Economic Sustainability: 
The Sad Case of Alaska

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The discovery of oil at Prudhoe Bay on Alaska’s North Slope in 1968 dramatically altered the state government’s revenue picture. The first large infusion of Prudhoe Bay revenues to the state came from $900 million in North Slope oil lease sales in 1969. The $900-million bonanza (equivalent to $2.9 billion in 1993 dollars) was five times the previous year’s total state budget.

State spending nearly doubled between 1969 and 1971 and increased by 46 percent again in 1972 as the legislature began gearing expenditures to expectations of huge oil revenues once the Trans-Alaska Oil Pipeline was completed. Construction delays pushed the pipeline’s completion date back several years, but rapid growth in government spending continued. To bridge the gap between current government spending and expected oil revenues, the state raised severance taxes on oil again and enacted a reserves tax in 1976 on holders of North Slope oil and gas leases; because of a rebate provision, this reserves tax was really a forced loan from the oil companies.

The Trans-Alaska Oil Pipeline was finally completed in 1977, and oil began flowing to the Valdez tanker terminal in July of that year. State revenues from royalties and yet higher severance taxes rose slowly at first, but when the Iranian Revolution pushed oil prices to over $30 per barrel in 1980 ($58 per barrel in 1994 dollars), state revenues increased dramatically. General fund revenue skyrocketed from $1.5 billion in 1979 to $4.5 billion in 1982. State spending out of the general fund also spiraled upward, growing from $1.4 billion in 1980 to $3.6 billion the following year. From 1981 through 1988, Alaska’s state spending increased nearly twentyfold, with total state spending over this period amounting to $34 billion, or about $70,000 for each Alaskan resident.

As oil revenues soared, the taxes paid by Alaskan residents plummeted. The individual income tax and several other state taxes were repealed in 1979-80. As a result, real taxes paid to the state by individual Alaskans after 1980 were only 14 to 16 percent of the real taxes they paid during fiscal year (FY) 1976.

Alaskans also eased their tax burdens at the local level as state dollars flowed to schools and municipalities. By 1982, tax rates in boroughs throughout the state were 30 to 40 percent lower than they had been before the opening of the pipeline. The only exception was the newly formed North Slope Borough, where property tax rates were increased by more than 50 percent since nearly all property taxes were paid by oil companies operating at Prudhoe Bay. Alaska’s tax burden is ranked fifty-first, behind all other states and the District of Columbia.

Since Alaskans pay only a small percentage of the taxes needed to finance government spending, there is little public opposition to government spending. It is
easier for Alaskan politicians to increase taxes on the oil industry than to resist constituent demands for more spending. Taxes on the oil industry have increased eleven times since 1955. Currently Alaska’s tax rates on oil producers are the highest in the United States.

With Alaska able to export almost all of its tax burden, it is not surprising that the state dominates the competition in per capita state spending: In 1990, Alaska’s per capita state spending was almost four times the national average and nearly two-and-a-half times higher than that of Wyoming, its closest competitor. The additional per capita spending in Alaska is far in excess of the amount that can be explained by the higher cost of living in Alaska.

The Path Not Taken

The magnitude of the fiscal windfall to Alaska provided the state with a unique opportunity to realize sustainable benefits from its natural resource endowment. The state could have increased total spending in response to the population growth motivated by the development of its petroleum resources and still guaranteed that the revenue from those resources continued to provide indefinitely for future generations of Alaskans. If the state government of Alaska had behaved in the farsighted way that the most vocal advocates of sustainable growth believe governments will, it would have saved enough of the temporary oil revenues to generate the interest income necessary to sustain state spending at generous levels.

The state did try to preserve some of its oil wealth, which everyone recognized as a temporary windfall. In 1976, in response to a voter-approved amendment to the Alaska Constitution, the state began depositing a portion of all mineral lease rents and royalties into what is known as the Permanent Fund. Special legislative appropriations helped fatten the fund, and by the end of 1993 the value of the fund’s investments totaled $15.6 billion—roughly $26,000 for each Alaskan citizen. Each year some of the fund’s earnings go to “inflation proof” the principal, and by formula most of the remainder is paid out to Alaska’s citizens as a “dividend.” In 1993, each man, woman, and child who qualified as an Alaskan resident (anyone who has lived in the state for at least one year) received a dividend check in the amount of $949.46.

However, a state government motivated by the concern of sustainability would have done much more to assure a secure fiscal future for Alaska. In 1967, the year before oil was discovered at Prudhoe Bay, per capita state spending in Alaska was 2.47 times the U.S. average. Adjusting for Alaska’s higher cost of living, real spending per capita was still 1.6 times the national average. Consider a policy in which, starting from this already high base, the state had allowed real per capita spending to grow at a rate equal to the U.S. average rate of growth in real per capita state spending through 1993 (adjusting for the year-to-year differences in the cost of living increases between Alaska and the rest of the United States), with the excess revenue being deposited in Alaska’s Permanent Fund. Assuming that this augmented hypothetical fund generated a rate of return equal to that of the actual Permanent Fund, the fund would have contained $66.7 billion by the end of 1993.

Assuming that the hypothetical fund continues to earn an average real rate of return of 5.15 percent (as it has since it started earning interest in 1978), the real value of the hypothetical Permanent Fund of $66.7 billion could be maintained indefinitely, with no net additions, with $3.4 billion being spent each year to finance state spending. This amount is $500 million (or 17 percent) more than the total state spending in 1993. If the state had not distributed the $4.47 billion in annual dividend checks to Alaskan residents and had instead put this money in the Permanent Fund and allowed it to accumulate interest, the hypothetical fund would have contained $75.03 billion at the end of 1993. At an interest rate of 5.15 percent, this fund would be producing an annual revenue stream of $3.9 billion.

Wasting Resources and Disregarding the Future

In other words, in our completely possible hypothetical world, Alaskans could now be benefiting on a sustainable basis from lavish state expenditures without paying a single cent of state taxes! And our hypothetical exercise understates on two counts the opportunity the Alaska state government had to benefit from a policy of fiscal sustainability. First, the population figures used to determine the hypothetical spending levels are based on the actual population, which surely increased in response to the larger actual state spending. Second, if state spending were financed entirely out of interest payments from the hypothetical Permanent Fund, all future revenues from the oil industry could be used to further augment that fund. Surely the program of fiscal sustainability just discussed would have done more to promote the long-run well-being of Alaskans than the program of fiscal depletion that has been the hallmark of Alaskan spending policy since the North Slope oil revenues became available.

There is little evidence from Alaska’s recent fiscal history that politicians are motivated by the ideals of sustainability. The Alaska state legislature has spent