FOUR POSSIBLE ALASKA FUTURES

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12/15/10

Introduction

Tonight we'll be talking about four possible futures for Alaska. The state's history offers some justification for believing in any one of them.

WE ARE THE CHOSEN ONES: Those who think good luck will keep the good times coming can point to a number of times in the past when luck did save the day for Alaska—say, the Prudhoe Bay oil discovery, or the high oil prices that have spared us from most of the effects of the current national recession. So it's possible to be optimistic and believe that the state's luck will hold—with rising oil prices driving future developments and keeping the economy healthy and the state treasury full.

THE BIG CRASH: Alaskans who know the state's history as a boom-and-bust economy—and especially the economic turmoil Alaska went through when oil prices crashed in the mid-1980s—have reason to believe it could happen again. World oil markets are nothing if not volatile. So it's possible to be pessimistic and think plummeting oil prices could dry up investment in petroleum development and blindside Alaska's economy again.

THE SLOW SQUEEZE: The economy enjoyed moderate, steady growth in the 1990s. But at the same time flat oil prices and falling oil production were eating away the state's oil revenues. The state balanced the budget during most of the 1990s by using the Constitutional Budget Reserve—and if it hadn't been for that rainy-day account, the need for dramatic budget cuts and tax increases would have put the brakes on the economy. So it's not unreasonable to think that if future oil prices flattened and there was little new exploration and development, both state spending and the economy could dwindle.

STRATEGIC PLANNING: Alaska does have a record of actively managing its publicly owned resources for the maximum benefit of residents (as the state constitution requires). One of the first acts of the new state legislature was banning fish traps and breaking the hold of outside interests on Alaska's salmon fisheries. A more recent example is creation of the Permanent Fund, which Alaskans approved as a way to save part of oil revenues, in anticipation of a time when those revenues would be gone. So looking ahead, there is precedent for the state to actively manage its petroleum resource—through strategic planning—instead of letting world oil markets, the federal government, or other outside interests determine the fate of our economy.

1. WE ARE THE CHOSEN ONES or NO ROOM AT THE FISHING HOLE

Alaska has always been lucky. Taxes on the oil at Prudhoe Bay, the largest oil field ever discovered in North America, and the other North Slope fields, have relieved Alaskan households and most businesses of the need to pay taxes (except for local property and, in some communities, sales taxes). Beyond that they have paid for a level of public services only dreamed of in other states. And the much loved Permanent Fund Dividend comes from the investment earnings on royalties the companies pay the state. When oil revenues don't seem high enough, OPEC, or China, or someone else intervenes to drive up the price and keep us from the need to tighten our belts. When the economy slows we find a way for the federal government to send us another billion or so in stimulus funding to tide us over. Today we are enjoying good times while most of the rest of the nation is struggling through the great recession.

Just a decade ago the price of oil at the wellhead was only $20, and the future looked so grim that we almost passed an income tax. But then the price went through the roof, where it has remained. In late December it was about $80 a barrel. In spite of current North Slope oil production at only 1/3 the historical peak (1989), state petroleum revenues, which lubricate every gear in the economy, are near an all time high at $6.105 billion (FY2010) and are projected to remain so for at least another decade. It appears we can keep on partying since we also have more than $10 billion in the bank (not even counting the Permanent Fund with another $38 billion).

Looking ahead, this scenario calls for the price of oil remaining high, bolstered by growing demand in China, India and elsewhere and the disappearance of low cost supplies outside OPEC. The federal government recognizes the importance of Alaska petroleum resources to the nation's national security. ANWR is opened to development and the federal lands offshore (OCS) are also explored. The state is able to extract better royalty sharing terms from the federal government from production from these regions and this goes a long way to keeping the state treasury full. The petroleum industry, spurred on by an attractive investment climate created by reworking ACES (The state tax on oil production) figures out how to make production of heavy oil, the stuff that looks like molasses, commercially viable. That doesn't generate much in tax revenues, but it takes thousands of jobs to get the stuff out of the ground and down the pipeline. Of course the North Slope gas line to the lower 48 also gets built.

