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The Management of Public Natural Resource Wealth

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INTRODUCTION

As improved but often more environmentally-obtrusive technologies such as hydraulic fracturing facilitate the extraction of billions of dollars in natural resource wealth, more states are now faced with a welcome but exceedingly complex set of problems: Who should benefit from natural resources extracted from public lands? If the state retains much of this wealth in the form of tax receipts, how should these funds be spent? What do states owe to the communities from which these resources were extracted? What do states owe to future generations? While these are questions of first impression for a few, fortunate states, a number of states have been trying to address these issues for decades, and have enacted a variety of responses that have crucial implications for the states, their citizens, and their natural environments.

Alaska’s story is illustrative. The land that eventually became the State of Alaska was acquired from Russia in 1867 for $7.2 million—about 2 cents an acre. Although the land attained much attention when gold was discovered along the Klondike River in 1896, Alaska remained a relative obscurity in terms of subnational status, first labeled a “department,” then a “district,” and finally a “territory.” Alaska did not attain statehood until 1959. As was customary with new entrants to the union, the federal government provided the state with extensive land grants to provide the states with an economic foundation. Unlike with prior federal land grants, in which states were typically granted designated parcels of each township, the federal government gave Alaska the right to choose 103 out of the 365 million granted acres of land within the State of Alaska. In what has been described as “the single most important decision in the state’s

history,” the state selected 1.6 million acres near Prudhoe Bay as a portion of that 103 million-acre endowment. The state knew that oil drilling in the area was likely to be profitable, though they significantly underestimated the profitability of the wells, initially projecting that oil leases in Prudhoe Bay would bring in $11 million. The leases instead brought in $900 million.

How should a state spend nearly a billion dollars in natural resource wealth? The question was of deep, lasting importance to Alaskans, and of immediate significance to money managers and consultants who rushed in to offer advice. Lehman Brothers suggested a solution that subsequent state funds have also considered: the deposit of the funds into a capital improvement account, which would serve as a backing for bonds issued for various public works projects throughout the state. Others suggested using the funds more directly to combat state needs, including “extreme rural poverty, inadequate or nonexistent schools and public facilities, and a lack of basic services.” These uses seemed consistent with the concept of a land grant as an economic catalyst that helps new states catch up to a basic standard of living enjoyed by other states in the Union. In particular, spending on education served this present need while also connecting future generations to the benefits provided by the natural resources. Some, including legislators, expressed concerned with government growth and the potentially corrupting influence of a large pool of funds at the disposal of state politicians.

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3 Id. at 118 (citing STATE OF ALASKA DEP’T OF REVENUE, WHAT’S HAPPENING TO ALASKA’S MONEY—AN EXPLANATION 17 (1971)).
4 Id. at 119.
5 Id.
6 Id. at 119–20 (citing Representative Tom Fink’s position that “the oil money [was] a problem as much as an opportunity,” and that “if you have a big surplus, it’s just an attractive nuisance like gambling or prostitution.”)
Ultimately, the $900 million was spent in a variety of ways, primarily focused on projects with intergenerational impact, such as infrastructure and education. Afterwards, however, many Alaskans experienced “buyer’s remorse” and questioned the spending choices. But as money continued to come in from Alaskan oil fields, the question again presented itself: how should a state spend money it receives through the extraction of its natural resources? Granted, a state can (and states often do) restrict the extraction of natural resources. But as resources are extracted, states must determine the appropriate trade-offs for extraction of these resources, and they must confront the question of what duties the state owes to current and future constituencies that are affected by resource extraction.

One of the most important policy responses to the challenge of managing natural resource wealth has been the creation of public natural resource funds that hold monies generated by resource extraction in a permanent trust. Because state public natural resource funds operate within a federalist system, they create unique challenges and concerns: some of these concerns, including the taxation of resource extraction by states and the allocation of federal spending among states, are made weightier because of the Financial Crisis and subsequent Congressional efforts to reduce governmental spending. State public natural resource funds also raise important concerns about state governance and state management of public resource wealth. This article illuminates these issues by asking two essential questions: First, what are the policy justifications for public natural resource funds? Second, does the legal and governance framework of these funds operate ensure the funds achieve their stated goals?

This article proceeds by providing in Part I historical background on the crucial legal developments which allowed state

(Interview by Charles Wohlforth with Tom Fink, former Speaker, Alaska House of Representatives (Jan. 4, 2006)).

7 Id.
public natural resource funds to develop. In Part II, the article turns to the first of the two central questions by introducing the principal policy justifications of state public natural resource funds through a review of the stated objectives of the funds, the funds’ governance and distributions mechanisms, the role the funds play in state policy making and budgeting, and the aspects of federalism implicated by the state funds. The article identifies several common justifications for state resource funds, including revenue smoothing, intergenerational equity, and autonomy preservation.

Part III then analyzes the operations of the funds in light of these policy justifications. The operational choices of funds include how states invest, and what states do with the returns from those investments. These choices have important governance implications, as the choices affect not only the returns from the investments but can also either enhance or reduce agency costs and rent-seeking by politicians and asset managers. The article concludes by showing how governance weaknesses often limit the effectiveness of funds in achieving their policy goals, and suggests ways in which states can create appropriate legal and governance structures to enhance their funds’ effectiveness.

I. THE LEGAL ORIGINS OF STATE PUBLIC NATURAL RESOURCE WEALTH

State natural resource funds primarily arise from two separate legal origins. The first and much older type is the land grant fund. The second, more recent type of fund is the severance tax fund.

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8 Indeed, these funds may comfortably fit in the definition of “sovereign wealth funds” (SWFs), and if this premise is accepted, U.S. land grant funds are, by a wide margin, the oldest SWFs in the world. Many sovereign wealth fund experts consider U.S. land grant and severance tax funds to be SWFs. See, e.g., Largest Sovereign Wealth Funds by Assets Under Management, SWF INSTITUTE, http://www.swfinstitute.org/fund-rankings/ (last visited Jan. 26, 2013).
following two sections describe the legal origins—legislative and judicial—of each of these types of funds.

A. Land Grant Funds

The origins of many natural resource permanent funds date to the 18th century; indeed, the legislation creating these funds predates the U.S. Constitution. While the original 13 colonies inherited a property tax base that helped to support public school systems and other vital governmental services, the Western territories had no public financial infrastructure. Some members of the Continental Congress feared that as settlements expanded in the new territories under federal control, land speculation would quickly ensue, natural resources would be depleted, and, most worryingly, “the fragile new Union might fracture if settlements decided to secede or establish non-democratic governments.”

The legislative response to these concerns was set out in two acts: the Land Ordinance of 1785 and the Northwest Ordinance of 1787. The Land Ordinance of 1785 required a survey and division of western lands into townships of seven square miles with 36 sections in each township. The statute also stated that “[t]here shall be reserved for the United States out of every township, the four lots, being numbered 8, 11, 26, 29, and out of every fractional part of a township, so many lots of the same numbers as shall be found thereon,” and that “[t]here shall be reserved the lot No. 16, of every township, for the maintenance of public schools within the said township.” This brief provision provided the crucial funding mechanism for state public schools.

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10 U.S. Continental Congress, An Ordinance for Ascertaining the Mode of Disposing of Lands in the Western Territory (May 18, 1785).
schools, and placed public school lands literally and figuratively in the center of the township structure.¹²

¹² Because the same section was set aside in each township without regard to the condition of the lands, the sixteenth sections vary dramatically in quality and usefulness. Some are mineral rich, some are arid, some are forested, etc. Later grants also reserved a second section, Section 36, for public schools and other public institutional recipients. See, e.g., Wyoming Enabling Act of July 10, 1890, ch. 664, 26 Stat. 222, and a handful of land grants provided for four sections: 2, 16, 32 and 36. See PETER W. CULP, DIANE B. CONRADI & CYNTHIA C. TUELL, TRUST LANDS IN THE AMERICAN WEST: A LEGAL OVERVIEW AND POLICY ASSESSMENT 10, available at http://www.lincolninst.edu/subcenters/managing-state-trust-lands/publications/trustlands-report.pdf.

The Continental Congress also hoped that the public school system would inculcate in future generations of students the democratic principles upon which the Union had been founded.\footnote{CTR. ON EDUC. POLICY, supra note 9, at 10.} As Justice Cambell wrote in \textit{Cooper v. Roberts} (1855), the Land Ordinance Act of 1785 had a definite purpose,

\begin{quote}
\text{declared to consecrate the same central section of every township of every state which might be added to the federal system, to the promotion "of good government and the happiness of mankind," by the spread of "religion, morality, and knowledge," and thus, by a uniformity of local association, to plant in the heart of every community the same sentiments of grateful reverence for the wisdom, forecast, and magnanimous statesmanship of those who framed the institutions for these new states, before the constitution for the old had yet been modeled.}\footnote{Cooper v. Roberts, 59 U.S. 173, 178 (1855).}
\end{quote}

The second Congressional act, the Northwest Ordinance of 1787, provided the more formal mechanisms by which states would apply for statehood, to be achieved through the passage of an Enabling Act for each state, which would set out the specific land grant.\footnote{The Texas Permanent School Fund ("TPSF") is a notable exception to the standard public school funding mechanism provided in the Land Ordinance of 1785 and the Northwest Ordinance of 1787. The TPSF was established in 1854, making it one of the oldest permanent funds in the world. Unlike the other land grant funds, which were established by a direct grant by the U.S. government of federal land to newly admitted states in order to support public education, the TPSF was created by grants and funding provided by the State of Texas itself. First, the Texas legislature appropriated $2,000,000 for the TPSF out of a $10 million payment from the U.S. government in exchange for relinquishing claims to lands claimed by the former Republic of Texas. \textsc{Tex. Permanent Sch. Fund., 2010 Comprehensive Annual Financial Report} 5 (2010), \textit{available at} http://ritter.tea.state.tx.us/psf/PSF_Annual_Report.pdf.}
Despite the intentions of the Northwest Ordinance, the process of moving from catalyzing land grants to viable school systems was often slow and inconsistent.\textsuperscript{16} The typical structure involved the grant for the benefit of the state’s schools. This structure has been viewed as creating a trusteeship, with the federal government as the settler, the township (or, later, the state government as trustee), and the township school system as the beneficiaries of the trust. However, a legal trust was not created by these early statutes, and states had considerable authority to use the lands in whatever manner they saw appropriate. In 1835, Michigan was the first state to create a permanent school fund, with restrictions on the sale of the lands, coincident with its entry into the Union in 1837.\textsuperscript{17} Other states followed Michigan’s model, although it was not until the Colorado Enabling Act of 1875 the U.S. Congress itself specifically placed restrictions on the sale of lands set aside for public schools, and that the sales of such lands would constitute a “permanent school fund.”\textsuperscript{18} The trust relationship was not created by the federal government, the logical settler of a trust of lands granted by the federal government for the support of state schools, but by states through their own constitutions or statutes. Colorado’s 1876 Constitution, for example, contains a provision stating that the public school fund "shall forever remain inviolate and intact," and the interest from the fund "shall be expended in the maintenance of the schools of the State,"\textsuperscript{19} and requires the legislature to ensure that the land grants are “judiciously located and carefully preserved and held in trust subject to disposal, for the use and benefit of the respective objects for which said grants of land were made . . . .”\textsuperscript{20}

Many of the original grant lands have been sold, with most states taking the view that the pressing needs of fledgling school systems required substantial and immediate funding through sales, rather than a trickle of funding through leasing of the trust lands. In Oregon, for example, the state engaged in a systematic liquidation of state trust lands “based on the theory that once this property was in

\begin{footnotesize}
\textsuperscript{16} CTR. ON EDUC. POLICY, \textit{supra} note 9, at 11.
\textsuperscript{17} \textit{Id.} at 13.
\textsuperscript{18} Colorado Enabling Act of Mar. 3, 1875, ch. 139, 18 Stat. 474, para 11.
\textsuperscript{19} \textit{COLO. CONST.} of 1876, art. IX, § 5.
\textsuperscript{20} \textit{See id.} at art. IX, § 10.
\end{footnotesize}
private hands, the lands would generate more revenue for the state in property taxes than it would in public ownership.”

According to one recent review, “the states created before 1850 have sold all or most of their granted lands. California, which joined the Union in 1850, now retains only 10% of its original grant lands. On the other hand, newer states still hold a majority of their grant lands; approximately 87% of lands in Nevada and 75% in Arizona are in federal holding.” The lands are, as Culp, Conradi and Tuell report, “actively managed for a diverse range of uses, including: timber, grazing, mining for oil and gas and other minerals, agriculture, commercial and residential development, conservation, and recreational uses such as hunting and fishing.”

Aside from direct payments into local school systems, the revenues generated from these trusts also support school bond financings, school construction projects, and provide limited support to a wide range of other institutions, including universities, hospitals, and even penitentiaries.

Culp, Conradi and Tuell find 18 states with appreciable land trusts still in operation. Some of these natural resource funds produce very little revenue as a proportion of the state’s overall education budget. For example, in 2004 California’s trust lands provided only 0.01% of the state’s education budget. In New Mexico, by contrast, trust lands provided 14.33% of the educational budget.

