

Four Alaska Innovations

by

Gunnar Knapp
Professor of Economics
Institute of Social and Economic Research
University of Alaska Anchorage¹

Presented to the Board of Directors of the
Federal Reserve Bank of San Francisco and its Seattle Branch
Anchorage, Alaska
July 11, 2007

Welcome to Alaska

I'd like to begin by welcoming you to Alaska--especially those of you who are here for the first time. I hope you have a chance to experience some part of the magnificent beauty of Alaska. After twenty-six years, I'm still filled with awe at last night's sunset over Cook Inlet; at eagles soaring over our July 4 campsite, at the salmon in our city streams, at the moose I encounter almost daily while jogging, at the mountain wildflowers, at the winter sunshine blazing on perfect cross-country ski trails, at the extraordinary northern lights you sometimes see on a clear crackling cold winter evening.

All this is part of why I fell in love with Alaska when I came here twenty-six years ago. But another part of what has made Alaska a wonderful place to live and work is that it is very interesting. It's not only Alaska's mountains and glaciers and fish and wildlife that are unusual—it's also Alaska's people, Alaska's society and Alaska's economy.

I would happily talk to you all evening about Alaska's economy.

But since my time is limited, what I'd like to do is focus rather narrowly on what I'll call four Alaska "innovations"—four Alaska public policies which have been unusual or even unique, and which may be instructive or relevant for other parts of America or the rest of the world. Two of these innovations are policies of the State of Alaska and have to do with issues that arise out of the fact that Alaska has a lot of oil wealth. The other two innovations are policies of the federal government that have to do with Alaska Native peoples and the fact that parts of rural Alaska are extremely poor, underdeveloped and facing very difficult economic challenges.

My goal is not to argue that these innovations are either good or bad. Rather, I'd simply like to tell you enough to whet your appetite: to convince you that they are interesting innovations—and that it's worth learning more about them and thinking about them and

¹ I welcome comments or questions on this presentation. I can be reached at Gunnar.Knapp@uaa.alaska.edu (e-mail); 907-786-7717 (telephone); ISER/UAA, 3211 Providence Drive, Anchorage, Alaska 99508 (mailing address); www.iser.uaa.alaska.edu/iser/people/knapp (website).

some of the issues they raise. I hope you'll talk about them with some of the Alaskans you meet during your visit to Alaska. You'll hear many different perspectives than my own.

Some Basic Alaska Facts

Let me begin with a few basic facts about Alaska.

Alaska is a big place but it has a small population—only about 650,000. About 18% of the populations are Alaska Natives. Most Alaskans live in Anchorage and a few other medium-sized cities and towns that are basically like most other places in America. The economy, infrastructure and public services in these places are in relatively good shape.

But there are also several hundred small remote villages, mostly off the road system, with mostly Alaska Native residents, which are in a very different situation—with few jobs or economic opportunities, substandard housing and utilities, very high costs, and a mixed economy dependent on traditional subsistence fishing and hunting, cash transfers, and government jobs.

Part of the challenge for Alaska public policy is to address the needs and aspirations of people in these two very different kinds of places.

By far the most important drivers of Alaska's economy are federal government spending and the oil industry. My colleague Scott Goldsmith estimates that federal spending and the oil industry each drive about one-third of Alaska's economy. Everything else--all other "basic industries" that bring money into the economy, like fishing, mining, timber, and tourism—together drives only about one-third of the economy.

The oil industry is particularly important because oil revenues pay for about 85% of state general fund revenues, which support our large state government and a big part of local government as well—particularly education.

Unfortunately for Alaska, our oil production peaked in 1988 and has since declined by more than half. In all likelihood oil production will continue to decline as the biggest oil fields are depleted.

Oil made Alaska rich compared with other states. But as our revenues went up so did our spending and our dependency on oil revenues. This is likely to put us in a significant fiscal bind as oil production declines. That problem has been postponed because of the dramatic recent rise in oil prices—but we're very vulnerable to any downturn in oil prices.

Now, let me turn to our four "Alaska innovations."

The Alaska Permanent Fund

The first innovation is the Alaska Permanent Fund. The Permanent Fund is a dedicated fund owned by the State of Alaska. It was established by a constitutional amendment approved by Alaska voters in 1976, as the Alaska pipeline construction neared completion and Alaska anticipated receiving substantial oil revenues once the oil began flowing. The amendment reads as follows:

“At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law.”

