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Testimony on SJR 38 "The Cremo Plan"

before the
Alaska Senate State Affairs Committee

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The Cremo proposal would establish, by constitutional amendment, a system under which all natural resource revenues would be deposited into the Alaska Permanent Fund and each year a fixed percentage of the fund assets, equal to the long run average real return on the Fund, would be withdrawn for appropriation by the legislature. During an initial 10 year transition period the fixed percentage withdrawal rate would decline geometrically from 20 to 6 percent.

The purpose of the plan is to eliminate the booms and busts associated with state spending driven by periodic fluctuations in natural resource revenues. It accomplishes this through the prohibition of direct appropriation of natural resource revenues.

An additional feature of the plan is that it forces a transition from the present unsustainable high level of state spending and reliance on petroleum revenues to a level which can be maintained using a combination of the annual fund withdrawal and conventional revenues. Each year during the transition phase less revenue is withdrawn from the fund and made available for appropriation. The legislature and administration are forced to fund the operating and capital budgets as well as the Permanent Fund Dividend through a combination of this declining withdrawal and non-resource revenues (the income budget).

Based upon the analysis provided by Mr. Cremo, the amount available for appropriation (income budget) would be $3.079 billion in 1996, the first year of the transition phase, and $2.860 in 2005, the last year of the transition phase, (Fall 1993 revenue projections, 12% annual growth rate for non-resource revenues (conventional revenues), 10% rate of return on the fund, and 4% rate of inflation). At a 4% inflation rate the $2.860 income budget would have the equivalent purchasing power of $2.00 billion in 1996. In other words, the transition to the level which could be maintained requires a 1/3 reduction in spending. The veracity of this estimate of course depends upon the accuracy of all the assumptions.

This plan is the only systematic proposal to deal with the many problems associated with state financial dependence on both fluctuating and declining natural resource revenues. As such it should get serious consideration. An obvious study which should precede endorsement of this plan is a sensitivity analysis of the projected income budget with different assumptions regarding revenues, rate of return, etc. This would give some idea of whether the plan produces comparable results if the future turns out to be different than currently envisioned. Time has not permitted me to conduct such a study.

In evaluating this plan the potential risks and costs should be identified and the plan should be compared to alternative methods of addressing the problems targeted in the plan. In my testimony I want to discuss the potential problems I see with the plan and suggest some alternative policies for addressing specific problems associated with our dependence on oil revenues.

1. There is No Magic and Painless Solution to the Fiscal Gap Problem.

The critical problem facing the state is how to deal with the decline in petroleum revenues from depletion of the Prudhoe Bay field at the same time that demands for government services continue to expand with population growth. Solution to this problem will require a transition over a number of years involving a reduction in government spending, the imposition of taxes, and restructuring the use of the Permanent Fund including the dividends.

The Cremo plan is one way to implement what we have characterized in the ISER Fiscal Policy Papers as the "Soft Landing". Three points are important in thinking about the plan as a means of accomplishing the "Soft Landing".

a. No increase in revenues results from plan implementation.

There may be the appearance of more resources under the Cremo proposal for three reasons. First, it assumes an average annual 6% real rate of return on Fund assets is possible compared to more conservative estimates of annual average long term rate of return made by the Permanent Fund Corporation, ISER, and others. However, since the real rate of return depends on the investment portfolio of the fund and not on whether all or a portion of petroleum revenues are deposited in the Fund, it is inappropriate to compare the Cremo proposal and its high real rate of return with other proposals using lower rates of return. All should be compared using the same rate of return.

Second, the Cremo analysis is presented in **Nominal** dollars whereas most other analyses are in **Real** dollars. Since its analysis assumes a 10% nominal return on investment with a real return on investment of 6%, the inflation rate in the analysis is 4% annually. Consequently its projections of available revenues in future years will appear to be higher than other projections simply because inflation is driving up all its variables at the rate of 4% each year. Furthermore its projections of available revenues in any particular year cannot be compared to any subsequent year because inflation reduces the purchasing power of those later dollars by 4% each year.

