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NATURAL RESOURCE TRUST FUNDS:  
A COMPARISON OF  
ALBERTA AND ALASKA RESOURCE FUNDS

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## 1. INTRODUCTION

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Alberta and Alaska have many similarities. Historically both are young as human settlements; they are geographically north, large in size, remote from large markets, and sparsely populated. Both economies primarily are resources-based in nature. Further, these resources are substantially publicly owned. Their economies are cyclical, with volatile swings between booming prosperity and economic recession that strains affordability of reliable public services and lifestyles. A common public policy challenge is to achieve stability and sustained prosperity for their respective diverse population groups. More precisely, can the resources-based riches of nature be managed to assist in economic stabilization offsetting the inherent cycles of resources employment and financial yields?

In the early seventies, Albertans and Alaskans shared a common desire to reduce the volatility of their resource-based economies. During late 1973 and through 1974 the Organization of Petroleum Exporting Countries (OPEC) initiated strategies that would effectively quadruple the world price of oil. Therefore, the governments of both Alberta and Alaska began to receive oil and gas royalties that were far beyond their expectations. This large and sudden windfall reminded many that the dependency of government revenues on uncontrollable world resource prices could be short lived, and in many cases fortunes could be reversed. The concerns of many that the revenue streams from natural resource revenues were unsustainable led to ideas of a “rainy-day” fund. Many argued that non-renewable resources could be transformed into renewable ones by the existence of an endowment-type fund. Thus, a gradual transition away from dependence on non-renewable resources could be facilitated, while the responsible management of these resources could be undertaken. Although Alaska began considering such a fund as early as 1969, the existence of large revenue surpluses provided the perfect opportunity for both regions to begin seriously debating the merits of such a public policy.

In 1976 both the Alberta Heritage Savings Trust Fund and the Alaska Permanent Fund were created. A fundamental objective of each jurisdiction was to provide economic stability by setting aside government revenues from natural resource royalties. When they were created, these two funds had a similar purpose: to save for a time when natural resource revenue would begin to decline. It was hoped that during boom times, the economies would have the opportunity to diversify, while in the meantime, a “nest-egg” would provide security and stability for the future. Although the two funds were created with similar purposes, the policies that governed them evolved quite differently. In terms of management, structure, governance, and objectives, the two funds would follow very different paths and produce markedly different results for their citizens. This paper compares the two regions’ funds and the policy options that have affected their growth and successes

## 2. ALBERTA

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Alberta is young, large and sparsely populated with only 3 million inhabitants. It is the fourth largest province of Canada in both size and population. There are two major metropolitan centres in Alberta. Edmonton is the capital and is the location of the provincial Legislative Assembly. Edmonton and its surrounding satellite centres are home to almost one million citizens. Many Albertans consider Edmonton to be the gateway to the vast space and riches of the north. Calgary is located in southern Alberta. Canada's hydrocarbon sector is dominated by the city of Calgary. As a result of these settlement patterns and the province's resources potential, Alberta has developed a north-south transportation system, while the national context for such systems is oriented in an east-west direction.<sup>1</sup>

Alberta has an abundance of natural resources and a wide array of geographical features. The landscape includes extensive prairies and farmland, black-loam parkland, northern boreal forests, foothills, a large mountain range and an extensive Lakeland zone.<sup>2</sup> Two-thirds of Alberta is government-owned "Crown land". Crown land is used in various capacities: national parks, military bases, and livestock grazing, but most importantly for natural resource exploration and production. The majority of agricultural production is on privately held land. All commercial forest production, and nearly 80% of oil and gas production, occurs on Crown land.<sup>3</sup> Government revenues in the form of royalties and stumpage fees are substantial, permitting a low-tax regime for the province.

Although Alberta's economy revolves around three primary industries, (energy, agriculture, and forestry) the provincial government has been attempting to diversify the economy for many years. A number of policies have been implemented to expand Alberta's capabilities toward manufacturing of raw materials and knowledge-based businesses. Indeed, the Alberta Heritage Savings Trust Fund was one such policy.

