members of the Board of Directors, actively exercising voting shares, statutory regulation of investment operations and maintaining a permanent or intermittent

public body to audit the activities and reports of the public financial institution. The CDC act provides for none of these supervisory measures. According to most observers, such lack of government input and control eliminates CDC from use as a tool in any centrally planned economic development effort.

VI. EVALUATION

Recalling the three purposes of the institution (p. 3), how has CDC performed? Before attempting an answer, we must recognize that evidence is limited to skimpy annual reports covering only four years of operating experience.

Regarding the creation and maintenance of strong, Canadian-controlled industries, CDC has followed a policy of expansion and consolidation of existing firms. CDC's equity presence in Polysar allowed the company to incur debt to finance capital expansion at a much quicker rate than was realized under government ownership. In assembling Connlab Holdings, CDC seems to be creating a vertically-integrated drug complex covering research, production and distribution. What these policies will mean in terms of rationalization, investment and employment remains to be seen.

CDC has increased investment opportunities open to Canadians only marginally. Its one public stock issue was in the fairly large denomination of \$100/share and was apparently bought in

blocks averaging 75 shares. Clearly, this kind of marketing will not broaden participation in equity ownership. Quantitatively, however, this was a very big issue: During the decade previous to the issue, gross new issues of Canadian preferred stock averaged only \$132 million, compared to the \$150 million sold in one shot by CDC.

CDC has shown some profit in terms of earnings per share every year.

CANADA DEVELOPMENT CORPORATION

<u>Year</u>	<u>Capitalization¹</u>	<u>Value of Holdings²</u>	<u>Earnings/Share</u>
1975	708	857	\$0.31
1974	548	549	\$0.81
1973	344	465	\$1.89
1972	138	200	\$0.57

¹Capitalization = Capital stock plus retained earnings, in \$000's.

²Value of Holdings = Investments plus fixed assets of wholly-owned subsidiaries, in \$000's.

Given the \$10+ price of shares, earnings have been modest. They have fluctuated with the general conditions of the Canadian economy and have been well below the CDC Board's stated profit target of 15 percent.

CONSOLIDATED BALANCE SHEET
December 31, 1975
Canada Development Corporation

	1975	1974
	(thousands	of dollars)
ASSETS		
Current Assets	\$ 378,430	\$ 321,811
Investments	354,581	332,354
Fixed Assets of Subsidiaries	502,792	216,271
Other Assets	41,73	29,155
TOTAL	<u>\$1,277,537</u>	<u>\$899,591</u>
LIABILITIES		
Current Liabilities		
Short-term loans	\$ 95,198	\$ 97,484
Accounts payable and accrued liabilities	95,674	74,752
Dividends payable	4,280	1,437
Income and other taxes payable	15,222	3,575
Long-term debt due within one year	10,416	15,672
Total	220,790	192,920
Long-Term Debt	250,358	137,439
Deferred Income Taxes	25,337	9,744
Interest of Minority Shareholders in Subsidiaries	73,218	11,172
Total	569,703	351,275
SHAREHOLDERS' EQUITY		
Capital Stock	564,563	422,000
Retained Earnings	91,699	74,744
Excess of Book Value over Cost at Date of Acquisition of Subsidiary	51,572	51,572
Total	707,834	548,316
TOTAL	<u>\$1,277,537</u>	<u>\$899,591</u>

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

In analyzing the relevance of the Canada Development Corporation to the Alaska Permanent Fund we will review the major headings in this memorandum in order: Purposes, Sources and Uses of Funds, Management, and Accountability.

Purposes: The purposes of the Canada Development Corporation appropriate for consideration by the Permanent Fund are:

- 1) to encourage the establishment and maintenance of strong Canadian controlled enterprises;
- 2) to widen investment opportunities for Canadian investors; and
- 3) to operate for a profit.

The achievement of the first two goals is conditioned by and dependent on the third. Profit is the operational goal most frequently and explicitly mentioned by management in its official reports. They attempt to make a case for their pursuit of profit by claiming that the partially public benefits of the first two goals will never be realized unless a rate of profit and growth higher than that enjoyed by foreign controlled elements of the Canadian economy are achieved. In the first annual report, management stated,

If we as a nation are to increase the Canadian content of our economy, it must be essentially by encouraging the sound growth of Canadian-controlled enterprises at a pace which exceeds that of their non-resident-owned competitors.

In the case of altering the balance of Canadian/Foreign control of Canadian industry, the statement above amounts to a tautology. In terms of providing wider investment opportunities in Canadian enterprise to Canadians, the statement is true to the extent that CDC issues must out-perform competitive securities in order to be attractive to investors. Canadian investors have access to international capital markets, and, in 1970, 40% of the securities held by institutions and individuals in Canada were of foreign issue.

The achievement of extraordinary profits by an investment holding company like CDC is unlikely. Recent work in investment portfolio theory and the experience of the securities industry in the past decade have demonstrated the futility of attempting to "out-perform" the market in the long run.

CDC may even be compounding its difficulties by investing in as few enterprises as it does. This investment strategy may lead, and in CDC's case has led, to unstable earnings and cash flow. Such a situation may inhibit the planning of future operations.

CDC's investment operations raise issues of control over the exploitation of natural resources, operations of the Canadian capital market and ownership structure of major industries, all of which are legitimate concerns of the Federal government and the Canadian people. The proponents of CDC in its present form

convinced Parliament that it was necessary to give up control over these matters in order to achieve the more limited goals in the statute. However, what the government got for relinquishing such controls is of questionable value. Lack of government input into CDC operations is the major weakness of the institution.

Sources and Uses of Funds: The management of the Canada Development Corporation has intentionally developed a strong equity base with only 40 percent debt in order to undertake the kinds of long-range, high-risk strong ownership positions which are essential to carry out its purposes.

On the other hand, the Canada Development Corporation must maintain a very strong return on its invested capital in order to attract the substantial private investment in the Canada Development Corporation which it is seeking. The Permanent Fund will not have such a constraint, which has both negative and positive aspects. From a positive standpoint, it will not be forced to get such a market return; from a negative standpoint, it will not have the correction of the marketplace monitoring its investments quite so carefully.

Management: The Canada Development Corporation has the kind of strong, independent, professional staff necessary to any successful development bank. The Canada Development Corporation follows the wise course of only overseeing the major strategic

planning decisions of its subsidiaries and affiliates, and not involving itself in day to day decision making.

Also, the Canada Development Corporation management has been given the very broad managerial discretion to make investment decisions which is contemplated in the current draft of the Permanent Fund.

Accountability: On the other hand, the Canada Development Corporation is a preeminent example of a development bank which does not have sufficient accountability to either the executive or the legislature.

INTRODUCTION

The National Enterprise Board, established under the Industry Act of 1975, is a public financial and promotional institution whose principal objectives are to assist the economy of the U.K., to promote industrial efficiency and international competitiveness and to expand opportunities for productive employment.

From 1968 to 1971, the British government operated a public financial institution with a similar purpose--the Industrial Reorganization Corporation (IRC). IRC's functions were limited to promoting and providing finance for mergers which the directors felt would help effect the rationalization of an industry. (Many of Britain's manufacturing sectors are characterized by firms too small to compete on an international scale.) IRC generated a great deal of opposition from private financial interests which felt that they were being subjected to unfair competition. The institution was disbanded by the newly elected Tory government in 1971. NEB, which incorporates the functions of IRC into the comprehensive program described below, began operations in November 1975.

I. PURPOSES

In order to meet these broad objectives the NEB carries out several different functions. Some observers feel these functions

are not consistent with each other. In planning its investments, the Board is to apply standard commercial criteria of profitability. On the other hand, it is viewed by government and its own directors as an instrument of national industrial policy and is therefore responsible for meeting various public policy criteria in its operations. The implications of NEB's mixed agenda will be examined in the detailed enumeration of the institution's purposes below.

NEB's operations fall into four conceptually separable classifications:

a) Finance for Industrial Investment - NEB acts essentially as an investment banker, purchasing the equities of private firms where it feels the investment will show a reasonable return, will help effect the purposes of the Act and will not displace private investment. NEB also makes loans on commercial terms.

b) Industrial Holding Company - NEB is responsible for the strategic management and financial monitoring of several large nationalized firms.

c) Assistance to Companies in Financial Difficulty - NEB administers capital assistance to firms in temporary financial difficulties. Funds for this activity are provided by the Secretary of State for Industry who is also responsible for deciding which firms will be considered for such assistance.

d) Promotional Activity--NEB offers assistance in procuring foreign contracts for British firms or groups of firms and in coordinating the activity of regional development authorities.

Each of these four purposes is analyzed below.

a. Finance For Industrial Investment

NEB's main function is the provision of finance for industrial investment, particularly for the expansion and modernization of productive facilities in manufacturing. In addition, finance or advisory services may be provided to promote industrial restructuring. Finance is normally provided in the form of equity, but loans at commercial rates of interest may also be provided.

NEB's investment policies are shaped by an interim statement of guidance from the Secretary of State for Industry, which is now pending statutory enactment. Except for those investments made at the direction of the Secretary* (see Section c), profitability, defined as the projected discounted rate of return to capital, is to be the main investment criterion. Subsidiary to this are certain public policy considerations, including:

*Note: In this profile, "Secretary" denotes the office of the Secretary of State for Industry.

- i. preparing for growth by action to increase longer-term capacity in key sectors of manufacturing industry;
- ii. increasing exports or savings imports; and
- iii. where there is a choice of location, creating new jobs in areas of high unemployment.

NEB devoted considerable time to identifying sectors where its assistance would be most beneficial in terms of promoting efficiency. They incorporated data and analysis from the White Paper accompanying the Industry Act and a 39-sector industry study by the National Economic Development Councils into their annual investment plans. NEB intends to use these studies and other analysis provided by the Secretary to guide future investment policy.

→ b. Industrial Holding Company

The NEB acts as a holding company for a number of shareholdings previously held directly by the government. The portfolio will be added to from time to time as a consequence of the NEB's role as a provider to new equity finance and through the purchase of existing shares in companies. In addition, the NEB has power under the Act to set up new enterprises or to participate in joint ventures with the private sector.

The basic job of the NEB as shareholder is to ensure a proper

return is secured to the taxpayers who provide capital through the Consolidated Fund, the general tax revenues of the British government. In so doing, the Board does not intend to participate in day to day management. Their oversight consists in most cases of making arrangements for the provision of regular monthly information to the NEB on performance and financial prospects, for the provision of annual and long-range plans for the approval by the NEB and for the submission (in the case of subsidiaries-- wholly-owned companies) of major capital investment proposals, acquisitions and disposals for approval.

Many of the "transferred companies'" problems have arisen from unstable industrial relations resulting from the inability of management and labor to work out satisfactory wage and productivity provisions. There are three high union officials on the NEB's ten-member Board of Directors. Their presence may be interpreted as a move to force some rapprochement between labor and management, given the Board's responsibility for strategic management and oversight of the troubled enterprise.

c. Assistance to Companies in Financial Difficulty

The NEB may be directed by the Secretary to assist a company in financial difficulties which needs to be restored to a sound state for reasons of employment or industrial policy. In some

cases, the Board will consider the provision of funds in some combination of commercial and subsidized terms. In such cases, the NEB will be reimbursed specifically for their involvement; and to ensure that their financial discipline is not undermined, these activities will be accounted for separately.

d. Promotional Activities

Foreign Contracts - In keeping with its policy to expand exports, the NEB attempts to use its central organizing and financial capabilities to help British industries compete for large foreign contracts. According to the Directors' analysis, "Overseas contracts are becoming so large in value, and the conditions attached to them so onerous, that many UK companies do not have a big enough asset base to undertake the risks; in addition there is a tendency among developing countries to favour tenderers with some form of government backing." NEB has announced that it is willing to joint venture with firms or groups of firms competing for such contracts. In 1976, it assisted in two such projects. The contracts were, however, awarded to other bidders.

Regional Activities - The Secretary's interim policy statement directed NEB to give particular weight to creating jobs in areas of high unemployment. In accordance with this direction, NEB has set up offices in Liverpool and Newcastle. The Regional

Directors' initial task has been to establish their offices, to build up close relations with public and other bodies concerned with regional development and industrial investment in their regions, and to seek out companies with potential which might require finance from the NEB to fulfill their modernization and expansion plans.

II. SOURCES OF FUNDS/CAPITALIZATION

NEB's investments are financed wholly by the national government. NEB may draw on two sources within the government: the National Loans Fund, and "public dividend capital" appropriated annually by Parliament to the Secretary of State by the Treasury for use in industrial investment. The National Loans Fund is a revolving fund to be used to make loans to private firms. The amount of money in the fund and the annual volume of loan activity is set by Parliament; it is administered by the Secretary. NEB may borrow from the Fund at private commercial rates and lend this money to the firms in which it invests. NEB must repay these loans on a fixed schedule set in advance in consultation with the Secretary. NEB may charge a small interest rate differential to its borrowers to cover its costs in originating and monitoring the loan.

Public dividend capital is another pool of investment funds

made available to the Secretary by Parliament, with controls similar to those exercised over the National Loans Fund. Repayment of these advances are flexible. Dividends and recovery of capital are set by the Secretary in consultation with NEB on a yearly basis. In 1976, NEB paid no dividends on the public dividend capital it received and subsequently invested in the firms it financed. Returns on public dividend capital are to be paid into the Consolidated Fund.

The Secretary and the Treasury must approve all advances from both the National Loans Fund and public dividend capital. The Board must supply accounts of the application of these funds to both offices.

The Treasury may authorize the use of general tax revenues to guarantee repayment of loans undertaken by NEB. The Treasury must notify Parliament of all such guarantees.

As of December 31, 1976, the breakdown of funds received by NEB was:

Public Dividend Capital

Debt assumed from the government upon transfer of investments; Directed by Secretary of State to be treated as public dividend capital:	Subsidiaries	418.4
	Associates	6.2
	Others	1.2
		<u>425.8</u>
<u>Issued to NEB during 1976</u>		54.0
<u>Total</u>		<u>479.8</u>

Loans

Capital debt assumed from transferred companies:	77.8
New loans issued to NEB during 1976	21.3
<hr/> Total	<hr/> 99.1

(All figures in £ million.)

Since NEB does not market securities, debt/equity ratios are not material to its success in obtaining further funds for investment. More important will be its return on capital and the performance of its subsidiaries. These factors will figure prominently in the Secretary's decision to continue providing investment funds to NEB.

III. USES OF FUNDS/INVESTMENT OPERATIONS

NEB's assets consist largely of investments and loans to five large public corporations transferred to it by the government. All of these companies have suffered financial, managerial and labor problems in the last few years. They have been only marginally profitable or have shown losses. The book value of these companies' assets was £624.1 million at the time of transfer. Their negotiated price, discounted for their market problems and used for calculating returns to NEB, was £495.7 million. During 1976, NEB made £40.41 million in new equity investments and £20.13 million in loans to these companies.

The operating status of NEB's major industrial holdings as of the date of transfer from the government was as follows:

British Leyland Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£1,868 mill.	£2,692 mill.
Profit (Loss), Before Tax	(76.1)	70.5
U.K. Employment	191,000	183,000

British Leyland is a major manufacturer of motor vehicles and allied products. The companies comprising this conglomerate had shown steady losses during the Sixties. They were consolidated and nationalized in 1973. British Leyland's small profit in 1976 is attributed to higher export margins resulting from the decline of the pound. The firm's major problem is that it has been unable to produce enough vehicles to meet demand. This is due mainly to disrupted labor relations. During the 15 months ended December 1976, 7.1 million man-hours were lost due to strikes and subsequent layoffs.

Data Recording Instrument Co. Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£10.15 mill.	£8.50 mill.
(Loss) Before Tax	(0.14)	(0.09)
U.K. Employment	923	1,030

Data Recording is a young firm producing computer peripheral equipment. Some 60 percent of its output is sold overseas. Its management has announced expansion plans calling for a doubling of employment in the next four years. However, the sales figures above do not seem to warrant such optimism.

Ferranti Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£86.3 mill.	£108.5 mill.
Profit (Loss) Before Tax	(0.5)	4.1
U.K. Employment	16,651	15,576

Ferranti is a conglomerate producing many lines of heavy electrical equipment and electronic instruments. Its operations are international, with subsidiaries in Canada, Brazil and Scotland. As of the end of 1976, divisional management was being decentralized in an attempt to accelerate the increase in profitability indicated above.

Herbert Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£49.7 mill.	£49.4 mill.
Profit (Loss) Before Tax	(13.4)	(0.7)
U.K. Employment	6,716	6,017

Herbert is one of Britain's largest machine tool manufacturers. This industry had been particularly hard hit by the recession of the early Seventies, and the firm had been forced to postpone planned equipment modernization. As of the end of 1976, domestic and foreign orders were increasing. Herbert was planning to complement upgrading of its capital with wide-reaching decentralization of divisional management responsibility and worker participation in plant-level management.

Rolls Royce Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£602.1 mill.	£620.2 mill.
Profit (Loss) Before Tax	4.5	(21.9)
U.K. Employment	62,375	59,758

Rolls Royce Ltd. produces aircraft engines and industrial turbines. The automotive division was separated from the firm upon nationalization in 1971. Recessionary declines in demand for air travel and electricity cut severely into the derived demand for Rolls Royce's products. Declining sales leading to increased unit costs forced management to close three plants and curtail subcontracting business. Despite steady international orders for military aircraft engines, RR intends to continue cut-backs in capital expenditure and production.

During 1976, NEB also invested in new and existing smaller firms, mostly in the machine tool, computer and metalworking industries. These investments amounted to £11.51 million in equity and £21.18 million in loans.

IV. MANAGEMENT

NEB is managed by a Board of Directors consisting of two full-time and eight part-time members. The two full-time members, Chairman and Deputy Chairman, are former senior executives of industrial enterprises. Of the eight part-time members, five are business executives and three are union officials. The Board is the ultimate authority in investment decisions except in those cases reported in the "Functions" section.

The Board is assisted by a professional staff of 47, headquartered in London with regional branches in Liverpool and Newcastle.

V. ACCOUNTABILITY

Accountability to the Executive

The NEB is subject to a great deal of oversight by the Secretary of State for Industry and the Treasury. NEB must satisfy these officers that its investments are sound by commercial criteria (except in the case of investments directed by the Secretary).

NEB STATEMENT OF SOURCE AND APPLICATION OF FUNDS
for the period from 20 November 1975 to 31 December 1976

	<u>Note</u>		
<u>Source of Funds</u>			
From Her Majesty's Government			
Public dividend capital	14	53.97	
National Loans Fund	15	<u>21.29</u>	
			75.26
From Her Majesty's Government upon the transfer of investments and loans under Section 5 of the Industry Act 1975			
Public dividend capital	14	425.79	
Capital Debt	15	<u>77.84</u>	
			<u>503.63</u>
 <u>Application of Funds</u>			
Overall Excess of Expenditure over Income	7		1.09
Less Depreciation			<u>.05</u>
			1.04
Purchase of Fixed Assets	7		.65
Purchase of investments			
Subsidiaries	9	40.41	
Associates	11	10.70	
Others	10	<u>.81</u>	
			51.92
Loans to			
Subsidiaries	9	20.13	
Associates	11	.76	
Others	10	<u>.42</u>	
			21.31
Investments transferred by Her Majesty's Government			
Subsidiaries	9	418.36	
Associates	11	6.24	
Others	10	<u>1.19</u>	
			425.79
Loans transferred by Her Majesty's Government			
Subsidiaries	9	74.59	
Associates	11	<u>3.25</u>	

It must also make an effort to fulfill a rather long list of public policy responsibilities as well. These include:

- 1) location of new facilities in areas of high unemployment;
- 2) ensuring the furthering of democratic managerial practice;
- 3) ensuring that the use of funds is consonant with anti-inflation policy;
- 4) ensuring that public corporations maintain financial discipline;
- 5) assisting and coordinating activities with regional planning agencies; and
- 6) ensuring protection of consumer interests.

