

Blinded by Riches: The Prudhoe Bay Effect

By Terrence Cole and Pamela Cravez

The economy was booming, with military construction money pouring in. But Alaska didn't have money to pay its bills. With \$6,000 in the general fund and overdue bills of \$758,000, the territorial legislature faced bankruptcy. It was 1948.

The new State of Alaska was having trouble paying for roads, schools, and other services—and a special state commission predicted that Alaska would soon exhaust its savings accounts. It was 1960.

Today, Alaska's government in many ways faces the same problem it did in 1948 and 1960 and indeed has for the past 150 years: finding a stable way to pay for services, with an economy that relies so much on unpredictable, one-time resource revenues.

A new paper by Terrence Cole, a professor of history at the University of Alaska Fairbanks, describes that historical pattern and offers insights for Alaska's current budget woes. Here we summarize some of that paper (cited in full on the back page).

Alaska has repeatedly been saved by surprise developments or events. Prudhoe Bay oil was by far the largest such development—worth *seven* times more than *all* previous Alaska resource value combined. But the enormous value of Prudhoe Bay oil—the

“Prudhoe Bay effect”—has blinded Alaskans to the perennial dilemma created by relying on temporary resource revenues. Now, with oil revenues declining, Alaska once again has a budget crisis. But today there's a crucial difference that can be summed up in two words: Permanent Fund. Figure 1 shows why Prudhoe Bay oil gave Alaska an opportunity unlike any previous development.

From 1867 to 1958, about \$40 billion (in today's dollars) worth of fur, gold, copper, and salmon came out of Alaska in waves. The salmon industry has been Alaska's most enduring resource industry, despite its many ups and downs.

But everything that came before pales in comparison with the value of oil. From 1959 through 2002, Alaska produced resources valued at nearly \$350 billion. More than 80 percent was from Prudhoe Bay oil. Oil has been worth far more than any previous resource not only because there was so much of it, but also because oil is such a valuable commodity. Good luck, high prices, and foresight allowed Alaska to see huge benefits from oil production.

Before statehood, the territorial government taxed resource industries at very low rates—about 1 percent

*The road is long, supplies are costly,
seasons are short, Fortune is fickle.*
Alaska Mining Record, Juneau, 1895

of the value of minerals and 2 percent of the value of salmon. And when mines played out or salmon runs crashed, Alaska was left with empty pockets.

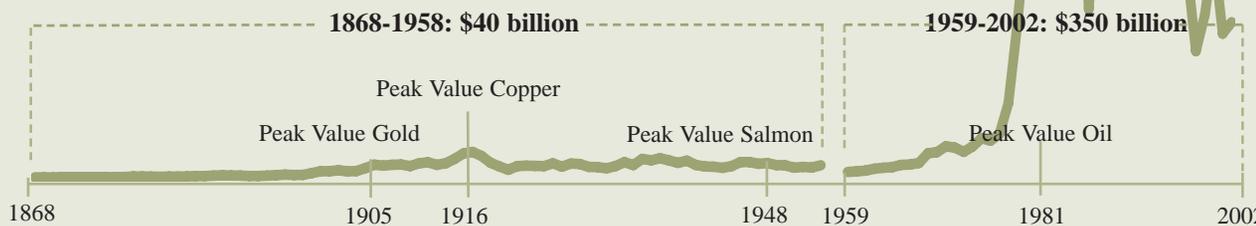
By contrast, the state government's taxes and royalties have been about 26 percent of the value of oil production (as measured at Valdez, the pipeline terminal). And even before Prudhoe Bay oil started flowing, Alaska voters approved creation of the Permanent Fund, to save some of the state's oil wealth. With that vote, Alaskans transformed a temporary resource—a huge but temporary resource—into a permanent asset.

The Permanent Fund is worth more than \$27 billion today. With prudent management, it can produce an annual income of \$1.4 billion—forever, even without new deposits. That's in addition to the earnings needed to protect the fund principal from inflation.

So Alaska has, at last, a stable income from resource development. Alaskans right now are debating how to use that income in the future—and looking at history can help shed light on that question.

Figure 1. Value of Alaska Resource Production, 1868-2002

(In 2002 Dollars)



From Resource to Permanent Asset



BACKGROUND

The headline at the bottom of the page, reproduced from an Anchorage newspaper in 1960, could have been taken from today's headlines. Relying on resource revenues has caused periodic Alaska financial crises.

This summary talks about the role of resources in Alaska's history. But that history is also interwoven with the history of the federal government here, as we describe below.

FEDERAL GOVERNMENT IN ALASKA

For decades after the U.S. bought Alaska in 1867, there was no territorial government and little local government. The federal government owned virtually all the land and carried out most government functions—like managing resources and building roads. Governing Alaska turned out to be an expensive proposition. It was huge and isolated, with a harsh climate, small population, almost no infrastructure, and widely-scattered towns.

Even after a territorial legislature was established, in 1912, the federal government continued to own and manage the resources. Alaskans by and large favored resource development, but resented federal management—and that resentment fueled the drive for statehood. When Alaska won statehood in 1959, Alaskans gained much more power over resources—and were able to benefit enormously from oil development.