## 3. ALBERTA HERITAGE SAVINGS TRUST FUND (AHSTF)

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By the mid-1970s Alberta was debating the issue of a Heritage Fund. The rationale behind the fund centered on the idea of the prudent management of a resources-based economy. Many felt that a fund of this type could become a financial instrument for resources management over time. Four reasons emerged for supporting the Heritage Fund:

- fairness to future generations – recognizing that Alberta's non-renewable resources are depleting;
- substantial capital investment would be instrumental in an economic restructuring;
- provide quality of life improvements that Alberta otherwise could not afford; and
- provide an alternative revenue base for the future if required.<sup>4</sup>

### **3.1. FUND HISTORY, STRUCTURE AND OBJECTIVES**

In late 1974, the Heritage Fund was proposed as policy by the Alberta government. After vigorous debate during the 1975 Election, the Alberta Heritage Savings Trust Fund Act was passed in May 1976. The initial installment (symbolically on 30 August 1976, exactly five years after the new government was elected) to the fund by the government was \$1.5 billion. At its inception in 1976, the Heritage Fund was composed of three divisions, and separately a Cash and Marketable Securities Portfolio that consisted of funds not immediately required by the noted divisions.<sup>5</sup> These latter funds were invested in short and medium term marketable securities. In 1980, a legislative amendment provided for two additional divisions. Each of the five divisions was to have distinct objectives.

#### **3.1.1 The Alberta Investment Division (AID)**

The AID was created to make debt or equity investments to strengthen and diversify Alberta's economy. Investments made by this division were expected to make a reasonable return, but "not necessarily a commercial return".<sup>6</sup> Up to 1997, this division was by far the largest component of the Heritage Fund. The AID primarily was comprised of loans to Alberta Crown corporations and shares of other provincial government investments. The largest investments included those to the Alberta Mortgage and Housing Corporation, Alberta Agricultural Development Corporation, Alberta Municipal Financing Corporation, and Alberta Government Telephones (privatized as TELUS in 1990).

AID functioned as a private-placement financing mechanism, reducing government borrowing from external financial institutions to fund its own Crown corporations. As a major portion of the fund, the AID at times was used as a political lever -- indirectly covering shortfalls in government revenues from ailing Crown corporations. As a result this division offered no real "upside" potential for returns, only exposure to default by its debtors. Just one significantly successful investment was made through this Division. An initial investment of \$180 million for a 10% stake in the Syncrude Oil Sands megaproject was made in 1977. The project made substantial annual returns for the government and was eventually sold for \$ 352 million in 1995.<sup>7</sup>

#### **3.1.2 The Canada Investments Division (CID)**

The CID loaned funds to other provincial governments or government agencies at concession-level interest rates. The CID made Canada's first province-to-province loan when funds were provided to Newfoundland in early 1977, forestalling higher interest rates due to the late-1976 election of a separatist government in Quebec. In later years Alberta loaned funds to Quebec -- an interesting fact considering a separatist government was in power at the time. Loans to Quebec Hydro still are in place, until 2005. Since its inception, the CID has made 33 loans totaling \$1.9 billion. Lending activity in this division was suspended in 1982.<sup>8</sup> It should be noted that borrowing provinces were given preferential treatment; their interest rates were the same as if Ontario Hydro, the lowest-risk Canadian government entity, was the borrower. Compared to today, these

interest rates seem high. But at the time of the loans market interest rates were very high due to high rates of inflation.

### **3.1.3 The Capital Projects Division (CPD)**

The CPD invested in projects that were to provide long-term social or economic benefits to Albertans. No financial return was contemplated. Investments in both physical and social infrastructure projects were common throughout its history. While projects in this division were not expected to yield a financial return, an objective was to enhance economic strength and stability. The CPD invested in many and varied projects. Although the top priority has been to medical research facilities, investment has occurred in education facilities, agriculture, transportation and telecommunication projects, as well as other areas of the Alberta economy. The CPD has been controversial over the years. CPD projects were kept on the balance sheet of the Heritage Fund as “Deemed Assets”, despite not being expected to yield conventional returns. Thus the book value was inflated over the actual market value of the fund. In 1987, the Auditor-General disallowed CPD investments to be included in calculating the fund’s overall value.