Petroleum drives the economy on a continuing upward trajectory as these developments unfold over the next two generations. High wages and incomes, business opportunities, low or no taxes, abundant public services, and first class public infrastructure characterize the affluent Alaska economy. More opportunities develop in other industries like tourism, mining, health, and providing amenities to residents.

The strong economy brings with it population growth that has some negative consequences like traffic congestion and a squeeze on limited resources like your favorite fishing hole. Not all Alaskans share the view that bigger is better as growth drives change. Urban Alaska becomes more and more dominant, with rural parts of Alaska feeling left behind in the process. But with good leadership, sharing of the prosperity from petroleum can benefit all Alaskans.

2. THE BIG CRASH or I CAN HANDLE THE HANGOVER BECAUSE THE PARTY WAS AWESOME

It's possible to see Alaska as a perpetual boom and bust place. The economy depends largely on natural resources, and cycles in the markets for furs, fish, timber, gold, and other minerals were all important before Alaska became a state. Even bigger were the economic cycles driven by WWII and the Korean War. Each boom was a time of tremendous opportunity and vitality for some—but not everyone. Each bust was a time of gut wrenching loss and retrenchment. And after each cycle Alaska emerged looking different.

The petroleum boom we have been riding for the last 30 years dwarfs all past resource booms in its size and length. It has transformed Alaska economically, socially, and politically. Booms tend to lull people into thinking they will go on forever. But sometimes economic booms stop dead in their tracks with no warning. That certainly happened to the US economy two years ago. And it happened, on a smaller but still scary scale, in Alaska 25 years ago when the bottom suddenly and unexpected fell out of the world oil market.

An intense "boom within a boom" began in 1980 when the revolution in Iran led to a dramatic oil price increase just as oil production in Alaska was ramping up. The unexpected bounty of state revenues led to an unprecedented expansion of government spending at the same time that activity on the North Slope was booming. The entire economy took off like a rocket, only to crash and burn at the end of 1985 when Saudi Arabia, the biggest OPEC producer, decided to open its oil taps. Overnight the world oil price went into free fall from about $27 on the west coast to $9. The crash rippled through the Alaska oil patch but was felt throughout the state as Juneau put the brakes on the huge capital budgets that were entirely dependent on the continued flow of oil dollars.

The whole economy took a nose dive and everyone was hurt, not just people working for government or the oil companies. Overall employment dropped 10%, housing prices fell through the floor, and 10 percent of the population left, many walking away from the homes that had been their biggest asset. Half the banks in the state failed and closed their doors. The human toll was reflected in highly publicized suicides. The economy limped along for several years until it was saved by another disaster in 1989—the Exxon Valdez oil spill—that pumped billions of cleanup dollars into the economy. Without that boost, the economy could have languished in the doldrums for a decade. Higher oil prices in the last decade then propelled the economy even higher.

Looking ahead, this scenario starts out like the first one. Optimism about the future of the petroleum economy leads to overextension of both government and business in the expectation of continued growth. But suddenly the economy gets blindsided by a crash in the world oil market that causes the price to plummet and settle back where it was a decade ago. The gas line to the lower 48 is not built, ANWR remains closed to development, OCS development proves too costly to be economic, and production on state lands continues to dry up. Since dramatic price swings have occurred many times in the past, and the current oil price is 3 to 4 times the historical average, this possibility cannot be ruled out.

When the floor falls out of the oil market petroleum industry investment dries up and the state, 90% dependent on petroleum revenues, effectively goes bankrupt. After running through cash reserves, draconian program cuts are imposed at the same time that taxes on households and businesses are imposed and rates increased. It becomes clear that the state does not have the tax base to support anything beyond a minimal level of public services. Rural areas are particularly hard hit by state budget cuts while most of the private and public job loss from less money flowing through the economy occurs in urban areas. When oil production drops below 200 thousand barrels a day the pipeline shuts down.

This watershed event convinces many Alaskans who have not already left the state that there is no alternative to a permanent "economic downsizing" although a minority continues to hold out the hope that a big project will come along to reverse our fortunes. (The Alaska dream dies hard.)