But statehood also brought higher costs than Alaskans had anticipated, because during territorial days the federal government had paid most of the costs of services. The high costs of providing services in Alaska have historically magnified the problems created by an unstable tax base.

RESOURCE PRODUCTION IS UNSTABLE

The struggle to strike it rich, no matter what the cost, is the center of Alaskan economic history, and risk takers with an incurable strain of optimism have always been the dominant players.

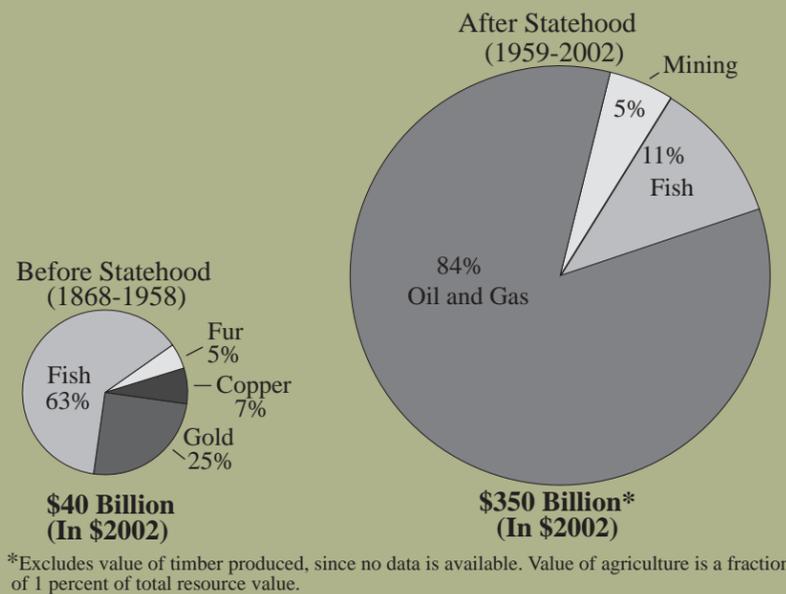
Tremendous wealth has come out of Alaska in successive tidal waves of fur, gold, copper, fish, and oil. Figure 2 shows the value of resource production and the contributions of each before and since statehood.

Relying on these shifting natural resources as a tax base has proven structurally unstable in the short run and unsustainable in the long run. At best, it requires modifying the tax regime whenever the resource tax base shifts and fosters arguments over who should pay and how much.

Modifying the tax regime has proven very difficult over the years. There has been a recurring battle over who should pay for government services—the residents who benefit directly; the non-resident corporations that extract the resources; or the transient workers who come to Alaska for temporary jobs. The corporations argue that they shouldn't bear too much of the tax burden, since they assume the risks and costs of development. Residents argue that the developers who profit from Alaska's resources ought to pay a significant share of the local taxes.

The influence of the corporate interests, both on the territorial legislature and on Congress, kept tax rates on resource production in territorial Alaska extraordinarily low, averaging somewhere around 2 percent of the gross value of production. Statehood and the tremendous profitability of oil have, by contrast, given Alaska a much bigger share of the value of oil—about 26 percent of the gross value of North Slope oil (as measured at the pipeline terminal).

Figure 2. Contribution of Individual Resources to Total Alaska Resource Production Value



KENNECOTT SYNDROME

Governor Gruening chastised the territory for not taking steps to deposit a fraction of the value of the Kennecott mine in a savings account, or "Alaska fund"—an idea remarkably similar to what would become the Alaska Permanent Fund 35 years later.

In 1941, Governor Ernest Gruening pleaded with the territorial legislature to enact a modern system of taxes, to retain a greater share of Alaska's wealth for Alaska's residents, because "far too much survives in Alaska of the earlier practice of take-it-all-out, take-down-below, leave-as-little-as possible, spend-nothing-in-Alaska."

For many Alaskans, the Kennecott copper mine typified this "take the money and run" mentality—which here we call the "Kennecott Syndrome." In its nearly 30-year lifetime, Kennecott paid minimal taxes and produced upwards of \$200 million in copper (worth \$3 billion today) before it ceased operations in 1938.

The mining company then abandoned the Copper River and Northwestern Railway and left the town of Cordova without its principal economic base.

ON THE BRINK OF BANKRUPTCY

The failure of the 1947 legislature to tackle the fiscal crisis was probably the single greatest political failure in the history of the Territory of Alaska.

In the late 1940s, with the decline of its two primary revenue sources—fishing and mining—the territorial government was left without a tax base to support roads, schools, and other services. (Ironically, the value of salmon was high at the end of the 1940s, because a long-term decline in salmon runs had pushed prices up. But the territorial tax was on the volume of production—so revenues declined even when the value of production grew.)

At the same time, unprecedented growth in federal spending for military bases and Cold War installations in Alaska created an economic boom accompanied by an even greater demand for local government services—but without an increase in the tax base.