Commercial standards for investment are well understood, and there exist permanent agencies within the government to monitor NEB's performance on this account. No standards or mechanisms of oversight have been brought forth by which to judge NEB's performance on the social criteria or to hold it accountable.

In setting guidelines for NEB, the Secretary acknowledged that the institution had to be left with enough discretion to respond flexibly to quickly changing investment opportunities. Thus, government oversight is to be exercised through the review of three-year investment plans submitted annually to the Secretary. The plan is to include sections dealing with:

- a) existing NEB holdings (with particular attention to the activities of large companies);
- b) acquisitions, joint ventures and new ventures; and
- c) assistance operations;

with a discussion of the balance between these various activities.

The Secretary may enforce his decisions through two mechanisms discussed above, regulation of certain investment activities and control over the amount of investment funds available to NEB. Should the policies of the Board and the Secretary seriously diverge, these provisions could become powerful sanctions on the discretion of NEB management. At the moment, however, relationships between NEB and the government seem more collaborative than adversary.

The overall framework of the NEB's accountability to the government on matters of public policy and financial goals is given above. Here we list certain types of investment operations which require notification of or approval from the Secretary of State.

Notification of the Secretary is required when:

- 1) commitments exceed £10 million or the investment raises new or significant policy issues;
- 2) NEB acquires more than 10 percent of the voting shares of a company; and/or

3) the acquisition may require investigation under monopoly laws.

Approval is required when:

- 1) NEB wishes to dispose of securities;
- 2) commitments exceed £25 million; and/or
- 3) the costs of acquiring share capital exceed £10 million or confer upon NEB more than 30 percent of voting stock in a company.

Most of these restrictions on investment activity were enacted in order to assure the business community that NEB would not use its access to large amounts of government funds to compete at an advantage with private investors. NEB is subject to the same laws regarding ownership acquisition and disclosure that apply to private investors; it may not make use of privileged information such as planning agreements worked out between the government and private firms; it may not compell private owners to sell out.

Legislative Accountability

NEB is only indirectly accountable to Parliament through ministers appointed by them. Parliament also controls the amount of National Loans Funds and public dividend capital available to all recipients.

VI. EVALUATION

The most remarkable aspect of the NEB is the array of conceptually separable functions it is to fulfill and problems it is to address. After only one year of documented activity, it is impossible to assess the Board's performance. We can, however, review NEB's functions and design to make some prognosis on its chances of success. First we must review interpretations of Britain's present industrial difficulties.

Since 1960, the post-tax rate of return on physical capital to British commercial and industrial companies has fallen from 8 percent to near zero. The cause most frequently identified by commentators on this phenomenon is lack of sufficient reinvestment to maintain capacity. However, recent studies have shown that Britain's rate of reinvestment has been stable and comparable to those of other Western industrialized countries.

Recently, attention has been focused on the low productivity of labor as the major cause of unprofitable manufacturing activity. In manufacturing and utility sectors, Britain's enterprises rank consistently lowest in international comparisons of output (sales) per unit of manpower employed. This condition is particularly acute in the nationalized industries where, for example, British Leyland uses about twice as much manpower/unit as its continental counterparts producing similar cars with similar

equipment. Frequent strikes cut further into productivity of capital. For obvious political reasons, both Labour and Tory governments have been obliged to maintain employment and have thus subsidized losses in nationalized enterprises and in larger private manufacturing companies as well. Unions, therefore, face few constraints, in terms of membership job loss, in pressing for more and more costly wage and benefit settlements. Nationalized industries have also been subject to price controls in the face of continuously rising factor costs.

These are only a few of the problems facing large-scale industry in Britain; they face conditions weighing on all import-dependent industrial economies. They do, however, have the advantages of a relatively modern industrial plant and a highly trained technical and managerial elite.

What are the prospects for NEB's various roles given the simplified analysis above? Taking them one at a time:

Provision of Investment Capital: NEB's operations are a substantial improvement over previous British systems of capital assistance to private firms. Under older programs, the Treasury had to be petitioned for virtually every disbursement of investment funds, bureaucratic response tended to be slow to the point of obstructing the completion of deals. Furthermore, most assistance was in the form of loans with inflexible repayment terms.

Recipients often had to petition for further assistance to pay off their government loans.

Within rather high per investment limits, the NEB may act on its own initiative, without executive approval. Since its own source of capital for new investments is predominantly public dividend capital (76 percent of the total funds available to it in 1976), it may advance equity to the companies it invests in. Thus, NEB can absorb long gestation periods necessary for new enterprises or new operations within existing enterprises to show profits.

holding Company: The problems facing Britain's nationalized industries are too complex, too embedded in historical patterns of class, social and economic relations for any super-managerial authority to turn around in the foreseeable future. The NEB may provide one of many desperately needed forums in which labor and management representatives can be induced to address common problems.

Assistance to Financially Troubled Companies: This is NEB's least enviable and least-to-be-emulated function. To the extent that the analysis above holds true in individual cases, provision of additional capital under any terms is economically inefficient. It may, however, be politically necessary. NEB keeps separate accounts for such activities and is reimbursed for them. Thus,

the "subsidy" nature of these activities is acknowledged in NEB's records, allowing for the application of other-than-commercial standards in judging performance.

Promotional Activities: Both the foreign contract and regional development functions seem to be sensible approaches to creating markets and encouraging coordination, particularly in sectors dominated by small units. Coupled with NEB's financial powers, these could be particularly effective services for increasing Britain's international competitiveness.

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purpose: The British National Enterprise Board, like the Canada Development Corporation is relevant to the Alaska Permanent Fund in that its central function is to finance the restructuring of ownership to ensure that assisted firms are efficiently operated under British management control.

Like the Canada Development Corporation and like the proposed draft of the Alaska Permanent Fund, the British National Enterprise Board is required to return a profit on investment that essentially meets the norms of the marketplace. On the other hand, the British National Enterprise Board statute goes one major step beyond that of the Canada Development Corporation in requiring that any subsidies are borne directly by the British General Fund and not by the National Enterprise Board. That implication exists in the current draft of the Alaska Permanent Fund but should be made more explicit.

Finally, the principal weaknesses of the British National Enterprise Board are the conflicts in incompatible goals. As was emphasized in the July 11 memorandum to the House committee, this is a principal danger of an improperly structured development bank. Any separate goals such as the separate and conflicting tasks of the British National Enterprise Board should

be separated into subsidiary institutions which have sources and uses of funds and management capable of dealing with those distinct functions.

Sources and Uses of Funds: The British National Enterprise Board is, of course, 100 percent financed by the British government. Unlike the Canada Development Corporation, it does not have to float its stock issues or bonds on the private market. Therefore it does not have a market sensitivity.

The Canada Development Corporation is too sensitive to the marketplace; the British National Enterprise Board is not at all sensitive to the marketplace. The result is that the British National Enterprise Board can and does make unsound investments which are unproductive and in the long run a disservice to the British economy. The ideal is a mixed public and private financing in which the initial capitalization of the government provides flexibility but the subsequent financing is from the marketplace and is market sensitive as, for instance, in the case of the European Investment Bank. The Alaska Permanent Fund can be organized to create a substantial multiplier of private financing on its public capital which will both improve its performance and make more efficient use of its resources.

Management: The British National Enterprise Board, like the Canada Development Corporation, does not involve itself in the day to day management decisions of its affiliates or subsidiaries, a policy which should again be followed by the Alaska Permanent Fund.

It is also important to note the balance among government, business and labor on the British National Enterprise Board, a balance which may or may not have any relevance to Alaska.

Accountability: The British National Enterprise Board statute and its executive implementaiton provide some of the most striking models for the legislative and executive oversight of a large and powerful development bank.

First, NEB's financial reporting standards are extremely rigorous. Even in its Annual Report, all accounts are unconsolidated, so that the performance of subsidiaries and special purpose funds is apparent from casual perusal. For example, the conversion of a large portion of Rolls Royce government debt to public dividend capital was duly noted. This was a relaxation of financial discipline contrary, perhaps, to NEB's stated policy. However, this information was picked up by the British financial press and used by members of Parliament to bring political pressure to the struggle to impose stricter standards on nationalized industries. Since the solutions to

Britain's industrial problems must be worked out in the political as well as the economic and financial spheres, the informed participation of the interested public may serve as an important control on NEB's activity.

Secondly, day-to-day investment activities are subject to regulations designed to ensure that NEB is not displacing private market investment. While the success of these regulations is impossible to measure, it should be noted that CDC is under no such control.

Thirdly, and most importantly, NEB must justify its requests for investment funds on an annual basis to the Secretary of State for Industry, who makes the final decision on the disbursement of these funds. The Secretary is, in turn, accountable to Parliament, which appropriates the money. On one hand, this ensures that NEB's management is using its funds in a manner consonant with national policy and financial responsibility (to the extent these two goals do not conflict). On the other hand, such approval mechanisms may involve bureaucrats far removed from the operations of the assisted firms. They may also inhibit the timely provision of funds necessary to negotiate and effect deals. However, this does not seem to have been a problem so far.

~~Handwritten scribbles and signatures at the top left.~~

~~Handwritten scribbles and signatures at the top right.~~
C.C.C. James Home Loan, ERPA

B. EXPANSION OF SMALL AND MEDIUM SCALE PRODUCTIVE ENTERPRISE

CONNECTICUT DEVELOPMENT AUTHORITY
Discussion Draft

September 14, 1977
Page 46

~~Register~~

~~Register to 1/1/78~~

~~get Blue Cross~~

Call P. Regis
Pammy

INTRODUCTION

The Connecticut Development Authority (CDA) is one of many independent state agencies in the United States designed to assist existing small- and medium-sized firms in obtaining long-term debt financing for expansion and upgrading of physical plant and equipment. Created in 1973 by an act of the Connecticut state legislature, its operations to date are noteworthy on several accounts:

Ask Val
to Ed on 10
got in writing
rept.
-ADL - most
of effective
Use of 50
RR - 25
see ID

- 1) They have been self-sustaining. All operating expenses have been financed by service fees and float from efficient cash-flow management.
- 2) Screening procedures have been rigorous. Virtually all CDA service users have been financially successful.
- 3) Management has been innovative in harnessing the private money markets to provide finance to firms which, due to their small size, have had restricted access to capital on suitable terms, particularly during tight money periods.

I. OPERATIONS: PURPOSES, SOURCES AND USES OF FUNDS

The Authority manages five programs, each of which deals with a somewhat different aspect of providing expansion capital to small- and medium-sized firms. The volume of these operations in the past three years is shown in Table i, in terms of number of loans closed or insured and their total dollar amounts. Since

Table I
\$ AMOUNTS IN MILLIONS

Program	Self-Sustain	Umb. Bond	Ind. Mort. Ins.	Small Business	Contractor
Year					
1974 #	37	18	2	5	-
\$ amount	172.4	5.1	4.4	.09	-
1975 #	19	8	3	9	-
\$ amount	48.6	4.3	5.2	.10	-
1976 #	11	10	8	5	2
\$ amount	35.3	4.9	21.2	.09	.04
Total #	67	36	13	19	2
\$ amount	256.3	14.3	30.8	.28	.04

sources and uses of funds are functionally tied to each other by these financial mechanisms, these two important topics will be discussed in the context of the individual programs rather than summarized separately as in the other profiles in this series.

CDA's three major programs, both for volume of business and for purposes of illustrating the match of perceived need for financial services to program design are:

- 1) The Industrial Mortgage Insurance Program which insures loans made by private institutions to finance the purchase of plant and equipment;
- 2) The Self-Sustaining Revenue Bond Program through which the CDA administers a conventional state-wide industrial revenue bonding system; and
- 3) The Umbrella Loan Program, a direct industrial mortgage lending operation financed by revenues bonds of the Authority.

The Umbrella Program is the most innovative and aggressive of these operations and, for purposes of program design, the most important.

A. Self-Sustaining Revenue Bonds

In Connecticut, industrial revenue bonds are sponsored at the state as opposed to the local level. IRB's are a mechanism by which a state or municipal authority may transfer the tax-

exempt status of the interest it pays on borrowings to bonds of private industrial concerns. The recipient firms usually use the proceeds of such issues to finance new plant or pollution control facilities. These securities are evaluated in the market solely on the financial condition of the borrowing firm. Thus, state involvement lowers the interest cost, but not the risk, information or transaction costs--factors influencing the availability--of such capital. Hence the term self-sustaining. CDA charges a fee to cover the legal investigative and administrative costs of such issues. These fees are used to cross-subsidize the more costly and time consuming operations involved in the other programs managed by CDA.

B. Industrial Mortgage Insurance

Purpose

Commercial banks tend to view smaller firms as risky borrowers due, mostly, to the volatile nature of the markets in which they operate. Larger firms are favored borrowers for several other reasons, including:

- 1) They offer the prospect of entering into larger, more profitable customer relations with the lenders for services such as business accounts (compensating balances).
- 2) Loan origination costs per unit of earning assets tend to be less the larger the loan.

3) Commercial banks are seldom willing to make loans with long repayment periods appropriate for the financing of plant and equipment, and small firms do not have access to the corporate bond and private placement markets which provide long-term finance to larger firms. CDA claims that banks have been willing to extend their typical five to seven year terms when participating in the insurance program. This reduces the borrowers' annual debt burden.

4) Small firms often cannot afford the downpayment on an asset required by banks under reserve requirements. Insured loans are not counted against reserve requirements under certain circumstances. Thus banks are induced to lower their up-front requirements of small borrowers.

Salient Features of the Service

Recent empirical studies show that, during periods of high loan demand, loans to small businesses are the first to be curtailed. In order to counteract the reluctance of commercial banks to lend on favorable terms to smaller businesses, CDA offers to insure all payments, interest, principal and property insurance, on loans for up to 90 percent of the value of new or expanded real assets and 80 percent of the value of equipment. Loans to recreation and commercial projects are not eligible for

coverage, nor are working capital loans. All loans must be secured by a first mortgage on the asset. Eligible borrowers include firms wishing to locate or expand facilities in Connecticut, community foundations, private developers or realty holding companies. Other important features of the service are:

Eligible projects: Manufacturing and processing or research facilities and offices or warehousing attached thereto;

Project limits: Real property - \$10 million

Equipment -

Maximum terms: Real Property - 25 years

Equipment - 10 years

Application Fees: Sliding scale determined by loan amount.

Maximum - \$7,500

Minimum - \$300

Premiums: Real Property - 1/2 percent of outstanding balance

Equipment - 1 percent of outstanding balance.

Screening and Review

A bank which agrees to be the primary mortgage lender to a firm seeking an insured loan applies to the CDA for coverage on behalf of the borrower. The CDA screening process includes a review of the borrower's eligibility under the programs and a brief review of the firm's financial condition and plans. The bank

performs the usual assessment of the borrower's ability to repay the loan. The program rejection rate is approximately 10 percent.

Financing

The CDA supports its obligations under insurance contracts through an insurance fund in which all premiums are deposited. As of December 31, 1976, this fund stood at \$2.4 million. Should this fund prove insufficient to meet its obligations, CDA may request that the State Bond Commission authorize the issue of general obligation bonds up to \$100 million in order to cover defaulted payments.

Operating expenses of the program are covered by application and commitment fees.

Operating History

The Mortgage Insurance Program was begun in 1961 under the management of the Connecticut Industrial Building Commission. It was taken over by CDA in 1973. As of July 1976, the program had insured 123 loans (not including loans made under the Umbrella Program), and had suffered only three defaults. Through cooperation with creditors in disposing of insured property, none of these defaults ever led to a charge on the insurance fund. Bond authorization for \$600,000 was used in one case to finance the

acquisition of a defaulted property. The CDA has been able to lease the repossessed facility at rates which more than cover debt service on the bonds.

Volume of activity under this program for the past three years has been three, two and eight loans per year, respectively. For the prior 10 years, the average number of loans insured was 11. The decline in insurance contracts may be traced to a cyclical loosening of the market for loan funds and to competition in similar services from the CDA's Umbrella Bond program. Because the Umbrella program has been used to deal with loans below \$1 million, the average amount of the loans in the Insurance program has risen.

C. The Umbrella Bond Program

During the period 1970-1972, when markets for commercial loans to small companies were particularly tight, the management of CDA determined that it was necessary to take more positive action (than that permitted by an insurance program) to address the problems enumerated in the previous section. The CDA now issues tax-exempt bonds, the proceeds of which are used to provide long-term loans to small companies seeking first mortgage finance for plant and equipment. The process by which this is accomplished is rather complicated and might best be understood through a brief, step-by-step outline.

The Process

- 1) CDA solicits and receives loan applications from small firms with eligible projects.
- 2) After screening similar to that of a commercial bank's, applications are submitted to the Board of Directors for approval.
- 3) If the loan application is accepted, the borrower is issued a conditional loan commitment which (s)he uses to help procure temporary financing from a private institution for the construction of the project. The Authority may only make loans secured by completed projects.
- 4) Upon completion of the project, the Authority takes a mortgage from the borrower, the proceeds of which are used to pay off the construction loan. Umbrella program borrowers are required to participate in the Industrial Mortgage Insurance program. In order to finance this loan, the Authority has procured a \$12 million line of credit with two commercial banks. Before the success of this scheme had been demonstrated, the Authority had issued Bond Anticipation Notes to cover interim financing. The line of credit reduces uncertainty over the terms and availability of interim financing, which in turn makes it less likely that CDA will violate IRS rules pertaining to arbitrage. During this period before a bond is issued to provide permanent financing for the mortgages, the Authority may charge its borrowers an interest rate of 1/2 percent above its own cost of funds.

5) When a sufficient number of loans have been made such that their repayment would secure a marketable revenue bond issue (about \$10 million--minimum), the loans are consolidated into several series on the basis of size and maturity. (Series cannot exceed \$1 million due to IRS regulations.) These revenue bonds are then sold to the public.

6) A portion of the proceeds of these bonds is used to pay off the interim creditors. The borrower's terms are then restructured so that interest rates under permanent financing are 1/2 percent above the Authority's cost of funds under the bond issue. After costs of issuance are paid, the remainder of the bond proceeds are placed in a Special Capital Reserve Fund whose function is described below. Principal and interest payments on the bonds are so structured that repayment of the loans should cover them.

Salient Features of the Service

Other features of the service are similar to those of the Insurance Program. The only significant difference is the project limits: \$500,000 for real property, \$400,000 for equipment. Besides being necessary to meet IRS requirements for unconsolidated reporting and filing, this limit targets services to smaller firms.

Screening and Review

The screening process used by the Umbrella Bond program is considerably more stringent than that at a commercial bank. Besides the usual financial records and projections, independent asset appraisals, security checks, insurance on principals, personal pledges and on-site investigations are required. These policies have paid off in that there have been no defaults during the program's five-year operating history.

Authority officials claim that the extra cost imposed on borrowers to meet these requirements are more than compensated by reduced interest and more favorable repayment terms of Umbrella loans.

Financing

In order to facilitate sales in an already crowded market for tax-exempt securities, the Umbrella Bonds have extensive financial backing. Should loan payments be insufficient to cover debt service, the first pool of funds to be tapped is a Special Capital Reserve Fund maintained at the level of one year's debt service. Should this fund fall below the required level, the Authority must use the Insurance Fund to make up the deficit. This fund is backed by general obligation bonding authority. Should these resources be insufficient to restore the Reserve Fund to its required

level, money from the general fund of the state is "deemed to be appropriated" at the end of each calendar year to make up the deficit. Since this backing requires no legislative approval, it is a good deal stronger than the "moral obligations" which underlie most revenue bond issues. In some states, this arrangement is likely to be unconstitutional.

Operations are financed by the 1/2 percent spread between borrowers' interest rates and the Authority's cost of funds, application and commitment fees and float generated by deposit of loan payments prior to disbursement of debt service.