B. Severance Tax Funds

The legal origins of the second type of state natural resource fund, severance tax-based permanent funds, are also tied to federal action; in the case of severance tax funds, it was a 20th century

21 CULP ET AL., supra note 12, at 14.
22 CTR. ON EDUC. POLICY, supra note 9, at 2.
23 Id.
24 CULP ET AL., supra note 12, at 59.
Supreme Court decision, rather than an 18\textsuperscript{th} century act of Congress, that served as the legal foundation for these funds.

Through a 1973 legislative act, New Mexico was the first state to use severance tax revenues on natural resources, including copper, timber, and rare and precious metals, to establish a permanent fund. While New Mexico and other natural resource-rich states benefit from the extraction of these resources, the benefits are offset by significant costs. Indeed, when one hears of a “resource curse” affecting countries with abundant natural resources, the term refers not only to the tragedy that lower economic development is frequently associated with resource-rich countries, but also that the land is often made much worse as a result of the extraction of resources. The land may no longer be arable, ground water may become polluted, and air quality may be compromised. It is this particular aspect of resource extraction that led Former New Mexico Governor Jerry Apodaca to exclaim:

Let there be no mistake—the West will not become an energy colony for the rest of the nation. We will not sacrifice our greatest assets—our blue skies and clear streams, our unblemished plains and mountains—to an endless national thirst for energy.\textsuperscript{25}

As discussed below, severance taxes imposed by resource-rich states are thus set at levels that are designed to produce revenues that offset the burdens associated with resource extraction, while accounting for the value that resource extraction already brings to a state (aside from the tax revenues) in terms of employment and related benefits to local economies. Resource extractors and the states that are net importers of these resources have historically viewed severance taxes as, in the words of two commentators, “ill-disguised attempts to carve out larger

shares of the profits derived from resource extraction. These larger shares are said to be unrelated to the costs the states incur from stepped-up mining.\(^{26}\) On the other hand, resource-rich states have countered that “mining depletes their physical wealth, imposes undesirable consequences on portions of their population, and may foreclose other developmental alternatives.”\(^{27}\) Under this view, severance taxes are a way to force resource-poor states to pay for the negative externalities—both short term and long term—created by resource extraction.\(^{28}\) If severance taxes on states over-compensate the resource-rich state, however, then the state enjoys a form of federal subsidy. On the other hand, if the severance tax fails to adequately compensate the state, the state is subsidizing other states.

These issues were litigated in Commonwealth Edison v. Montana. The State of Montana imposed a severance tax on coal mined in the state; appellants, a collection of Montana coal producers and out-of-state energy companies, argued that the tax violated the Commerce Clause and the Supremacy Clause of the U.S Constitution. The trial court upheld the tax, and the Montana Supreme Court upheld the trial court decision.

The case was then argued before the U.S. Supreme Court. Justice Marshall, writing for a 6-3 majority, evaluated the tax under the four-part test set out in *Complete Auto Transit*, which allows a


\(^{27}\) Id.

state tax if it "[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to services provided by the State."\(^{29}\) The satisfaction of the first two prongs of the test was stipulated by all parties. The court found that Montana’s severance tax did not discriminate against interstate commerce under *Complete Auto Transit* since the tax was applied without regard to whether the end-users were in- or out-of-state. Appellants sought to show that the tax was not "fairly related to the services provided by the State" by providing evidence that the tax receipts exceeded the benefits of the tax provided to the coal mining industry. The court found this to be a misreading of Complete Auto Transit’s fourth prong. Citing *Wisconsin v. J.C. Penney Co.*\(^{30}\), "the incidence of the tax as well as its measure [must be] tied to the earnings which the State . . . has made possible, insofar as government is the prerequisite for the fruits of civilization for which, as Mr. Justice Holmes was fond of saying, we pay taxes." Under this broad reading of the taxing power, “the ‘operating incidence’ of the tax . . . is on the mining of coal within Montana. Because it is measured as a percentage of the value of the coal taken, the Montana tax is in ‘proper proportion’ to appellants’ activities within the State, and, therefore, to their "consequent enjoyment of the opportunities and protections which the State has afforded" in connection with those activities.”

The court also found the severance tax in compliance with the Supremacy Clause. Although several federal acts regulated mineral leasing on federal lands (and a significant amount of Montana severance taxes came from extraction activities on federal lands), the court found that Congress specifically allowed for severance taxes on federal lessees pursuant to §32 of the Mineral Lands Leasing Act of


\(^{30}\) 311 U.S. 435, 446 (1940).
920. Likewise, the tax was not held to be in not unconstitutional “on the alleged ground that it frustrates national energy policies, reflected in several federal statutes, encouraging production and use of coal,” the court refusing to accept “appellants' implicit suggestion that these general statements demonstrate a congressional intent to preempt all state legislation that may have an adverse impact on the use of coal.”

Although the decision in Commonwealth Edison gave mineral-rich states the legal justification for severance taxes, not all states have used these taxes to create permanent funds. The following chart shows the severance tax funds currently in operation:

[INSERT CHART 2: SEVERANCE TAX FUNDS]

Although the historical roots of public natural resource funds may tap cultural and partisan political sources, as in Alaska, funds must ultimately arise as a clear policy choice by legislative and executive bodies, and this policy must be justified to the electorate. After all, the money could be used in many different ways: saved in a “rainy-day fund” for use in difficult economic times, spent on programs directly benefiting the communities most affected, spent widely on economic programs, and so on. The fundamental question, then, is why do these funds exist? In the next part, this article will attempt to provide answers to this question by setting out the principal policy explanations for public natural resource funds.

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31 Section 32 states, inter alia, that “That nothing in this Act shall be constructed or help to affect the rights of the States or other local authority to exercise any rights which they may have including the right to levy and collect taxes upon improvements, outputs of mines, or other rights, property, or assets of any lessee of the United States.” Mineral Lands Leasing Act of 1920, 41 Stat. 437 (1920), 30 U.S.C. § 181 et seq. (2012).
33 Id. at 633.
II. **Policy Justifications for State Natural Resource Funds**

The most obvious answer to the question of why states have these funds—that the states simply had large amounts of revenues and so created a vehicle to hold those revenues—merely tells us that state legislatures decided to hold at least some of the revenue for a time rather than immediately spend it (as some other states do). But why retain these funds? And when (if ever) and how should the states spend the funds? This Part and the next address those questions both descriptively and normatively, first by focusing attention on the various justifications for state public natural resource funds, and second by describing how states invest the funds coming into their funds.

U.S. state natural resource funds may be considered, both in sources of revenue and in policy justification, to be a type of sovereign wealth fund (SWF). Much of the academic literature on SWFs explains them in terms of political risk, or the potential use of SWFs as political tools. The use of a SWF as a political tool is but one among many explanations for the existence of SWFs, and while it may be true that some SWFs are used for political purposes on occasion (though there exists scant evidence of this), less nefarious purposes seem to drive the creation of most SWFs, whether at the national or state

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34 A workable definition of a SWF is a “government-owned and controlled (directly or indirectly) investment fund that has no outside liabilities or beneficiaries (beyond the government or the citizenry in abstract) and that invests its assets, either in the short or long term, according to the interests and objectives of the sponsoring government.” Ashby H.B. Monk, *Is CalPERS a Sovereign Wealth Fund?*, ISSUE IN BRIEF (Ctr. for Ret. Res. at Bos. C., Boston, M.A.), Dec. 2008, at 1, 4, http://www.publicpensionsonline.com/public/images/CalPERS%20Sovereignty.pdf. To this definition we can further narrow the concept of SWFs to include only funds that operate under an “endowment” model, so that the fund produces income through investment of the fund’s corpus, with only the income distributed. Under this definition, some of the oldest SWFs are not foreign funds, but the public natural resource funds created by acts of the U.S. Congress and state legislatures over a century ago.
level. Indeed, for the first state public natural resource funds, an educational purpose was directly tied to the creation of the funds.

This Part critically examines the purposes underlying the creation of state funds, which in turn provides a foundation to analyze whether the state fund’s governance and distribution mechanisms effectively achieve these purposes. For land grant funds, the initial purpose was essentially to provide the equivalent of a property tax base for the benefit of public schools, but the initial reason may not be the exclusive justification for the operation of a state land grant fund. Other justifications may arise as the fund matures. Although the specific reasons justifying the existence of a SWF are expressed in unique ways, the various justifications may be grouped together under several general categories. None of the justifications are necessarily exclusive, although for most SWF sponsors one or two justifications will predominate. Because the state funds described in this article all have their origin in natural resource commodities sales, focusing primarily on justifications for commodity funded SWFs (as opposed to the justifications for funds generated from currency reserves) gives the greatest insight into the intended function of state natural resource funds.35

35 “Dutch disease,” one of the justifications for national SWFs, is not applicable to state natural resource funds. Dutch disease refers to the phenomenon wherein resource exports lead to rising currency appreciation, which in turn affects the relative pricing of manufactured goods from the same country. As the currency appreciates, other products become less competitive, resulting in a distortion to the economy, and possibly a reduction in total exports. However, U.S. states do not have their own currencies and states would not (and probably could not) reasonably expect to regulate a response to whatever effect their mineral, oil and gas sales would have on the national currency. Additionally, sovereign wealth funds have also been explained as products of state capitalism, as effectively described by Gilson and Milhaupt: “[S]ome major developing countries (China foremost among them) increasingly reflect a form of state capitalism—what we call the new mercantilism. In this form, the country is the unit whose value is to be
A. *Smoothing Revenues.*

As commodity prices fluctuate, governments that are dependent on commodity sales for a portion of their revenues may have difficulty in planning expenditures in the face of revenue volatility. As Monk explains, “volatile commodity revenues have a negative impact on the growth of resource-rich countries . . . [and] fluctuating revenues make it extremely difficult to pursue a prudent fiscal policy, especially over the long-term which, in turn, aggravates maximized, with a corresponding increase in the role of the national government as a direct participant in and coordinator of the effort.” Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1346 (2008). Mercantilist theories seem inapt to describe state public natural resource fund behavior since international trade policy is primarily regulated at the national level. However, state funds could be seen as expressing a kind of state capitalism to the extent that they are used to directly fund social policy initiatives. As a general matter, it may be difficult to extricate the political from the economic when analyzing SWF creation and behavior. SWF and state-owned enterprise investments occur against a backdrop of political relations between the SWF sponsor country and the target investment’s home country, and it should not be surprising that warm economics accompanies warm politics. For example, Jiang describes a significant reduction in Chinese investment in Canada from 2006 to 2009, as the newly elected conservative government attempted a “cold politics, warm economics” approach to China, with the result that “Canada lost ground to China on the economic and trade fronts.” Wenran Jiang, *The Dragon Returns: Canada in China’s Quest for Energy Security* 16 (Canadian Int’l Council, China Papers No. 19, Oct. 2010), available at http://www.asiapacific.ca/sites/default/files/filefield/the_dragon_returns_canada_in_chinas_quest_for_energy_security__wenran_jiang.pdf. The investments themselves may also be made for hybrid political-economic purposes, of course: investments by Chinese enterprises and Chinese SWFs form part of the “go-out” strategy of the central government to seek out and secure reliable sources of energy and materials around the world in order to meet domestic manufacturing and energy demands.
other problems in resource economies.”\(^{36}\) Norway’s SWF is perhaps the best example of the creation of a SWF in response to this problem.\(^{37}\) Used in this way, SWFs serve as a kind of self-renewing rainy-day fund that may be drawn down maintain domestic economic stability: “In this sense, countries have not established SWFs because they are resource-rich: they established SWFs because being a resource dependent economy means their societies are vulnerable to changes in the global market for commodities.”\(^{38}\) This same logic applies to American state natural resource funds. In making the case for a severance tax fund to West Virginia lawmakers, Mike Sullivan, former governor of Wyoming, noted that Wyoming’s fund contributes about 13% of the total general fund,\(^{39}\) and that Wyoming “had difficulty just balancing the budget. We would have had trouble taking care of the most necessary needs. Probably we could not have balanced our budget without it.”\(^{40}\) He stated that “[w]e're a resource state, just as you are, and we've seen the peaks and the valleys. I think it clearly


\(^{37}\) Mon, supra note 36, at 9 (reporting that “the establishment of Norway’s SWF was based on the potential short-term costs of fluctuating revenues for macroeconomic stability, which is a characteristic shared by many commodity-based economies” (citing Gordon L. Clark & Ashby Monk, The Norwegian Government Pension Fund: Ethics Over Efficiency, 3 Rotman Int’l J. Pension Mgmt. 14 (2010); Gordon L. Clark & Ashby Monk, Resource Wealth and the Ethics of Global Investment: The Legitimacy and Governance of Norway’s Sovereign Wealth Fund, 42 Env’t & Plan. 1723 (2010))).

\(^{38}\) Id. at 10. Emphasis in the original.

\(^{39}\) Id.

\(^{40}\) Id.
smooths out some of the peaks and valleys.” As described in the next section, this “smoothing” typically results from a stable source of revenue, rather than from draw-downs in time of crisis.