The magnitude of the CPD component is totaled over three billion dollars. A particular feature of this division is the Alberta Heritage Medical Research Endowment; this is the only portion of the overall Alberta Heritage Fund that has been managed with an endowment approach. This Endowment, \$300 million initially allocated, was established in recognition that capital medical facilities and programs would require future operations costs to be paid on an ongoing basis. Other capital projects were irrigation works, parks, hospitals, and research funding. This spending stopped in 1995.

### **3.1.4 Commercial Investment Division (CMID)**

The CMID was established by legislative amendment in 1980. It was to invest in Canadian stocks and money market securities. Although this portion of the fund is expected to yield a commercial return on its investments, it has been an inconsequential portion of the fund. Only a tiny portion of the Heritage Fund was invested on a basis of seeking a reasonable rate of return. The lack of size and importance of this division has been disappointing for many who feel that the fund should function as viable “savings account” for future generations. In 1997, the Heritage Fund was restructured to focus on optimizing returns, including a renewed focus on market securities and secured debt.

### **3.1.5 The Energy Investment Division (EID)**

The EID, also established in 1980, was designed to invest in debt or equity positions that would facilitate the further development of Canada’s energy sector. Similar to the CMID, this division is inconsequential. While there was limited activity in this division in the early 1980s, it was curtailed in response to the Federal government’s imposition of the National Energy Program (NEP). It remained empty until the Heritage Trust Fund Act Amendments of 1997.

### 3.2 FUND SOURCES AND RESULTS

Through the first decade, a portion of revenues from natural resource royalties was allocated to the Alberta Heritage Savings Trust Fund. Fund yields were ploughed back into AHSTF until 1982.

1976:	\$1.5 billion initial allocation, and initial Fund yields retained
1976 - 82:	30% of non-renewable resources revenues, plus all financial yields retained in Fund
1983:	30% of such resources revenues, but Fund yields diverted to provincial general coffers
1984-87:	15% of such resources revenues (no yields retained)
1987-today:	None, all such resources revenues and yields taken into the Alberta budgets.

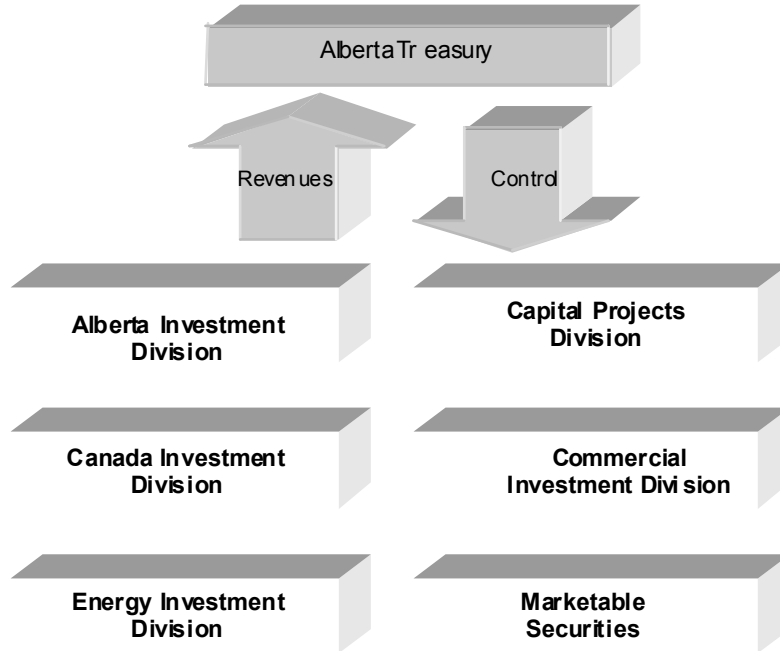
Total transfers and yields into the fund from 1976 to 1987 were about \$15 billion, with around \$3 billion having been allocated to Capital Projects Division commitments.<sup>9</sup> Thus the financial value of AHSTF reached about \$12 billion; the Fund size has languished at that level ever since. No inflation proofing took place, so the purchasing power of the Fund eroded in the intervening years. The Fund has been valued at approximately \$12 billion ever since.