Operating History

The Umbrella program was established in 1972. As of January 1977, 173 firms had submitted formal applications of which 80 had been rejected or were voluntarily withdrawn. Seven were in process and 86 had been approved. Of these, 67 had been closed, and 66 were outstanding with a balance aggregating \$24.4 million. Approved loans not yet closed totaled about \$5 million.

These loans have been financed by two bond issues; one in 1975 for \$23.5 million, of which \$20 million was applied to permanent mortgage financing; one in 1977 for \$10.5 million of which \$9.2 million will be applied to permanent financing. The average loan size has been about \$300,000 with the majority being for 25

years. Interest rates to borrowers, including insurance premiums, were 9.38 percent for real property and 9.3 percent for equipment on the first issue, and 7.23 and 7.73 percent for the second issue. Commercial interest rates without insurance coverage at the time of these issues were approximately 10.5 and 9.5 percent, respectively.

Considerable delay and difficulty accompanied the first bond issue, despite its AA rating due to the dislocations in the tax-exempt market caused by New York City's financial difficulties and the unprecedented form of the issue itself. The second issue, however, went off smoothly, the bonds being well-accepted in the marketplace.

D. Other Operations

CDA also administers, for the Connecticut Department of Commerce, two smaller programs funded by occasional general obligation bond issues of the state.

Cooperative financing of 502 Local Development Corporations - Under this program, the CDA lends 50 percent of the front-end investment which a local development corporation must raise in order to receive either SBA or EDA long-term financing. CDA is empowered to lend up to \$2 million of its resources for this seed money financing. As of July 1976 it had made \$228,000 in such loans.

Contractor's Loan Programs - The CDA has provided small loans on a contract by contract basis to construction firms who demonstrate a need for working capital to carry out procured contracts. CDA accords priority to minority businesses.

II. MANAGEMENT

The CDA is a subdivision of the Connecticut Department of Commerce. However, it is an independent agency whose operating decisions are made by a seven-member Board of Directors. The Board consists of the Commissioners of Finance and Commerce, the Treasurer and four members appointed by the governor, who have tended to be executives in private financial institutions. The Board is assisted on all Umbrella Loan decisions by a nine-man screening committee composed of experts in various sub-areas of industrial finance. Each loan write-up is submitted to three members of the committee who review the proposal and return a recommendation to the Board. These outside reviewers are compensated by a set fee for each loan reviewed.

The professional staff of ten, which performs most of the screening loan evaluation and program administration functions, consists of an Executive Director, managers for the programs, and loan officers. The fact that this staff is subject to state civil service regulation has caused some operating problems.

Because the state civil service commission regulates the Authority's hiring practices and the salaries it may offer, CDA has found it difficult to hire staff in the timely manner required by professional financial operations. It has also found it difficult to retain qualified personnel since the private market provides higher salaries and more opportunities for advancement to those with commensurate skills.

Although CDA is an independent agency, it is very much tied to the Connecticut Department of Commerce in which it is housed and whose Commissioner is Chairman of the Board. On one hand, this close connection is beneficial in that the Department's promotional activities are a source of new business. On the other hand, differences of opinion concerning professional judgment on financial matters have arisen between the Board and the Staff.

III. ACCOUNTABILITY

To The Executive

The Authority's operations are, for the most part, unencumbered by executive oversight or control. Approval of the Treasurer and the State Bond Council is needed in order to issue bonds, and yearly reports must be submitted to the Commissioner of Commerce. Indirect power may be exercised through appointments to the Board. However, any sanctions go into effect only if the

Authority is in financial trouble or wishes to expand its already generous program limits. Given CDA's record, this situation is not likely to arise soon.

Given the stringency of IRS regulations on disclosure and arbitrage and the competitiveness of an already-glutted tax-exempt market, it would appear that CDA is more fully accountable to the IRS, the banks with whom it cooperates, and its investors than to any state governmental body for its financial performance.

In terms of public benefits, CDA does require loan applicants to submit employment estimates for their projects. However, the Authority makes no attempt to analyze the incremental impact of their operations (new as opposed to retained jobs, replacement of private sources of investment funds, etc.). Authority managers state bluntly that these considerations are secondary to maintaining the financial credibility of CDA operations.

To the Legislature

CDA is not required to report its activities to the state legislature. This body exercises no sanctions over the operations of the Authority.

IV. EVALUATION

The CDA has been particularly effective in countering the

informational and cyclical money market problems which many observers feel account for recurrent contractions in the long-term debt market for small firms. The benefits of the Authority's services can be divided into two classes: assistance in making capital markets more efficient, the pecuniary benefits of which accrue mostly to banks and investors; and assistance to firms receiving financial services, to the extent that these services would not have been offered on as favorable terms, or at all, by the private market.

Making Capital Markets More Efficient

Numbers of applications for CDA services have been highest during periods of tight money, indicating that the Authority picks up the private institutions' lower priority customers. Yet the Authority's borrowers and insurees have not been bad credit risks. In fact, the default rate on CDA's portfolio of "risky" loans is considerably lower than that of most banks'. This constitutes some evidence that the Authority is tackling informational problems sloughed off by banks and investment houses which prefer to lend to bigger customers. Through the Insurance Program and the Umbrella program, CDA reduces the information costs involved in adequately assessing the creditworthiness of small firms to banks and individual investors. The expenses for this

service, however, are borne by the borrowers through fees and premiums and by the taxpayers who must somehow make up revenues foregone due to the use of tax-exempt financing.

Benefits to service users have included access to capital during a period of universally-recognized shortage in the case of the first Umbrella Bond issue and access to capital on extremely attractive terms in the case of the second. Participants under both the Umbrella and Mortgage Insurance programs enjoy lower down payments and decreased annual debt burden, both of which may be important factors for firms with uncertain or variable cash flows. The size of these benefits, however, is nearly impossible to estimate.

Finally, it should be remarked that the CDA's success and integrity are due to the efforts of its management rather than to any features of its legal structure or capitalization. Similar arrangements have led to unproductive allocations of capital and serious defaults in mortgage insurance programs in other states and most notably in special-purpose public authorities with tax-exempt bond issuing powers.

V. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes: The principal importance of the Connecticut Development Authority to the Alaska Permanent Fund is as the best North American model of a state-sponsored development bank financing intermediate- and long-term capital for medium and small business on a collaborative basis with the private marketplace. The Connecticut Development Authority has been extremely efficient in carrying out that purpose.

The Connecticut Development Authority, however, need not take 90 percent of the risk in all of its financing. In that regard, the Massachusetts Industrial Finance Agency (modeled after the Connecticut Development Authority in most respects) is pursuing a course much more like that of the European Investment Bank in taking only 40 percent of the risk, once again ensuring local and private market participation in both the risk and the resources.

Sources and Uses of Funds: The sources and uses of funds of the Connecticut Development Authority are again the ideal model for this purpose of appropriate state backing to ensure that virtually all of the used funds are raised in the private market. The Alaska Permanent Fund will be able to set up the same kinds of reserves with its own capital resources without the

need of any Alaska General Fund backing, in my judgment, given the vast size of the Alaska Permanent Fund's paid-in capital resources.

Management: The Connecticut Development Authority has built up an extremely fine management, but has tended to lose good staff or not be able to hire them in the first place because of the constraints of a Civil Service salary structure. Were the Connecticut Development Authority capable of hiring independent professional staff as does the Canada Development Corporation or the European Investment Bank, it might be an even stronger institution.

The Connecticut Development Authority has also made good use of professionals from the private market both on its board and on its investment committee to ensure that its decisions are sound.

Accountability: CDA is essentially unaccountable to any division of the Connecticut state government. Any sanctions reserved to the executive are activated only in the event of severe financial crisis, say the default of a substantial number of insured or umbrella loans. Even the token legislative oversight entailed in "moral obligation" arrangements has been relinquished. This

insulation from democratic scrutiny and control has not left CDA operations free of political influence. The Executive Director of the Authority has reported confidentially that professional staff judgment on loan applications has been compromised, on occasion, by pressure from appointed officials to take on the deal.

C. COMMUNITY DEVELOPMENT IN UNDERDEVELOPED AREAS

COMMUNITY DEVELOPMENT FINANCE CORPORATION
Discussion Draft

September 14, 1977
Page 67

INTRODUCTION

The Community Development Finance Corporation (CDFC) is a state-owned institution designed to provide equity investment in enterprises sponsored by community-based economic development organizations in depressed areas of Massachusetts. It was created by an act of the Massachusetts state legislature in 1975. It is funded by a \$10 million general obligation bond issue authorized in 1976. At present, the CDFC Board of Directors has been appointed; counsel and accountants have been selected. However, the institution is not yet staffed, nor has it undertaken any investment activities.

Despite this lack of actual operating experience, CDFC is of considerable interest to policy-makers concerned with state assistance to community-based economic development in depressed areas. The institution has been the object of a great deal of interaction, not to mention controversy between government officials, businessmen, community leaders and academics. All these groups sought to have their political and economic interests in the design of CDFC's structure and operations. Some of these concerns have been addressed in the definitions, statements of purpose, required findings and operating procedures specified in the CDFC bill. Others, less easily-specified, will have to be worked out on a case-by-case basis when operations begin.

The basic issues discussed in this profile are:

1) The nature of the financial needs of firms likely to locate in depressed areas; why these needs are seldom met by conventional financial institutions; how CDFC's proposed structure and operations are designed to meet these needs.

2) The mechanisms by which investment funds are to be targeted to eligible areas and projects. Where is investment likely to produce the greatest good in terms of increased employment and its concomitant benefits? What organizations are likely to be most capable of managing the investment?

3) The methods by which financial responsibilities and rewards will be distributed among CDFC, the management of the ventures it finances and the local public organization sponsoring the venture. How can the motivations of the key participants be balanced: the desire of the management of the enterprises financed for an adequate return on investment of time, energy and capital; CDFC's claim to a return on its investment sufficient to maintain operations; and the local organization's wish to ensure that substantial benefits accrue to its constituents?

4) By what standards, financial and social, can CDFC's performance be measured, and how can the various participants be held accountable?

I. PURPOSES

CDFC's purpose is to help increase levels of employment, capital ownership, tax revenues and overall economic activity in depressed areas by providing financial services to firms located or intending to locate in those areas. (See Section B for the legislative definition of depressed areas.) The plan for the type of financial services CDFC would offer proceeded from an analysis of the type of firms that could operate efficiently in depressed areas and their financial needs. The elements of this analysis were drawn from academic and empirical work on the determinants and patterns of business location and from the operating experience of financial, non-financial and governmental managers in Massachusetts. The argument for CDFC's planned operations is as follows:

1) Massachusetts employment, particularly in the manufacturing sector had been declining rapidly for at least 15 years prior to the formulation of the CDFC idea. The effects of this decline were particularly visible in cities and towns dependent on one or a few manufacturing plants for their economic activity. These towns contained high levels of surplus, semi-skilled labor and abandoned or underutilized physical plant.

2) Empirical analysis of the composition of employment level change, taking the individual states as the unit of observation, demonstrated that:

a) The creation of new firms and the expansion of existing firms contributed most of the increases in the number of jobs in a given state.

b) The contraction or closing of existing firms composes the greatest portion of the decrease in the number of jobs within a given state.

c) Interstate movement of business activities, despite the publicity such incidents received, accounted for little change in employment levels in the states of origin or destination. Most interstate moves were accounted for by the relocation of branch plants of corporations serving a national market. These moves were usually in response to conditions such as differential factor costs and proximity to markets which state governments, acting independently, were powerless to affect.

4) The actual location of smaller and newer firms was not adequately explained by cost-minimization. In the absence of such behavior, their location might be influenced by active state promotion and financial assistance. These firms accounted for approximately 80% of the manufacturing employment in Massachusetts.

5) At the time, CDFC was first proposed, the United States was suffering its worst recession since the Great Depression. New stock issues had slowed to five per year, and venture

capitalists were reluctant to invest in any company in its early stages of development. Without such investment, firms were unable to develop products, markets and operations to the point where they could attract debt financing from conventional sources.

6) The experience of business and financial people in Massachusetts indicated that there were many businesses, falling into several distinct categories, whose potential viability would be greatly enhanced by the provision of equity capital, but which could not offer the potential for return (30% is a frequently mentioned rule of thumb) sufficient to attract commercial venture capitalists.

The categories of firms were:

a) Manufacturers of high-technology products who needed time, money and freedom from debt burden to develop products and markets.

b) Firms in manufacturing industries which had been bought and subsequently mismanaged by national corporations and were now threatened with closure. In some cases, local management had fought to restructure ownership and control, re-establishing the plants as viable enterprises. Equity financing was essential to such deals in order to obtain favorable treatment from lending institutions.

c) Many local development organizations were involved in initiating and managing projects such as rental housing and community service facilities, which improved the living conditions of their constituents. Most of these projects required property development, which in turn required equity to leverage construction loans and mortgages. The organizations themselves were seldom able to generate such equity, and the major institutional sources of equity--the Federal Government and private foundations--were cutting back such funding.

Thus, categories of enterprises which could operate, or, in the case of housing and services, should operate in depressed areas were identified. All three types needed financing which did not impose an inflexible repayment schedule, and all observers of the financial scene agreed that this kind of financing was unavailable through conventional private channels.

The use of State funds to provide such financing was further justified on the basis that the Commonwealth would capture pecuniary benefits in addition to conventional return on investment. These would consist of increased income sales and business tax collections and decreased welfare and unemployment insurance payments amounting to about \$3000/year per job created or retained.

II. SOURCES OF FUNDS/CAPITALIZATION

CDFC's source of investment funds is the proceeds of a \$10 million state general obligation bond issue. These funds will be transferred to CDFC in a lump sum. Increments to this capital would require further legislative bond authorization. The interest and principal on the bonds will be paid out of general state tax revenues as opposed to operating revenues of CDFC.

This form of capitalization is justified by the following argument:

1) According to the analysis of the economic conditions in depressed areas presented above, equity financing of enterprises is the most potentially productive form of capital assistance to businesses in these areas. So far, CDFC is the only state financial intermediary designed to provide equity financing.

2) CDFC cannot count on a regular stream of returns from these investments. Therefore, it could not meet its own financial responsibilities if it were forced to pay off its investment capital on an inflexible schedule demanded by debt financing. The experience of SBIC's and MESBIC's demonstrate that intermediaries charged with making equity investments cannot fulfill their mandate if they themselves rely on loans for their

investment funds. One response of these institutions to their capitalization has been to invest conservatively, usually through debentures, in order to assure a regular income stream. The other has been to make equity investments and run the risk of going broke, which several SBIC's have. In neither case is the statutory function, for which these institutions have been granted special borrowing rights, been carried out.

3) The use of general tax revenues to pay off the bonds issued in behalf of CDFC is justified on two counts:

- a) It matches the sources of costs and prospective benefits. In the long run, it is hoped that the increased employment provided by CDFC-financed enterprises will generate benefits to the general fund in terms of increased tax collections and decreased welfare payments.
- b) It matches costs and benefits on the time dimension. Debt service costs will be paid over a period of 20-30 years, and the benefits described above should accrue over a similarly long period.

III. USES OF FUNDS/OPERATIONS

A. General Powers

In order to tailor its services to the specific financial

needs of each project, the CDFC Board has been granted a panoply of financial powers and broad discretion over their use. CDFC may finance all costs of a project which the directors deem recoverable and necessary to the carrying out of the act's purpose. Thus, money to finance market surveys, product planning, early staffing and working capital could be advanced as well as more traditional finance secured by physical assets. CDFC may also provide directly or pay for technical advisory services to the venture. CDFC may advance such finance in the form of purchase of equity, convertible debt instruments or straight loans. It may formulate and readjust the terms for loan repayment or payment of dividends to accommodate the venture's cash flow as it evolves. CDFC may also acquire, hold and transfer real property where necessary to further the establishment or expansion of an enterprise.

Although CDFC has the statutory flexibility to advance money on longer and less onerous terms than private financial institutions of any type, it is constrained to seek some return on its investments if it is to continue operations. The way in which financial returns must be realized and the constraints thus imposed on CDFC financing operations are discussed in section D.

B. Targeting

There are two sets of targeting requirements involved in the statutory directions to CDFC investment activity: one defines eligible sponsoring agencies as Community Development Corporations (CDCs) not dissimilar to regional and local development corporations in Alaska; another defines eligible geographic areas.

Targeting to CDCs - All CDFC financing is advanced to CDCs, which then transfer the funds to the ventures. The statutory requirements for eligible CDCs have been formulated to assure that they are accountable to their constituents.

In the legislation, a CDC is defined as, "a quasi-public, non-profit corporation organized under the General Laws to carry out certain public purposes and with by-laws providing that:

- 1) it is organized to operate within a specific geographic area coincident with existing political boundaries;
- 2) that membership in the corporation shall be open to all residents of said area who are eighteen years or older;
- 3) that at least a majority of its board of directors shall be elected by the full membership with each member having an equal vote;

- 4) that the by-laws of the Community Development Corporation shall provide that any other directors be either appointees of elected state or local government officials or appointees of other non-profit organizations having as a purpose the promotion of development in the designated geographic area;
- 5) that said elections shall be held annually for at least one-third of the members of the Board of Directors so that each elected director shall serve for a term of at least three years;
- 6) that the designated geographic area shall be consistent with some existing, or combination of existing, political district, provided that the aggregate population of such geographic area shall not exceed one hundred and fifteen thousand people based on the most recent appropriate census."

In addition to these formal requirements, observers and supporters of the bill have suggested that several further criteria be incorporated into CDFC's operating guidelines. These include:

- 1) The organization should be active in the community prior to CDFC funding, although not necessarily in economic development. Involvement in social service

provision or political organizing provides a community group with the opportunity to develop stable leadership, strategy and visibility that may contribute to its ability to manage a subsidiary or ensure community support of a sponsored venture. Evidence of prior activity also indicates that the CDC is not a "front" set up by private interests merely to take advantage of CDFC financing. Finally, prior experience provides the CDFC Board with some basis for judging the competence of the CDC's management to oversee the use of state funds.

- 2) There should be paid management and/or professional staff responsible to the CDC board. This might insure continuity and stability of venture oversight or management.
- 3) The leadership of the CDC should have demonstrated initiative in soliciting the participation of its constituents. Evidence of this activity might include frequency of public meetings, the publication of newsletters and other publicity efforts.

Targeting to Depressed Areas - The CDFC legislation requires that CDFC operate exclusively in depressed areas. The legislation defines a target area as "any area in which, according to the

most recent government census, the household income is reported to be at least 15% lower than the reported income for the Boston standard metropolitan statistical area" or "any contiguous area in which the board of directors of the particular CDC finds and publishes in accordance with statistical criteria previously established by the CDFC that substantial conditions of blight, economic depression, and widespread reliance on public assistance exist in said area."

CDFC is perhaps the only government financial intermediary that places restrictions on the location of the projects it will finance on the basis of descriptive statistical criteria. On the other hand, these criteria are not unambiguous. There is no specific measure of "average household income" in the 1970 census. The two closest approximations are "mean family income" and "median family income." (The median is a preferred descriptor of income distributions since it is not subject to bias stemming from concentrations in the low or high ends of the distribution.) The lists of eligible towns differ depending on which measure is used, and the preferred "median" excludes some of Massachusetts's most visibly depressed towns.

However, an area does not have to be a city or a town in order to qualify for CDFC financing. The legislation states that a CDC must be located in a target area that is consistent with

political boundaries." This might be a state representative district, a ward or even a precinct. Many cities that do not qualify do have sections within them that do.

C. Balancing the Interests of the Parties in Individual Projects

Any CDFC-financed project involves three organizations with different, and in some cases conflicting, aims.

Management of the venture wishes to obtain financing on the favorable terms CDFC can offer. It can be assumed that they wish to give up as few of the operating prerogatives and financial returns of conventional management as possible.

Members of the CDC want to be able to exert sufficient control over the venture to assure that the jobs it offers CDC constituents are as well-paying, secure and satisfying as possible. If the CDC itself is able to take an equity position in the venture, it will want to realize a return on its investment in order to finance its own operations or further investments.