With no alternative we start to borrow from the Permanent Fund and invest it in "developmental infrastructure"—a course of action shown in the past not to work, but one driven by panic rather than reason. But there is a terrible battle between those who favor infrastructure projects and the temporary jobs they produce and those who favor continuation of the Dividend. This is just one example of the struggle to get a share of the dwindling public resources of the state.

Within a decade the Permanent Fund is gone. Alaska applies to the federal government to return to Territorial Status.

3. THE SLOW SQUEEZE or UP A LAZY RIVER

It's possible to see what happened in the 1990s as a cautionary tale for the future. The Alaska economy enjoyed a decade of solid growth, a pleasant surprise after the earlier economic crash and oil spill of the 1980s. And although oil production dropped 50 % over the decade from its peak of over 2 million barrels per day in 1989, the economy continued to add jobs each year. Falling production was ignored and there was a feeling that the economy was maturing to the point that it could continue to expand even as its biggest driving industry was shrinking.

Expanding tourism, mining, and air cargo sectors were bringing new money into the economy and attracting a lot of attention, but their overall contribution to economic growth and the state treasury was small. In retrospect we can see that much of the growth during that decade was due to two temporary phenomena. First, the state was playing "catch up". Past resource booms had been short lived, but the flow of oil from the North Slope and the wealth it generated provided the economic stability that allowed a support economy finally to take root in the state. This was the decade when the big box stores discovered the Alaska market and began to move in, eventually transforming the retail landscape. Personal and business services also accounted for a big part of the growth in jobs, particularly in health care. Second, there was a boom in federal spending, much of it funneled through state government and the Native Corporations.

But even as we were congratulating ourselves during the 1990s that the economy had taken off on a permanent growth trajectory, petroleum employment was trending slowly downward and state oil revenues were falling by half due to a flat oil price and falling production. Throughout most of the decade the state budget was balanced by borrowing from the Constitutional Budget Reserve ($5.3 billion during the decade in 2010 $) which was nearly empty by its end. Without this temporary revenue source, the need for dramatic budget cuts and tax increases would have put the brakes on the economy. As it was, job growth was 14% over the decade, but we fell short of the rest of the nation that added 18%. Since then high oil prices have kept the wolf from the door.

Looking ahead, this scenario portends a future of flat prices--not only for oil and gas, but commodities in general--as new supplies are found throughout the world and technological innovation allows these supplies to compete in the market at modest prices. This eases concerns about the need for a domestic supply of energy and elevates concerns about environmental quality resulting in less federal interest in developing oil and gas resources in ANWR and off the coast of Alaska in the OCS. At the same time the state is unable to craft a petroleum tax policy that stimulates investment in new exploration and development of existing, but expensive to produce, petroleum resources. It chooses instead to maximize short term revenue in the belief that the level of investment is insensitive to tax policy, or that additional investments will not generate much revenue for the state and so the best policy is to "get it while you can".

This leads to a protracted decline in petroleum employment and petroleum revenues that is slow, but inexorable, and easy to ignore. Attention turns to "economic diversification", a development policy that has been pursued since before statehood, but with limited success. Rather than face up to the "writing on the wall" that the state economy will need to shrink as it enters its post petroleum phase, the state spends its time and energy continuing the search for the economic development "silver bullet" that will bring on the next economic boom. Much of this search involves spending state resources on large scale projects that proponents guarantee will lead to economic growth. Although most fail to live up to expectations (like Delta barley), some are successful, and hope springs eternal.

At the same time public spending is squeezed from the decline in petroleum revenues and the aversion to imposing taxes on households and businesses to pay for basic services. Rural Alaska feels the loss of spending first, but it quickly spreads to urban areas as well. Fights over how to share the cuts become increasingly disruptive. In this environment job growth stagnates and young workers who cannot find jobs are forced to leave the state. The population ages, incomes fall, and a sense of discouragement emerges.

As the economy shrinks population outmigration is driven by a self selection process. Those most tied to the market economy are more likely to leave while those who put more value on the non economic attributes Alaska has to offer are most likely to stay. They are more willing to accept a lower income in exchange for those values. Those who stay develop a new common bond around a vision of the state as a place to live a good life rather than a place to get rich.