In addition to financial impacts, there are important externalities that have resulted from the Alberta Heritage Fund. They are both positive and negative. Positive ones for Alberta include lower taxes than fellow Canadians, generally lower utilities prices, and jobs that were created by AHSTF funding of projects that otherwise would not have been affordable. Negative externalities include misallocations from underpricing of Crown Corporations' outputs (eg. telephone services), natural gas price subsidization, funding of uneconomic projects, and lending from the Heritage Fund at interest rates below market rates of return. To determine a social rate of return on the funds used by AHSTF, the private rate of return would need to be taken and adjusted with both positive and negative externalities. No attempt has been made here to measure externalities, but it is important to enumerate and understand them.

In 1995, the government invited input from Albertans on the future of the Heritage Fund. The response was overwhelmingly in favour of keeping it, but with some fundamental changes.<sup>10</sup> On 1 January 1997 steps were taken to restructure the Heritage Fund. Two separate portfolios were created: the Transition Portfolio and the Endowment Portfolio. The Transition Portfolio was created to hold temporarily all "old" Heritage Fund assets. A minimum of \$1.2 billion of the assets (ten percent of the total) was to be transferred annually from the Transitional to the Endowment Portfolio. Hence, the transfers to the restructured Heritage Fund would take place over a decade. The asset mix of the new Endowment Portfolio will be 35% - 65% fixed income securities and 35% - 65% equities; thus the portfolio would become much like a conventional one. To put the proposed changes into perspective, at the end of 1996, the Heritage Fund had only about 8% (\$990 million) invested in equities.<sup>11</sup>