CDFC wants to assure that the purposes of the bill are met by its investments and that it can recover its investment plus sufficient surplus to finance further operations.

All of these claims are on the same pool of funds; revenues generated by the venture.

The key to balancing these claims is the form of participation the CDC takes in the project. The six possible forms allowed by the legislation are as follows:

- a) The project is conducted by a wholly owned subsidiary of the CDC.
- b) The CDC owns a majority of the voting stock of the corporation or other organization conducting the project.
- c) The CDC owns a majority of the capital stock of the corporation or other organization conducting the project.
- d) The project is conducted by a limited-dividend corporation or other association organized under the laws of the Commonwealth to provide public benefit and which exists for a public purpose.
- e) The project is conducted by a non-profit corporation including local development corporations organized under the Small Business Act.
- f) In all other cases, adequate provision is made for reporting to the CDC, and that the CDC must approve all major transactions including but not limited to any sale, merger, dissolution, the sale or issue of substantial amounts of stock and corporate reorganization.

No one form of participation will be suitable or preferable in all cases. Particular circumstances will differ from venture to venture and CDCFC will have the flexibility to consider each deal separately. In projects conducted under clauses d and e below, the forms of participation are determined by the statutes which govern federal and state programs. We focus on two types

of participation: the wholly owned subsidiary (form a) and the joint venture between a CDC and a private entrepreneur (forms b, c and f). The national CDC experience indicates that both joint ventures and wholly owned subsidiaries can be viable vehicles for economic development. There are different costs and benefits to the various parties from both.

Wholly Owned Subsidiaries: A wholly owned subsidiary requires that the CDC provide or hire its own management. This could limit the resources available to other activities in the community. However, by undertaking the entire financial and managerial responsibility for a venture, the CDC could develop considerable management skills, produce a product useful to its constituents, control the labor practices of the venture and retain all earnings for other CDC activities. The fact that a venture is a wholly owned subsidiary is no guarantee that the company will contribute to community goals. There have been CDC subsidiaries which have provided few benefits to local residents. Therefore, CDCFC will need to be certain that adequate safeguards of community interests are written into any investment agreements it underwrites.

Joint Ventures with Majority CDC Ownership: A joint venture requires much less CDC staff time and in-house expertise than a subsidiary. However, it also generates less earnings for the CDC and allows the CDC less control of the venture's activities. On the other hand, the prerogatives and returns given up by the CDC are generally appropriated by the venture's management, a situation which should leverage more watchful and energetic private control of the enterprise.

Forms b and c in the legislation provide for joint ventures in which the CDC owns a majority of either the voting or the capital stock. This strong CDC ownership position and the influence implied by that ownership may be sufficient to represent and protect the community's interests. The CDC would be able to share in the benefits--both earnings and employment--if the venture succeeds. Similarly, the CDC can protect the interests of the community if the venture does poorly. For instance, the CDC could determine the distribution of labor cut-backs and the proceeds from the liquidation of assets.

Joint Ventures with Minority CDC Ownership: There may be cases in which the CDC is willing to assume a minority ownership position in the venture (form f) in return for substantial employment or other benefits. In those cases, the CDC's interest can

be protected by including specific legally binding requirements in the agreement between the CDC and the entrepreneur. Examples of these requirements are as follows:

1) The venture must obtain the express written approval of the CDC before undertaking any expansion of operations outside the local area and before altering any of the Articles of Incorporation or By-laws.

2) The management agree to make reasonable efforts to hire and promote local unemployed people as long as the quality of work was not sacrificed.

It is clear that any agreement between a CDC and the venture it sponsors will require compromise by both parties, especially in regard to managerial prerogatives. It is important that CDCFC ensure that the extent of each party's prerogatives is stated as explicitly as possible in the documents of the transaction.

A final issue is the financing of the CDC's equity position if it does not have internally generated funds to purchase it outright. The functions and appropriate rewards to CDCFC and the venture management are those of the conventional financier and entrepreneur. The CDC's presence can appear to be a legal formality (to assure the publicness of the expenditure) and a political necessity (to assure that constituents and local

political leaders feel they are being involved in the expenditure of community resources). What economic justification is there for CDFC subsidizing the CDC's equity participation?

First, the CDC may offer services in packaging the deal and mobilizing community support for the venture which will accrue to the venture as pecuniary benefits. Second, the possibility of monetary returns may induce the CDC to monitor the venture's financial and social performance vigorously, helping to assure CDFC that its objectives are being accomplished. One proposal for providing this equity position is to award the CDC a "finder's fee" of 5-10% of the venture's returns, depending on the CDC's role in assembling the deal.

D. Constraints on Uses of Funds Caused by Sources

The Board's investment decisions are constrained primarily by CDFC's capital structure. For all intents and purposes, CDFC's original \$10 million bond authorization is its entire, non-renewable capitalization. The institution may seek to borrow or issue bonds to finance further operations, but here they would be constrained by market perception of the quality of the assets--the ventures--which would generate the repayment stream.

The only reliable way in which CDFC could prolong its operations is to recover its equity investment. It may sell the securities of the ventures it holds. The CDC, by statute, holds the right to first refusal for any sale of securities of the venture it sponsors. If, as is most likely, the rate of return on the ventures is below the conventionally marketable level--say 14-16%--CDC's will be the major secondary market for these securities.

Even if CDFC realizes no capital gain or some loss on these sales, in selling its interests to CDC's it will be fulfilling one of its secondary objectives, "to enhance capital ownership in depressed areas."

CDFC may try to make part of its stream of investment returns more predictable by providing financing in the form of debt or warrants. These are cash flow problems which can only be worked out as the program's operations evolve.

IV. MANAGEMENT

The nine-member CDFC Board of Directors is responsible for all investment decisions. Three of these members are state cabinet secretaries. The other six are gubernatorial appointees serving staggered terms of five years. Two are to be individuals experienced in investment finance, three are to be representatives

of CDCs from eligible target areas and the final member is to represent organized labor. It is important to notice that all interests involved in any individual CDFC deal are represented on the Board.

The staff, whose number will be determined by the volume of business CDFC receives or generates is headed by a President. This designation for the chief staff officer was chosen over "Executive Director" in order to reinforce the fact that CDFC has been designed as a business enterprise, not a social service organization. The staff will enjoy a great deal of discretion in undertaking the promotional activities necessary to generate financial opportunities and in structuring the terms of individual deals.

V. ACCOUNTABILITY

Financial - CDFC will keep standard financial accounts and will report annually to the state legislature. These reports and the books on which they are based will be audited periodically by state officials. From an operational point of view, CDFC will be held accountable for its financial performance by the constraints imposed by its capitalization. These constraints are described in Section IIID.

Social - The CDFC Board has engaged an accounting firm experienced in the operations of public authorities to design reporting and measurement systems to be used in evaluating the Corporation's progress in achieving its non-financial objectives. The consultants have been charged with designing methods to project employment, both by number and types of jobs to be created by a proposed investment. They are also developing methods by which to estimate a project's impact on tax collections and state expenditures.

Before CDFC money can be advanced to a project, the Board must find that all jobs in the enterprise will be full-time and non-seasonal, pay 150% of the minimum wage and provide medical benefits. Further statutory guidelines may be enacted after CDFC begins operations.

VI. EVALUATION

CDFC's proposed operations raise complex financial and political issues. While those issues concerning the nature of its services and targeting have been largely worked out in the CDFC statute, critical problems remain. Despite the pages of required findings and precautions in the bill, CDFC could fail to carry out its mission due to any number of managerial decisions. By investing too conservatively in too few enterprises,

CDFC would merely be displacing private market activity. If investment decisions are overly determined by political considerations and subsequently fail, CDFC will not only shorten its own life but discredit an important and controversial approach to depressed area development.

The program's success is dependent on the ability of individual CDC's to use the availability of CDFC funding to leverage the cooperation of private business ventures. The history of such attempts is predominantly one of failure with a few encouraging exceptions. One of the lessons of this experience has been that new community-based enterprises often require technical assistance if they are to succeed. The Massachusetts state government has so far made no explicit provisions for providing such services to CDFC-financed ventures. Criticism of the program from community groups has focused on this point.

Equally important for success will be the CDFC's ability to manage its limited financial resources. Choices in this matter, however, will largely be determined by the success of the ventures in which CDFC invests.

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes - CDFC is offered as an example of a program designed to provide community development finance to depressed areas. In this regard, the two most important points of the CDFC experience are 1) that the program design was based on an analysis of the economic problems of depressed areas in Massachusetts and 2) that provisions for targeting investment, based on this analysis and the experience of similar efforts, were built into the CDFC statute.

Capitalization - CDFC's lump sum financing by general obligation bonds of the state allows it the flexibility to provide financing in a timely manner on terms suited to the individual enterprise. This form of financing also imposes the discipline of a finite pool of funds. The corporations' investments must generate a return if it is to continue operations.

Uses - The current draft of the Alaska Permanent Fund statute is seriously flawed in that it does not permit equity investments in community development projects. The long experience of CDCs in the United States demonstrates that this type of finance is necessary if community-based enterprises are to succeed.

Management - The need to balance the political interests involved in CDFC's operations is reflected in the composition

of the Board, which includes representatives of the state, the financial community and CDCs.

Accountability - Accountability for operations such as CDFC's requires, first, a set of reporting and measurement procedures to evaluate performance along financial and social criteria. Reporting conventions and criteria exist by which to judge financial performance, and CDFC has begun to develop similar procedures for judging performance on social criteria. Accountability also requires effective sanctions to unsatisfactory operations. In the case of financial performance, unwise or wasteful performance is kept in check by CDFC's finite (and rather small) capitalization. Effective sanctions in response to unacceptable performance on social criteria have not yet been developed beyond the required findings necessary for investment disbursal.

D. REGIONAL ECONOMIC DEVELOPMENT

EUROPEAN INVESTMENT BANK
Discussion Draft

September 14, 1977
Page 92

INTRODUCTION

The European Investment Bank (EIB) was established in 1958 by the Treaty of Rome, the charter of the European Economic Community. It is an autonomous, publicly-owned financial institution whose primary function is to lend long-term to projects promoting the balanced development of the member economies and of the Community as a whole. The Bank also guarantees a small number of loans each year.

I. PURPOSES

Statutory Goals

According to its statute, the EIB's purpose is to contribute to the "balanced and steady development of the common market" by lending to:

- a) projects for developing less developed regions;
- b) projects for rationalizing industries or for developing new activities called for by conditions arising from the establishment of the Common Market, where these projects are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States; and/or
- c) projects of common interest to several Member States which are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States.

Evolved Management Goals

These were the goals of the bank at its inception. For all practical purposes, the bank now allocates its funds among:

- projects in less developed regions of the Community (e.g., southern Italy, Ireland, northern Denmark, western France);
- projects in industrial regions where redevelopment and investment in fresh activities is called for by the decline of established industries;
- projects of special interest for the development of the Community as a whole (e.g., advanced technology, and especially energy supply and distribution systems);
- infrastructure projects of common interest to several Member States such as railways, motor ways and telecommunications; and/or
- projects involving technological and economic cooperation between enterprises in the different member States.

EIB has been directed by the European Commission, its parent organization, to assist regional development efforts, but the Bank may exercise its discretion in how to do so. In examining EIB's lending policies, capitalization and operations, we will focus on the mechanisms which facilitate the regional reallocations and employment of capital the bank is able to effect.

Lending Criteria

EIB sets lending criteria which follow from its position as a multinational, publicly-owned bank which can facilitate specific development projects through the provision of capital. These criteria are:

a) The project must further development of the Common Market. The Bank will finance capital investments which relate to well-defined, economically homogeneous projects, geared to a specific objective which can be obtained in a set period of time.

b) The project must either be implemented within the territory of the EEC or, if outside the territory, be of common benefit to all the members of the Community (e.g., an oil supply facility).

c) The project must, in the case of infrastructure, contribute to increased economic productivity or, in the case of a private enterprise, must offer prospects of a reasonable return on investment.

d) EIB financing should not replace financing available from other, particularly national, sources.

Eligible Borrowers

a) Public and private enterprises may borrow directly from the Bank provided their project meets the criteria discussed

above. EIB will finance investments by foreign corporations as long as their project is located within the EEC's territory.

b) Banks and other financial institutions may also borrow directly from the EIB to finance loans to enterprises which meet EIB's criteria. In fact, this is the method the EIB uses to make its funds available to small- or medium-sized ventures.

c) Finally, the EIB will lend to autonomous state or regional authorities, such as the German Lander, which retain certain powers under federal systems of national government.

Restrictions on Use of Funds

EIB loans may not be used

- a) to finance cash requirements of firms or working capital;
- b) to finance speculative real estate development; and/or
- c) in the case of governmental authorities, to finance state social overhead capital such as health and welfare services.

EIB will not negotiate loans below 1 million UA directly. Its funds are channeled to enterprises with such small capital needs through intermediate institutions under the "global loan program." Direct loans to projects run from 20 to 30 million UA.

Lending Terms

EIB will not lend funds equalling more than 40 percent of the value of the asset to be financed. This policy requires local promoters and financial institutions to share the risks of the enterprise and, hopefully, forces them to bring their detailed knowledge of local conditions to the careful evaluation of the project.

The terms of most EIB loans fall into the seven to twelve year range. In the case of particularly desirable infrastructure projects, it may be stretched to 20 years.

IB requires appropriate security for all its loans. Usually this takes the form of a guarantee of repayment by the state in which the project is located. Other forms of security acceptable to the Bank are:

- a guarantee from a public authority with a good credit rating;
- a guarantee from a major bank, industrial or financial group; and/or
- a claim on specific assets which are liquid enough to cover the outstanding balance at any time.

Interest rates are uniform to all borrowers across several classes of loans, defined by the currency in which they are disbursed and their repayment period.

II. SOURCE OF FUNDS/CAPITALIZATION

EIB's share (equity) capital is provided by the treasuries of the nine states comprising the EEC. The total amount of subscribed capital and the amount to be contributed by each member is determined by the Bank's Board of Governors. Capital is subscribed in the form of a pledge, a portion of which the members deposit with the Bank. These deposits plus reserves funded by EIB operating surpluses must, under statute, equal 20 percent of pledged capital; this is more than sufficient to meet EIB's debt service should its borrowers be unable to repay loans in the short term.

This "paid-in" portion has ranged from 25 percent to its current level of 15.7 percent of subscribed capital during the 19 years of EIB operations. The balance of the pledge may be called in by the Board of Directors should these funds be needed to meet Bank obligations. Thus, members are permitted free use of the greater portion of their pledge. In 1976, pledged capital amounted to 3.54 billion UA of which 557 million was paid in.

Under its statute, EIB may not have loans or guarantees outstanding in amounts greater than 250 percent of its subscribed capital. In practice, EIB has been considerably more liquid. In 1976, loans outstanding of 5.49 billion UA were held against capital and reserves of 3.96 billion. Total EIB borrowings were

4.72 UA backed by 3.54 billion in equity, for a debt/equity ratio of only 1.33.

EIB maintains this high degree of backing to ensure access, on favorable terms, to European debt markets; its low paid-in/subscribed capital ratio to minimize the burdens of participation to its members. This arrangement seems viable so long as there is no sustained period (several consecutive years) of loan defaults. In that case, EIB would have to rely on its members' ability and willingness to contribute further portions of their subscriptions in order to meet obligations

Given EIB's financial performance, such a crisis is not likely to arise. During the past seven years, operating revenues have exceeded annual operating expenses by at least 15 percent. Instead of paying out the surplus to the member states as dividends, the EIB internalizes them to supplement its various reserve funds. The growth of these funds is traced in Table 1.

The EIB's ability to transfer its profits into these reserve funds without paying taxes has allowed the funds to grow at an impressive rate. These reserves may replace paid-in capital in accounting deposit requirements. So, even though the Bank is non-profit, it does act to the direct pecuniary benefit of the member nations by using its "profits" as reserves which decrease the need for paid-in capital. Should the reserves get large

Table 1
GROWTH IN RESERVE ACCOUNTS
1970-1976

<u>Reserves:</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>
Statutory	57.3	63.7	68.5	97.7	110.0	130.0	150.0
Loan Risk	56.0	64.0	71.0	105.0	118.0	143.9	174.7
Equalization	9.0	9.0	9.0	13.0	13.0	13.0	13.0
Monetary Risk	5.0	5.0	12.5	23.0	29.0	33.5	38.4
Building	2.0	4.0	6.5	11.0	16.0	25.0	45.0
TOTAL RESERVES	129.3	145.7	167.5	249.7	286.0	345.4	421.1

enough, the Bank may be able to order increased subscriptions without calling in any capital.

The European Investment Bank acquires virtually all its loan funds on the European bond market. Although the Bank resorts mainly to the European market, it has been able to sell its debt internationally, particularly in the United States and Japan.

The issues range from a low of 6.3 million UA to a high of 239.1 million, averaging from 20 to 40 million. About 40 percent of these issues are placed privately. Since 1974, the Bank has raised more than 800 million UA per year through the sale of bonds. Virtually all the public issues are underwritten by syndicates composed of European commercial and savings banks.

The interest rates the EIB must pay are in line with its strong backing. Rates rose from about 7.0 percent in 1972 to nearly 10.0 percent in 1974, and has since declined. In fact, the Bank has just adjusted its uniform lending rates downward to reflect this movement.

The most noteworthy aspect of the EIB bonds is that they are all long-term. There are a few occasions where the Bank borrowed for less than seven years. Most issues are for at least 10 years, with some going for as long as 15 to 20. The lengths of these liabilities match that of the productive capacity of the assets EIB finances--capital intensive plant and infrastructure.

Table 2
FUNDS RAISED UP TO AND INCLUDING 1976

Year	Issues				Participations by third parties in EIB loans (mil. UA)	Funds raised (mil. UA)
	Number	Amounts (mil. UA)				
		Private issues	Public issues	Total		
1961	3	7.6	13.8	21.4	-	21.4
1962	2	-	32.3	32.3	-	32.3
1963	3	8.0	27.2	35.2	-	35.2
1964	5	13.5	53.3	66.8	-	66.8
1965	4	-	65.0	65.0	-	65.0
1966	6	24.0	114.5	138.5	-	138.5
1967	8	40.0	154.5	194.5	-	194.5
1968	13	112.5	100.0	212.5	-	212.5
1969	9	63.7	82.3	146.0	-	146.0
1970	7	66.6	102.3	168.9	-	168.9
1971	20	208.0	204.9	412.9	-	412.9
1972	19	133.4	328.6	462.0	17.5	479.5
1973	22	207.0	401.0	608.0	4.3	612.3
1974	16	704.2	121.3	825.5	-	825.5
1975	26	318.6	495.1	813.7	17.0	830.7
1976	17	221.0	510.9	731.9	17.0	748.9
1961-1976	180	2128.1	2807.0	4935.1	55.8	4990.9

The EIB has enviable access to the European bond market and is beginning to offer its issues in the American and Japanese markets. The burgeoning growth of its demand for funds, shown in Table 2, has not compromised this access. The benefits of timely access to funds, long repayment terms and favorable interest rates derived from EIB's strong backing are transferred to its borrowers.

III. USES OF FUNDS/LENDING OPERATIONS

By Sector

Over EIB's operating history, its loans, in terms of money volume, have been concentrated in infrastructure projects, predominately in energy, transportation and telecommunications. EIB has made about four times as many loans to industrial sectors as to infrastructure projects. However, total money volume of these loans was only about half of that devoted to infrastructure. Manufacturing projects have received the preponderant number of industrial loans. Table 3 summarizes this allocation pattern and Tables 4 and 5 give more complete breakdowns of historical and current activity.

