Reflections on the Surplus Economy and the Alaska Permanent Fund

The Alaska Permanent Fund was created in 1977, shortly after oil from Alaska’s North Slope began flowing to market through the Trans-Alaska Pipeline. It was originally envisioned to serve two general purposes—to set aside a share of oil revenues for the benefit of future generations of Alaskans after the depletion of the oil reserves, and to keep a share of oil revenues out of the hands of the current generation of politicians who could be counted on to spend it on wasteful government operations and capital expenditures. It was clear that oil production would be a temporary phenomenon, simply because of the unique size of the huge Prudhoe Bay field. The mistrust of the politicians was grounded in the fact that the original bonus of $900 million paid to the state for the North Slope leases, left in the hands of the legislature, seemed to disappear overnight, leaving behind a legacy of bigger government without an enhanced ability to pay for it.

The balance, funded by deposits of 25 per cent of state royalties (about 10 per cent of total oil revenues), initially increased slowly so that by the end of fiscal year 1979 it had reached $137 million. Shortly thereafter, the price of oil took a dramatic leap upward and within seven years the fund balance, including subaccounts, stood at $8.4 billion. Since 1986 the fund has continued to grow, albeit at a slower pace, so that at the end of fiscal year 2001 it stood at $24.8 billion. (The fact that this is $1.7 billion less than one year earlier seems to have passed without notice.) At a real rate of return of 5 per cent, the annual earnings of the fund would be able to fund the Alaska state general fund budget at a level equal to the per capita expenditures of the average state, but would fund only a little more than half of the actual general fund budget.

The structure of the Permanent Fund was in place and Alaska oil production was ramping up when high world oil prices prompted Alaskans to ponder the question of whether Alaska would become a “surplus economy” and, if so, what course of action should be adopted. In 1978 the state budget was about $800 million, $500 million of which came from oil revenues. Four
years later, at the peak of the boom, oil revenues were nearly $4 billion; the
equivalent today of $17,000 for every Alaska resident. There was no doubt
that the state was enjoying a short-term public surplus. Since the conven-
tional wisdom at the time was that the real price of energy would grow
between 1 and 2 per cent a year far into the future, the surplus was viewed
as permanent.

The euphoria was short-lived. In 1986 the oil price crashed and swept
away much, if not all, of the apparent surplus. But, just as the predictions
of the optimists were shattered, so were those of the pessimists, who pre-
dicted that oil production would quickly end with the depletion of the giant
Prudhoe Bay field. Today, although production is at only 50 per cent of its
former peak level, it has consistently been higher than official state projec-
tions. The rate of decline has slowed and oil companies are projecting stable
production through this decade.

The point of this introduction is to remind us that even if it we could
theoretically determine the size of the surplus, prices, production, technol-
yogy and other factors confound our ability to forecast it, even within a wide
range, in practice. In considering fiscal policy for dealing with a surplus, it
is best to proceed with caution.

With that introduction, let me pause and clarify what I mean by a sur-
plus economy. I take it to mean a situation in which the public sector
experiences a large increase in revenues that is expected to persist for a
long period of time. The increase is based on production of a natural re-
source and, because of market conditions, is difficult to quantify both in
the short and long runs. The issue is how to design a set of public fiscal
institutions that, taking this new revenue into account, will maximize long-
term social welfare. One aspect of this is the determination of the best balance
between private and public expenditures, today and in all future periods.
In this article, I offer my observations on the Alaska experience.

TRANSFORMING A DEPLETING RESOURCE INTO
ONE THAT IS SUSTAINABLE

The Alaska Permanent Fund has been a successful tool for converting a
portion of Alaska's depleting oil resource into a renewable financial re-
source. Only time will tell whether the balance in the corpus of the fund
grows to equal the value of the state share of oil in the ground before deple-
tion. We cannot say whether conversion to a financial asset is necessarily in
the best economic interests of the state when compared to investment in
physical infrastructure, human capital or some other resource. However,
the financial return on the fund is a benchmark against which other poten-
tial investments can be evaluated. (Some have argued that if Alaska had
put all of its oil revenues into the Permanent Fund and only spent the
earnings, we could completely fund government today from the earnings. This ignores the fact we would have had to endure two decades of inadequate public infrastructure and programs to get to that point.)

Some of the reasons for the success of the fund are clear. First, it grew out of the perception that the earlier $900-million windfall associated with the Prudhoe Bay lease sale had been wasted. Second, it had its formative years and years of most-rapid growth at a time when the state treasury was bursting with oil revenues: the Permanent Fund contributions, a small share of total revenues, were not missed. Third, its purpose was not clearly defined. Consequently, it could be supported by those favouring less government spending as well as those concerned about the ability of government to pay its bills in future years. Fourth, the investment policy was insulated from the political arena by the decision to invest the portfolio in stocks and bonds rather than in Alaska loan programs or infrastructure building. Fifth, the management of the fund was vested in a board of directors and corporation with the narrowly defined role of maximizing the financial earnings of the fund. The corporation operates independent of the rest of state financial structure and, in particular, takes no part in discussions regarding the best use of fund earnings, which are the preserve of the legislature. Finally, the fund acquired a powerful constituency with the establishment of the Permanent Fund Dividend Program, an annual cash distribution of earnings to all residents.

Interestingly, as oil production and revenues fall and the need to find alternative revenues to fund government grows, some of the features of the fund that have contributed to its longevity may prove to be problematic in the future. Many Alaskans have envisioned the earnings of the fund as a source of alternative revenues, and no other revenue source has yet been identified that could fill that role. However, because the ultimate use of the fund was never clearly spelled out at its inception, there is no consensus on what role fund earnings should play in dealing with the current and expected future state budget shortfalls. A significant minority of the population feels that under no circumstances should the earnings of the fund be used to help pay for state government.