1. State Public Natural Resource Funds and the Financial Crisis

Although state natural resource funds create a long-term source of revenue that will persist after revenue generating resources are depleted, state severance tax funds generally do not draw from their funds to smooth out lumpy earnings or to meet revenue shortfalls in the short term, nor do they generally draw from the funds even in times of crisis. State constitutions and statutes, as discussed in more detail below, generally limit the ability of the state government to spend any more than the income produced by the fund, which limits the effectiveness of the fund as a large-scale revenue-smoothing device if the income of the fund makes up only a small percentage of the state budget.

With the exception of Alabama, state natural resource funds do not appear to have a general “rainy day” function as part of their funds’ objectives. Even in Alabama, the ATF only lends money to state rainy day funds, and the ATF must be repaid within 6 or 10 years, depending on the type of loan. While there is some “smoothing” that may be achieved through these loans, the founding and governance documents of the ATF, as with the other state natural resource funds, do not suggest that smoothing revenues is a primary purpose or justification for the funds.

As Governor Sullivan noted, smaller-scale revenue smoothing is sometimes possible with natural resource funds. For example, the income from land grant trust funds may have allowed some states to

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weather the Financial Crisis slightly better than others. Although states do not receive a large amount of education funding from land grant SWFs, the funding may have been sufficient to act as a buffer for some states, allowing them to avoid cuts to K-12 education. At least 34 states made cuts to K-12 education during the Financial Crisis, but states with large land grant funds, including Texas, New Mexico and Wyoming, were not among them.42

But wasn’t the Financial Crisis—a once-in-a-generation event that has severely strained state budgets—the kind of event that would justify the use of the corpus of state severance tax funds? There is some evidence that, in response to the Financial Crisis, foreign-controlled SWFs did, in fact, respond to the crisis by pulling money out of some foreign assets and reinvesting it in local businesses or infrastructure. Balin reports that between June 2008 and late 2009 ten different sovereign wealth funds participated in stabilization efforts, including direct capitalization of banks, the purchase of domestic real estate, and financing budget shortfalls.43 While such a response might seem justified, it also creates the impression (which SWFs have been at pains to avoid) that SWFs can be politically manipulated. SWFs are thus in a quandary—the use of a SWF as a rainy day fund may alleviate some of the shocks created by severe economic downturns, but it may also increase the risk that the fund could be used as a political expedient. Balin argues that this “re-coupling of SWFs with their sovereign governments may also create an undesirable follow-on effect: governments may now be rhetorically better-positioned to squander national resources for short-term political gain.”44 Clark and Knight describe this risk as a temptation

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44 Id.
requiring a principled approach to political decision-making:

In modern democracies, subject to the ups and downs of electoral cycles, the short-term political advantages of spending windfall earnings are readily apparent; it is also apparent that the beneficiaries of long-term investment are often not represented in the political process. Put more formally, the democratic political process heavily discounts the future – the discount rate being the product of the length of the political cycle, the degree to which sectional interests underwrite the power of governing parties, and the synchronization of the political cycle with the economic cycle.45

Succumbing to this temptation also had another negative effect for SWFs. As Balin reports, prior to the Financial Crisis many SWF fund managers did not believe that their fund would be tapped by the national government for current spending needs, and so their portfolios contained relatively few liquid assets such as cash, bonds, and interest-bearing deposits, and instead favored riskier, less liquid but higher-yielding assets like corporate equities, venture capital, and real estate: “When sovereigns did call upon SWFs to participate in domestic stabilization efforts, some managers were caught by surprise, forcing them to sell assets at substantial losses to cover their sovereign’s funding request.”46

46 Balin, supra note 43, at 4 (citing an interview with S. Steinitz, January 21, 2010).
2. Managing Short-Term Temptations

State natural resource funds are, of course, susceptible to the same temptations as national SWFs. Texas provides an example of how budget pressures have affected state natural resource funds, and of how the legal structure is related to the temptation presented by the fund. Texas created a permanent endowment fund, the Permanent Health Fund, with the tobacco settlement funds it receives under the MSA. However, in an effort to cover large cuts to the funding of state health-related institutions, Texas senate budget writers voted to liquidate the fund and distribute the corpus to the institutions.\(^{47}\) Again, however, this liquidation seems more likely with tobacco settlement funds than natural resource-based funds because of a weaker link to intergenerational equity concerns.

Most state natural resource funds have attempted to avoid such issues through incorporating within their founding documents the strong commitment device mentioned above: the corpus of the funds generally can only be drawn down through a constitutional amendment, which will require a vote of the citizens of the state. However, even though the corpus may not be spent, legislators may still attempt to maximize short term gains in order to maximize the amount of funds available to them during their terms of office. To structurally and statutorily discourage such behavior, states typically have legal restrictions on the kinds of investments that natural resource fund can make (discussed in Part III, \textit{infra}), which make it more difficult for those administering the natural resource fund to sacrifice long-term prosperity for short-term benefits.

The robustness of these measures is ultimately dependent on the will of the citizens, because they may, by constitutional amendment (or by demanding a statutory amendment), either change the mandated fund allocations or other investment restrictions, or allow for the fund corpus to be drawn down. However, in the case of Wyoming, at least, voters have shown a surprising resilience to the temptations to draw down on the PWMTF. The issue came to a head in 2005 when the Wyoming Attorney General issued an informal opinion that only the severance tax portion of the PWMTF was untouchable. Subsequently, a House Joint Resolution called for a constitutional amendment specifying that “all monies deposited in the Permanent Wyoming Mineral Trust Fund are inviolate permanent funds of the state.”

The original language of the Wyoming constitutional provision creating the PWMTF was rather vague, stating only that the “fund shall remain inviolate.” The proposed amendment sought to clarify that “[t]he fund, including all monies deposited in the fund from whatever source, shall remain inviolate.”

In the 2006 general election, voters overwhelmingly—by a 3-1 margin—approved the proposed amendment. Consequently, the language of Art 15, § 19 of the Wyoming constitution now more clearly affirms that the corpus of the fund is untouchable and only the income can be spent by the legislature. Part of the explanation for the lopsided vote lies in the fact that what was at stake was not whether funds would be distributed directly to the citizens of the state, as in Alaska, but rather whether the legislature should be granted additional funds to be spent at its discretion. When presented in this light, the outcome of the vote is predetermined.

49 Id.
50 Id.
Alabama’s voters also recently resisted efforts to use the Alabama Trust Fund for stabilization purposes. In 2010, Alabama voters resoundingly voted against a constitutional amendment that would have allowed for a legislative appropriation of the ATF for state and local transportation purposes.52 This vote is significant because, unlike Wyoming’s vote, the issue was presented to voters in the midst of the Financial Crisis, yet they refused to allow for additional funds to be appropriated to the legislature. In 2012, however, a similar vote to tap into the fund passed by a 28 point margin. What changed? In part, the answer lies in how the issue was presented to voters. In 2010, the ballot measure presented to voters read,

Proposing an amendment to the Constitution of Alabama of 1901, as amended, relating to the Alabama Trust Fund, to provide for the appropriation of funds in the Alabama Trust Fund to be distributed for state and local transportation purposes and to provide for funds for the County and Municipal Government Capital Improvement Fund.

The measure was defeated by 14 points. In 2012, again facing a funding crisis, legislators in Alabama framed the constitutional amendment differently:

Proposing an amendment to the Constitution of Alabama of 1901, to provide adequate funding for the State General Fund budget, to prevent the mass release of prisoners from Alabama prisons, and to protect critical health services to Alabama children, elderly, and mothers by transferring funds from the Alabama Trust

Fund to the State General Fund beginning with the state’s 2012-2013 fiscal year and concluding with the state’s 2014-2015 fiscal year; to provide a new procedure for distributions made from the Alabama Trust Fund beginning 2012-2013 fiscal year; to create a County and Municipal Government Capital Improvement Trust Fund advisory committee; and to provide further for distributions made from the County and Municipal Government Capital Improvement Trust Fund.

Alabama’s 2012 vote seems the exception, not the rule, and the result of the vote is perhaps more due to the alarmist language of the ballot measure than a belief by voters that the state should turn its natural resource fund into a rainy day fund. In other cases, voters have kept permanent funds permanent. The reliability of the constitutional amendment as a commitment device derives from the checks-and-balances within the amendment itself: the legislature only has access to the income of the funds, the public does not have direct access to the funds, and the legislature cannot grant itself additional funds without the approval of the public. While other kinds of commitment devices (such as heightened standards of duty) may provide security that the funds will be less susceptible to political manipulation, the constitutional amendments and statutory restrictions discussed here provide a robust and time-tested means of reducing political opportunism and short-termism.

B. Credit Ratings Agencies as “Catalyst”: The Natural Resource Fund as a Mechanism to Decrease the Cost of Public Debt

Credit ratings agencies may also play a significant role in catalyzing the formation of sovereign wealth funds both here and abroad. Credit ratings agencies recognize that while the typical legal structure of the natural resource fund as a permanent fund means that the natural resource fund cannot serve as a reserve or rainy day fund, the income generated by the fund produces a relatively stable
source of income for the state. An example of how a state may be influenced by the credit rating agencies is apparent in West Virginia’s debate on whether to create a severance tax-based fund. West Virginia has been advised that, among other benefits, a severance tax permanent fund will “[b]uild assets toward the state’s unfunded pension and long-term liabilities (West Virginia ranked 4th highest in the nation, according to Moody’s Investors Service) and improve the state’s credit rating.” An investment bank also advised Alaska to use its original $900 million lease payment as a credit-enhancing backstop fund.

Because the creation of a natural resource fund can improve the state’s credit rating, the state’s cost of capital can be lowered in two ways. First, as in the case of Wyoming, the existence of the natural resource fund improves the state’s credit rating, which in turn makes the state’s debt issuances relatively more marketable. This allows the state to offer debt with a relatively lower rate of return, thereby producing interest payment savings for the state.

The existence of a state natural resource fund may also have a second and perhaps even more beneficial effect. A state natural

53 See, e.g., Standard & Poors, Wyoming: General Obligation (Jan. 15, 2013), available at http://treasurer.state.wy.us/pdf/bondcreditrating012813.pdf (“Wyoming’s permanent mineral trust is established by the state constitution (Article 15, section 19) and constitutionally receives a 1.5% mineral severance tax. The corpus in the mineral trust fund cannot be spent, although the fund income is deposited as unrestricted income in the general fund.”) at 4.
55 ROSE &WOHLFORTH, supra note 2, at 118.
56 See Press Advisory, Office of Wyoming State Treasurer Joseph B. Meyer, State’s Issuer Credit Rating Upgraded (May 10, 2011) (attributing the AAA S&P rating in part to “[m]aintenance of large general fund balances, despite the cyclical components of the state's economic base, enhanced by the existence of a permanent fund, whose interest earnings are available for general fund expenditures”).
resource fund that by statute provides support for locally-issued bonds (such as municipal school bonds) may help those municipalities issue debt at relatively lower rates, thereby incrementally reducing the need for direct state support. Texas provides an example of how this works in practice. The Texas Permanent School Fund guarantees local school district bonds, allowing the local school districts to effectively piggy-back on the ratings of the State of Texas. Ely reports that “[s]tates with substantial natural resources followed the lead of Texas’ PSF to create programs that leverage royalty-supported permanent funds.”

The benefits derived from natural resource fund support of local bond financing seems to be significant from the point of view of the individual school districts, but not very substantial when compared to the overall educational budget of the state. Before the Financial Crisis, most school districts issuing debt would have been able to purchase private bond insurance as a credit enhancement and would have received interest rate savings comparable to what a PSF guarantee would provide. However, Ely reports that after the Financial Crisis “no active insurer has comparable credit quality to the PSF’s ‘AAA’ rating and access to a competitive insurance market is more limited for issuers with lower credit quality.” Ely estimates that a total annual interest cost savings to school districts of $140 million. He notes, however, that “the savings are small when compared to either the annual Texas formula assistance of nearly $17 billion or school district property tax revenues of almost $18.8 billion in 208. Annual savings for Texas school districts, at the full $140

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58 Todd Ely, Indirect Aid for Uncertain Times: State Credit Enhancement Programs for School Districts 17 (Mar. 25, 2011) [need permission to cite].
59 Id. at 28.
60 Id.
million annual estimate, are less than one percent of state formula assistance.”

Although the credit enhancement effect of a state natural resource fund may provide some benefits to both local and state governments, the lower cost of capital may result in an “overinvestment” by governments. Overinvestment can occur because as the cost of capital is lowered, the government may undertake projects with a lower rate of return than those in the private markets. This in turn may result in the “crowding out” of superior private projects as funding flows to inferior public projects.

Arguably, the effects of these funding shifts are primarily felt in the larger national and perhaps even international markets for debt issuances. In other words, a municipal bond is one of thousands of issuances in the debt markets, and the effects of the credit enhancement of a particular state will be dispersed across the markets rather than concentrated at the level of the state’s private issuers. From the point of view of the state, then, the credit enhancement provided by a natural resource fund is a low-cost means of lowering the overall cost of capital for numerous governmental entities without significant negative effects on local private businesses. In the case of West Virginia, a natural resource fund based on a coal severance tax is thought to have the potential to achieve these savings with relatively limited local effects (ignoring the broader market effects of a shift in funding from private to public projects), because the tax is a “[h]ighly exportable tax (e.g. 87% of coal produced in WV is exported) with little effect on employment, production, and business location decisions.”