By Objective

In reporting its loan activities by statutory objectives, EIB

Table 3
EIB FINANCING, 1976 AND TOTALS 1958-1976

Sector	1976			1958-1976		
	#	Amt. (mil. UA)	% of Total	#	Amt. (mil. UA)	% of Total
<u>Infrastructure</u>						
Agriculture	1	30.1	2.8	8	123.9	2.0
Water Supply	6	74.3	6.8	19	220.9	3.7
Transport	6	107.2	9.9	60	1001.2	16.7
Telecommunication	8	200.1	18.4	38	853.7	14.2
Other	-	-	-	2	16.3	0.3
Energy	18	376.5	34.7	109	1764.2	29.4
Total	39	788.2	72.6	236	3980.2	66.3
<u>Agriculture, Industry and Services</u>						
Agriculture	-	-	-	5	7.5	0.1
Industry	120	297.8	27.4	874	2004.0	33.4
Services	-	-	-	7	13.7	0.2
Total	120	297.8	27.4	886	2025.2	33.7
<u>Grand Total</u>	159	1,086	100	1122	6005.4	100.0

All figures in millions UA.

Table 4

SECTORAL BREAKDOWN OF FINANCING PROVIDED WITHIN THE COMMUNITY, 1958-1976

Sector	Number		Amount (million u.a.)		% of total
	Total	of which global loan allocations	Total	of which global loan allocations	
Infrastructure	236		3 980.2		66.3
Agricultural development	8		123.9		2.0
Water supply and distribution	19		220.9		3.7
Transport	60		1 001.2		16.7
Railways	14		221.8		3.7
Roads, bridges and tunnels	34		587.9		9.8
Shipping and inland waterways	8		144.9		2.4
Airlines	3		41.7		0.7
Other	1		4.9		0.1
Telecommunications	38		853.7		14.2
Other	2		16.3		0.1
Energy	109		1 764.2		29.4
(Production)	(77)		(1 243.7)		20.7
Nuclear	29		620.2		10.3
Thermal power stations	13		138.2		2.3
Hydroelectric and pumped storage plant					
Development of oil and natural gas deposits	17		245.5		4.1
Solid fuel extraction	16		223.1		3.7
(Transport)	2		16.7		0.3
Transmission lines	(32)		(520.5)		(8.7)
Gaslines and oil pipelines	6		65.8		1.1
Other	26		454.6		7.6
Agriculture, industry and services	886	553	2 025.2	262.4	33.7
Agriculture, forestry, fishing	5	4	7.5	2.0	0.1
Industry (2)	874	548	2 004.0	255.9	33.4
Mining and quarrying*	18	15	12.8	6.1	0.2
Metal production and semi-processing*	77	31	558.4	22.5	9.3
Construction materials*	63	39	107.2	20.1	1.8
Woodworking	39	37	19.2	13.2	0.3
Glass and ceramics	25	13	33.2	6.9	0.6
Chemicals*	97	25	457.2	12.1	7.6
Metalworking and mechanical engineering	153	119	166.9	52.9	2.8
Motor vehicles, transport equipment	32	19	139.5	8.3	2.3
Electrical engineering, electronics	47	32	74.4	18.4	1.2
Foodstuffs	132	95	159.4	46.3	2.7
Textiles and leather	65	53	37.2	23.2	0.6
Paper and pulp*	28	23	29.6	10.3	0.5
Rubber and plastics processing	41	30	58.7	12.7	1.0
Other	14	11	6.9	3.9	0.1
Building - civil engineering	4	4	1.7	1.7	—
Global loans	39	—	141.6(3)	—	2.4
Services	7	3	13.7	1.4	0.2
Tourism	5	3	9.3	1.4	0.1
Research and Development	2	—	4.4	—	0.1
Grand Total	1 122	553	6 005.4	262.4	100.0

(1) See note 4 to Table 2, page 23.

(2) Of which basic industries (marked with an asterisk): 1 165.2 million u.a.

(3) This amount represents the unallocated portion of the global loans.

Table 5
SECTORAL BREAKDOWN OF FINANCING PROVIDED WITHIN THE COMMUNITY, 1976

Sector	Number		Amount (in million E.C.U.)	
	Total	of which global loan allocations	Total	of which global loan allocations
Infrastructure	39		788.2	72.6
Agricultural development	1		30.1	2.8
Water supply and distribution	6		74.3	6.8
Transport	6		107.2	9.9
Railways	1		19.7	
Shipping and inland waterways	5		87.5	
Telecommunications	8		200.1	18.4
Energy	18		376.5	34.1
(Production)	(11)		(247.6)	
Nuclear	3		111.3	
Thermal power stations	2		33.4	
Hydroelectric and pumped storage plant	2		42.1	
Development of oil and natural gas deposits	3		60.5	
Solid fuel extraction	1		3.3	
(Transport)	(7)		(128.9)	
Gaslines and oil pipelines	7		128.9	
Agriculture, industry and services	120	86	297.8	47.5
Industry (1)	120	86	297.8	47.5
Mining and quarrying*	3	3	2.2	2.2
Metal production and semi-processing*	21	11	103.3	8.3
Construction materials*	8	7	7.2	3.6
Woodworking	4	3	3.8	1.4
Glass and ceramics	2	1	4.7	0.6
Chemicals*	15	8	23.7	4.2
Metalworking and mechanical engineering	14	13	3.7	3.1
Motor vehicles, transport equipment	4	3	17.1	2.0
Electrical engineering, electronics	9	8	6.3	4.6
Foodstuffs	16	15	7.7	6.0
Textiles and leather	5	5	4.4	4.4
Paper and pulp*	3	3	1.3	1.3
Rubber and plastics processing	7	4	11.9	2.1
Other	1	1	0.1	0.1
Building -- civil engineering	1	1	0.6	0.6
Global loans	7	—	13.7 (2)	—
Grand Total	159	86	1 006	100.0

(1) Of which industries (marked with an asterisk): 218.7 million E.C.U.

(2) Difference between the sum of the 7 global loans granted in 1976 (€1.2 million E.C.U.) and the sum of the allocations from other than global loans (€12.5 million E.C.U.)

consolidates its three mandates (see page 1) into two classifications: projects for "regional development" and projects of common interest to several member countries. Some projects cannot be unambiguously classified and are counted in both categories. About 18 percent of all projects undertaken by EIB since it began operations have been so counted. Keeping that in mind, some 76 percent of EIB's 6 billion UA in loans have been justified on the basis of furthering the development of less developed regions. Projects of interest to several countries have been mostly in the fields of energy and transportation. Table 6 shows a more complete breakdown of loans by objective.

Global Loans

The management of EIB recognizes that small enterprises are the dominant type of industrial organization in labor-intensive sectors. These firms seldom have capital needs which match EIB's 1 million UA direct lending minimum. However, they are an important source of employment and, in certain sectors and areas, an efficient form of organization.

In order to meet these firms' needs, EIB lends to intermediate institutions, usually regional development authorities who in turn lend to small firms. The authorities are allocated a given amount and are given a finite period in which to use the funds.

Table 6
FINANCING PROVIDED WITHIN THE COMMUNITY IN 1976 AND FROM 1958 TO 1976
Breakdown by Economic Policy Objective

Objective	1976		1958-76 (*)	
	million u.s.	%	million u.s.	%
Regional development (1)	820.0	100.0	4 558.6	100.0
Belgium	17.9	2.2	75.1	1.6
Denmark	9.1	1.1	35.7	0.8
Germany	9.2	1.1	366.4	8.0
France	60.1	7.4	846.0	18.6
Ireland	57.4	7.0	164.1	3.6
Italy	347.1	42.3	2 200.6	48.3
Luxembourg	—	—	4.0	0.1
Netherlands	30.4	3.7	70.5	1.5
United Kingdom	288.8	35.2	799.2	17.5
Common interest to several Member Countries (2)	438.6	100.0	2 470.1	100.0
Energy	376.5	85.9	1 490.3	60.3
Thermal power stations	30.4	8.1	30.4	1.2
Hydroelectric and pumped storage power stations	42.1	11.5	141.4	5.7
Nuclear	111.5	29.4	598.6	24.2
Development of oil and natural gas deposits	60.5	16.6	258.6	10.5
Solid fuel extraction	3.3	0.9	27.9	1.1
Gaslines and oil pipelines	128.9	34.2	153.4	6.2
Transport	16.4	4.4	589.6	23.9
Railways	—	—	103.9	4.2
Roads and bridges	—	—	423.9	17.2
Shipping	16.4	4.4	40.4	1.6
Airlines	—	—	6.5	0.3
Other	—	—	4.9	0.2
Telecommunications	—	—	30.5	1.2
Other infrastructure	—	—	16.3	0.7
Protection of the environment	—	—	18.0	0.7
Industrial cooperation	25.9	6.9	213.6	8.7
Research	—	—	2.7	0.1
New technology	19.7	4.5	19.7	0.8
Modernisation and conversion of undertakings (3)	—	—	89.4	3.6
<i>DEDUCT to allow for duplication in the case of financing justified on the basis of both objectives - 172.6</i>				
Total	1 086.0		6 005.4	

(1) Article 130 (a) and (b) of the Treaty of Rome.

(2) Article 130 (c) of the Treaty of Rome.

(3) Article 130 (b) of the Treaty of Rome; these projects, classified as projects of common interest, have now been included under 'Common interest to several Member Countries' by way of simplification and in view of the modest amount involved. In the 1976 Annual Report, 1976-77, the total amount of financing provided for projects of common interest to several Member Countries, has now been deducted to avoid duplication: 123.8 - 93.5 = 30.3.

Projects so financed must meet EIB criteria and be located in a specified area, usually one of the less-industrialized regions. If suitable projects cannot be found within the specified time, the loan money is restored to EIB.

In the nine years of this program's operations, 404 million UA have been allocated to various regional authorities, of which 262.4 million has actually been disbursed. EIB has withdrawn from participating national and regional financial intermediaries 11 of the 38 global loans it has made in the last eight years. Apparently these institutions were unable to find suitable investments, and EIB was intent on enforcing its lending criteria. The average size of the loan has been 474,000 UA, and most have been concentrated in depressed areas of Italy, France and Germany. Although the global loan program represents a sound concept, allowing small firms access to an expanded capital market, it comprises a very small part of EIB's total lending activity--about six percent in 1976.

The overriding impression left by this review of EIB's operations is that the Bank takes a regional approach to its lending--acknowledging the interaction of public investment and private productivity. It then cooperates with national and regional level public and private financial institutions to provide capital to directly productive enterprises.

This pattern has been particularly evident in EIB's operations in the Mezzogiorno (southern Italy), one of the most depressed regions in Europe. Over the years 1961-1972, the Bank provided 7.5 percent of all investment capital coming into the region, concentrating its investments in roads, telecommunications, energy distribution systems and capital intensive industry. I cooperated with the World Bank and Italian public and private financial institutions in encouraging coordination and planning, providing capital to finance these plans where Italian sources were insufficient.

IV. MANAGEMENT

There are three basic levels of administration at EIB. The Board of Governors is responsible for strategic decisions; ensuring that statutory directives are carried out, designating levels of subscribed capital, authorizing changes in policies conditioned on movements in exchange rates, etc. Each member state appoints one Governor. A majority of the Board, representing at least 40 percent of subscribed capital, is necessary to carry motions.

The Board of Directors is responsible for all lending and borrowing decisions. They are appointed by the Board of Governors and have renewable terms. The number of directors from each

member state is set by statute, and the larger states, France, Germany, the United Kingdom and Italy are most heavily represented.

The Management Council, headed by a President, is responsible for seeing that the professional staff carries out the Director's decisions. The EIB retains agents and industry specialists in all member states to evaluate and monitor loans. Loan agreements are executed under the national laws of the state in which the project is located.

V. ACCOUNTABILITY

There is a minimal formal structure of reporting and sanctions by which the Board of Directors, EIB's operating decision-makers, are held responsible for their work. The Board of Governors, acting on behalf of the executive of their respective states, must approve the Directors' Annual Report. If performance is not satisfactory, Directors may be dismissed. States may further effectively censure Bank decisions by refusing to subscribe more capital. But all these measures would operate only in extreme cases of mismanagement or violation of statutory directives. In the important daily work of lending and borrowing, the Directors seem to have a free hand.

VI. EVALUATION

EIB is an operating arm of the European Commission, the central planning and policy-making body of the European Community. We have seen that EIB's major operations have been concentrated in aiding efforts to develop regions characterized by lack of industrialization (the Italian Mezzogiorno) or inefficient industries declining under the force of increased competition stemming from the lowering of trade barriers (Belgian coal regions).

The European Commission has not yet developed a Community-wide policy for coordinating the planning and finance of economic development in subnational regions. In such efforts, national authorities must take the initiative and be responsible for overseeing or executing the planning, financing and administering activities involved. Where the financing of costly industrial plant or infrastructure is involved these authorities may not be able to raise sufficient capital in a timely manner. The private or quasi-public financial systems of the several member states are set up primarily to service national needs. As yet there exists no institutional mechanism to coordinate these systems to provide the massive amounts of capital necessary to finance large-scale development projects.

EIB is designed to do just this. With its solid equity backing, it can raise large amounts of capital quickly in the inter-

national bond market on the terms necessary to finance long-lived assets such as capital intensive physical plant and infrastructure. Because EIB borrows and lends in stable currencies, some promoters in countries with weaker currencies have been unwilling to take EIB loans. They would suffer a loss if their national currency, in which they would receive the revenues generated by the asset financed, were devalued in relation to the currency in which they would have to pay off the loan. This risk is offset in many cases by the favorable interest and repayment period terms on which EIB can offer its funds. For example, Italian firms and authorities have been EIB's largest borrowers.

Real economic factors affecting a borrower's potential performance are not susceptible to EIB influence. Long and concerted effort is needed, for instance, to improve infrastructure, labor productivity and the stability of the regional population in the Mezzogiorno before it becomes a suitable location for the capital intensive facilities the EIB prefers to finance.

The Bank appears to take these considerations into account in pursuing its policies. First, it lends to infrastructure projects, where the ability to mobilize large amounts of capital is critical. Second, it will not lend more than 40 percent of the value of an asset. In a fact, its participation has been substantially less in most cases. EIB seeks to provide the incremental

amount of financing needed to implement a project which already enjoys sound national managerial and financial backing. Financial responsibility is thus not transferred from local government and business organizations whose political and economic fortunes are closely tied to the success of the projects. Unfortunately, EIB's performance, in terms of allocating capital to efficient uses, cannot be inferred from its financial success. Most of its loans are secured by guarantees from national governments. The performance of its borrowers is not reported in central documents. Due to the guarantees, poor performance does not show up as a default rate. The pattern of financial responsibility and ultimate accountability therefore corresponds to the European Commission's as yet decentralized regional development policy.

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes: The primary way in which the European Investment Bank is relevant and important to the Alaska Permanent Fund is in the strong regional orientation of the European Investment Bank, where 63 percent of its portfolio has been invested in the development of lesser developed regions of Europe. It is important to note that although the vast percentage of its resources has been employed in regional development, only six percent of those resources have been employed through the "global loan program." The importance of that point to the Alaska Permanent Fund is that the global loan program would be most analogous to a regionalized effort in which the regional projects of the Alaska Permanent Fund were implemented through the regional and local community development corporations. This matter bears further consideration.

It is also worth noting that the European Investment Bank rarely takes more than 40 percent positions in its loans, to ensure that the risk and responsibility are borne by both local financial institutions and the private marketplace. Analogously, in Alaska, this is the intent of the present language of the Alaska Permanent Fund and in the case of regional development suggests the wise course of joint venturing with the

regional corporations and with the private marketplace in all regional loans.

Sources and Uses of Funds: There are three principal matters concerning the European Investment Bank's capitalization which are worth noting for the design of the Alaska Permanent Fund:

First, all of the earnings of the European Investment Bank have been retained for reinvestment in strengthening the capital structure of the European Investment Bank. This is a different use of retained earnings than those of either the Alaska, Inc. proposal or a proposal to use the earnings for General Fund purposes at some future date.

Second, with a strong equity base the European Investment Bank has been very successful in borrowing the substantial amount of its capital needs in European and worldwide private capital markets. This is a very important model for the Alaska Permanent Fund. In designing the Alaska Permanent Fund the \$2 to \$4 billion of oil revenues should be viewed as a paid-in equity capital base for the Alaska Permanent Fund against which it can then borrow for its lending purposes on world markets.

Third, the European Investment Bank has a nice balance of its sources and uses of funds. The majority

of the European Investment Bank's borrowings in world capital markets are for seven to ten years, to support expansion capital lending running seven to ten years. The longer infrastructure loans of 15 to 20 years are then in turn supported by borrowings in the international capital market of from 15 to 20 years.

Fourth, all of the infrastructure investing is backed by a government guarantee. In my judgment, it would be much more efficient for Alaska to do the majority of its infrastructure financing through the Permanent Fund, but backed by general revenues.

Management and Accountability: The management and accountability issues of the European Investment Bank are less relevant to the Alaska Permanent Fund.

E. AN ALASKA CENTRAL BANK OWNED BY LOCAL COOPERATIVE DEVELOPMENT BANKS

1. BRITISH COLUMBIA CENTRAL CREDIT UNION
Discussion Draft

September 14, 1977
Page 117

I. PURPOSES

The British Columbia Central Credit Union is a private, federally-chartered financial institution owned by the credit unions of British Columbia. Established in 1944, its major function is that of a reserve bank for British Columbia's 178 credit unions. In 1970, it merged with the B.C. Credit Union League, a promotional and educational institution and has since provided a wide range of financial and administrative services to its members. Credit unions require most of these services in order to compete with other types of financial institutions for the deposits and loan business of British Columbia savers. In general, credit unions are too small to undertake the capital expenditure and staff requirements necessary to provide these customer services efficiently.

Credit Unions in British Columbia - Credit unions are deposit institutions offering a full range of customer services. Their investments tend to be concentrated in home mortgages, consumer credit and property development. They are distinguished from banks in that they are cooperatively owned by their depositors, each of whom is entitled to one vote in electing the board of directors and who may participate in membership-management meetings.

All members are required to have a "common bond," a legally construed economic association. These bonds may be of three types: community (those who live or work in a given political jurisdiction serviced by the credit union), associational (e.g., ethnic or church groups) or occupational. About one half of the credit unions in B.C. have community common bonds.

In 1975, there were 178 credit unions with 261 branch offices in B.C. These serviced some 600,000 members, about 23% of the population and composed some 23% of all deposit institution offices in the province. About one half of these offices are located in the greater Vancouver area.

The industry has grown remarkably and become more concentrated in recent years. Since 1971, membership has been growing at a compound annual rate of 11%, assets at 35%. In 1971, there were 217 credit unions holding slightly less than \$500 million in assets. In 1975, the 178 credit unions held over \$1.5 billion in assets, with half of these held by the 15 larger units. (The remaining units are extremely small, median asset size being less than \$70 million.) Credit union assets account for 10% of those held by all financial institutions in the province (20% if corporate business is excluded). Individual units are usually located within communities serviced by commercial banks and are in competition with them for deposits.

Distribution of assets - There has been a sharp rise in the demand for housing in B.C. due to the migration of large numbers of young families. Consequently, the credit unions' assets have become concentrated in home mortgages. In 1971, they composed 62% of the \$400 million in loans outstanding. In 1975, they composed 76% of the \$1,280 million in loans outstanding. Other credit union assets include municipal, provincial and federal government securities and consumer loans.

Liabilities - The main source of funds to credit unions is the deposits of members. Credit unions offer term and demand accounts as well as retirement and home owner savings plans. The latter two types of deposits have grown at a remarkable compound annual rate of over 100% in the past four years. Of the \$1,409 million on deposit in 1975, 36% were in demand and 64% were in term accounts.

Liquidity - Credit unions are required by law to maintain liquidity reserves with a bank, a central credit union or in qualifying federal government securities equal to 10% of deposits shares and borrowings. Virtually all British Columbia credit unions maintain their reserves and surplus in B.C. Central. In recent years, aggregate Loan/Deposit ratios for the industry have exceeded 90%. The credit unions as a whole, then, have

demanded funds from other sectors of the capital market. This borrowing and the cash management involved have been handled by B.C. Central. B.C. Central's functions within the credit union system and its mediating role between the system and the outside capital market is the subject of the following sections.