The separation of the management and accounting of the fund from the rest of state government has exacerbated this problem. For most of the past decade the state general fund has operated at a substantial deficit. At the same time the Permanent Fund has generated large surpluses after payment of the dividend. Taken together, the consolidated account of the general and Permanent Fund has usually shown a surplus. The public becomes confused and suspicious when they are given this inconsistent message. It often surfaces in discussions about whether the dividend should be considered an appropriation controlled by the legislature, which it legally is, or whether it should be considered a separate entitlement program.
The creation of a constituency for the Permanent Fund through the establishment of the Permanent Fund Dividend Program has, for a large number of Alaskans, identified the ultimate purpose of the fund. In fact many Alaskans incorrectly call our savings account the Alaska Permanent Dividend Fund. Politically, the dividend is so popular that any politician who is even suspected of proposing any measure that might, today or in the future, negatively impact the size of the dividend will be turned out of office at the next election. The result is an absence of discussion about the role of the fund in the future of the state.

THE PUBLIC/PRIVATE CONSUMPTION BALANCE

In response to the perceived public surplus, the Permanent Fund has been a mechanism for creating a balance between public and private consumption, but it has been only one among many. For example, state personal income tax in Alaska was abolished in 1980. (In retrospect many think it would have been better to retain it but reduce its rates to a minimum. Two reasons for this are given: it would be easier to reinstate higher tax levels when needed and, secondly, it would provide a link, now missing, between taxes and public spending, thus giving citizens an appreciation of how public finance works under normal conditions, as well as a means to directly test the trade-off between the benefits of public programs and the cost, through taxes, of paying for those programs.)

The fund influences the public/private split of consumption through the dividend both directly through the annual distribution—the cumulative amount of which has been $10 billion over the last nineteen years—and indirectly by imposing discipline and constraint on the state budget. Politicians, who would otherwise love to appropriate the annual earnings of the fund for their pet projects, be they Republicans or Democrats, are constrained by the knowledge that such a move would be political suicide. For the past decade, partly as a consequence of this, per capita public spending in Alaska has been falling at the same time that the size of the Permanent Fund dividend payment has doubled. The financial assets in the Permanent Fund have not been fungible in another dimension, not because of legal constraints, but because of political pressure. Although there are periodic suggestions that the balance in the Permanent Fund be used to back borrowing in one form or another, that idea would be seen by fund constituents as a threat to the fund’s financial integrity.

AUTOMATIC STABILIZER

The Permanent Fund has served as an important “automatic stabilizer,” reducing the regional business cycles associated with swings in energy
prices and production. Borrowing from the terminology of the medical profession, Alaska has experienced two forms of the "Dutch disease"—Dutchosis and Dutchitis.

The state economy is somewhere along the downside of a long, thirty- to forty-year economic cycle driven by the production-decline curve for oil, and in particular Prudhoe Bay oil. One of the primary symptoms of the later stages of Dutchosis—deceleration and even contraction of employment and regional income due to the loss of government spending as an economic driver—is currently being offset by expansion of the dividend payment. (Unfortunately, this offset cannot continue because the state has been operating for a decade with an unsustainable deficit.)

In the early 1980s, when the oil price shot up, the state developed a serious case of Dutchitis. Unprecedented growth in government spending, fuelled by an unsustainable boom in oil revenue, drove investment and consumption spending through the roof, only to crash back through the floor a short time later. During this period the money "taken off the table" in the form of regular contributions to the Permanent Fund was modest, but there were larger special deposits into the fund that amounted to over $4 billion. Although state spending precipitated the boom-bust cycle through a range of imaginative and unsustainable spending programs, including loans for many purposes, capital grants to local governments, expansion of transfer programs to individuals and elimination of the personal income tax, the deposits to the Permanent Fund did much to moderate the cycle.

Interestingly, one of the largest public costs of this bout of Dutchitis was not the overexpansion of wasteful or inefficient public programs, although there was much of that. Rather it was the additional costs imposed on state and local governments from the temporary in-migration generated by the boom. Since those migrants contributed nothing in taxes, expected to stay but left the state during the subsequent crash, permanent residents ended up not only with an overexpanded public sector, but less revenue to support it. Without the Permanent Fund to soak up some of the oil revenues, the situation would have been much worse.

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**THE CONSTITUTIONAL BUDGET RESERVE**

Finally, note should be made of the Constitutional Budget Reserve (CBR), a companion fund to the Permanent Fund established in 1990 to deal with the problem of short-term oil revenue variability. Unlike many stabilization funds, deposits into the CBR consist of the back taxes and other revenues owed to the state due to the settlement of disputes over valuation and other issues. Draws from the fund to support general fund expenditures, which must be repaid, require a two-thirds vote of the legislature. Thus far, in order to maintain a relatively stable level of public spending, the general
fund has amassed a debt to the CBR of about $4 billion. It is extremely unlikely that the general fund will ever repay the debt, and the use of the dwindling resources of the CBR to fund the general fund allows the state to maintain the fiction that it is not spending beyond its means.

Another problem with the CBR is conceptual. It is based on the mistaken assumption that the general fund deficit will remain constant over time so that paybacks will balance draws. The reality is that paybacks will consistently be less than the draws due to both falling oil revenues and growing spending requirements. Thus, the CBR is programmed to fail in its mission.

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**CONCLUSION**

The Permanent Fund has served many functions for Alaska as it attempts to deal with its large and nonsustainable oil revenues. Study of the fund can provide insights for others wrestling with similar issues. Lessons for other regions and jurisdictions should be drawn with care, however, as every place and time has its own unique circumstances and challenges.