61 Id.
62 Id. at 13.
63 Ely, supra note 58, at 13.
64 Kriesky, supra note 54, at 19.
C. **Intergenerational Equity**

SWFs and natural resource funds are also thought to be a mechanism for ensuring intergenerational equity; this is particularly true of land grant trust funds and severance tax trust funds. The term intergenerational equity is somewhat ambiguous, as it can refer both to an imperative to save present capital in order to use it to satisfy future commitments, such as pension benefits, or as an imperative to save it specifically for the benefit of future generations, irrespective of commitments to present generations. In ageing populations, intergenerational equity suggests a fairness concern that if a citizen has paid taxes and social security or equivalent public pension payments, they have a proper claim on the government for a reasonable income in their retirement. Intergenerational equity can also refer to a principle of distributive justice: the primary concern in this sense of the term is not that present generations may enjoy some of the fruits of their life’s work through government benefits in retirement, but that future generations should be able to enjoy the fruits of the nation’s resources just as present generations have. Thus, a natural resource fund is not created so that (or merely that) it may provide a present generation with an acceptable standard of retirement benefits, but also that future generations should also benefit from the sale of a finite store of resources taken from the land that they are to inherit.65

Intergenerational justifications for saving a portion of present wealth have also been used to justify university endowments. As Tobin explains:

> The trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve equity among

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generations. The trustees of an endowed university... assume the institution to be immortal. They want to know, therefore, the rate of consumption from endowment which can be sustained indefinitely. In formal terms, the trustees are supposed to have a zero subjective rate of time preference.\textsuperscript{66}

The concerns for present and future generations overlap as the obligations owed to older generations saddle younger generations with enormous commitments that can affect the quality of life of future generations through heavier tax burdens and reduced benefits. Australia created its Future Fund with these concerns in mind: as stated by then-Treasurer Peter Costello, the Future Fund was “designed to fund Australia to meet the costs of the ageing of the population,” and “in particular, unfunded superannuation liabilities.”\textsuperscript{67} Similar concerns have also driven other resource-rich countries to create SWFs.

Generally, the concept of setting aside funds to provide for future generations, as opposed to shorter-term spending to businesses or support institutions that may or may not be valuable to future generations, is not without controversy. In the context of endowment funds, which also raise intergeneration concerns, Hansmann argued:

There is every reason to believe that, over the long run, the economy will continue to grow in the future as it has in the past and that future students will therefore be, on average, more prosperous than students are today, just as today’s students are more prosperous than their predecessors. Thus, equity does not call for a transfer of


\textsuperscript{67} Clark & Knight, \textit{supra} note 45, at 12.
wealth through saving, from the present generation to later ones. On the contrary, it would seem more equitable to have future generations subsidize the present.\textsuperscript{68}

Likewise, Andrew Rozanov questions the principle of intergenerational equity:\textsuperscript{69}

[\textit{S]}hould one suppress current consumption and capital formation by the present generation in an underdeveloped economy – all for the sake of maximising financial savings of future generations? And what would future generations actually prefer: inheriting a broadly diversified global financial portfolio or a broadly diversified, highly advanced local economy, which provides plenty of local employment opportunities and a solid entrepreneurial potential?\textsuperscript{69}

Alaska’s experience provides a good example of how the intergenerational equity debate helped shape the purpose of the APF. Proponents of the APF offered several rationales for the creation of the Alaska Permanent Fund: first, the Fund would “help to create an investment base from which to generate future income. Then, when oil revenues ran out, there would still be a major source of state revenues to pay out the costs of government services;” second, the APF would “remove a significant portion of the oil revenues from the legislative spending stream, thus reducing the opportunities for excessive spending by the Legislature;” and third, the fund would prudently “transform” oil wealth into a “renewable source of wealth for future generations.”\textsuperscript{70} Although the APF had several clear purposes for its

\textsuperscript{68} Hansmann, \textit{supra} note 66, at 14.
\textsuperscript{69} Andrew Rozanov, \textit{Sovereign Wealth Funds: Defining Liabilities}, 4 ST. STREET GLOBAL ADVISORS 1, [ ] (May 2007).
\textsuperscript{70} Clark & Knight, \textit{supra} note 45, at 12.
existence, the particular means of achieving these general goals had not yet crystallized by the time the APF began receiving funds. The debate focused on generational issues: should the APF be managed as an investment fund that would distribute income over the long-term, or should it be managed as a development bank and used to “force-feed” Alaska’s economy in the short-term?\(^{71}\) This second possibility is not necessarily inconsistent with the third rationale, intergenerational wealth transfer, justifying the creation of the APF. By using the APF as a development bank, providing loans and grants to Alaskan businesses, the fund could increase the number of small businesses in Alaska, which would serve to increase the number of jobs and broaden the economy, thereby ultimately decreasing the dependence of the state on oil and other natural resource revenues. On the other hand, a development bank would increase the possibility of political mischief as the Fund could be used as a mechanism for political patronage.

Those arguing in favor of the investment fund model were motivated by the protection of the principal managed by the APF. They believed the APF should manage the funds in accordance with the prudent investor rule and only make investments that were of “trust-grade quality” at market rates. Ultimately, the proponents of the investment fund model prevailed, although the state allocated some funds that were not part of the 25% of revenues dedicated to the APF to create several state agencies\(^{72}\) charged with achieving some of the short-term goals envisioned by the proponents of the development bank model.

By contrast, a mixed objective model prevailed in New Mexico and Wyoming. A mixed model indicates political compromise (with some wanting the funds spent on pressing current needs, while others

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\(^{71}\) *Id.* at 7.

\(^{72}\) These agencies include the Alaska Housing Finance Corporation, the Alaska Industrial Development and Export Authority, and the Alaska Renewable Resources Corporation.
wanting to save the funds), but also complicates the goal of using a natural resource fund to promote intergenerational equity. The mixed model requires a state to make bets on present funding opportunities in the hope these will pay out for both present and future generations. Or, in the case of some state agency recipients of state natural resource fund dollars, there may in fact be no particular goal of providing for future generations or for the general economic welfare of the state; short-term regional or local needs may control.

Aside from state-level concerns about the appropriate means of providing for future generations—whether to use a natural resource fund as a development fund or an investment vehicle, for example—significant federal concerns come into play. When combined with a fiscal federalism in which states receive increasingly large federal subsidies, the issue of intergenerational equity includes not merely whether and how present citizens of natural resource fund sponsor-states should subsidize future citizens, but also whether other states’ citizens should subsidize present and future sponsor-state citizens despite the existence of a state natural resource fund.

D. Preservation of Autonomy

Although intergenerational equity may be the primary stated reason for the creation of a state natural resource fund, they can be also explained as a tool to preserve autonomy and sovereignty. This function may occur first at the level of the citizenry of the SWF sponsor state or, second, at the level of the elites that govern the SWF sponsor state. In the first case, focusing on the preservation of autonomy of the citizenry, Monk notes that the government of the Maldives believed a SWF would help it buy new land should global warming submerge all or part of the country. Likewise, subnational
national governments have viewed SWFs as enabling independence from national governments.\footnote{Monk writes that “Greenland recently set up a SWF for the purpose of facilitating independence from Denmark. Likewise, Scotland mooted the idea of a SWF to facilitate independence from the UK. Even South Australia’s Commissioner for Aboriginal Engagement, Klynton Wanganeen, saw a SWF as an innovative tool to help Aboriginal communities support themselves instead of relying upon government welfare. . . Viewed in this light, SWFs are perceived by some policymakers to be a means of insulating completely against the outside world: the SWF is seen to be a tool to allow the state sponsor to continue with institutions, plans or policies that, in a totally open and competitive world, would be sub-optimal.” Monk, supra note 36, at 23–24.}

Hatton and Pistor offer a description of the second type of autonomy preservation. Focusing on China, Singapore, Kuwait, and Abu Dhabi, which they state are “without representative democracy, or where the institutions of democracy are clearly subordinate to authoritarian rule,” Hatton and Pistor argue that “SWFs act to maximize the domestic autonomy of the ruling elite in the sponsor-country.”\footnote{Kyle Hatton & Katharina Pistor, \textit{Maximizing Autonomy in the Shadow of Great Powers: The Political Economy of Sovereign Wealth Funds} 10 (Columbia Law Sch. Working Paper No. 395, 2011), available at http://ssrn.com/abstract=1787565.} In such states, these elites are not directly accountable to the public in general, and “it is easy to see how “governmental interest” becomes tied to the personal interests of the ruling elite. Indeed, the internal governance structures of the SWFs themselves ensure that SWF management is directly accountable to the ruling elite in each sponsor country.”\footnote{\textit{Id.}}
1. State natural resource funds as Bulwarks against National and International Pressures

Because state natural resource funds operate in a federalist system with a powerful national government, there is little reason to believe that state natural resource funds exist to provide protection for its citizens against the forces of globalization. Even if such a purpose were intended, it would show remarkable prescience given that many state natural resource funds date from periods when globalization was either a non-existent or unimportant issue for state citizens. It is also unlikely that state natural resource funds could serendipitously serve such a role, given their limited effect on state economies. However, as Monk has pointed out, some SWFs are not designed to serve as a bulwark against international forces so much as against national forces. The question thus arises as to whether state natural resource funds could be used as vehicles to maximize state autonomy within the federal system. For instance, could a state natural resource fund be used as a substitute for federal funding, thus eliminating the need of the state to comply with obligations the federal government might attach to such grants? The perhaps surprising answer is that state natural resource funds do not serve this function, and, in fact, states with large natural resource funds (with the exception of Texas) also tend to be the states that receive the most federal funding, as shown in the graph below.

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76 This idea was seminally proposed in Gordon L. Clark and Ashby H. B. Monk, Government of Singapore Investment Corporation (GIC): Insurer of Last Resort and Bulwark of Nation-State Legitimacy, 23 PAC. REV. 429 (2010).

77 For a discussion of the tension between states and federal government with respect to funding and compliance, see Bruce J. Casino, Federal Grants-In-Aid: Evolution, Crisis, and Future, 20 URB. LAW. 25, 40 (1988).
Although there are numerous policy explanations for these aid patterns, the irony of this federal funding is striking. Alaska, for example, is known for rugged individualism that sometimes translates into animus against the federal government; yet as a New York Times reporter recently stated, Alaska is a paradox, “a nation-size state of about 700,000 souls where many seem to revile the federal government even as their politicians excel at reeling in and spending its money.”

Alaska has long enjoyed significant federal funding, so much so that a finance scholar at the University of Iowa recently purported to demonstrate that “in financial terms, [the purchase of]

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Alaska has clearly been a negative net present value project for the United States.”\textsuperscript{79}

Wyoming, on the other hand, is considering the drastic step of refusing federal education funds because at least some legislators do not want to accept the federal guidelines, regulations and reporting requirements which reportedly burden local school districts.\textsuperscript{80} Since income taxation of Wyoming individuals and entities contributes at least in part to this funding, however, Wyoming would in effect be funding other states’ educational systems. For reasons I will address below, this is not necessarily an inequitable outcome.

As a general matter, state natural resource funds simply do not produce the kind of revenue that would allow for complete autonomy, even in a limited area like education policy. Considering just the nine states that hold approximately 85\% of all remaining trust lands in the lower 48 states, New Mexico receives by far the largest percentage of public school funding from its permanent fund at approximately 14\%. No other state receives more than 5\% of its public school funding from its permanent fund. By comparison, of the $1.13 trillion spent at the state level on education for the 2010-2011 school year, the U.S. Department of Education contributed about 10.8\% of the total.\textsuperscript{81} While a state natural resource fund may provide a state with flexibility in its spending, it does not serve as a replacement for federal funding.


What explains the large amount of federal funding that flows to Alaska, Wyoming and New Mexico? Like many Western states, these states have vast territories that require roads, bridges and other transportation funding to facilitate interstate commerce, but also have relatively sparse populations, translating into a high per-capita distribution of federal funds. Not all (or even most) of the federal funds go to highway projects, however. Significant portions go to Medicaid/Medicare costs, to educational funding, and to innumerable other “programmatic requests” for federal funding.

The large amount of federal funding of state programs raises concerns about the equity in allocation of federal resources. It is perhaps a truism, but one worth repeating, that the allocation of federal funds may be more a result of the political acumen of particular state representatives than of a reasoned process of analysis and prioritization of needs among the citizens of all states and territories. As a matter of public governance, however, it is worth asking the question of whether this allocation is equitable, and whether the federal government has appropriate mechanisms in place to reduce the likelihood that inequitable allocations are made.\(^2\)

Federal funding to states with natural resource funds raises the additional question of interstate equity: given the resource wealth that these states enjoy, should the federal government continue to fund natural resource fund-owning states at these levels? This article

\(^2\) As examples of the sort of mechanism that seeks to address potential inequalities, President Obama vowed in his 2011 State of the Union address to veto any legislation containing “earmarks”, and the House of Representatives has also stated that it will not approve legislation containing “earmarks.” Instead, members of the House are to make “programmatic requests” for funding. A.B. Stoddard, *Earmarks indelible in Congress*, THE HILL’S PUNDITS BLOG (Nov. 24, 2010, 3:22 PM), http://thehill.com/blogs/pundits/blog/lawmaker-news/130691-earmarks-indelible-in-congress. It is unclear whether the distinction between earmarks and programmatic requests is meaningful.
will not attempt to do more than raise this extremely complex question, but it is a critical question that should be addressed by policymakers not only in the United States but in other jurisdictions that have or are considering the creation of subnational SWFs. The implication of high funding levels for natural resource fund-owner states is that other states are effectively subsidizing states that are resource-rich. As subnational entities are more integrated within the national government and economy, this may be less of a concern, but where a bright-line form of political federalism or quasi-independence obtains, such an arrangement seems correspondingly less equitable. If an increasingly larger part of the benefits and services provided to citizens come from federal rather than state dollars, should the federal government receive a portion of the severance taxes collected by resource-rich states?