B.C. Central Operations

Financial - B.C. Central's main financial function is to provide individual credit unions with funds sufficient to meet local loan demand when local deposits prove inadequate. These funds are provided in the following forms:

- non-restricted reserve credit lines equal to 10% of the credit union shares and deposits for use only in meeting any net reduction in shares and deposits due to increased loan demand;
- restricted and non-restricted credit lines to credit unions equal to four to six times a credit union's monthly cash flow for operational purposes. Approved lines of credit under these first two provisions equaled \$262 million in 1975;
- term loans to credit unions to finance office buildings and credit union mortgage loans;

- emergency loans through the Canada Deposit Insurance Corporation.

Actual borrowings by credit unions from B.C. Central have grown rapidly in recent years from \$26.1 million in 1971 to \$91.8 million in 1975, reaching a high of \$108 million in the tight money market of 1974. Credit union credit line and loan requirements are worked out annually in consultation with B.C. Central's financial staff on the basis of financial statements, loan records and cash flow projections.

Credit union deposits are not covered by the Canadian Deposit Insurance Corporation. Insurance of deposits is handled by another central institution, the Credit Union Share and Deposit Guarantee Fund. The Fund is administered by a five member Board of Directors, three of whom serve on the B.C. Central Board. The Fund, which stood at \$13 million in 1975, is capitalized by annual assessment of member credit unions. The Board of the Fund may intercede directly in the operations of individual credit unions experiencing financial difficulties and may grant financial assistance where deemed necessary.

B.C. Central provides other important financial services to its members. These include centralized check clearing, bad debt collection, investment management for retirement and home ownership saving plans and secondary marketing of credit union

mortgages. The last service is another form of increasing member liquidity.

Non-financial services - B.C. Central's most important non-financial service is the provision of on-line teller terminal data processing to handle deposit and loan transactions in local offices. In 1975, this system covered one-half of all credit union offices. The savings in time and cost effected by this system increase credit union ability to compete with other deposit institutions. Other nonfinancial services provided for the most part on a fee basis are economic forecasting, personnel recruitment, printing and supply purchase, collection assistance, data processing and systems development, market research, facilities design and planning, education, advertising and public relations, legal counsel, housing development and travel services. B.C. Central also provides financial services to British Columbia's 108 cooperatives.

II. SOURCES OF FUNDS/CAPITALIZATION

Equity - B.C. Central's major source of equity is the sale of shares to member credit unions. In 1975, members held 6.26 million shares with a par value of \$31.3 million, all of which was paid in to B.C. Central. B.C. Central is required by law to maintain a 10/1 debt/equity ratio. Their debt consists

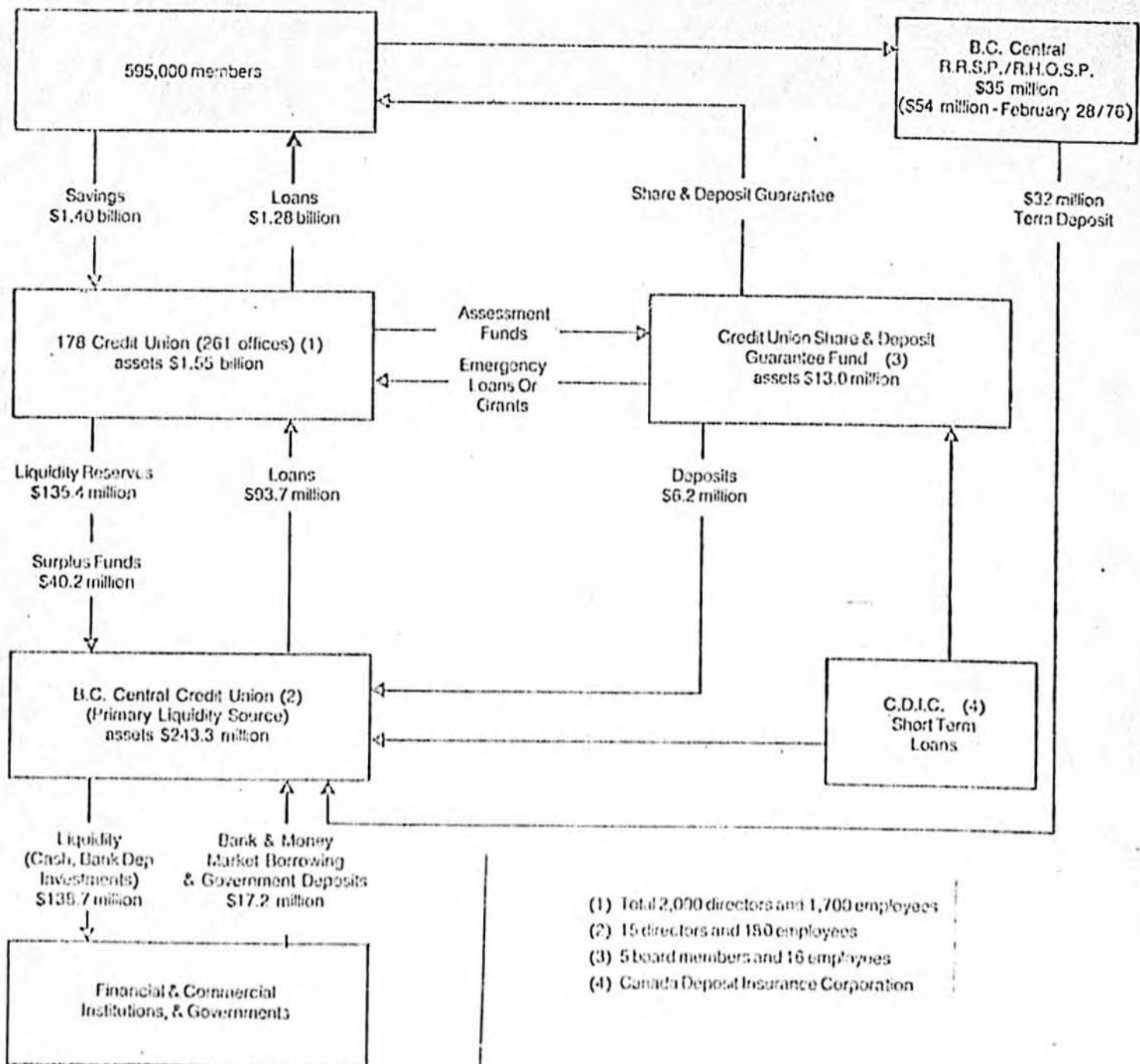
of deposits and borrowings; equity of membership shares, retained earnings and provisions for dividends. Despite rapid recent growth of deposits in the credit union system and consequently in B.C. Central's deposits, its debt/equity ratio was a fairly conservative 5.7 in 1975.

Deposits - B.C. Central's deposits are comprised of the liquidity reserves and surplus funds of its members. As credit union deposits have grown, so has B.C. Central's; from \$49.7 million in 1971 to \$195.8 million in 1975. These developments are illustrated in Table I. B.C. Central also receives one-half the total in the Credit Union Share and Guarantee fund as deposits. In 1975, this amounted to \$6.2 million. Central pays interest on all deposits, which composes its largest capital expense. See Table 3.

Borrowings - Because credit unions' lending activity has outstripped their deposit base in recent years, they have been demanders of funds from sources outside their system. These demands are mediated by B.C. Central. To finance loans to credit unions, B.C. Central borrows from Canadian, US and foreign banks and has established non-restrictable credit lines with three of the largest Canadian commercial banks. Borrowings vary greatly from year to year depending on the level of deposits

FIGURE I
Credit Union Financial System in British Columbia

December 31, 1975



- (1) Total 2,000 directors and 1,700 employees
- (2) 15 directors and 150 employees
- (3) 5 board members and 16 employees
- (4) Canada Deposit Insurance Corporation

TABLE I

Summary Statistics for B.C. Central Since 1971

(000's except where indicated)

	1975	1974	1973	1972	1971
ASSETS					
Liquid Assets	\$127,885	\$ 61,824	\$ 64,408	\$ 50,541	\$35,626
Loans to members	91,823	108,973	56,705	45,371	26,177
Total assets	243,290	193,225	141,721	109,027	67,807
LIABILITIES					
Notes payable	4,500	12,490	13,150	23,519	5,643
Members' Deposits	195,817	145,048	101,685	66,389	49,679
Members' Shares	31,300	24,815	18,317	12,746	9,153
INCOME AND EXPENDITURES					
Income	27,175	19,938	12,768	7,296	4,916
Expenses (financial)	18,941	13,906	8,032	3,962	2,706
Net Income	2,299	1,621	1,103	1,343	1,008
Dividends per share	35¢	35¢	35¢	30¢	30¢
Percent Growth in Assets	25.9%	36.3%	30.0%	60.8%	29.7%

and loan demand at the local level. See Table I, "Notes Payable," for the level of debt outstanding in recent years.

Income - B.C. Central derives between 80 and 85% of its income from interest payments on loans and returns on investments in securities. The split between loan interest and investment income varies from year to year, depending on loan demand from members. Other sources of income are service charges, fees for services to members and membership dues. Gross income has grown from \$4.9 million in 1971 to \$27.2 million in 1975.

III. USES OF FUNDS/INVESTMENTS

Reserve Requirements - B.C. Central is required to maintain liquidity reserves in cash or short term assets equal to 20% of its deposits and commercial paper liabilities. In 1975, it held \$48.3 million in such assets; 23.5% of its deposits and market liabilities. See Table II.

Loans and Investments - B.C. Central's longer term uses of funds are concentrated in loans to members and investments in securities. The flow of loans to members varies from year to year, depending on demand. Interest rates are adjusted to B.C. Central's borrowing terms, and a spread of 1/2% is permitted by law.

B.C. Central invests primarily in high yield, short term notes of Canadian corporations. Other securities held include Canadian Governments, Canadian corporate bonds, bonds of co-operatives and shares in other credit unions and cooperatives.

Operating Expenses - All expenses involved in providing B.C. Central's many services--salaries, materials and rents--are paid out of B.C. Central's operating income. After-tax earnings, having subtracted financial and administrative expenses, came to \$2.29 million in 1975. Of this, \$1.87 million was distributed as dividends to members. (The current dividend on membership shares is 7%.) Retained earnings at the end of 1975 totaled slightly over \$3 million. See Table III for a complete breakdown of income and expenses. See Figure I for a schematic representation of the relationships described above.

IV. MANAGEMENT

The strategic management policies of B.C. Central are set by a 14-member Board of Directors elected by the member credit unions. Day-to-day management of the institution is handled by a managerial staff of 80 (total staff - 180) in three divisions: Administration and Finance, Services and Development.

Each division is headed by a manager and is further subdivided along functional lines.

V. ACCOUNTABILITY

B.C. Central is a privately owned institution and is subject to no special forms of government oversight or control. Its operations are inspected annually by the federal Superintendent of Insurance office. On the provincial level, Central's operations are monitored by the Department of Consumer Affairs to ensure that consumer and mortgage credit practices accord with department guidelines and provincial usury laws.

VI. EVALUATION

B.C. Central has performed its function of helping a system of small depository units operate effectively and grow in highly competitive and quickly changing local markets. The most remarkable feature of B.C. Central is that it invests primarily within the system from which it draws its funds. Of its \$173 million in loans and investments outstanding in 1975, 50% were directly in cooperatives and credit unions. Another 36% were held in very short term corporate notes for cash management purposes and could presumably be converted to cash should there be a sudden increase in membership loan demands. Thus,

virtually all credit union deposits remain within the system.

B.C. Central's importance as a promotional institution should also be noted. Competition for deposits demands timely and cost-efficient customer service as well as professional promotional activity and well-trained personnel. These are functions which all but the largest credit unions could not afford to undertake on their own.

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes: B.C. Central, as noted in the July 11, 1977 report, is the best model of a cooperatively owned state central bank capable of providing deposit and lending services to those rural areas too small for full commercial banking services. It has the twin advantages of insuring local, cooperative ownerships sensitive to local needs on the one hand. On the other hand, it provides aggressive centralized capital and management services to ensure that each village receives the most sophisticated economic development assistance possible.

It is also important to note that British Columbia's economy, geography and demography is not unlike Alaska's.

Sources of Funds: B.C. Central's equity comes from the local member cooperative banks or credit unions. It is owned

and governed by local users. As noted in the July 11, 1977 report, the Permanent Fund could initially capitalize the state central bank, and then arrange to transfer ownership to the local cooperative banks. This could be along lines used to devolve ownership of the Farm Credit System from the Federal Government to local users. For a description of that procedure, see II.

Regionalization Models and Options in this Report

B.C. Central's debt is raised in international capital markets, based on its strong equity base and sound management. The Alaska Permanent Fund and its affiliated Alaska State Central Bank could do the same.

Uses of Funds: B.C. Central is a model of a strong central organization capable of raising international capital to support effective local economic development under effective local control.

Management: B.C. Central is governed by its local user institutions and attracts extremely able and aggressive central management.

Accountability: B.C. Central is fully accountable to its local member cooperative banks. The Alaska Permanent Fund could ensure that it is equally accountable to public purposes.

TABLE II
Consolidated Balance Sheet
1975

ASSETS

Cash and Demand Deposits	\$35,296,728
Short Term Deposits, due 1976-1979 (callable notice 1 - 15 days)	13,000,000
Investments	81,680,246
Loans	91,823,385
Mortgages Receivable	15,165,509
Accounts Receivable and Accrued Interest	4,099,861
Land, Buildings and Equipment	2,224,522
	<hr/>
	\$243,290,251
	<hr/>

LIABILITIES

Notes Payable and Deposit Balances	\$200,317,269
Accounts Payable, Accruals, and Outstanding Acceptances	6,495,372
Deferred Income Taxes	215,400
Provision for Dividends	1,875,595
Retained Earnings	3,086,610
Members' Shares	31,300,005
	<hr/>
	\$243,290,251
	<hr/>

TABLE III
Income and Expense Statement - 1975

INCOME	
Loan interest	\$ 7,745,411
Investment income	15,096,769
Service charges and sundry	1,340,040
Fees for services to members	2,643,521
Members dues	349,007
	<hr/>
	27,174,748
	<hr/>
DIRECT EXPENSES	
Interest on deposits	14,393,292
Interest on borrowings	4,123,399
Service charges and sundry	423,963
	<hr/>
	18,940,654
	<hr/>
INCOME LESS DIRECT EXPENSES	8,234,094
	<hr/>
ADMINISTRATIVE AND GENERAL EXPENSES	5,803,650
	<hr/>
EARNINGS BEFORE TAXES	2,430,444
Income taxes - deferred	131,609
	<hr/>
NET EARNINGS FOR THE YEAR	2,298,835
Retained earnings - beginning of year	2,659,631
	<hr/>
	4,958,466
Dividends	1,871,856
	<hr/>
RETAINED EARNINGS - END OF YEAR	\$ 3,086,610
	<hr/>

I. PURPOSES

The Deutsche Genossenschaftsbank (German Cooperative's Bank or DG Bank) is the central reserve bank of the vast West German cooperative system. Founded as the Deutsche Genossenschaftskasse, a cooperatively-owned financial institution, shortly after World War II, it was reorganized as a corporation and renamed the Deutsche Genossenschaftsbank in 1972.

DG Bank is the apex institution of a three-tiered system which holds 13% of all deposits in German financial institutions. The base of the system is composed of some 6,400 small banks and building societies which service the members of agricultural, industrial and trade cooperatives, as well as unaffiliated depositors. Ten regional cooperative banks provide liquidity management, auditing, check clearing and investment services to the base. DG Bank provides similar services to the regional banks. This system and DG Bank's place in it are described below.

Cooperatives in Germany

Structure of the Movement - After World War II, the German cooperative movement was organized into four sectors, each with its own credit system and network of regional and national unions.

The four sectors are agriculture, industry, consumers coops and non-profit housing finance societies.

By far the largest of these sectors is agriculture. In 1971, more than 1.8 million farmers were members of one or more of the 12,590 local societies. 1,650 marketing and supply cooperatives, 4,300 trade cooperatives and 12 centralized cooperatives with 1,500 branches or depots were engaged in the buying and selling of goods and achieved a total turnover of \$6.4 billion.* In addition, there were in 1971, 4,780 specialized cooperatives with 29 affiliated regional federations. The agricultural credit coops take deposits from and finance the fixed and working capital requirements of their members.

The industrial and trade cooperatives perform similar functions, and are active primarily as central material purchasers for their members. They were serviced by 624 coop banks in 1971.

Consumer and non-profit housing coops (central purchasing agents for the residential construction industry) comprise a relatively small part of the system.

The breakdown of local financial institutions servicing these sectors in 1971 was as follows:

*All monetary figures in the text are given in dollars, converted from DM at the exchange rate prevailing at the time the figure was reported. This is done for ease of comprehension. Figures in Tables I and II are presented in DM, where a sense of proportion is more important than absolute totals.

Agriculture	5,680
Industry	668
Housing and Consumer	45
	<hr/>
Total	6,393

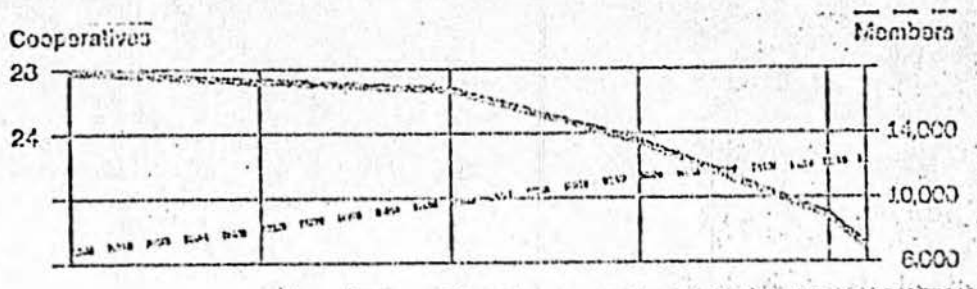
The system also includes 10 mortgage banks unaffiliated with cooperative societies.

Recent trends in total units and membership are illustrated in Figure I. Overall, the graphs show increasing membership and concentration, especially in the two most important sectors, agriculture and credit. Concentration has mostly been achieved through the merger of two units.

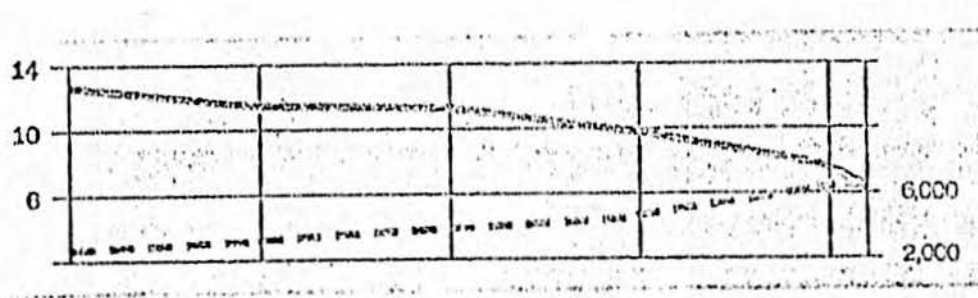
Despite these mergers at the local level, the cooperative system maintains the most extensive branching system of any sector of the German financial market, and its units are incredibly small. In 1971, there were 18,665 coop bank branches, compared to 14,506 for savings and 5,428 for commercial banks. In terms of aggregate balance sheet totals, the cooperatives are behind both the other sectors. The average balance sheet total for the banks serving industrial coops was \$23.3 million; for those servicing agricultural customers, only \$3.7 million.