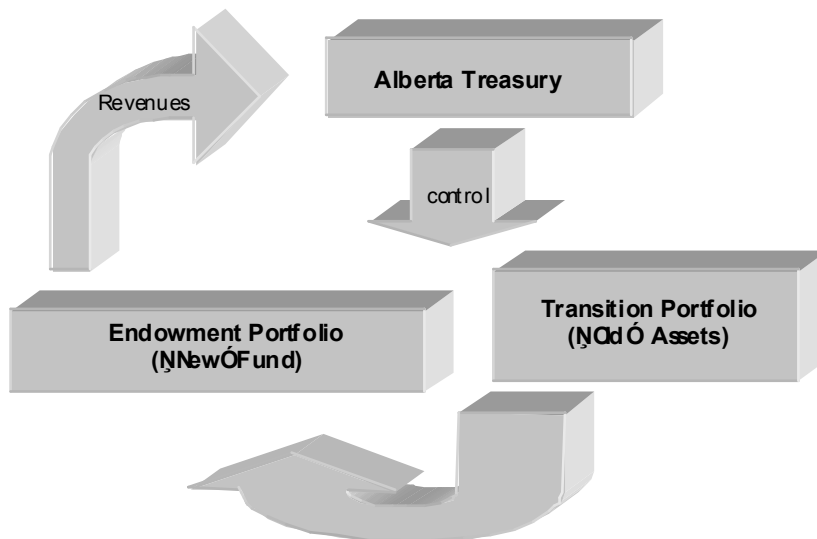
Figure 1. AHSTF Structure

**Pre-1997 Structure**



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**New Structure**





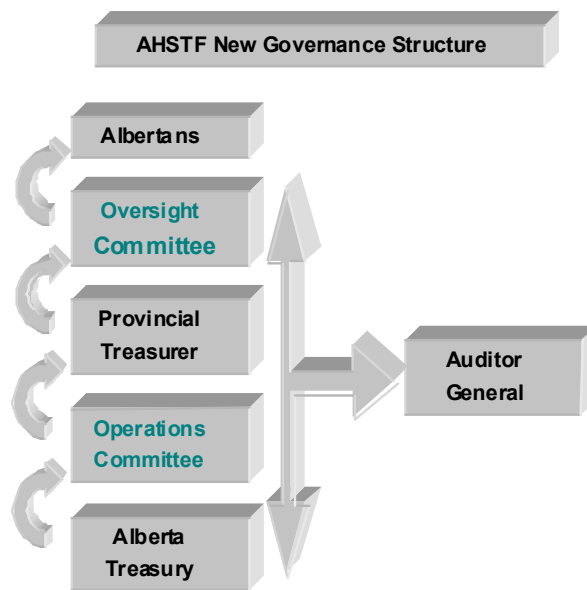
In addition to a new investment strategy, the fund would now become inflation-proofed in accordance with endowment management principles. A portion of income earned by the fund would be transferred back into the Endowment Portfolio to offset losses in capital value due to inflation. All other income would be transferred into General Provincial Revenues. A new business plan was implemented for the fund with three primary objectives:

- To earn income to support the government’s fiscal plan,
- To maximize long-term financial returns through the Endowment portfolio, and
- To improve Albertans’ understanding of the fund.<sup>12</sup>

As well as a new focus for the Heritage Fund’s investment policies, governance of the Fund also was changed. A new layer of reporting was added called the “Oversight Committee”, comprised of Members of the Legislative Assembly of Alberta. As well, a new advisory “Operations Committee” was added consisting of private-sector individuals.

The changes made to the Heritage Fund, restructuring its investment activities, may have far-reaching ramifications on how the fund will be organized and managed. However, many Albertans question whether there is substantive change to the fund. Proponents argue that the Heritage Fund is nothing more than a political lever used to implement and reinforce public policy decisions. They allude to the fact that income is transferred directly into General Revenues, indicating that the direction of the fund is dependent on the desires of the government of the day. The introduction of people from the private sector into the Operations Committee to review the Heritage Fund’s business plan is a step towards increased accountability. However the Oversight Committee, which consists of 9 MLAs (3-non-government)<sup>13</sup>, can easily be viewed as another layer of government added to the fund’s governance.

**Figure 2. Governance Structure**



## 4. ALASKA

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On 18 October 1867, after it was purchased for a mere 2 cents per acre from Russia, Alaska officially became the property of the United States. Once the famous Gold Rush of the 1880s dissipated, Alaska seemed once again forgotten by the rest of the country. However, its strategic position became apparent when the United States declared war on Japan in 1941 pursuant to the attack on Pearl Harbor. In 1943, Japan invaded the Aleutian Islands, starting the "One Thousand Mile War", the first battle fought on American soil since the Civil War.<sup>14</sup> Alaska's Constitution was adopted in 1956, and became effective in 1959, the year it was admitted to the union as the 49th state.<sup>15</sup>

Alaska's population of just over 600,000 makes it the third least populous state in America. The state's coastline extends over 47,000 miles with a diverse range of climate and habitat. The state capital is Juneau, a southeastern and coastal panhandle city of approximately 30,000 people. The state's largest city is Anchorage, with a population of 225,000. Fairbanks has an area population of about 70,000.

Much like Alberta, Alaska is prized for its vast size and natural resources. Alaska's most important revenue source is oil and natural gas resources, which has constituted as much as 90% of the state's revenues.<sup>16</sup> Prudhoe Bay, on the northern slope of Alaska, is North America's largest oil field and accounts for about 25% of the oil produced in the United States. However, the level of oil production is waning, as the pace of expansion is less than that of depletion.