III. POLICY JUSTIFICATIONS MEET POLITICAL REALITIES: THE USES AND GOVERNANCE OF STATE NATURAL RESOURCE FUNDS

The preceding Part addressed the first of the two central questions indicated at the beginning of the article by describing the policy justifications for public natural resource funds. This Part now moves to the second question: how does the legal and governance framework in which these funds operate ensure the funds achieve their stated goals? The argument thus far has shown how the key choices discussed above—how to spend natural resource funds and whether to provide a dividend—have important political and fund governance implications. Transferring high-level justifications for natural resource funds into sound fund governance is exceedingly difficult, and state natural resource funds differ significantly in their management philosophies. The differences are particularly apparent when considering the management of severance tax funds. This article will argue that states often fail to provide an appropriate governance structure for their funds, and are falling short of the policy justifications described in Part I.
Some states may have more than one fund in operation. Land grant funds and severance tax funds may have come about for somewhat different reasons, and may operate somewhat differently. State trust lands are typically invested through an investment division operating within the state’s land management department or the state’s education department, or, in the case of states with a severance tax fund, both of the state’s natural resource funds are managed by a single investment entity that may operate as a stand-alone entity. In Texas, for example, the Permanent School Fund ("PSF") is managed by the State Board of Education, while the administrative activities for the PSF are handled by an investment division of the Texas Education Agency. In New Mexico, on the other hand, both the Land Grant Permanent Fund and the Severance Tax Permanent Fund investments are managed by the State Investment Council ("SIC").

Because the income generated by the funds is typically dedicated to various public entity beneficiaries, land grant funds traditionally do not invest funds in social programs as, discussed below, some states do with their severance tax funds, nor can revenues from trust lands be redirected to other purposes. Texas is again an exception to the rule, however, as legislation passed in 2007 allows the State Land Commissioner to designate some funds that would have been deposited in the PSF to be redirected to a "real estate special fund account," and also expanded the PSF’s investment authority, allowing the PSF to invest in “land; interests in real property for biological, commercial, geological, cultural or recreational purposes . . . [to make investments] to protect, maintain, or enhance the value of public school lands; [or, to make investments to] acquire . . . an investment or interest in public infrastructure, or other interests.”\(^\text{83}\)

The balance of this Part provides case studies of the three largest state severance tax funds, the Alaska Permanent Fund ("APF"), the Wyoming Permanent Mineral Trust Fund ("WPMTF"), and the New Mexico Severance Tax Permanent Fund ("STPF"), and briefly describes the governance structure, investment policies and distribution mechanisms of the funds. Most state natural resource funds use outside investment managers to help invest some or all of their funds, and fiduciary standards and asset allocation requirements serve to constrain the behavior of the funds and their investment managers. Aside from these similarities, the three funds discussed in this Part have considerably different investment goals, ranging from an aggressive, total return-focused management style that produces a large annual cash dividend for Alaskans, to mixed total return and social investment strategies in Wyoming and New Mexico. After describing these models, the article then turns to the governance implications of the models, and concludes that a dividend model provides a more sound governance structure than mixed-motive, budget-expanding models.

A. Supporting Social Programs while Seeking High Returns: The New Mexico Severance Tax Permanent Fund

New Mexico’s State Investment Council ("SIC") is tasked with management of the STPF. The SIC is chaired by the Governor of New Mexico and has ten other members, including the State Treasurer, the Commissioner of Public Lands, the Secretary of the Department of Finance and Administration, four public members appointed by the Legislative Council, one of whom must be the Chief Financial Officer “of a state institution of higher learning,” and three Governor appointees. Public members are appointed with the advice and consent of the New Mexico Senate, and must be confirmed by the

Senate. Additionally, New Mexico has a Private Equity Investment Advisory Committee, chaired by a SIC member and including three additional public members and the State Investment Officer. The public members selected to serve on the SIC must be “qualified by competence and not less than ten years’ experience in the field of investment or finance.”

As with states natural resource funds generally, the SIC and its managers are obligated by statute to apply a “prudent investor” standard of care; in the case of New Mexico, the standard is that found in the Uniform Prudent Investor Act (UPIA). The SIC’s general investment policy also states that “[i]nvestments of the fund shall be diversified to minimize the risk of significant losses. Total return, which includes realized and unrealized gains, plus income, less expenses, is the primary goal of the Funds.”

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85 Id.
87 N.M. STAT. ANN. § 6-8-3(B) (West 1978).
88 The standard requires the manager to “invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution, [and] a trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.” UNIF. PRUDENT INVESTOR ACT § 2(a)–(b) (1995), available at http://www.uniformlaws.org/shared/docs/prudent%20investor/upia_final_94.pdf; see also N.M. STAT. ANN. § 45-7-602 (West 1978); SIC General Investment Policy, N.M. STATE INV. COUNCIL (Mar. 14, 2008), available at http://www.sic.state.nm.us/PDF%20files/080314%20SIC%20GENERAL%20INVESTMENT%20POLICY-Final.pdf.
89 SIC General Investment Policy, supra note 88, at 1.
Notwithstanding this basic total return focus, the investment activities of the SIC from STPF funds are complicated by numerous statutory imperatives. When the STPF was formed, New Mexico’s legislature created a patchwork of investment targets for the STPF, with a specific social policy associated with each type of investment target. The legislature effected this by separating the fund’s investment into two general categories: “differential rate investments” and “market rate investments.” Differential rate investments are intended to “stimulate the economy of New Mexico and to provide income to the severance tax permanent fund,” while market rate investments are only intended “to provide income to the severance tax permanent fund.”

The investment criteria for market rate investments are relatively standard and similar to those employed by other large institutional investors. The investment policies place limitations on the total amount of equity securities that may be owned, for instance, and restrict the percentage of ownership of any given company. On the other hand, the list of differential rate investment targets reveals a remarkable effort at social engineering on the state level, with some of the investments paralleling federal efforts. Among other things, the SIC may make investments in mortgage pass-through securities (stimulating the mortgage market and increasing home ownership levels), New Mexico small businesses, and the New Mexico film industry.

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91 Id.
Differential Rate Investment

<table>
<thead>
<tr>
<th>Investment</th>
<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional mortgage pass-through securities</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>New Mexico business investments</td>
<td>20% of the STPF</td>
</tr>
<tr>
<td>Educational loan notes</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Educational institution research and development facilities revenue bonds</td>
<td>10% of the STPF</td>
</tr>
<tr>
<td>New Mexico private equity funds and business investments</td>
<td>9% of the STPF</td>
</tr>
<tr>
<td>Employers mutual company revenue bonds</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Deposits in New Mexico financial institutions</td>
<td>20% of the STPF</td>
</tr>
<tr>
<td>Deposits in New Mexico credit unions</td>
<td>Not Limited</td>
</tr>
<tr>
<td>New Mexico lottery revenue bonds</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Investment in obligations issued for corrections facilities</td>
<td>Not Limited</td>
</tr>
<tr>
<td>Investment in obligations issued for state capitol buildings and renovations</td>
<td>$10,155,000</td>
</tr>
<tr>
<td>Investment in films to be produced in New Mexico</td>
<td>6% of the STPF</td>
</tr>
</tbody>
</table>

The State Investment Council has published detailed investment policies for its private equity, film, real estate, mortgage loan, and hedge fund investments. Overall, the general investment policy of the SIC attempts to balance the two objectives of the differential rate program of the STPF—first, to produce a “risk adjusted rate of return under the Prudent Investment Rule,” and second, “to enhance the economy of New Mexico”—by ensuring that “credit quality is maintained and risk is minimized, market-based yields that are proportional to the assumed risks are obtained, each

93 Id.
investment will stimulate the economy of New Mexico on a continuing basis, each investment will expand business activity in the state, and each investment will promote the creation and preservation of jobs.”

B. *The Many Uses of Wyoming’s Severance Tax Funds*

Wyoming also has multiple objectives for its severance tax fund investment program. The general policy for Wyoming trust funds requires the State Loan and Investment Board to invest public funds “in a manner that strives for maximum safety, provides adequate liquidity to meet all operating requirements, and achieves the highest possible investment return consistent with the primary objectives of safety and liquidity.” Wyoming holds the Board, the state treasurer, and any fiduciary appointee (such as an external manager) to the prudent investor standard set out in the Uniform Prudent Advisor Act as enacted by Wyoming. The Board is made up of the Governor (as President of the Board), the Secretary of State, the State Auditor, the State Treasurer, and the State Superintendent of Public Instruction. The State Treasurer handles most of the monitoring of external managers and is tasked with setting up internal controls systems and

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94 **STATE OF WYO. STATE LOAN AND INV. BD., MASTER INVESTMENT POLICY AND SUB-POLICIES 3** (June 3, 2010), available at http://treasurer.state.wy.us/pdf/investmentpolicy060310.pdf. Along with safety of principal and liquidity, the Board also lists the following “objectives and priorities”: Yield; Recognition of differing objectives and needs of various fund portfolios; Conformance with state law and other pertinent legal restrictions; Maximization of the total rate of return on investment consistent with the foregoing objectives; Diversification by asset type, security and investment manager in order to smooth the volatility of quarterly returns. *Id.*

95 **WYO. STAT. ANN. § 4·10-901 to -913** (West 1977). The standard requires, *inter alia*, that a trustee “invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust.” **WYO. STAT. ANN. § 4·10-901** (West 1977).
developing and recommending investment policies, among other things. All of these officials are elected in statewide general elections and serve a four-year term.

Wyoming has set out by statute a set of permissible investments and investment allocations. The statutes contain only two significant restrictions on investments. First, only up to 35% of the fund may be invested in common stocks. Second, prior board approval must be obtained before the state is allowed to invest in “alternative investments.” The Board’s investment policy adds to these restrictions by prohibiting self-dealing transactions, floating rate securities, individual certificates of deposit, letter stock and other unregistered equity, commodities (if not part of an alternative investment), most real estate transactions, natural resource properties, and short sales and margin transactions. Derivatives may be used to manage risk, and the use of derivatives, “in pursuit of strategies to achieve ‘above market’ performance is considered speculative and is strictly forbidden,” except as part of an approved alternative investment program.

Like New Mexico, Wyoming’s statutes also expressly permit state natural resource funds to invest in various investments that further targeted social policies. Among other things, the state treasurer is permitted to invest (or in some cases, pledge) up to $25 million in non-delinquent federally guaranteed or insured higher

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96 STATE OF WYO. STATE LOAN AND INV. BD., supra note 94, at 6–7.
97 “Alternative investments” are defined as “investments in nontraditional asset classes or in traditional asset classes which are utilized in a nontraditional strategy.” WYO. STAT. ANN. § 9-4-714(a)(i) (West 1977). The statutes grant authority, however, for the state’s chief investment officer (by statute, the state treasurer) to invest funds in any investment authorized by the legislature or authorized or approved by the board. WYO. STAT. ANN. § 9-4-715 (West 1977).
98 STATE OF WYO. STATE LOAN AND INV. BD., supra note 94, at 11.
99 Id. at 11–12.
education loans from any nonprofit Wyoming corporation organized to acquire such loans;\textsuperscript{100} up to $300 million from the common school account in the permanent land fund to guarantee school district bonds;\textsuperscript{101} up to $100 million to guarantee local government bonds;\textsuperscript{102} and, “to promote economic development,” the state treasurer may invest up to $100 million in industrial development bonds issued by joint powers boards, municipalities or counties.\textsuperscript{103} The state treasurer may not invest more than $50 million “for a specific public purpose authorized or directed by the legislature,” although the amount may be adjusted by recommendation of the state treasurer and approval by a Board subcommittee on capital financing and investments.\textsuperscript{104}

The state investment policy also sets out various portfolio guidelines. For example, the state may only own one percent or less of the common stock of any corporation,\textsuperscript{105} and only up to one and one-half percent of the total book value of the funds may be invested in the common stock of any corporation.\textsuperscript{106} Like many funds, Wyoming also acknowledges the challenge of matching its investment policy to its fiduciary duties when a higher return may be generated with investments that are at odds with other social, ethical and political goals. In a somewhat convoluted provision, the state investment

\begin{footnotesize}
\begin{enumerate}
\item Wyo. Stat. Ann. § 9-4-715(m) (West 1977). Investments under this statute require the recommendation of the Wyoming business council created by W.S. 9-12-103, and also require written approval of the governor. A number of other restrictions also apply, and new investments of this type are not allowed to be made as of June 30, 2011. \textit{Id.}
\item State of Wyo. State Loan and Inv. Bd., supra note 94, at 12. However, “[a]n exception may be made for Alternative Investments and for companies with a market capitalization below $5 Billion.”\textit{Id.}
\item Id.
\end{enumerate}
\end{footnotesize}
policy attempts to discourage certain investments while reaffirming its commitment to invest in the economic interest of the fund:

The Board is concerned with terrorism and human rights violations occurring worldwide, yet recognizes its fiduciary responsibility to invest only in the best economic interest of the portfolio. While the Board cannot make investments based on social or political objectives, it does consider the economic effects of social and humanitarian issues in the analysis of investments. The Board seeks to avoid investments that support terrorism or the violation of human rights. As such, the Board will require its investment managers to acknowledge that they will seek to avoid such investments.\textsuperscript{107}

The actual investment of the funds is outsourced to a number of different external managers, including core plus fixed income managers, corporate fixed income managers, mortgage fixed income managers, global/emerging market fixed income managers, public equity managers, cash and extended cash managers, private equity (alternative investment) managers, real estate (alternative

\textsuperscript{107} The policy imposes the following requirement on its investment managers: “Investment Managers are required to check portfolio holdings no less frequently than quarterly against the companies listed on the Specially Designated Nationals List and the countries listed on the Lists of Sanctioned Countries, maintained by the U.S. Treasury Department Office of Foreign Assets Control ("OFAC"), to ensure that the companies or countries on the list are not represented in the portfolios. If a current holding appears on the list at the time of the quarterly check, the Manager will eliminate the position from the portfolio within a reasonable period of time and will not make additional purchases unless the issuer is removed from the OFAC list.” \textit{Id.}
investment) managers, overlay strategy (alternative investment) managers, and absolute return (alternative investment) managers.  