Over time, as oil revenue has flowed in—and as the legislature has made various additional deposits to the principal—the value of the fund has grown dramatically. The estimated market value of the fund reached \$1 billion by 1981, \$5 billion by 1984, \$10 billion by 1989, \$20 billion by 1997—and almost \$40 billion by last week. That’s about \$60 thousand per Alaska resident.

Permanent Fund Management

The Permanent Fund’s assets are managed by the Alaska Permanent Fund Corporation, which is a small and efficient organization which contracts most of the investment management to outside firms, with a Board of generally highly qualified and respected Alaskans who have been committed to investing wisely and prudently. Almost all of the fund is invested in outside Alaska in government bonds, stocks, and real estate.

Under law, the legislature may spend realized Fund investment earnings. But we haven’t spent all of the earnings. We’ve only spent about half of them—about \$14 billion—and we’ve put a good part of the rest into the principle of the fund as “inflation-proofing.”

Is the Permanent Fund an Innovation?

Is the Permanent Fund an innovation?

In one sense, it isn’t. The idea of putting one-time money in an endowment and just spending the interest is familiar: it’s what any billionaire does for his kid’s trust fund, and what you’re supposed to do if you win the lottery or if you’re Harvard University.

However, Alaska’s Permanent Fund is a big innovation in terms of the scale of the fund, and Alaska’s success in converting a non-renewable one time income flow--from a resource which peaked twenty years ago--into a permanent revenue stream which will be shared with future generations of Alaskans.

In 1999, we hit a big milestone when the value of Permanent Fund earnings—which had been steadily rising—exceed the value of our oil revenues—which had been steadily falling. That’s really a remarkable achievement. (It’s not the case at the moment, because fortunately oil prices are really really high so that Californians are paying a lot for gas and some of the money comes back to us.)

Why Has the Permanent Fund Succeeded?

I think there have been two keys to Alaska’s success in growing the Permanent Fund.

First, we wrote into the constitution that we HAD to save a fixed percentage of our oil revenues, and we couldn’t spend from the principle.

Second, we’ve invested the money wisely. In particular, we’ve invested it outside of Alaska. We haven’t given in to the temptation—which can be very strong—to “invest” in all exciting development projects which have so much potential (in the eyes of their proponents) to forever transform our economy and way of life—if they can just get a little government backing.

Risks, Challenges and Questions

The Permanent Fund does face some risks. It creates some challenges. And it raises some questions.

One risk is that investments don’t always increase in value, no matter how careful you are. The stock market can go down. Real estate values can go down.

Another risk is that as the value of the fund grows, so does the temptation to invest just a little in all those wonderful Alaska projects that just need a little public money to get them started, such as our much hoped-for North Slope natural gas pipeline.

An interesting challenge is that the more money we have in the Permanent Fund, the harder it is for the rest of the country to understand how poor we actually are and why we so desperately need and deserve all that federal funding we get.

If you think it’s a good idea to save one-time resource revenues, that raises the question of how much you should save? If saving 25% of Alaska’s oil revenues has been a good idea, why not 50%--or 100%?

Of course the biggest question is how we should use the earnings of the Permanent Fund?

Which leads to our second Alaska innovation—the Alaska Permanent Fund Dividend Program—which is what all of the \$14 billion that we’ve spent from Permanent Fund earnings has gone towards.

The Alaska Permanent Fund Dividend Program

A marvelous thing about living in Alaska is that we don't pay any state income tax, or any state sales tax, or any other broad-based state tax. Instead, the state sends us money each year—our Alaska Permanent Fund Dividends checks. It doesn't take very long living here before this begins to seem like a perfectly natural state of things—or even essential.

The dividend program is extremely popular among Alaskans. Alaskans love their dividends—and so do Alaska's retailers when the dividends are distributed in October.

The Permanent Fund Dividend program began in 1982. It began with a nice big \$1000 check. After that dividends were calculated based on a formula of one-half the average realized earnings of the Fund over the past five years, divided by the number of qualified Alaskans. The annual dividend grew from \$386 in 1983 to \$1850 in 2001. Then, because the stock market went down, the dividend also went down to \$845 by 2005, but now it's on its way back up.