Although oil and gas are the primary resources in Alaska, other natural resources contribute to the economic well being of the state. With waters rich in fish, Alaska's seafood industry is the state's largest private industry employer. Forestry is important to Alaska's economy, especially that of the southeastern region. The timber industry provides thousands of jobs and hundreds of millions of dollars in revenue to Southeast Alaska. Mining is one of the most important undeveloped natural resources, including coal, gold, silver, copper, and other minerals. Tourism is also an important industry; every year over a million of people visit the state of Alaska.

### 4.1 ALASKA PERMANENT FUND (APF)

The APF was created within the same context as the Alberta Heritage Fund. Alaska also believed there was a need to provide stability and sustainability by allocating resource revenues so as to preserve future opportunities for growth and prosperity. However, the two funds took on markedly different characteristics. The idea for an Alaska Permanent Fund germinated in 1969. That year the state auctioned drilling rights to 164 tracts of state-owned land at Prudhoe Bay. The proceeds amounted to \$US 900 million. Considering that the state budget that year was only \$US 112 million, the new revenues were a multiples increase in wealth for Alaskans.<sup>17</sup> The debate immediately began as to whether or not the monies should be saved or spent. Due to Alaska's lack of development at the time, the consensus was to spend the money to provide and improve upon basic services for all communities. Water systems, schools, roads, airports, *etc.* were constructed as infrastructure to improve the quality of life for the State's citizens. These infrastructure investments were quite similar to those of the Capital Projects Division of

the Alberta Heritage Fund. Because Alaska is such a large and sparse area, the \$US 900 million was exhausted quickly. Soon public opinion was that a significant portion of the money had been wasted. Expenditures on infrastructure did not seem to have achieved the goals and expectations of Alaskans.

#### 4.2 FUND HISTORY, STRUCTURE AND OBJECTIVES

As Prudhoe Bay was proving to be one of the richest oil fields in North America, it was apparent that the oil and gas royalties would continue to flow into the government. Many argued that all Alaskans should get some permanent benefits from this new stream of revenues. The idea for the Alaska Permanent Fund was beginning to gain in popularity. Three basic arguments were offered by the APF's supporters:

- the fund could help to create an investment base from which to generate future income; thus, when oil revenues diminished, a stream of revenues would remain for the State;
- the fund could remove a significant portion of the revenues from government, reducing the opportunity for excessive spending by the Legislature; and
- the fund could take non-renewable wealth and transform it into renewable wealth. As it was designed, the APF would require a Constitutional Amendment. The necessary ballot was proposed to voters during the general election of 1976. The Alaska Permanent Fund was approved by an almost a two-to-one majority.<sup>18</sup>

The reason that the fund required constitutional amendment was the presence of dedicated funds in the APF's structure. The Constitution of Alaska prohibited the dedication of state funds so no portion of state money could be automatically assigned. As a result of this dedicated nature of the APF, constitutional amendment was necessary. It took four years of debate until a clear objective of the fund was determined. Those who wanted to establish the APF as a "trust" won over those who wanted a development bank concept. Instead, additional resource royalties not appropriated to the APF were used to create government agencies with clear mandates of economic development and diversification.

The APF is made up of two parts: Principal, and Earnings Reserve. The Principal is the main body or the "dedicated" part of the Fund. Once monies have been allocated to the Principal they cannot be removed unless by a majority of all voters in a statewide plebiscite. Sources of the Principal include:

- Dedicated oil revenues automatically deposited in the Fund under the terms of the State Constitution; the legislated amount is 50% of all mineral royalties (25% prior to February 1980);
- Legislative appropriation;
- Income transferred from the Earnings Reserve to provide inflation-proofing.<sup>19</sup>

The Earnings Reserve is an accumulation of net income that has not been allocated to the Principal. It is not money appropriated by the legislature, but represents unpaid (*i.e.* retained) earnings dividends. Decisions about the use of the Earnings Reserve are made each year by the people's elected representatives - the State Legislature and the Governor.

The APF invests its assets in a number of financial instruments and real estate to generate income and capital gains. All investments made by the Fund must follow the "Prudent Investor Rule",<sup>20</sup> which states that security of principal outweighs the possibility of high returns and their associated risks. Investments are not made for social or political reasons, and all investments are made with the objective of earning a return.