The subpolicy for the PWMTF provides additional detail on the strategy, distributions and allocation of the PWMTF. Under this subpolicy, in accordance with statute, the corpus of the PWMTF is inviolate: only income and capital gains may be distributed. The subpolicy notes, however, that the state legislature has often directed portions of the PWMTF to “directed investments” mandated by the legislature, and therefore “only the remaining portion is available for discretionary investments by the State Treasurer’s Office.” Because the legislature may withdraw significant portions of the PWMTF, “the fund must be managed to allow an extensive range of investment maturities that will provide for funds availability for directed investments as they come into existence as mandated by the Legislature.”

C. Distribution of Severance Tax Fund Income to State General Funds

In the case of both New Mexico and Wyoming, most of the income from their severance tax fund is deposited in the state’s general funds. Under the Constitution of the State of New Mexico, the STPF distributes 4.7% of the average of the year-end market values of the fund for the immediately preceding five calendar years. The distributions are made in 12 equal monthly increments. The fund distributions are “appropriated by the legislature as other general

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108 *Id.* at 12–16.
109 *Id.* at 25–26.
111 However, “a specially managed portion” of the PWMLTF must be held inviolate,” even against the occasional legislative mandate: “[t]hese funds are to be invested for the long term to produce a higher return without the cash flow or legislatively directed investments.” *Id.*
operating revenue is appropriated for the benefit of the people of the state.”

As with New Mexico, the income from the PWMTF is deposited in the state’s general fund.\(^{112}\) The PWMTLF provides a large portion of Wyoming’s general fund. In 2008, for example, the PWMLTF contributions made up 24% of the state’s general fund. In 2009 the PWMLTF contributed 12.7% of the state’s general fund, and in 2010 the PWMLTF was expected to contribute 13.6%\(^{113}\). The constitution also provides that the legislature may specify “conditions and terms under which monies in the fund may be loaned to political subdivisions of the state.”\(^{114}\) The PWMTLF presently loans money under several programs, including the Farm Loan Program, the Joint Powers Act Loan Program (providing loans to local governments), and the Hot Springs State Park Loan Program (providing loans for capital improvements to businesses in the park).\(^{115}\)

**D. The Dividend: Alaska’s Permanent Fund**

The Alaska Permanent Fund (“APF”) is directly overseen by the Alaska Permanent Fund Corporation (“APFC”), a state-owned entity that operates as a “quasi-independent state entity, designed to be insulated from political decisions yet accountable to the people as a

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\(^{112}\) WYO. CONST. art. 15, § 19 (2011).


\(^{114}\) WYO. CONST. art. 15, § 19 (2011).

\(^{115}\) STATE OF WYO. OFFICE OF STATE LANDS AND INVS., SUMMARY OF STATE LOAN PROGRAMS AND ASSOCIATED LOAN LOSS RESERVE FUNDS 1 (April 30, 2011), available at http://slf-web.state.wy.us/osli/BoardMatters/2011/0611/SLIB/Loan0611.pdf. The combined loan balances for fiscal year 2011 were approximately $44 million. *Id.* at Schedule 1. Loan interest rates vary by program and range from 4% to 10%. *Id.* at 2–3.
whole.” The establishment of a corporation as a separate entity, rather than as an agency within the state government, is intended to “protect the Fund’s long-term performance by keeping it as removed as possible from short-term political considerations.” Yet at the same time, the APF was created as a means of controlling political power; while the fund’s structure (as set out by Alaska’s constitution and statutes) prevent the APF from being employed for short-term political uses, the dividend structure, described below, imposes on the government overseers of the APF the incentive to maximize the value of the fund.

The APFC retains direct political accountability through an annual APFC report to the Legislative Budget and Audit Committee, and through approval of the APFC budget by the Legislature. The APFC also has a six-person Board of Trustees, all of which are appointed by the governor. Four of the trustees are public members, and two are cabinet members (the Commissioner of Revenue and another cabinet member selected by the governor). The four public appointees must possess “recognized competence and expertise in finance, investment and other business management-related fields.” The public appointees serve staggered four-year terms, and each year one of them is elected to serve as the chair of the Board.

1. The Creation of the APF Dividend

The distinguishing feature of Alaska’s fund is that a significant portion of the income generated by the fund is paid out to Alaskan citizens in the form of an annual dividend. The dividend is paid out

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117 Id.

118 Id.
according to a specific formula as set out by statute.\textsuperscript{119} After this calculation, a determination is made as to whether there are sufficient funds in the earnings reserve account to pay the dividend. The dividend may not be paid out of the principal\textsuperscript{120}

\textsuperscript{119} The dividend is essentially calculated by averaging the net income of the APF over the past five years, multiplied by 21 percent, divided by 2, then divided by the number of eligible applicants. In 2010, the amount was calculated as follows (amounts in thousands, except individual dividend amount): Net income from previous five years, $8,171; multiplied by 21% = $1,716, divided in half = $858, then after various minor adjustment are made, the total is divided by the estimated number of dividend applicants: $822,100,000/641,595 = $1281.00 (rounded to nearest whole dollar).

\textsuperscript{120} As succinctly reported in a recent news article,

The Permanent Fund’s value is divided into two categories — principal and “realized gains.” The categories let managers calculate how much can be used for state expenses and how much is off limits from such spending. The principal is the value of the assets owned by the corporation at any given time, and it’s off limits, as mandated by the Alaska Constitution. The realized gains are dividends, rents, bond interest payments and profits from sales of assets, and they can be spent by the Legislature.

As of June 30, the realized gains account held more than $2 billion. By law, up to half that account can be used to pay the Alaska Permanent Fund Dividend to Alaskans. The formula that’s used to calculate the dividend put the full cost of the October 2010 checks at $858 million, so the account held enough to pay the bill. The Legislature approved that spending.

The APF paid out over $16.7 billion to Alaskans between 1982 and 2008. For many Alaskans, particularly native Alaskans and those in rural Alaska, the dividend is a major source of income.

2. APF Investment Policies

In the early years of the APF, the fund’s investment policy was based on traditional asset allocation techniques, and was heavily invested in bonds. However, in 2009 the Board of Trustees “recognized that some investments might have more in common with investments from other asset classes with regard to their expected levels of risk and return.” For example, corporate bonds may not act like U.S. Treasuries as much as they act like stock; “this makes sense when you consider that the companies that issue these corporate bonds are the same companies traded in the stock markets.” Under its new strategy, the Board thus determined to group assets by risk characteristics, rather than by asset class. So rather than grouping assets as stocks, bonds, cash, etc., the APF now classifies investments as “Cash,” “Interest Rates,” “Company Exposure,” “Real Assets,” and “Special Opportunities.” “Cash” includes liquid instruments with durations of less than 12 months. “Interest rates” includes low credit-risk securities such as U.S. Treasury bonds and non-U.S. government bonds. “Company Exposure” includes investment grade and high-yield bonds, U.S. and foreign stocks, bank loans and private equity investments. “Real Assets” includes real estate, infrastructure, and Treasury inflation protected securities (TIPS). The “Special Opportunities” category includes, among other things, absolute return assets, distressed debt, and commercial mortgage-backed securities.

The discussion surrounding the move to this new strategy in 2009 reveals the grip of the APF’s governance mechanisms. When the managers approached the Board about the shift (after significant consultation with external advisors), the Board initially balked. APF Chief Investment Officer Jeff Scott proposed moving money into a
hedge fund investment, but encountered some resistance. Trustee Nancy Blunck expressed concern that APF staff was moving too quickly into alternative investments, and the Board and the public were not “in the loop.” “This is public money,” stated Blunck, “It is not corporate money, it’s not private money.” The relationship between political accountability and fund performance is evident here: the Board operates with the knowledge of how important the dividend payout is to Alaskans, and is very reluctant to jeopardize a consistent payout. They thus have a political incentive to maintain strict control over APF fund managers. At the same time, letting the public “in the loop,” may affect the performance of the Fund as the market generally becomes aware of the fund’s strategy before the fund may execute the strategy. Another trustee, Pat Galvin, also voiced concern with the move to alternative investments: “It seems to me like we are being slow-walked down a path with these incremental decisions.” Scott expressed frustration at the comments, stating “if I can’t do anything, I need to know.” Ultimately Galvin indicated that the Board may want to reconsider whether it should invest in hedge funds, but did not block the proposal.

E. The Governance Implications of Targeted Investments and Dividends

If appropriately structured and managed, a state natural resource fund can act as a governance mechanism for controlling governmental use of income from resources—a large-scale governmental commitment device. A natural resource fund can enhance accountability in several ways. First, a natural resource fund

122 Id.
123 Id.
124 Id.
125 Id.
typically forms part of a structure to redirect certain revenues and places restrictions on how those revenues may be spent. In a corporate context, this would be akin to taking some spending discretion away from managers by forcing a certain amount of income to be reserved. This decision may be the result of a desire to restrict government expenditures generally, but it may also have a more partisan political objective. For instance, Oklahoma’s legislature recently sought to create a natural resource fund (the bill providing for the creation of the natural resource fund was ultimately vetoed by the governor), and some have speculated that the fund was designed in part to serve as “a policy tool implemented by Republicans (i.e. fiscal conservatives) to discipline the spending of a Democratic governor.”

Public natural resource funds can also serve as mechanisms for leveraging political accountability through trustee accountability: the management of the fund should produce clear results that allow for citizens to judge the quality of the fund management. While elected officials rarely have a direct hand in managing natural resource fund investments, at least some officials typically serve on boards that oversee state natural resource funds. They are thus ultimately responsible for the overall direction of the fund (subject to constitutional and statutory parameters) and for the selection of asset managers of the fund. Politically, the politician is incentivized to manage the fund well so as to ensure re-election. Since politicians are

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126 Ashby Monk, *Oklahoma Loves SWFs*, Oxford SWF Project (March 5, 2010), http://oxfordswfproject.com/2010/03/05/oklahoma-loves-swfss/. Commenter Rien Huizer agrees, and states that the SWF is a tool to “make vote buying by the other side harder,” and finds it an “interesting use of [government surplus] (similar to the Australian Future Fund), but here in a country that has severe budgetary problems.” Posting of Rien Huizer to Monk, *supra* (Mar. 7, 2010, 12:24 AM). But this, of course is the result of a federalist form of government, and the fact that local surpluses not only do not have a significant effect on the federal budget, but also do not seem to have the effect of decreasing the funds granted to states with significant natural resource revenues.
elected by current rather than future citizens, they may also have the incentive to maximize the welfare of the present generation of voters at the expense of future voters. The private law concept of trustee fiduciary duties is grafted onto constitutional and statutory restrictions on the use of funds to temper politicians’ incentives to benefit present generations at the expense of future generations. As with fiduciaries in private settings, transparency and accountability are key to managing the agency costs under this framework. As will be discussed below, cash transfers such as Alaska’s offer a relatively clear and transparent signal of management quality, thereby providing a significant impact on political accountability. On the other hand, a poorly designed natural resource fund merely layers agency costs on agency costs—managerial agency costs may be layered onto existing political agency costs. If the results of the fund are either not transparent or are ignored because the fund has little impact on the lives of current citizens, agency costs are likely to increase because politicians may not be incentivized to contain them. The natural resource fund may thus become a vehicle for rent-seeking at the expense of both present and future generations.