A couple week's ago, we learned that this year's checks will be about \$1500 per person. So for my wife and myself and our three kids, that will add up to about \$7500 (which I'm guessing my wife may have already spent).

Who Qualifies?

So who qualifies to receive an Alaska Permanent Fund Dividend?

To get the dividend, you must “have at least been an Alaska resident for the entire calendar year preceding the date you apply for a dividend, “and you must “intend to remain an Alaska resident indefinitely at the time you apply for a dividend.”

So, who is a “resident?” Well, to be a resident, you can't be absent from Alaska for more than 180 days unless you specifically qualify under certain exceptions, such as being a college student or being in the military. We've had a lot of debates about who else should be allowed to be absent and still get a dividend. Why not Peace Corps volunteers? Why not Olympic athletes training Outside?

(I'm sure you all know that “Outside” is a standard Alaska term which means “anywhere outside Alaska.)

There are lots of other rules about who qualifies. For example, you qualify if you were born or adopted during the qualifying year. Your Estate qualifies if you die during the application period. You qualify if you're a resident alien—if you received conditional or permanent status before January 1 of the qualifying year. But you don't qualify if during the qualifying year you were sentenced or incarcerated as a result of a conviction of a felony—but not a misdemeanor—unless you had a prior felony or two prior misdemeanors.

My point is that when a government starts distributing money you can assume there will be a lot of interest in every conceivable detail about who qualifies for that money.

Is the Dividend Program a Good Idea?

Is the dividend program a good idea?

That is an endlessly interesting question. I think it is much more complex than most people from outside Alaska suspect. Alaskans have all kinds of strong opinions about the dividend program, and I urge to ask some Alaskans about the dividend program and hear what they have to say.

Let me very briefly summarize a few of the perspectives you might hear.

I'll start with some of the things that supporters of the dividend program might say (and keep in mind they are the vast majority):

- The dividend program is not a government giveaway. It's money which rightfully belongs to the citizens of Alaska for the use of their resources.
- Dividends are the best possible use of the money. Citizens can put the money to far better use than the government.
- The dividend program is fair and equitable—probably more fair and equitable than anything else government does. (In fact, we're so interested in making sure it's fair that we have special programs to make sure that people on federal or state needs-based programs don't see their benefits go down as a result of receiving the dividend).
- The dividend program is particularly helpful for lower-income people, for whom it represents a major share of household income.
- The dividend program helps meet basic needs of Alaskans. My wife, who is a schoolteacher, says that "when the dividends come out, poor kids come to school with new shoes.
- Ending the dividend program would be incredibly regressive. It would be like taxing poor children at the same cash amount as rich adults.
- The dividends are a major stimulus to Alaska's economy.
- And a supporting argument, which trumps all the others, is that the dividend program is what keeps support so strong for the Permanent Fund. If we didn't have the dividend program—we'd have already spent the Permanent Fund.

Negative Perspectives

Now let me turn to some of the things that opponents of the dividend program might say (and they are definitely in the minority—so if you’re a politician, you have to be very careful about saying any of these things):

- Why should the government be giving out money to people to rich people who don’t need it? Why (for example) should the state of Alaska be giving my family \$7500?
- The dividend program attracts people to Alaska that we don’t want—in particular poor families with lots of children.
- The dividend program doesn’t actually make us any richer. It just subsidizes wages for Alaska employers, who can reduce what they need to pay to attract workers from outside by the amount of the dividend.
- The dividend program builds a culture of dependence on government.
- We need the permanent fund earnings to provide essential government services. How can we keep on giving away money when we’re cutting back on our road maintenance, our schools, and our state troopers?
- A large part of the dividend money gets wasted on alcohol and drugs.
- A big part of the dividends goes straight to the federal government in our income taxes.
- When we’re giving away money, it’s hard for the rest of the country to understand how poor we actually are and why we so desperately need and deserve all that federal funding we get.

Those are just a few perspectives for starters.

There’s been a lot of talk about potential changes to the dividend program, such as capping the amount of the annual dividend, or changing part of it to a “community dividend” which would go to local governments. But the message from most Alaskans seems to be “don’t touch my dividend.”