These changes at the primary level have affected the structure and operations of the regional cooperative banks. Each merger of two local units tends to reduce deposits with the regional banks, because the compensatory movements of

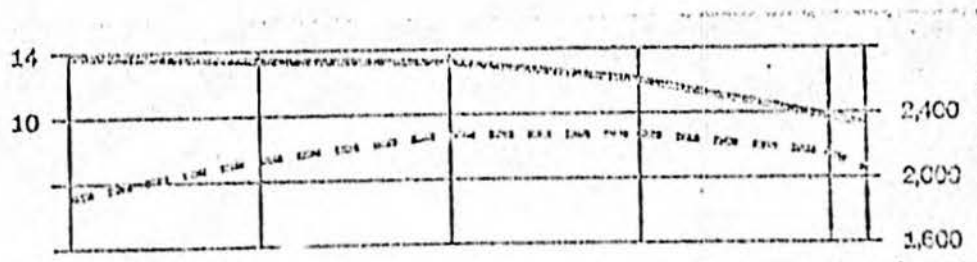
FIGURE I
Cooperatives and Their Membership in the
Federal Republic of Germany



Primary Cooperatives - Total

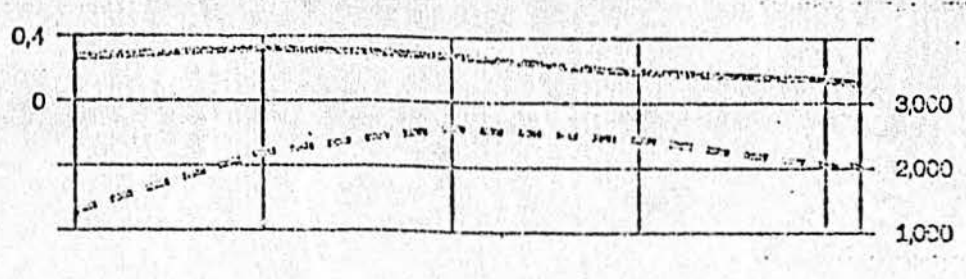


Cooperative Banks

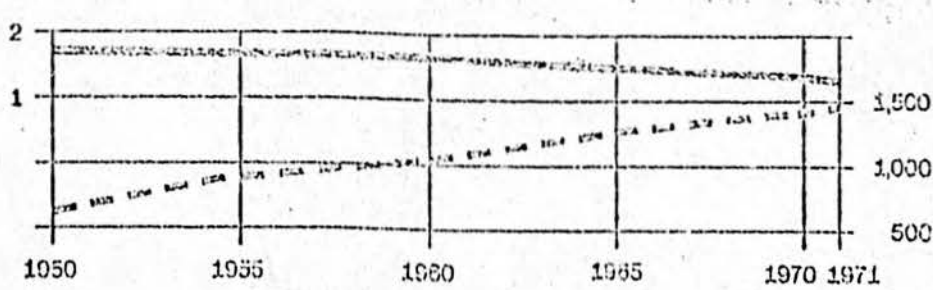


Trade and Service Cooperatives

FIGURE I (continued)



Consumer Cooperatives

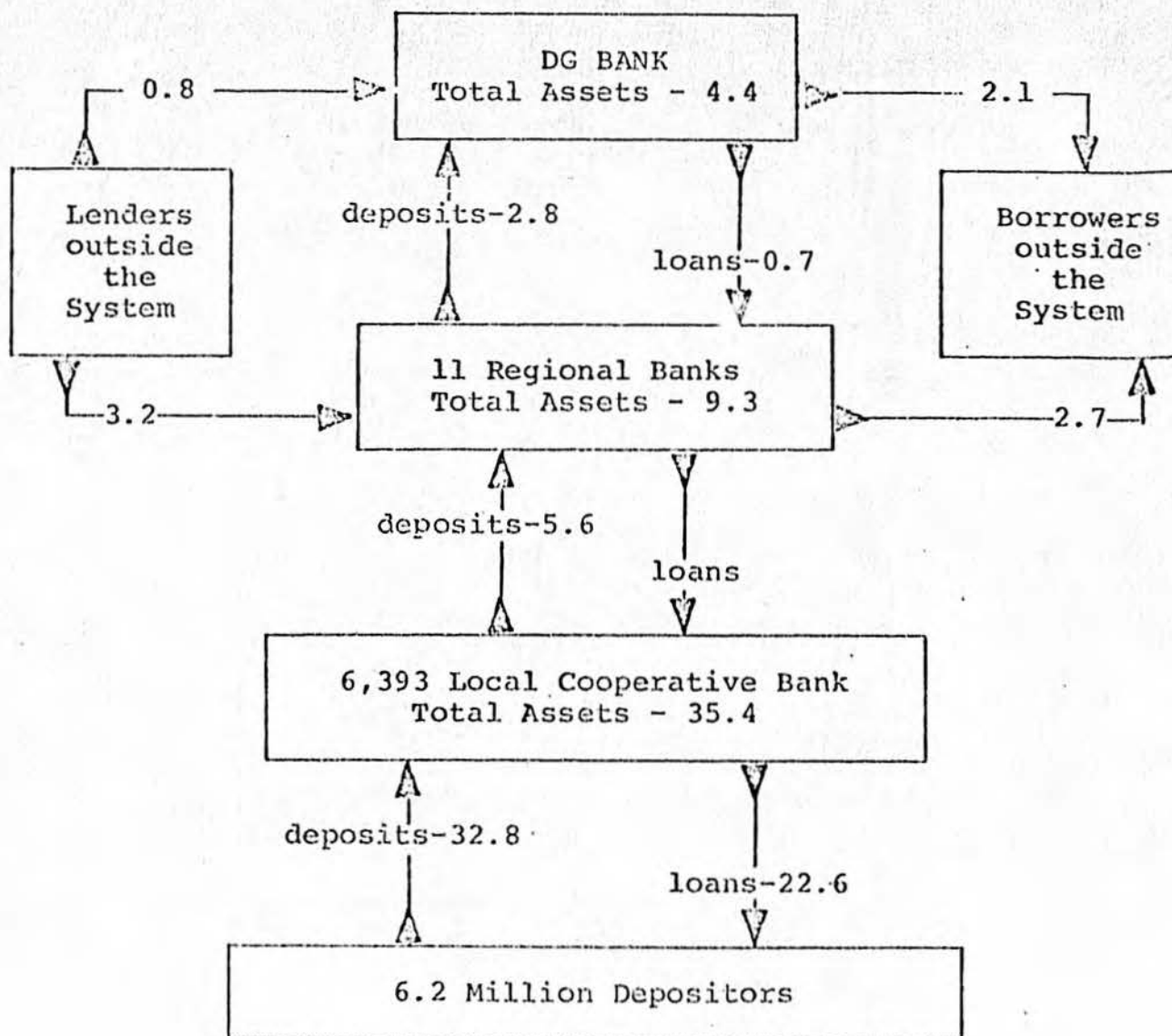


Cooperative Building Societies

FIGURE II

The German Cooperative Financial System (1971)

Figures in billions of dollars (US) at the
then-prevailing exchange rate



liquid funds increasingly take place within the new unit, instead of passing through the central institution. The percentage of customers' deposits held by the local cooperative banks at their affiliated regional bank has therefore been declining. Also, larger local cooperative banks usually make heavier demands on their regional banks, on which they depend for long-term funds to finance expansion in the volume of lending.

This situation has led to the need for larger units at the regional level, capable of maintaining larger balances of loanable funds and providing services such as check clearing where economies of scale can be realized. Since 1968, the parallel regional systems of the various primary cooperative sectors have been in the process of consolidation, and the number of regional cooperative banks has fallen from 18 to 10. Of these, seven have reorganized as corporations able to sell shares to the general public. These regional banks, in turn, rely on DG Bank for depository, liquidity management and other essential services. The financial interrelationships of this system, from local depositors to DG Bank are shown schematically in Figure II.

Sources of Funds - The source of funds to the local system is the deposits of members. The local coops offer a full range of deposit accounts and instruments: checking and savings

accounts, negotiable and non-negotiable savings certificates. These last instruments are issued for terms of 7 years and their proceeds are earmarked for term lending to medium-sized firms.

Uses of Funds - Besides consumer, home mortgage and business loans to members, coop banks undertake a number of lending and investment activities. These include construction financing, term loans to other credit cooperatives and industrial customers and leasing.

DG Bank Operations - DG Bank provides financial and non-financial services to the regionals in order to help them facilitate these local activities. Such tasks performed jointly by DG Bank and the regionals include check clearing, centralized electronic transaction procession, property broking, secondary mortgage marketing, advertising, personal training, and the placement of reserve and surplus funds in investments outside the cooperative system. This last function is reserved primarily to DG Bank. They underwrite and market domestic and foreign corporate equities and securities of various governments and public authorities.

II. SOURCES OF FUNDS/CAPITALIZATION

Equity - DG Bank is capitalized by the purchase of shares. Of the \$134.5 million in paid-in equity in 1975, some 75% was

held by the regional banks. The rest was held by corporate and institutional investors outside the cooperative system. The current dividend on shares is 8%.

Deposits - DG Bank's main source of deposits is the regional banks' reserve and surplus. Of the \$7.92 billion on deposit in 1975, \$5.36 billion was attributable to the regionals. Other banks and corporations provided the balance of the deposits. DG Bank pays interest on these deposits at prevailing rates, and these interest payments compose their largest financial expense. The volume of deposits in the entire system has risen rapidly in recent years.

Borrowings - When necessary to increase its base of loanable funds, DG Bank will raise money on the European bond market through issue of its own bonds. In 1975, it had \$832 million outstanding--down from recent years due to the simultaneous increase of deposits and decrease of loan demand within the coop system.

Income - Net interest payments on loans compose by far the largest portion of DG Bank's income, some 86% of the \$606.5 million in 1975 gross earnings. Other sources of income include that from investments and securities, commissions and fees and miscellaneous sources amounting to \$11.8 million.

III. USES OF FUNDS/INVESTMENTS

Because loan demand in the sectors from which the cooperative system draws its deposits--agriculture, small business and middle-income individuals--has fallen in recent years, DG Bank has had to find uses for its investible funds outside the cooperative system. Some 57% of its \$7.5 billion in loans outstanding in 1975 were to banks outside the cooperative system. Another 26% were to non-bank, corporate customers, leaving 17% to be channeled back to the regional banks. Over 70% of these loans were for terms of less than four years.

Unlike American banks, German banks are not restricted from engaging in equity and underwriting transactions involving corporate securities, and they may own subsidiaries directly instead of through a holding company. All these activities figure prominently on DG Bank's balance sheet. Of the \$1.24 billion in investments held by the bank, 46% are in corporate bonds, many of which DG Bank underwrote. Three percent was held in other securities, mostly corporate equities, 12% in shares of subsidiaries and 39% in Treasury notes.

DG Bank's underwriting business is substantial. In 1975, it underwrote 17 large issues, mostly for German public authorities and political units. The Bank also participated

in 47 other issues as guarantors for various private and public entities.

DG Bank held equity interest in over 50 other financial institutions, including the seven regional banks reorganized as corporations. Among the Bank's wholly-owned subsidiaries is the Deutsche Genossenschafts-Hypothekenbank, one of Germany's largest mortgage banks, several closed-ended mutual funds and several foreign subsidiaries engaged in placing DG funds in investments abroad. DG Bank also owns 19 and 50%, respectively, of the shares of the two leasing firms whose services they broker to the regional banks.

Thus, using the very sparse information provided in DG Bank's annual reports and including accounts which may register holdings outside as well as within the cooperative system, it appears that only 18.6% of DG Bank's investments are in the cooperative system.

IV. MANAGEMENT

The top level of management is the Managing Board, composed of five members elected by representatives of the regional banks and cooperative unions. DG Bank does not report the breakdown of managerial responsibility between its various divisions. Nor do they present any overriding management policies besides

a commitment to helping local credit cooperatives achieve a greater market share.

V. ACCOUNTABILITY

DG Bank is a privately-owned corporation and thus enjoys almost total freedom in its investment and liability-generating policies. It is restricted only insofar as it must obey laws designed to protect depositors.

VI. EVALUATION

DG Bank's major purpose is to help the thousands of tiny financial units which compose the cooperative credit system remain competitive with other sectors of the German financial system characterized by larger units. Banks in these other sectors tend to deal in larger blocks of money and thus have lower unit transactions costs. DG Bank and its regional affiliates seem to do this job well. From 1973 to 1975, the share of deposits in all German banks held by cooperatives increased from 11 to slightly more than 13%.

Perhaps the most striking aspect of DG Bank's operations is the extent to which it invests outside the cooperative system, especially when compared to the British Columbia Central Credit Union. Such a comparison is misleading, however, in that the

real economic conditions in the two institutions' deposit markets may be entirely different. Young families are heavily represented among the British Columbian cooperatives' members. Their demand for large mortgage loans is high, and they tend to keep little in savings. Thus, their central bank must channel funds from outside the system to its member units if they are to continue to compete for loan business.

DG Bank is the lead institution of a complex system financing many types of economic activity. Its managers claim and behave as if loan demand is declining in these sectors. An analysis of these sectors and a critique of DG Bank's lending policy is impossible given the paucity of information on these activities available in secondary sources and the Bank's own tight-lipped reporting policies. Management may be doing its members a service by investing outside the system if that is where their funds can earn the greatest return.

However, one of the Bank's financial policies does seem to be a disservice to the member cooperatives. This is the selling of shares by both the regional banks and DG Bank to investors outside the cooperative system when liquidity appears to exist among the individual cooperatives to buy these shares. Thus, earnings on the deposits contributed by the units at the base of the system (and ultimately their members) are siphoned off

to outside investors through the payment of dividends. According to our own calculations based on information given in DG Bank's annual reports, these payments outside the system amounted to 18.9% of the Bank's net earnings in 1975.

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes: DG Bank provides an important counterpoint to BC Central. It shows what happens to a similarly constituted cooperative development bank when it matures in a mature industrial economy.

Sources and Uses of Funds: DG Bank is no longer wholly owned by its users. It now is a net exporter of funds--not only out of local cooperatives, but out of Germany.

Management and Accountability: DG Bank is increasingly less accountable to its local cooperatives. It manages its funds similar to a large multi-national bank.

TABLE I
Balance Sheet - 1975

	DM Million
ASSETS	
Cash and Bills Receivable	627.4
Due from Regional Cooperative Banks	3,198.3
Due from Other Banks	
Less Than Four Banks	9,852.9
Four Years and Over	909.5
Treasury Bonds	1,313.1
Bonds and Notes	1,625.5
Other Securities	117.8
Loans and Advances to Non-Bank Customers	
Less Than Four Years	3,324.9
Four Years and Over	1,459.6
Due from Public Authorities - Equalization Claims	86.9
Own Bonds Held for Trading Account	38.0
Fiduciary Transactions	165.2
Investments in Subsidiaries and Affiliates	413.0
Premises and Equipment	45.1
Other Assets	107.6
Total Assets	<u>23,284.8</u>
LIABILITIES	
Deposits of Regional Cooperative Banks	13,381.9
Deposits of Other Banks	
Less Than Four Years	3,528.4
Four Years and Over	1,683.9
Deposits of Non-Bank Customers	1,192.5
Bonds and Notes Issued	2,302.1
Fiduciary Transactions	165.2
Other Liabilities	283.5
Capital Stock	366.6
Reserves	355.0
Profit After Transfer to Reserves	25.7
Total Liabilities	<u>23,284.8</u>
Endorsement Liabilities	417.8
Guarantees	1,694.7

TABLE II
Income and Expenses - 1975

	DM '000
INCOME	
Interest Earned	1,305,936.6
Income from Securities and Investments	159,911.1
Commissions and Fees	18,741.5
Other Income Including Adjustment of Special Reserves	29,471.3
Total Income	<u>1,514,060.5</u>
EXPENSES	
Interest Expense	1,272,019.7
Commissions	1,813.7
Depreciation, Provisions, Transfer to Special Reserves	32,048.8
Staff Expenses	34,542.4
Other Operating Expenses	23,918.2
Taxes	19,192.4
Other Expenses	4,852.5
Total Expenses	<u>1,388,387.7</u>
NET INCOME	125,672.8
Transfer to Reserves	100,000.0
PROFIT AFTER TRANSFER TO RESERVES	<u>25,672.8</u>

II. REGIONAL MODELS AND OPTIONS

REGIONAL MODELS
Discussion Draft

September 14, 1977
Page 149

International and Domestic Patterns

International development banking provides a pattern for regionalizing the Alaska Permanent Fund which is strikingly paralleled in a number of publicly-sponsored American development finance systems. In each instance a three-tiered arrangement has evolved with these common elements:

First, a government-sponsored development bank or fund which oversees the whole system.

In the middle, regional development banks or corporations which are more sensitive to local differences and act as a bridge between local needs and national or state resources.

At the bottom, local development corporations or banks with a great deal of autonomy and flexibility to respond to local needs and differences.

This essential three-tiered pattern is found in the international development banking system headed by the World Bank, in sophisticated national development banking systems in Third World countries such as those of Brazil, Mexico and India, and in regional development banking systems of developed countries of Europe such as France or Italy. The same pattern is followed in publicly-sponsored American credit systems such as the Farm Credit system and the Federal Home Loan bank system.

It is no coincidence that this pattern repeats itself in such a range of settings. The advantages of this pattern are elementary, sensible, and obvious.

In each instance, the system is publicly-sponsored and accountable but independently operated by an experienced, career-minded professional staff. Both capital and management are organized on a long-term basis and initial public investment is used to generate larger amounts of private capital from the private capital market.

Just as international and domestic experience provides us with important parallels, each gives us a better understanding of different aspects of the overall structure and organization which could help define the Alaska Permanent Fund as a development bank capable of supporting the quite different regional economic needs of different areas of Alaska.

For instance, international development banking systems are superior to American development finance systems in the provision of infrastructure financing and venture capital. By definition two major American credit systems, the Farm Credit system and the Federal Home Loan bank system, do not provide either long-term infrastructure finance or essential venture capital to new enterprise. Venture capital is essential to the development of rural regions of Alaska and lower-income

communities in those regions, as it is in Africa, Asia or Latin America.

Just as the international development banking systems help us understand the basic capital formation instruments for development banking systems, particular American experience in structuring financial institutions gives us a set of basic guidelines for constructing the regional units of the Alaska Permanent Fund. After looking at the evolution of international experience, it is worth taking a close look at the specific legal, financial and organizational mechanisms used by successful American development finance systems.

International Models

One of the most appropriate transferable lessons from international development banking experience is that a network is necessary in order to support regional economic development--not a single, monolithic institution. This is especially true where regional and ethnic distances are great, where infrastructure is inadequate, and where sensitivity to local needs must be particularly acute.

The evolution of the international development banking system into a geographically decentralized and functionally differentiated worldwide system was neither wholly planned nor

conscious. It simply evolved to fit the rising needs of various developing countries and regions of the globe.

For instance, early on, the World Bank began to recognize the value of working through local intermediary development banks, since they were much more sensitive to local practices and, in many cases, more likely to make sound financial judgments about loans and investments. The World Bank group began to work with existing national development banks and to sponsor the creation of a worldwide network of national private development finance corporations in a host of Third World countries.

Second, in large and complex countries with large geographic areas and significant regional differences, we can observe a tendency to complement this international decentralization with an intranational regional decentralization to subnational institutions. In one study of 209 development banks, nearly 40 percent were located in 10 countries--Argentina, Brazil, Colombia, India, Malaysia, Nigeria, Pakistan, the Philippines, Spain, and Venezuela--each of which has developed extensive, decentralized and regionalized development banking systems.

Third, this pattern repeats itself once again in the sophisticated and elaborate regional development banking systems which have been organized in France, Italy, and the United Kingdom.