1. Investment Policies and Agency Costs

Investment constraints written into the investment policies of the state—and in some cases, state statutes and even the state constitution—are often intended to serve as agency cost reducing mechanisms by restricting the ability of the managers to invest in riskier assets. As described below, these restrictions most often take the form of hard asset allocation rules, as well as lists of permissible investments. These fixed restrictions can serve as agency cost reduction mechanisms, but the restrictions can also limit the returns of the fund and expose the fund to additional, uncompensated risks. Perhaps because of the relatively larger size of the fund and because of its dividend policy, Alaska has been the most active state in matching its investment policies with current best practices for asset management. As discussed earlier, Alaska, like many national SWFs and other large asset managers (such as CalPERS), is moving away
from a traditional asset allocation approach to a “factor-based” or “risk-oriented” approach. These approaches classify assets by risk characteristics, rather than simply by broad asset class labels such as “corporate bonds” or “US public equities.” As Monk explains, “an asset allocation based on equities, bonds, and alternatives may ultimately be providing very little diversification in terms of the underlying factors that drive returns. So, by focusing on the factors, an investor can better grasp what asset classes will provide the desired risk exposures.”

127 He also notes how the Financial Crisis demonstrated the dangers of an asset-focused portfolio:

During the credit crunch, the “asset-oriented” approach didn’t provide the amount of diversification that the funds had expected/hoped. All the assets in their portfolios seemed to be moving in the same direction: down. For example, take CalPERS, which is one of the most diversified investors in the world. It lost $100 billion in roughly 18 months — the fund was worth $260 billion in October 2007 and touched $160 billion in March 2009.

128 While a factor-based approach “allows a better understanding of risk-return trade-offs,” as Ang argues, it also provides a more precise means of tailoring the fund’s investments to its payout model because “SWFs with different governance structures and payout rules have different optimal bundles of factors.”

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128 *Id.*
130 *Id.*
approach is complicated in Alabama, however, where the asset allocation strategies are defined by the state constitution, and a new strategy would need to receive public approval. In other states, the complication is somewhat less daunting because only the legislature would need to approve amendments to state statutes governing the investment policies of the funds.

Investment policies can also create classic governance problems like self-dealing and waste. Notwithstanding the fact that New Mexico, for example, has general policies that appear oriented to measurable economic outcomes, using STPF revenues for differential rate investments creates numerous (and apparently justified)\textsuperscript{131} concerns about how those funds will be allocated and increases the risk of political patronage. New Mexico’s history of limited public spending and a Constitutionally-mandated balanced budget (along with the allocation limitations mentioned above) eased concerns over wasteful spending.\textsuperscript{132} The investment choices have been presented not as mere subsidies, but as investments in industries that should develop over time, produce a significant return for the state economy, and, if possible, become self-sustaining. In discussing New Mexico’s film investments, for example, former Governor Bill Richardson stated "[o]ur main objective is to become a supportive satellite of Hollywood .

\textsuperscript{131} In 2011, the SIC filed lawsuits in state and federal court alleging that former SIC officials were engaged in pay-to-play schemes. The Shoe Finally Drops: New Mexico Files Lawsuits in Federal and State Courts in “Pay to Play” Scandal, CAPITOL REPORT NEW MEXICO (May 6, 2011), available at http://www.capitolreportnewmexico.com/?p=4365.

\textsuperscript{132} Considering spending of STPF funds on the film industry, for example, reporter Simon Romero writes that “there was little resistance to legislation allowing the state to invest in film projects. In fact, the state’s finances allowed officials to expand the authority and influence of its film commission while other states were cutting back.” Simon Romero, Coming Soon to a Screen Near You: New Mexico, N.Y. TIMES MEDIA (Jan. 26, 2004), http://www.nytimes.com/2004/01/26/business/media\-coming\-soon\-to\-a\-screen\-near\-you\-new\-mexico.html.
... 'We don't want to be greedy with this, but for a state with low per capita income, it's a way for us to attract a clean, environmentally friendly industry that leaves a positive impact.'

New Mexico’s experience with film investment reveals the difficulty of effectively pursuing its dual-objective investment approach. The result of New Mexico’s film loan program has been moderately successful in enticing film projects to the state, with New Mexico recently (and perhaps unfortunately) branded as “Tamalewood.” However, the SIC recently made significant changes

133 Id.
135 The name “Tamalewood” has been copyrighted by Leonard Sanchez, who appears to bear responsibility for the term: “I was working on a film in Taos in September of 2005 when I came up with the name Tamalewood. I mentioned it to someone I shouldn’t have trusted and the next thing I knew, The Santa Fe Reporter was using it as a headline. Nevertheless, I own the legally registered Service Mark “Tamalewood” in the state of New Mexico and I’ve applied for federal registration of my Service Mark.” Leonard Sanchez, History of “Tamalewood”, TAMALEWOOD,
to its film investment policies because of concerns that the state was not achieving adequate returns from the program. A primary problem was that the state apparently did not fully understand (or neglected to account for) the fact that it was unlikely to receive interest payments on its loans if the payout is contingent on a film’s profitability.\textsuperscript{136} Essentially, New Mexico took the position of a junior creditor, and so only after more senior film creditors were paid could New Mexico begin to collect interest on its loans. Often, the films did not make enough money to pay out any interest to New Mexico, and so the state only received its principal in return. Out of nearly $240 million loaned to film producers of 23 films from 2001-2011, only 1 film produced a profit to New Mexico.\textsuperscript{137}

Because of these losses, the SIC made substantial changes to its film investments policies: under prior investment rules, New Mexico provided zero-interest loans to film and television producers; under new guidelines, the state will lend at the national prime rate plus 1.5%. Additionally, in an effort to more tightly link film investment to local economic impacts, 75\% of the loan recipient’s film crew (with exceptions for the director, producer, and certain other employees) must be New Mexicans (up from 60\%).\textsuperscript{138} 75\% of the crew payroll must go to New Mexicans,\textsuperscript{139} and 85\% of a loan recipient’s

\hspace{1em}\textsuperscript{137} Id.
\hspace{1em}\textsuperscript{139} Id. Again, with exceptions for directors, producers, and certain other employees.
shooting schedule must be in New Mexico (up from a “majority”). The SIC also determined to fire Peter Dekom, a Hollywood entertainment lawyer who had helped New Mexico create and advise on its film loan program. Mr. Dekom was paid $2,153,566 over the course of his engagement with the SIC, making $260,000 a year under his most recent contract (after taking a pay cut from $370,000 under his prior agreement), although he was reportedly only required to work for the SIC a total of 30 hours a month.\footnote{140} 

Concerns have also arisen over the purpose of the New Mexico Small Business Investment Corporation ("NMSBIC"), which receives funds from the STPF. The NMSBIC operates independently from the management of the SIC, and the NMSBIC has its own mission: "to create new job opportunities by making equity or debt investments in New Mexico small business in cooperation with financial professionals."\footnote{141} SIC board member Doug Brown explains that the SIC and the NMSBIC thus have a "fundamental conflict" between the SIC’s purpose and the NMSBIC’s mission, “given that the SIC’s primary duty is to bring the best possible return on the state’s investments—regardless of any social benefit associated with the..." 

\footnote{140} Rob Nikolewski, \textit{SIC Extends $260,000 a Year Contract to Film Consultant}, \textit{CAPITOL REPORT NEW MEXICO} (July 27, 2010), \textit{available at} http://www.capitolreportnewmexico.com/?tag=new-mexico-film-commission. Mr. Dekom allegedly had conflicts of interest in his role with the SIC because at the same time he represented the SIC "he advise[d] producers and directors about doing business in New Mexico while, at the same time, his law firm writes contracts and represents Hollywood clients who make and distribute movies and television shows." \textit{Id.} 

\footnote{141} Minutes, New Mexico State Investment Council (Apr. 26, 2011), \textit{available at} http://www.sic.state.nm.us/PDF%20files/SIC%20MINUTES%204-26-2011.pdf.
enterprise—while the SBIC’s primary goal is to help small businesses thrive, not necessarily to make money for the state.”

Some members of the SIC have viewed the NMSBIC as a “social program” and believe its funding should originate from the general funds of the state “at levels determined appropriate by the legislature and governor” rather than from an investment program using permanent funds. Part of the anxiety for SIC members stems from the fact that while the NMSBIC selects how to appropriate funds, it does not do so under the same “prudent man” investment criteria that govern SIC investments: as stated by NMSBIC chairman Paul Goblet, “We’re not governed by the ‘prudent man rule.’” This difference reflects the fundamental tension not just between the SIC and state agencies, but between the differential rate investments and the market rate investments dichotomy created by New Mexico when it created the STPF. Because the state has an investment program


143 Minutes, supra note 141, at 13.

144 Id.


In response to this, SIC member Leonard Lee Rawson noted, “But we have to book your assets. This is where the tension builds.” Id. In an interview, Rawson also stated, “Their assets are recorded on our books as part of the Permanent Fund, and yet they have no accountability to us, no accountability to the Governor and really to the legislature. And so they’re kind of out there doing their own thing, and the responsibility, the accountability and the authority aren’t combined together.” Rob Nikolewski, *Rawson on NM Small Business Investment Agency*, YOUTUBE (May 27, 2011), http://youtu.be/i9cGzdWVKI.
that operates according to a profit-maximization rule but is at the same time required to fund agencies that have broader social goals, the SIC will be faced with governance difficulties as it attempts to manage an agent which, by statutory authority, has incentives that are misaligned with its own. The SIC is currently attempting to remedy these governance issues by appointing new members to the NMSBIC board, considering changes to the statute governing the NMSBIC, specifically considering how the NMSBIC makes investment decisions, and by issuing a request for proposals from independent investment advisers to help oversee NMSBIC decisions. The sensible goal of the SIC seems to be to align investment decisions with an overall profit-maximization focus, which will necessitate significant legislative effort.

Wyoming’s directed investments program presents similar concerns. Directed investments represent an opportunity for political patronage and waste, and it is seems unlikely that Wyoming’s voters would approve such a potential use of severance tax funds if the issue were put to a statewide referendum; the state appears to recognize the governance concern directed investments create, and has considered evaluating its policies regarding legislatively-designated investments.

146 Nikolewski, *The SIC Tries to Rein in the State’s Small Business Corporation*, supra note 145.

147 For example, a 1997 state audit report noted that “[o]ur research on selected states with significant permanent funds and on the pension funds of several states suggests that they do targeted investing under two circumstances: they either have defined guidelines for making such investing in targeted investments, or do so only when such investments result in at least a market rate of return. Unlike these comparators, Wyoming’s investment in LDIs for public infrastructure, economic development projects, and social programs generates reduced earnings.” The report recommends that “[i]n the future, the Legislature could consider defining the terms and conditions under which it will accept less-than-market returns on its
Political patronage and waste are not the only concerns with directed investment programs, however. In the case of New Mexico’s struggling film and other private sector investments, serious questions were raised not only about the possibility of corruption but also the losses incurred by the fund. To be sure, an investment focused on job or economy growth should not be expected to produce a direct return as large as an investment focused purely on financial returns. However, many of these investments will not only fail to produce a positive net return, but may actually produce losses. The losses may decrease the legitimacy of the state, in the eyes of its citizens, as a manager of the state’s wealth. A crisis of legitimacy may be allayed with careful metrics that demonstrate how the investment resulted in a certain number of jobs or provided other measurable benefits, although in the federal context such claims have been met with some suspicion.

148 As Monk states, “over the long-term, any fund focused on development will likely pay a price for this in financial returns (since the fund’s investment decision-making is as equally focused on “jobs” as it is on “profits”). And, as a result, the SWF could end up losing some of its domestic legitimacy due to a perception of “wasted resources” through loss-making investments (even if the fund is nonetheless successful at creating jobs or bringing technologies from abroad).” Ashby Monk, *Khazanah: Commercial and Strategic Success*, OXFORD SWF PROJECT (Oct. 11, 2010), http://oxfordswfproject.com/2010/10/11/khazanah-commercial-and-strategic-success/.

2. Distribution Policies and Agency Costs

The distribution imperative—how and when to pay out the earnings of the fund—necessarily impacts the governance of the fund. Most state natural resource funds are designed to lock away the corpus of the fund from the legislature, and most share the goal of doing so for the benefit of future generations. How those funds are dispensed to future generations varies significantly. For New Mexico, Texas and Wyoming, a portion of the revenues generated from the states’ mineral wealth is distributed to educational recipients, as required by state and/or Congressional fiat. Other revenues are generated through severance taxes, and the income from these funds goes into the state budgets, although, as noted above, some states set aside funds for targeted investment. Alabama also sets aside some of its revenues for specific purposes, such as the Alabama Forever Wild Land Trust. Whether the funds are sent to school districts, subfunds like the Forever Wild Land Trust, or to the general budget, the state intercedes as a mechanism for determining the appropriate allocation of resources to citizens and future citizens. With targeted investments in New Mexico, secondary mechanisms—the film council and the NMSBIC, for example—also play a role in determining the allocation of resources. On the other hand, Alaska uses a direct mechanism—the annual dividend payment—to transfer wealth to future (and present) generations. As will be discussed in more detail below, Alaska’s dividend was designed in large part to get money out of the hands of politicians and to make politicians more accountable to citizens.