The Alaska Native Claims Settlement Act (ANCSA)

The third innovation is the Alaska Native Claims Settlement Act of 1971, or ANCSA. This is the law which created the Alaska Native corporations which today include some of the largest businesses in Alaska.

The Native Claims Settlement Act and the Native Corporations have a very complicated political, legal and economic history. In a nutshell, the issue of Alaska Native land claims was recognized but not resolved from the time the United States bought Alaska from the Russians until the desire to build the trans Alaska oil pipeline created a political dynamic to resolve this long-standing issue.

The key feature of the act was that it created corporations with Alaska Natives as their shareholders. The corporations had the right to select lands—amount in total to about 12% of the area of Alaska—from federal lands in Alaska, following a complex set of rules. The corporations also received a total of about \$1 billion in cash to start up their operations. There were two kinds of corporations—13 large “regional” corporations for Native residents of each of twelve different regions of Alaska with distinct ethnic or cultural heritages, and 220 smaller “village” corporations for Native residents of villages. Most Natives became a shareholder in one of the regional corporations and one of the village corporations.

All Alaska Natives alive at time of Act became shareholders in these corporations.

One of many complex details of the act was a provision that required that regional corporations share 70 percent of their resource profits with the other Native corporations. The concept was that the benefits of the act would be more fairly distributed among the residents of resource rich and resource poor regions.

So how has the Alaska Native Claims Settlement Act worked? Has it been a success? Is it a model for how to resolve other aboriginal land and resource claims—for example, in Hawaii?

This is an extremely complex question which I’m not even going to try to answer here. My goal is mainly to encourage you to ask about it and learn about it.

There is no question that ANCSA was an extremely important innovation. Whether it was a good or bad idea has been the subject of a great deal of debate over the decades, both within and outside the Alaska Native community. But unlike the Permanent Fund Dividend, it’s not a topic that everyone knows about and cares about. In contrast, the great majority of non-Native Alaskans probably know very little about the Native Claims Settlement Act.

I’ll just make a few brief observations.

- Implementation of the Act was extremely time consuming and difficult. The land selection process took a very long time. The revenue-sharing provision for regional corporations became very contentious.
- There has been wide variation in the experience of different corporations. It takes more than money and land to make a successful corporation. Some corporations

have been extremely successful and others have brought very little if any benefit to their shareholders.

- Under the act only Natives alive in 1971 became shareholders. Since then two new generations of Natives have been born. This created a complex issue of how these new generations would share in the benefits of the act.
- If you want to maximize the return on an investment, the best place to invest is not necessarily in remote rural Alaska. This created a dilemma for corporations which faced the challenge of earning income but also expectations of creating jobs and economic opportunities for their shareholders.
- The resources that many Alaska Natives traditionally depended on were not so much the land but rather Alaska's fish and wildlife. The Act did nothing to guarantee them rights to these resources—even though the commercial fisheries are by far the most valuable resources in many parts of rural Alaska.

The Alaska Community Development Quota Program

The fourth and final Alaska innovation which I want to mention briefly is the Community Development Quota program, or CDQ program.

This is a federal fisheries program which is intended to encourage fisheries-related economic development for 65 communities along Alaska's Bering Sea Coastline--most of which are small Native villages. Historically these communities hadn't participated in or benefited in any way from the very large and valuable industrial fisheries of the Bering Sea, under which large fishing companies catch hundreds of millions of dollars worth of fish every year.

Under the CDQ program, quotas for about 10% of the fish harvests of the Bering Sea are allocated to six groups of villages known as CDQ groups. For the most part, they haven't caught the fish themselves. Instead, they've sold the annual catch rights to fishing companies, in return for tens of millions of dollars annually in royalty payments as well as other benefits such as jobs on fishing boats for village residents.

This program, which is almost unknown outside of the fishing industry, has brought a huge sum of money into this poor and remote region of western Alaska. One particularly interesting development is that a number of CDQ groups have used these revenues to buy ownership shares in fishing companies. As a result, several of these groups are becoming major players in the industry.

I don't have time to go into the details of the program. There are a number of issues related to how the quotas are allocated among the different CDQ groups, and various restrictions on how the earnings may be used. Not everyone likes the program.

But one clear lesson from this innovation is that the right to harvest fish in federal waters is very valuable.

Which leads to an interesting question which you don't hear many people in the fishing industry asking: why are we giving away most of our fish for free?