At the base of each system is the fundamental unit--the local development bank or corporation which serves to broker the risk between the local entrepreneur and the outside sources of capital. Between the local development corporation and the apex of the system there is often a regional development bank or corporation which mobilizes its own capital for local use and may be required to broker-finance between the local and the top institutions. At the higher levels in any event there is also a careful elaboration of different infrastructure and equity "windows" to provide more discrete forms of capital for specialized purposes. Figure 1 provides a highly abstract and stylized version of the institutional relationships among the World Bank, multinational regional development banks, and local national institutions on the one hand, and national development banking institutions, regional and local development corporations on the other hand.

An American Parallel: The Farm Credit System

The Farm Credit system has evolved as a highly sophisticated, publicly-sponsored but user-owned development finance system like the international development banking network. It has unfolded gradually since its establishment in 1916, assuming new functions and becoming more decentralized in response to

the credit needs of farmers. Today the federal Farm Credit Board and the Farm Credit administration operate at the financial level, while twelve district Farm Credit Boards at the regional level serve hundreds of constituent associations and cooperatives at the local level. The functional diversity of this system is reflected in twelve federal Land Banks serving 594 constituent Federal Land Bank Associations, twelve Federal Intermediate Credit Banks working with 442 local production credit associations, and twelve banks for cooperatives serving constituent farmers in cooperatives. This arrangement provides three different functional "windows" of credit to member farmers and ranchers in each of the twelve regional Farm Credit Boards.

The Farm Credit grid system, then, parallels the international development banking patterns both in its geographic decentralization of decision making and its separation of different functions. The pattern of geographic decentralization is repeated again in other American financial networks such as the Federal Home Loan bank system and, of course, the Federal Reserve system. These important domestic parallels not only confirm international experience; they also provide us with proven, workable, legal, financial and organizational precedents for a regionalized Alaska Permanent Fund.

The Farm Credit system has, for example, developed two structural attributes worth noting and using in constructing a regionalized Alaska Permanent Fund. In a characteristically American fashion, on December 31, 1968, the Farm Credit system became 100 percent user-owned with retirement of the original federal government capital investment in the system. Part of each farmer's loan purchases stock ownership in the capital structure of the banks and associations. Member farmers elect the Board of Directors of the Federal Land Bank Association, production credit associations, and cooperatives; the Boards of the associations and cooperatives in turn elect the District Farm Credit Board and make nominations to the President for the federal Farm Credit Board (see attached Figure 2).

The local users govern the system by electing or nominating each governing board in the system. The local users eventually repurchase the ownership of the system from the federal government with a small percentage of the proceeds received from the system. This user governance and eventual user ownership is a critical precedent for establishing local cooperative banking institutions in communities in the state too small to properly support a full-service bank.

Second, the private capital market finances the \$8 billion debt of the Farm Credit system through the sale in the bond

market of consolidated federal Farm Loan bonds. "Consolidated" is primarily what they are: thousands of individual farm mortgages, crop loans and farm equipment loans which have been put together by the Farm Credit system for resale in the private capital market. The private capital market supplies the bulk of the funds used, not the Treasury. On the other hand, the Treasury's standby credit is assurance to the market that the government stands behind the obligation, even though there is no direct government guarantee. I similarly feel that with the huge paid-in capital base of the Alaska Permanent Fund it will similarly be possible to sell many such packaged private obligations in consolidated bonds in the marketplace with the standby backing of the Alaska Permanent Fund itself.

Unlike virtually all international development banking systems, the Farm Credit system has not developed an affiliated venture capital corporation. As a result, the Farm Credit system is precisely that--a 100 percent debt financing system which is no longer able to respond adequately to the needs of those low-income farmers and lesser-developed regions of the country which it was originally set up in the 1920's to serve. Nor has it been able to be effective in its original purpose of seeking to end farm tenancy by making landowners out of sharecroppers. Credit does not make owners, only debtors. The

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

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

Other Domestic Models

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

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

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

FIGURE 1.

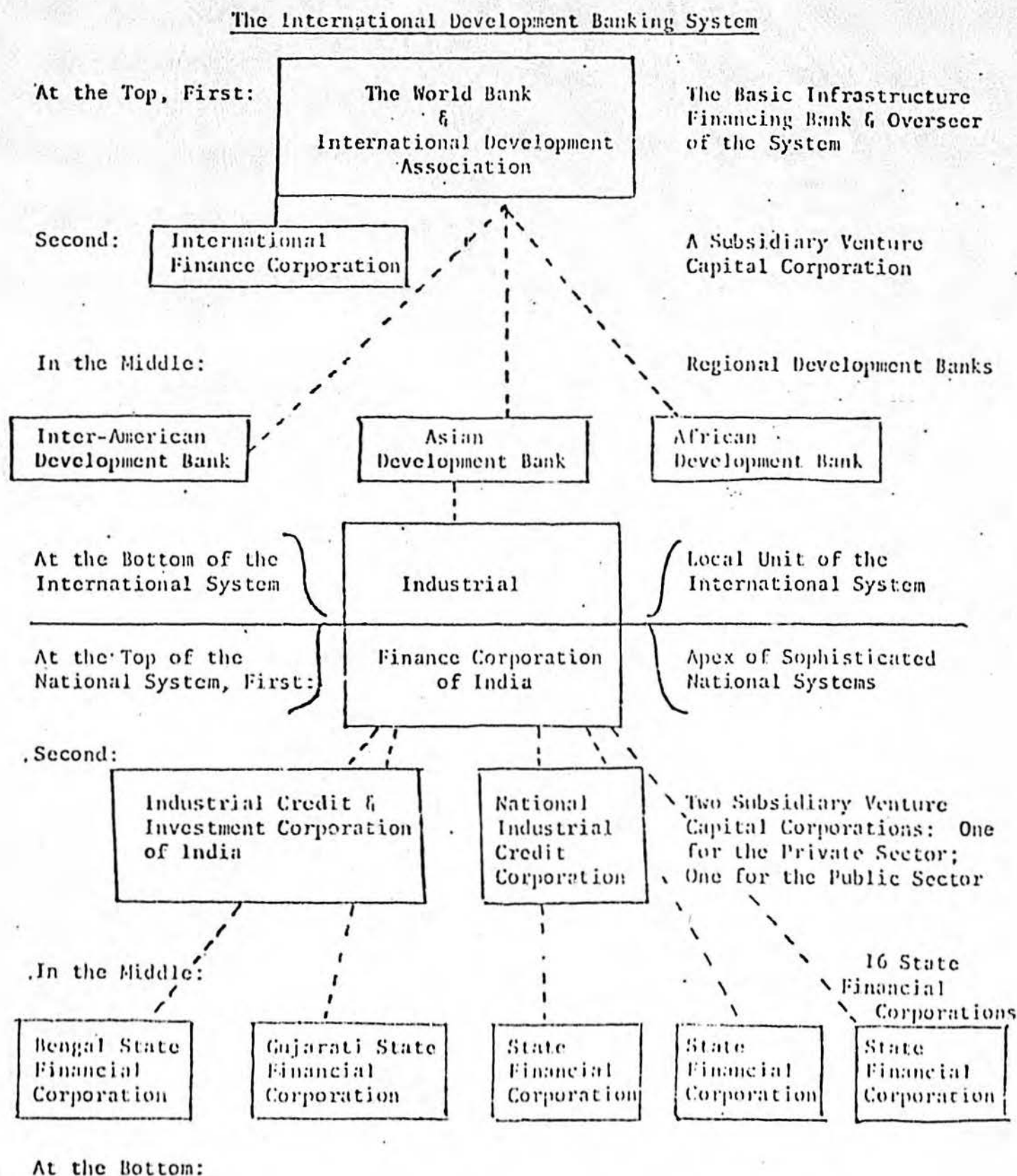
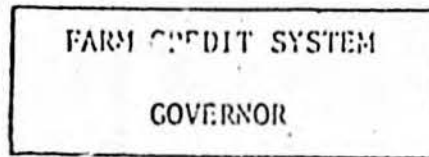


FIGURE 2

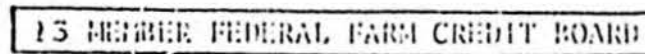
THE FEDERAL CREDIT SYSTEM

CENTRAL



Appoints

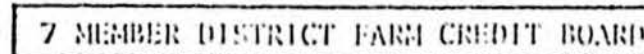
CENTRAL



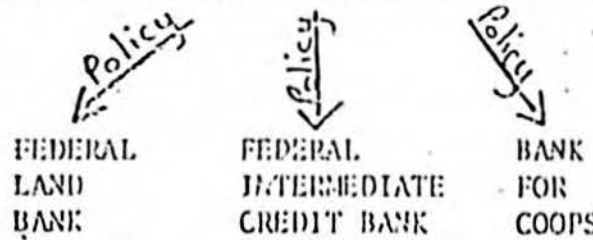
← 12 appointed by Pres. from nominee of each district, one by Secretary of Agriculture

REGIONAL
GEOGRAPHIC

(1 for each of 12 Districts)

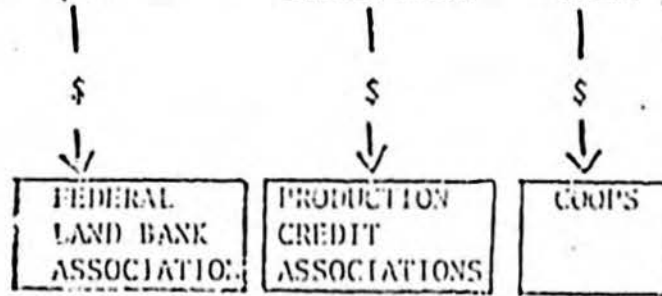


REGIONAL
FUNCTION



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

LOCAL
FUNCTION



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



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

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

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

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

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

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

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

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

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

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

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

V. 166 - mini-polit. process - build in users
11-175 - Findings → goals → procedures
11-177-181 - Reporting
4/B-11-180+1

181-
11-177

III. THE PROBLEM OF ACCOUNTABILITY

AN INTRODUCTION TO THE ISSUE

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

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

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

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

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

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

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

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

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

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

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

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

Specifically, these stages are:

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

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

this information is presented, and who gets the information?

3) Governance: Public Inputs into Operating Decisions:

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

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

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

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

At each of the four stages, democratic elements of the

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

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

A. Setting of Goals and Priorities

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

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

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

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

Still, attempts have been made to formulate goals so that

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

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

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

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

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

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

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

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

"The objects of the company are:

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

and shall be carried out in anticipation of profit and in the best interests of the shareholders as a whole."

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

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

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

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

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

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

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

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

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

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

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

F. Formulation of Measurement and Reporting Procedures

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

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

Finally, accounts are inherently incomplete in that they

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

Financial Reporting

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

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

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

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

Social Reporting

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

Projections

Projections are necessary to evaluate investment projects,

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

Cost-Benefit Analysis

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

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

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

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

C. Governance: Public Inputs into Operating Decisions

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

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

The four basic groups with whom we are concerned are:

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

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

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

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

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

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

The important relationships among these groups are:

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

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

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

Relationship of the Government to the Board

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

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

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

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

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

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

Relationship of Constituencies to the Board

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

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

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

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

The Role of Staff

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

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

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

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

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

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

D. Operating Sanctions

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

Removal of Personnel

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

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

Control of Funds

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

RISK and going to J-U to K MKTS - Benefit is not "Test!"

Private Market Finance

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

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

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

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

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

Financing Through Tax Revenues

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

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

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

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

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

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

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

E. Conclusion

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

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

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

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

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

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

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

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

MKT DEKS
K flow to rr - other
"invest" flows

~~Call Herb @ water~~
~~CA dev.~~
reg. impacts

~~Bill Simon~~
~~1/11/75~~
~~1/27~~

~~call Doris Sanford~~

should lower ~~per~~ dev.
be paid - ~~dev~~ - 7-19

RRE
7-16 - work w/
Dunbar
invest in ~~teach~~ 7-21

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

July 11, 1977

Specifics - 7/66

Belden Hull Daniels
Department of City and Regional Planning
Harvard University

Beldan Daniel's Insights - Structures ↔ Goals

① How should RRDF collaborate with existing banking system in its development function - participation as Check-Consistent Development Authority p.16

↳ ② Funds for technological innovation - Alaska-specific technology - p.21

↳ ③ Funds for lessening economic inequality - p.19

④ Users on the board p.69

Table of Contents

	<u>Page</u>
INTRODUCTION: A Sense of Limits	1
I. THE NEED FOR A COMPREHENSIVE ALASKAN ECONOMIC DEVELOPMENT PLAN WHICH RECOGNIZES THE LIMITS OF STATE INTERVENTION IN THE ECONOMY AND THE APPROPRIATE USES OF A DEVELOPMENT BANK	6
First Principles	6
A. Potential Kinds of Investment by the Alaskan Permanent Fund Within Alaska	11
1. Investments Which Contribute to a Sound, Balanced Alaskan Economy Less Dependent on Non- renewable Resources and Government Spending	11
2. Investments Which Decrease Economic Disparities Between Alaskan Regions, Commu- nities, and Demographic Groups	18
B. Potential Kinds of Investment by the Alaskan Permanent Fund Outside Alaska	19
1. Investments Outside Alaska Which Contribute to Overall Alaskan Economic Development	20
2. Investments in Investment-Grade Securities	21
II. USING THE FULL RESOURCES OF THE ALASKAN STATE GOVERNMENT TO PLAN FOR AND CONTRIBUTE TO A SOUND, BALANCED ECONOMY	24
A. The Role of State Expenditures in Stimulating Economic Development	24
B. The Impact of Tax Policy on Alaska's Economic Development	29
C. Regulatory Policy as It Affects State Economic Development	34

Table of Contents (continued)

	<u>Page</u>
1. Changes in the Regulation of Asset Management of Privately Owned Financial Intermediaries in Order to Stimulate Economic Development	35
2. State Government as a Public Entrepreneur to Create a New Financial Intermediary Either Initially or Eventually Privately Owned	37
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?	40
III. STRUCTURING THE ALASKAN PERMANENT FUND AS ONE TOOL IN ALASKA'S OVERALL ECONOMIC DEVELOPMENT PLAN	44
A. What Should be the Limited Goals of the Alaskan Permanent Fund Within the Framework of Alaska's Overall Economic Development Plan?	46
1. Investment-Grade Securities	48
2. Productive Private Enterprise	49
3. Community Development	54
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 Purpose?	59
C. What Board and Staff Management Structure is Most Efficient for Carrying Out These Goals?	67
D. What Capital Structure is Necessary to Ensure that the Alaskan Permanent Fund Has the Financial Capability to Achieve These Purposes?	74

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

July 11, 1977

INTRODUCTION: A Sense of Limits

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

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

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

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

July 11, 1977

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

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

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

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

July 11, 1977

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

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

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

July 11, 1977

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

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

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

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

July 11, 1977

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

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

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

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

July 11, 1977

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

July 11, 1977

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

First Principles

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

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

July 11, 1977

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

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

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

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

July 11, 1977

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

July 11, 1977

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

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

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

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

ALASKA LEGISLATIVE COMMITTEE / SUBJECTS 8672

123 HOUSE COMM. ON PERMANENT FUND 1977-78

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.

July 11, 1977

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

July 11, 1977

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?

f
OR
G+S

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

July 11, 1977

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.

July 11, 1977

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.

IS
OTN'S
YRIB
HERE

July 11, 1977

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

July 11, 1977

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.

July 11, 1977

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.

July 11, 1977

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.

July 11, 1977

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

July 11, 1977

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-

July 11, 1977

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.

July 11, 1977

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.

July 11, 1977

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

July 11, 1977

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-

July 11, 1977

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

July 11, 1977

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).

July 11, 1977

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 Retained Earnings of 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

July 11, 1977

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

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

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

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

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

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

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

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

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

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.

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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.

July 11, 1977

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.

July 11, 1977

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.

July 11, 1977

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

July 11, 1977

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-

July 11, 1977

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

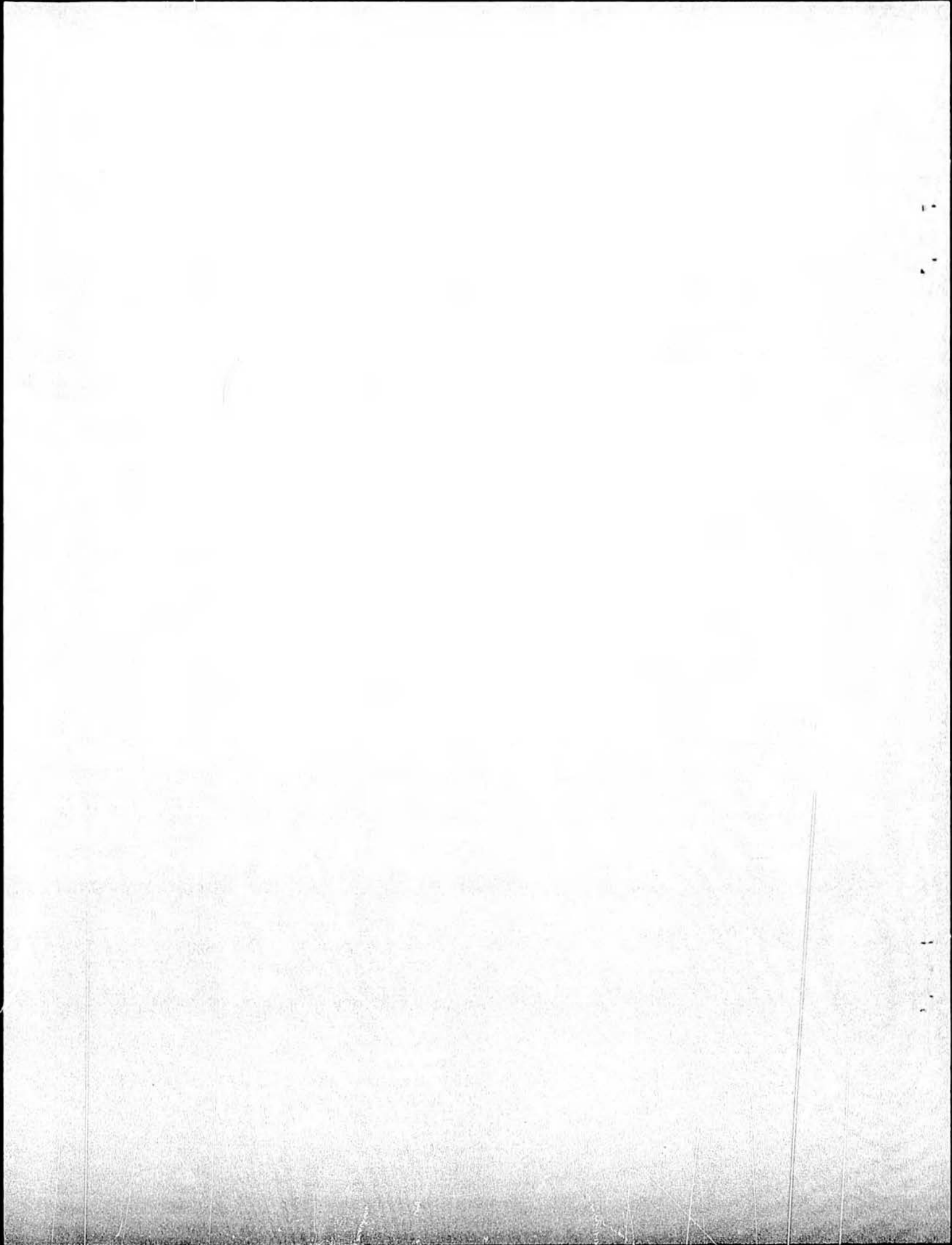
July 11, 1977

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.



July 11, 1977

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

July 11, 1977

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

July 11, 1977

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."

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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.

July 11, 1977

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

July 11, 1977

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)

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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.

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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.

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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

July 11, 1977

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).

Donald
Tom
FYI

MEMORANDUM

RECEIVED
AUG 17 1977

TO: Fran Ulmer
Director
Division of Policy
Development & Planning

DATE : August 17, 1977
POLICY DEVELOPMENT
TRAINING

FROM: *[Signature]*
Jim Edens
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