The distribution imperative and the governance structure of a fund are inextricably bound. From the perspective of the APF’s mandate, the issue becomes quite clear: make sufficient returns to pay out a substantial dividend. This creates a simpler governance structure: the fund is designed to achieve this goal, and is required to focus on the bottom line. If we look at the fiduciary framework that promotes this goal, it should likewise be narrowly focused. As the legislative mandate narrows, so too should the range of permissible activity and the scope of acceptable (non-liable) conduct. A broader
focus will be difficult to reconcile with accountability, because non-economic results will not be easily quantifiable. The scrutiny on Alaska’s fund has reflected this connection between accountability and payout. As noted above, the actions of Alaska’s fund managers are on occasion heavily scrutinized, making it difficult for them to act in the markets without signaling to the markets exactly what they plan to do.

New Mexico, on the other hand, has taken a different view of how the fund should pay out its earnings. Instead of paying out annual dividends, New Mexico’s fund pays into the general fund. Also, instead of investing simply to maximize the returns to the fund, New Mexico makes numerous differential-rate investments designed to provide funding to various programs or industries the New Mexico legislature has determined need the benefit of governmental funding. This creates a different sort of governance problem, as the sphere of accountability must expand to match the increased sphere of permissible use of the funds, in some cases for programs that may not repay the fund or the state for years, if ever. If non-economic goals (or economic goals that are not readily quantifiable) are an integral part of a fund’s mission, traditional fiduciary concepts such as the “prudent man rule” are perhaps not appropriate measures of the duty of the manager for such funds. When NMSBIC chairman Paul Goblet stated that “We’re not governed by the ‘prudent man rule,’” he was exposing the tension between accountability and non-economic goals. This is not to say that funds should never have non-economic goals, but to acknowledge that when funds do have non-economic goals, they introduce a new set of agency costs to the parent fund or state. The state already has agency costs at the fund manager level, and funds often have common agency costs as multiple principals push the fund to do one thing or another.\(^\text{150}\) A firm set of investment policies helps

eliminate common agency costs, but as non-economic factors come into play, investment policies become more difficult to create and to enforce. For example, a policy to invest in only public companies expresses a decision to narrow the range of permissible actions and to avoid certain types of risks.

On the other hand, a subfund with a mandate to invest in emerging companies not only accepts those risks, but also may be doing so for broader social goals: to increase the prominence of a certain industry in the state, to produce jobs in a certain part of the state, or (in the case of film investments) perhaps to increase tourism in the state. While such purposes may be legitimate political goals worthy of the investment of public funds, empowering agents to enact such goals creates a set of costs that are difficult to manage. The desire to keep such costs under control is precisely the reason why New Mexico is now making a push to contain both their film project investments and their investments through the NMSBIC. With complexity of the mandate comes complexity of the investment management structure and a corresponding increased need to create appropriate governance mechanisms to manage the agency costs created by the investment management structure.

The objective to provide for intergenerational equity—which, as stated above, is a primary reason for the creation of many state natural resource funds—is complicated by the lack of a defined end-goal for the fund: state natural resource funds operate like university endowments in that they are designed to exist in perpetuity, and do not have a set date at which the corpus of the fund is to be distributed. This means, in practical terms, that the goal of most state funds is to transfer wealth to future generations through the income generated by the fund that is then paid to the general budget of the state. In the case of Alaska, the transfer occurs more directly, through payments to multiple principals,” and “the executive, . . . Congress, courts, media and organized lobbies, all have a say.” *Id.*
citizens. There are several reasons why Alaska’s transfer mechanism arguably produces a more efficient result for citizens and future citizens. Primarily, a state natural resource fund’s distributions to the general budget can be thought of as an increasing tax upon the citizens, yet it is a tax increase that occurs incrementally and perhaps without representation. An incremental tax, largely increasing without notice, will likely not face challenge from the citizenry. It is probably also safe to assume the increases in distributions from a state natural resource fund are not typically met with corresponding decreases in the tax burden for citizens (although Alaska and Wyoming, notably, do not impose a state income tax). What mechanisms are in place to ensure that the funds are spent in a way that will maximize the benefits to present and future generations? It is likely that the increase is spent on bureaucratic increase, but since direct taxes, such as a state income tax, are not increased, the citizenry does not feel the pain of the increase and so is not motivated to hold the legislature accountable.

SWF and natural resource fund sponsor states can also promote accountability of elected officials by requiring that some of the fund revenues are paid out through direct cash transfers. As Moss explains,

Cash transfers from natural resource revenues would give citizens strong incentives to carefully monitor the incoming revenue, management of the resources, and how it is distributed. Because citizens would now have a direct personal stake in the resource, cash transfers would likely create an intense constituency for responsible management and demands for accountability. It is one thing to stand by quietly as oil reserves are mismanaged when the oil rents are kept in an offshore bank account or are distributed as patronage to a select few. It is quite another thing when the mismanagement of those oil fields threatens a direct source of income. This was the primary purpose of the
Alaska plan: to limit government waste by creating greater incentives for citizens to hold their governments accountable.\textsuperscript{151}

From the perspective of the natural resource fund as accountability mechanism, the benefit of paying a dividend as opposed to merely sequestering the funds for future generations is that the government is not able to hoard funds which, as discussed above, may prevent an expansion of government that may provide relatively weaker benefits for future generations, compared to a cash distribution. The question for the citizens of a state with a natural resource fund is whether they believe that placing the interest earned by the natural resource fund into the states’ general fund is a better use of the funds than the distribution of some or all of that interest to the citizens in the form of an annual dividend like Alaska’s.\textsuperscript{152}

Aside from the accountability effect an natural resource fund—and particularly one paying dividends to its citizens—may have on state government, Moss also argues that cash payments like Alaska’s have two important equitable effects. First, cash transfers are more equitable and “pro-poor” compared to fund distributions solely to the state’s general budget in that a “uniform and universal cash payment would instead allocate equally to every citizen (ideally, including children),”\textsuperscript{153} and would avoid regional spending disparities. Second, cash transfers “would have immediate and significant economic


\textsuperscript{152} Note that the question is not whether the state can adequately manage the funds as an investment manager—in the case of Alaska or New Mexico, the state is clearly assumed to be capable of investing the funds appropriately. Rather, the issue is what the states should do with the interest generated by the SWF.

\textsuperscript{153} Moss, \textit{supra} note 151, at 8.
benefits for poor households—and ultimately for development. . . . Indeed, it is hard to imagine any public services that would deliver an immediate income benefit of, say 10%, to the poor other than cash transfers.”

It is important to note that moving to a cash transfer system does not obviate the intergenerational equity function of a state natural resource fund. It simply implies that the governance of state natural resource funds may be improved by allocating some funds to present individual uses, which can have the salutary effects of enhancing accountability of state management of the funds, and reducing or eliminating natural expansion of state budgets in response to an increasing fund distribution.

A distribution structure designed to create accountability typically affects the asset allocation of the fund. Funds must be structured so that they can meet liabilities as they arise. If a state legislature or a state’s citizenry demands an annual revenue stream, the fund must hold sufficiently liquid assets to pay out of the fund as required. SWFs and natural resource funds are generally thought to be patient, long-term investors able to take advantage of certain asset classes (such as private equity, infrastructure and real estate) that are unattractive to many other investors. However, to the extent that state natural resource funds are expected to pay out annual distributions, the state funds will invest more like pension funds with set distribution imperatives rather than as other funds which have no set liabilities and, consequently, a truly long-term investment focus.

Lessons from some SWFs’ response to the Financial Crisis are instructive, as Balin highlights the connection between accountability and asset allocation:

154 Id.

In response to this new need to realize positive returns over a shorter time horizon and keep funds on-hand for sovereign stabilisation, fund managers have increased their cash positions and shifted some assets into securities that offer payouts over a shorter period. Increased scrutiny of SWF returns by democratic and authoritarian states alike has also put pressure on managers to focus on shorter time horizons. Although the demand for stable positive returns may spur some SWFs to invest in safer assets such as investment grade bonds, a demand for high short-term returns could also spur SWF managers to take on more risk. As annual SWF returns are now more closely scrutinized by sovereign governments, SWF executives could feel pressured to focus on more risky, speculative assets that could generate high initial returns but could later destroy value in an SWF's portfolio.\footnote{Balin, supra note 43, at 5.}

For Alaska, then, the increased accountability created by its payout structure may have some negative effect on the total returns generated by the fund if fund managers and supervising politicians respond to pressures to produce short term gains (and it is not clear that they are). If so, it is also unclear whether the agency costs that the distribution mechanism is designed to reduce are less than the returns that would flow from a longer-term approach. Just as Alaska may struggle with this issue, states that receive income from their natural resource funds may also be subject to the same temptations in that legislators may want to increase returns in the short term so that they maximize the funds available to them in their terms of office. As discussed earlier, however, these temptations may be mitigated with investment restrictions. The restrictions attempt (though not always successfully) to balance the agency problems presented by natural resource funds with the need for a responsive and flexible money
management policy. The consequences of this balancing of accountability and asset selection by natural resource funds are a worthwhile subject for future empirical investigation.

CONCLUSION

In analyzing the primary purposes for creating and maintaining state natural resource funds, it is clear that the governance structures and distribution imperatives for the funds not only often fail to achieve these purposes, but often are serious impediments to the funds’ success. First, state natural resource funds are not typically used to smooth revenue fluctuations in the short term, although the funds are designed to help protect revenues in the long term (for example, when the state no longer has significant severance tax revenues because of mineral depletion). This is by design: states have typically put in place constitutional and statutory safeguards that provide the legislature with access only to the income, but not the corpus, of the funds. These safeguards help reduce rent-seeking and agency costs. On the other hand, the restrictions also inhibit the ability of the state to deal with significant economic crises, such as the Financial Crisis that began in 2007–08.

Second, the typical mechanisms for providing for intergenerational equity, the primary justification for many state natural resource funds, appear to be relatively inefficient methods of transferring wealth to future generations. The largest and most important state natural resource funds, severance tax funds, usually pay income into the general fund. As noted above, a state natural resource fund’s distributions to the general budget operate as an increasing tax upon the citizens if we assume that the funds are held in trust for the citizens of the state and not merely in trust for the government administration itself. As the size of the natural resource fund increases, appropriate mechanisms do not appear to be in place to ensure that the funds generated by the natural resource fund are spent wisely. One such mechanism would be to ensure by statute or through the constitution that increases in funds distributed to the
general budget by the natural resource fund result in proportionate decreases in the citizens’ tax burdens. Alternatively, states could put limits on how the funds are used, so that natural resource fund distributions are directed to spending initiatives that are tied to direct benefits for citizens, and that this spending would not result in reductions in other spending priorities or tax increases to present such spending reductions. Essentially, appropriate rules should ensure that increases in natural resource fund distributions do not merely result in increased government waste. Alaska has dealt with this problem in part by distributing much of the cash generated by its natural resource fund directly to its citizens. Alaska does not distribute the corpus of the fund to its citizens, however, thus protecting the fund for future generations of Alaskans.

Third, while some nations use SWFs as a bulwark against the forces of globalization, state natural resource funds typically do not use their natural resource funds to enhance their autonomy. In fact, as discussed above, many states with large natural resource funds are also among the highest recipients of federal aid. This curious fact should again highlight issues of equity that were first raised several decades ago as mineral-rich states began charging severance taxes. While it is clear that the revenue-generating activities that provide income for state natural resource funds create numerous negative externalities for the states, these externalities are increasingly paid for through federal programs, rather than through state funds. For example, in 1970, around the time when many severance tax funds were being formed, federal funding of health-related programs (which should compensate for significant negative externalities associated with mining operations) amounted to around $20 billion (inflation adjusted). By 2007, federal funding of health programs exceeded $200 billion.157 Because the federal government is increasingly important—

157 Chris Edwards, Federal Aid to the States Historical Cause of Government Growth and Bureaucracy, POLICY ANALYSIS No. 593 (CATO Inst.,
from a budgetary perspective—to state citizens since the formation of most state natural resource funds, states with natural resource funds may be unfairly compensated for the externalities that severance taxes (and severance tax funds) were designed to address. In effect, states without such natural resource funds may be subsidizing states with such funds.

Finally, despite some of the concerns with state natural resource funds discussed above, natural resource funds may, if properly designed, leverage political accountability through market accountability. This is especially likely to be the case in Alaska, where an easily identified, market-related result—the annual dividend payment—encourages citizen attention to the government’s management of state resources. On the other hand, a poorly designed and poorly governed natural resource fund is likely to increase problems with political accountability, as the natural resource fund adds another means of rent-seeking by politicians and others. Natural resource funds that follow (even in part) an economic development model are particularly likely to have higher agency costs and rent-seeking. By contrast, an investment fund model that does not include economic development initiatives should be significantly easier to manage, from agency cost perspective, than an economic development model. Funds that follow an investment mandate have, by design, a narrower mandate that is easily measured by yearly returns. As the legislative mandate narrows, so to should the range of permissible activity and the scope of acceptable (nonliable) conduct. A broader focus, such as a mandate to provide for general economic development initiatives, will be more difficult to reconcile with accountability, because non-economic results will not be easily quantifiable.