Third, the flow of revenues for appropriation each year under the Cremo proposal (income budget) **includes** the revenues used to fund the Permanent Fund dividend. It is inappropriate to compare this flow with the revenues under alternate proposals which assume funding of the dividend by some alternate means.

b. With the plan in force budget cuts, restructuring of the dividend, and the imposition of new taxes are all necessary. For example using the assumptions in the current version of the plan, in 2000 there will be enough revenues to fund $2.4 billion of spending at the current price level (a drop of $700 million from 1996). With the $100 million in new taxes assumed, we would still be forced to choose between keeping the operating budget and eliminating both the capital budget and the dividend, retaining the dividend while eliminating the capital budget and cutting 20% out of the operating budget, or some compromise plan.

c. The plan does not speak to the questions of how or what taxes will be imposed, how the budget will be reduced, or how the dividend may be restructured.

I am not suggesting that the plan needs to answer all those questions, but I am concerned that the public may be getting the wrong message about what the plan will do and that this misconception may inflate expectations above what the legislature and administration can deliver. Specifically if people approve a plan they think will painlessly eliminate the state budget gap without the need to reduce services, impose taxes and restructure the dividend only to discover otherwise, they may be understandably upset.

2. This Proposal Represents a Risk to the Permanent Fund, our Biggest Asset.

The advantages of the Cremo plan have been clearly identified in the proposal. Among the more important I would highlight the fiscal discipline that results from its implementation, and the forced instant awareness that solving the problem of the budget gap will require a tradeoff among the budget, the Permanent Fund dividend, and taxes. (A cynic would add the fact that its passage would allow the postponement of hard choices among these alternatives until after the next election.)

The potential risks should also be clearly identified. This plan puts the Permanent Fund at risk in exchange for solving two pressing problems--the need to inject fiscal discipline into the budget making process and the need to convince the electorate that the legislature and administration are serious about fiscal responsibility. Other ways exist to accomplish both of these objectives. Caution should be the watchword when considering changes that put the Permanent Fund at risk.

The Permanent Fund works. In its 16 years it has not only survived but grown and prospered during both boom and bust times so that today its $14 billion represents our largest and most important financial asset as we move toward the Post-Prudhoe economy. One reason for its success has been the fact that it stands outside the annual budget appropriation cycle. There is no thought that the assets of the Permanent Fund could be available for appropriation when the budget is being built.

Its structure is not perfect. For example it could be producing a higher rate of return, and there is no constitutional guarantee against erosion of the corpus from the effects of inflation. These problems could be addressed without exposure of the corpus to the annual budgetary cycle.

The Cremo plan is a radical departure from the past. It brings the Permanent Fund to the center stage during the annual appropriation cycle, and during the "transition period" establishes a precedent for spending of the corpus. Budgetary attention will immediately focus on the Fund corpus. In politics as in economics INCENTIVES MATTER and a $14 billion asset in the middle of the budget process is a big temptation for anyone.

To get a sense of the potential risk to the Fund it is useful to run out some scenarios that include political motivations. For example, suppose oil prices linger below the Department of Revenue Fall 1993 projection through 1996 and the first year draw on the Fund at the 20% rate were to come up short of projections by a couple hundred million dollars. The capital budget would be the likely first casualty of the resulting budget squeeze, but the construction lobby would not give up without a fight. A logical line of attack would be for them to remind everyone that a 20% draw on the fund was a mandate to dip into its principal. A painless way to do that would be to fund the capital budget with a loan from the Permanent Fund that would be repaid when the oil price bounced back. Although this may sound far-fetched who would have believed the scenario just played out surrounding the Constitutional Budget Reserve.

3. This Proposal has Neither a Safety Valve nor Wiggle Room.

An impressive argument for this plan is that if we had instituted it in 1969 the Permanent Fund balance would be $70 billion now and we could draw $3.8 billion this year. I find it difficult to believe that such a Fund could have survived at all through the 70s and 80s. Consider 1982 when petroleum revenues were $4 billion and projections were for revenues to grow to between $8 and $10 billion by 1992. Under this plan the withdrawal in 1982 would have been a mere $400 million. It is inconceivable that the political pressure to spend could have been kept in check under those conditions.

