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Critical Reflections on the Future of Alaska's Permanent Fund and Dividend

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Our goal in writing this book was to discuss what the rest of the world can learn from the Alaska Model. It was not to tell Alaskans what they can learn from us. But in the course of researching this book, we have learned quite a bit about Alaska's fund and dividend, and we would like to respond to some of the issues brought up so far and make a few simple recommendations.

1. Brief remarks

We can deal with a few issues very briefly. Michael A. Lewis is right that the Permanent Fund Dividend (PFD) is far more volatile than it needs to be.[1] We believe that basing dividends on a fixed percentage of the market value of the Alaska Permanent Fund (APF)[2] is a simpler solution than Lewis's positive square root method.

In our contribution to Part Two of this book we will agree with Stephen Winter insofar as Alaska's basing so much of its economy on oil exports gives Alaska a special responsibility to contribute to the abatement of global warming.[3] In the sequel to this book we agree with Alanna Hartzock that the APF—and any Sovereign Wealth Fund—has a greater responsibility to invest ethically than the APF has held to so far.[4] That responsibility should impose a constraint on the prudent investor rule, but an investment strategy that is ethical first and prudent second can still support a growing fund and dividend.

We share Erickson and Groh's concern for the APF money that has been diverted from the dividend. It is distressing to learn that, although the PFD has been dubbed the third rail of Alaska politics, politicians have succeeded in diverting 25 percent of it to other uses.[5] Alaska voters need to remain diligent to protect their dividends.

2. Detailed comments

Two other issues need to be addressed in greater detail. We would like to give an optimistic reply to the concern that the PFD causes "demographic distortion." We would also like to discuss how the APF and PFD might be affected by declining oil production in Alaska, and suggest how the Alaska state government should prepare for the time when oil production runs out.

A. Demographic distortion

Chapters by Scott Goldsmith and by Gregg Erickson and Cliff Groh discuss the potential for the PFD to affect the state's population. Erickson and Groh identify three ways in which the PFD might cause this kind of demographic distortion: increased economic activity, increased fertility, and direct migration to receive the dividend.

The most substantial of these is the effect caused by increased economic activity, but we believe this is overestimated, because the calculations show the dividend's effect on economic activity compared to what would have happened if that money had gone *unspent*. But surely if the state government had not introduced the dividend it would have spent that money on something else, and that other spending would have cause the same effect on economic activity. Unless the alternative to the dividend was to let out-of-state oil companies take a larger share of oil revenue elsewhere (an unlikely policy for the state government to adopt), the money would get into the economy one way or another, and it would boost activity. Thus, this source of demographic distortion should not be attributed to the dividend at all. It is attributable to the state's oil wealth rather than to this use of the state's oil wealth.

The dividend makes it more affordable for Alaskans to have children, but we are not sure this is such a bad thing; and the incentive this creates to have more children could be offset by countervailing tendencies for more affluent people to have fewer children. Direct migration to receive the dividend is the more problematic case.

Two aspects particular to Alaska have contradictory effects on demographic distortion. First, Alaska is the most isolated of the U.S. states. This distance gives Alaska a natural barrier that other states do not have. Second, Alaska is not a nation, and it does not control its immigration. U.S. citizens can move to Alaska at any time, and they must be treated as full citizens as soon as they establish residency. The demographic distortion issue would be much less important if the Alaska model were applied on a national basis. A nation can control its immigration and can decide when immigrants become eligible for the full rights of citizenship.

Given the size of the dividend, we expect that the isolation of Alaska will have the greater effect. Currently the dividend barely covers someone's airfare from other states. They have to be in the state for a full calendar year before they can apply for their first dividend, and then they must remain in the state until the following October before they can receive it. It is hard to believe that the potential of a $1500 dividend would make a large impact on that decision. The evidence shows little demographic distortion from migration, and we would not expect a significant effect any time soon as long as the size of the dividend remains moderate.

But the demographic distortion issue would become important if the dividend were significantly larger. Many of the arguments in Part Two of his book pointed to the need for larger dividends to reduce poverty more significantly and increase financial security and freedom of recipients. If Alaskans decide to move substantially in this direction, the demographic distortion issue will return to importance.