The 1947 legislature failed to enact any new revenue measures, despite the very real threat of insolvency. In fact, for a short period after 1947, alcohol taxes became Alaska's chief source of revenues. By the end of 1948, the territory was fiscally bankrupt.

Enraged by the legislature's failure to do anything about the territory's financial crisis, Alaskans elected a group of new legislators, who in 1949 passed an income tax. That tax had the dual purpose of solving the fiscal crisis and also proving to the federal government that Alaskans were willing to finance their own government.

The income tax brought solvency to the territory and a surplus within three years. It would prove to be Alaska's most stable source of income for the next 30 years—until it was repealed in the wake of enormous Prudhoe Bay oil revenues.

Buoyed by the measure of stability and independence the income tax provided, Alaskans in the 1950s lobbied for statehood. Many believed that statehood would make them stronger in dealings with both the federal government and outside corporate interests.

They also hoped that with more control over resources, they could develop Alaska and create a sustainable tax base.

The 1958 Alaska Statehood Act included provisions to ensure there would be no repeat of the Kennecott Syndrome. One key provision prohibited the sale of mineral rights on state land, thereby providing Alaskans with a permanent equity interest in all mineral development. And when Alaskans drew up a state constitution, it included the requirement that natural resources be developed as a public trust for the maximum benefit of Alaskans. These measures—plus nearly \$30 million in transitional funding grants and the opportunity to select about 104 million acres—were calculated to give Alaska a firm financial footing.

But these safeguards were still no match for the costs Alaskans would face governing their new state. Revenues from development didn't come overnight. By 1960, one year after statehood, Alaska's governor told the heads of state departments to be ready for sharp cuts in their budgets. The new state legislature raised taxes and Alaskans just squeaked by.

SAVED BY OIL

Prudhoe Bay oil was worth more than everything that has been dug out, cut down, caught, or killed in Alaska since the beginning of time.

The discovery of the Prudhoe Bay oil field in the late 1960s fulfilled even the most optimistic dreams for statehood. It was the largest field ever discovered in North America, and its fantastic size camouflaged the underlying weaknesses of the Alaskan economy—which remained at the mercy of fluctuating resource prices and diminishing production. The ensuing 30 years of oil wealth made Alaskans forget the hard truth: Alaska's political, economic, and social geography make it the most expensive state to govern.

But Alaskans didn't completely forget past experience. To prevent a repeat of the Kennecott Syndrome, Alaskans created the Permanent Fund, transforming a temporary resource into a lasting, revenue-producing asset.

Yet despite a quarter century of warnings about the unsustainability of oil revenues, and a dozen years of steadily declining oil production, Alaskans are still reluctant to recognize that we can't build a sustainable future on a non-sustainable tax base. We can see the same pattern emerging as in the 1940s.

Anchorage Daily Times

ANCHORAGE, ALASKA, FRIDAY, JANUARY 29, 1960

FINANCIAL 'CRISIS' IS PREDICTED

And on top of its recurring financial problems, Alaska today faces much different circumstances as it deals with those problems. Alaskans—along with all other Americans—expect far more from government now than they did in earlier times. The decades after World War II saw the U.S. become a much richer nation, and expectations of Americans rose along with the nation’s fortunes.

Also, Alaska now has three times more people than it had in 1960—so it costs more to provide even basic services, when there are so many more people who need those services.

The “Prudhoe Bay effect” that blinded Alaskans to the inevitable decline of oil revenues has helped to polarize and warp virtually all discussions of current Alaska economics and politics—and is perhaps one reason why, despite almost twenty years of turmoil, no consensus has yet emerged on the future uses of the Permanent Fund.

Right now Alaskans are debating how best to use the earnings from the \$27 billion Permanent Fund. Whatever decision they make, those earnings are the enduring legacy of natural resource development—and they will in some way be part of the solution to closing the fiscal gap.

CONCLUSION

So what does the economic history of Alaska teach us that’s useful for today? Four important elements of the economy and government remain much as they always have been:

- Resource production is always an unpredictable tax base.
- Rapid changes in world markets and depletion of resources can change Alaska’s fortunes almost overnight.
- Arguments about who should pay for Alaska government—and what is a “fair share”—persist.
- Federal spending remains an important part of Alaska’s economy.

The big new element today is:

- The Alaska Permanent Fund. Thanks to foresight of Alaska’s political leaders and voters at the beginning of the oil era, Alaska has—for the first time—transformed one-time resource revenues into a permanent asset. If managed prudently, the fund can produce a steady stream of income into perpetuity.

We financed our government on the basis of how the red salmon ran and how much liquor people drank.

Mildred Hermann, Alaska Statehood Committee
(Describing how the Territory of Alaska financed itself)

Terrence Cole’s full 123-page paper, *Blinded by Riches: The Permanent Funding Problem and The Prudhoe Bay Effect*, is available at:

www.alaskaneeconomy.uaa.alaska.edu

under Non-Renewable Resources Economy.

Copies are also available from ISER for costs of copying. Call 907-786-7710.

The author thanks Lee Huskey, professor of economics at UAA, for contributions to and comments on the paper.

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Editor: Linda Leask

Graphic Designer: Clemencia Merrill



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