In fact one of the things that kept the Permanent Fund healthy and insulated from attack during those boom years was the safety valve we had in the form of the oil money that stayed OUT of the Fund. This money was available to pay for the capital, operating, loan, and other programs that seemed so essential at the time and that some now feel could have so easily been denied. In reality without that safety value the pressure on the

Fund would have been impossible to contain.

Wiggle room allows us the flexibility to deal with future issues and events that we cannot anticipate. We think we know what the future will bring, but Alaska continues to be the land of surprises.

For example, another scenario, which I personally think has a very low probability, would be that the oil price rebounds and we discover an oil field much larger than Prudhoe Bay. This field has a productive life of 100 years and can generate $3 billion each year for 100 years. (This would really move us into the Saudi Arabia class.) The sensible course of action in this case would be to allow spending of $3 billion each year and the population explosion such a discovery would create would demand it. With the Cremo plan in force we would be constrained to spending only 6 percent of the new annual revenues in the first year--$180 million, 12 percent in the second year--$360 million, and so on. Without wiggle room this constraint would be difficult to maintain.

4. No Plan Involving $14 billion is Simple.

The plan is elegant in its simplicity. Its implementation would surely be as complex as only the lawyers can conceive. The Constitutional Budget Reserve is an all too recent example of a simple idea that got complicated fast partly because the original idea was not subjected to enough review of how it would work once it emerged from the laboratory in the real world of politics.

5. The Benefits and Costs of This Proposal Should be Compared with Less Radical Alternatives.

The objectives of the Cremo plan can be achieved in other ways without endangering the Permanent Fund through exposure of the corpus during the difficult transition years. None alone is sufficient to deal with the fiscal gap and each individual policy should be evaluated as an element in an overall plan. For example capping the budget would force the tradeoff between spending cuts and taxes only if the cap was low or if the cap squeezed spending down over time. Neither would a budget cap force a decision on reformulation of the Permanent Fund dividend. A sample of alternate solutions to the main problems addressed by the Cremo plan includes the following:

1. Problem: Instability from year to year in government spending. (This is the immediate problem facing the legislature and administration.)

> Solution: CAP THE BUDGET AT $2.5 BILLION FOR 4 YEARS AND FORBID GROWTH TO ACCOMMODATE POPULATION INCREASE AND INFLATION. If instability in spending is the problem, the solution is to force stability directly. Wiggle room is retained by making the solution temporary, but renewable.

2. Problem: Price induced fluctuations in petroleum revenues from year to year.

Solution: RESTRUCTURE THE CONSTITUTIONAL BUDGET RESERVE TO FILL ALL OR A PORTION OF ANY SHORTFALL OF CURRENT REVENUES BELOW THE BUDGET CAP.

3. Problem: Petroleum revenues declining with production.

Solution: CAP THE BUDGET AT $2.5 BILLION FOR 4 YEARS AND FORBID GROWTH TO ACCOMMODATE POPULATION INCREASE AND INFLATION. Government spending is unsustainable with the gap between spending and recurring revenues growing as oil production declines. Capping appropriations for 4 years uses inflation to cut the budget and yet retains longer term flexibility to deal with the uncertain conditions at the turn of the century.

4. Problem: Minimize long term economic booms and busts associated with the cycles of resource extraction and depletion.

Solution: DOUBLE THE PERMANENT FUND CONTRIBUTION RATE FOR ROYALTIES ON NEWLY DISCOVERED NATURAL RESOURCE PRODUCTION TO 100%. Although the Cremo plan was originally proposed as a solution to this problem, it works only if put in place before the problem arises, not when the bust hits. The likelihood of a Prudhoe Bay sized boom again occurring in Alaska is slight although not impossible. The problem of boom and bust which a new Prudhoe discovery would create could be eliminated if the Permanent Fund contribution rate for royalties (and perhaps taxes) from yet to be discovered natural resources were set at 100% compared to the 50% rate currently in place for new discoveries (and the 25% rate for Prudhoe Bay).

5. Problem: Maximize the return on the Permanent Fund.

Solution: BASE THE DIVIDEND ON THE LONG TERM AVERAGE TOTAL RETURN OF THE FUND INCLUDING UNREALIZED GAINS AND LOSSES. This eliminates the need to hold interest bearing assets to produce cash for the dividends and allows more flexibility in choosing a portfolio to maximize long term rate of return.