The ideal solution to demographic distortion would be a worldwide dividend. For now we're stuck with the nation-state system and considerable squabbling over resource ownership among the nations. For the idea to catch on in all the nations, one state or nation is going to have to show the others how well a resource dividend can work. If other areas imitate a successful dividend, they will reduce or counteract the demographic pull of the dividend. Alaska will have to consider the demographic distortion problem if it ever decides to significantly increase the size of the dividend, but it would be best to wait for strong evidence of unacceptably high migration-based demographic distortion before accepting it as a reason not to increase the dividend.

B. Alaska after the oil boom

The biggest challenge to the APF and PFD is not an internal problem with either the fund or the dividend; it is a problem with the state's fiscal position. James B. Bryan and Sarah Lamarche Castillo and Gregg Erickson and Cliff Groh point out that Alaska is poorly prepared for the day when its oil runs out. In 1980, when the oil money was new and expected to be flowing strong for decades, the state government voted to eliminate the state income tax. Looking at short-term effects only, this seemed like a great idea. The state simply didn't need the tax; it was making far more money in oil revenue than it needed to run the state budget. But of course, everyone in the state knew that the oil revenue would be temporary.

Having nearly the entire state budget funded from temporary revenues will put the state in a precarious position when the oil runs out. The state will need to find new revenue sources just when the industry that dominates the state economy will be contracting. Perhaps, natural gas will create a new resource boom just as the oil money begins to run out. Perhaps some other part of the Alaskan economy will take over. But a danger is out there. Oil flow through the Alaska pipeline peaked in 1988. It has been gradually declining since, and some observers believe that we are only a few years away from the day when the amount of oil flowing through the pipeline will no longer be enough to maintain its economic viability.

We cannot be sure that Alaska has escaped the resource curse until after the state is no longer a major exporter of oil and gas.

Alaskans recognized the danger of running out oil before the revenue started flowing, and their solution was the *Permanent Fund*. Instead of spending all the oil money as it came in, the state would put some of it into a fund, and spend only the interest, so that it would benefit Alaskans permanently. Bryan and Lamarche are right to say that the Alaska Fund and Dividend provide a good model for preventing the resource curse, but we do not believe that Alaska has devoted enough of its oil revenue to the APF.

When the state eliminated its income tax, cooler heads thought it would be better to save more of the oil revenue. Governor Jay Hammond, the father of the Permanent Fund Dividend and a strong proponent of the APF, wanted to dedicate half of the state's total revenue from oil to the APF, but the final legislation gave the APF only one quarter of oil *royalties*, and royalties account for less than half of the state's total revenue from oil. According to Goldsmith (this volume), constitutionally mandated deposits into the fund have amounted to only \$11.8 billion (adjusted for inflation, as all dollar figures quoted below are) since the fund was created. That amounts to only 11.4 percent of the \$103.5 billion of revenue the state has received from oil. Over the years, the legislature has occasionally made additional deposits into the APF of \$7 billion, for a total of \$18.4 billion, or 18.2 percent of the total revenue the state has received from oil—still only a little more than one-third of what Hammond originally proposed. The APF's current market value (July 24, 2011) is a little more than \$41 billion.[6] It's simply too small to make up for the loss the state will experience when oil revenues cease, even if funds were not already designated for the dividend.

Had the state saved more of its oil revenue in the APF and continued to finance most government spending through regular taxes, the APF might now be large enough to be a real cushion against lost oil revenues. Instead, when those revenues run out there will be enormous pressure to redirect the PFD and perhaps even APF principal toward supporting the state budget. This looming pressure on the state budget is, by far, the biggest threat to the survival of Alaska Dividend.

The best response to this problem right now would be for the state to start saving more money immediately, while the oil revenue is still coming in. The transition to a state financed by taxes on something other than temporary oil exports would be much easier if the state reintroduced those taxes now so that it can save more of its oil revenue for the day when that revenue is no longer available.

Part Two

[1] Lewis, this volume.

[2] Erickson and Groh, chapter 7, this volume.

[3] Winter this volume; Widerquist and Howard, this volume, chapter 14.

[4] Widerquist and Howard, forthcoming.

[5] Erickson and Groth, this volume, chapter 7.

[6] Alaska Permanent Fund Corporation 2011.