4. STRATEGIC PLANNING or SOCIALIST TAKEOVER

It is possible to see Alaska as a state with a history of stepping up and determining how to manage its natural resources for the maximum benefit of Alaskans. That is what the state constitution requires, and it is reflected in one of the first acts of the new Alaska legislature after statehood. Outlawing fish traps broke the dominance of outside interests in the control and in the capture of the benefits of the Alaska salmon fishery. The state took control of the fishery and has since managed it very successfully to maximize the sustainable yield and to capture the annual flow of benefits for Alaska residents. The state also uses the capital budget, loans, and tax policy to try to commercialize natural resources, both publicly and privately owned. Examples include the construction of the road in Northwest Alaska to access the zinc deposits on Native corporation land at the Red Dog mine site and attempts to develop downstream processing of petroleum within the state through various methods.

Managing the state's petroleum resources presents a particular challenge because of their incredible value and because unlike the salmon fishery, they are not sustainable. The state, through a combination of royalties and taxes, has collected $156 billion (2010 $) in revenues from oil and gas production since statehood. This represents about 98 % of all the natural resource revenues collected including those from fishing, mining, timber, and even tourism. These revenues have allowed the state to eliminate most non petroleum taxes and to expand public services, including capital spending, to a level unheard of in the rest of the country. But this flow of revenues will not last forever, because the fields on state land are being depleted and because future developments will generate less revenue for the state.

It is for this reason that the Alaska Permanent Fund was created. The Fund is a way to save some of the revenues collected when petroleum is produced in anticipation of the time when that revenue flow has dried up. In fact the Permanent Fund savings account is a way to convert the non-sustainable petroleum resource into a permanent asset that could generate a sustainable flow of revenues potentially forever. The portion of oil revenues directly deposited into the Fund has been small, leaving most "on the table" and available for current spending. Concerns about runaway state spending growth have led to additional measures to manage petroleum wealth, most notably the creation of the Constitutional Budget Reserve, but also the Statutory Budget Reserve and the Spending Cap. Through their combined effects the state has been able to put 24 % of all petroleum revenues into financial savings that could generate more than $2 billion in earnings each year forever. This income flow could provide some cushion against any economic slowdown coming from a decline in the petroleum industry.

Although we have more than $45 billion in the bank today, most of our petroleum wealth is still in the ground. But there is no way of knowing how much additional revenue will be generated when it is ultimately produced. With high prices and production, petroleum revenues could continue to carry the state for a generation or more. But with low prices and production the industry could begin to contract and the state budget to tighten. Because of the importance of both to the overall health of the economy, this would put the state on very shaky economic ground.

Looking ahead, in this scenario the state continues to actively manage it petroleum resources, rather than letting the world oil markets, the federal government, and other outside interests determine the fate of the economy. It does this through tax and spending policies that look long term and balance current desires with long term revenue needs and employment opportunities. This would remove some of the uncertainty moving forward and let the state better manage the resource for the benefit of all

Alaskans, as required by the Constitution. There are three critical elements of a strategic plan for the management of the state's petroleum wealth—maximize long term revenues from production, control growth in state spending, and diversify revenue sources.

Taken together they represent a tradeoff that could be thought of as an insurance policy-- potentially less revenue from petroleum today, lower current spending, and the imposition of some taxes, in exchange for a more certain and stable future with more of the benefits of the petroleum wealth passed on to the next generation of Alaskans.

Some Alaskans would no doubt find this level of planning inappropriate. Not everyone would agree with this characterization of the uncertainty in the future for the economy. (They have heard the story before, and "Chicken Little" has been wrong every time.) Not everyone is concerned about the next generation of Alaskans, many of whom are currently living in Texas, or California, or some other state. No one is anxious to pay taxes today and many would rather take their chances about the need to pay in the future. Many see the critical needs that petroleum revenues could be paying for today and don't want to slow funding for these needs.

We have established a partial insurance policy in the form of the Permanent Fund, although its main purpose today is to pay the annual Dividend. Perhaps the real question is, what is the appropriate insurance policy level as we move forward?