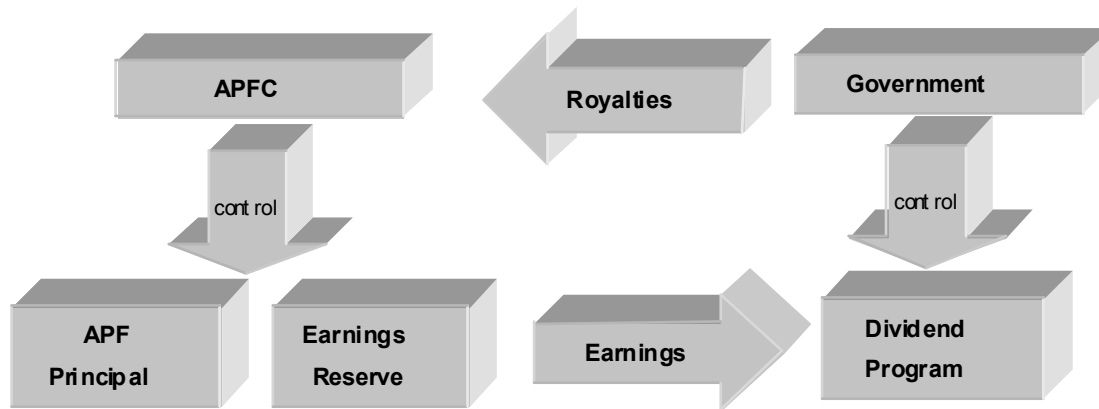
The goals and objectives of the Fund are that it will:<sup>21</sup>

- Consistently achieve a 4% real rate of return over time, with better-than-average investment performance and below-average risk;
- Achieve excellent, cost-effective management to help maintain the autonomy and integrity of the Alaska Permanent Fund Corporation (APFC) as a public corporation established in law to be managed by an independent Board of Trustees;
- Provide full, timely, reliable and objective information to all publics in order to foster accessibility, knowledge and accountability;
- Be a repository of institutional investment expertise that benefits the State of Alaska and facilitates a thoughtful public and investment policy evolution of the Fund; and
- Continually strengthen the APFC as an institution in which Alaskans take great pride.

To achieve these goals the trustees of the Alaska Permanent Fund Corporation set three-year rolling asset allocation targets once each year, and monitor them continuously. The early 2000 asset allocation is 9% real estate, 19% international stocks, 34% US stocks, 37% fixed income instruments (bonds).

The Alaska Permanent Fund Corporation (APFC), "a separate and independent instrumentality of the State", manages the APF.<sup>22</sup> The result is that the savings and investment function is separated from the spending function. A board of six trustees controls the APFC. Four are members of the public with recognized expertise in finance and other business management related fields. The other members are the Commissioner of Revenue, and a cabinet minister of the Governor's choice. The Trustees employ an Executive Director, who is responsible for hiring staff among other important duties. Expenditures of the organization are established by the legislature at approximately 1.2% of net income.<sup>23</sup> Both the trustees and the executive director are accountable for the achievement of the goals and objectives previously outlined.

**Figure 3. Alaska Permanent Fund**



Income during the year is credited to the Earnings Reserve. On June 30 of each year appropriations are made from the account. The first use of the fund's income is to pay dividends to every citizen in the state. The dividend is calculated as follows: i) Add together the Fund's net income for the last five years; ii) Multiply that number by 21%; and iii) Divide the result in half. This amount is then transferred to the Dividend Fund and divided among all Alaskan residents. The second use of the Fund's income is to provide inflation proofing for the fund via a simple calculation. The percentage change in the US consumer price index is multiplied by the Principal balance at year-end. This amount is then transferred into the Principal. If any income remains, it is left in the Earnings Reserve as undistributed income. This undistributed income can be requested for use in the event of a shortfall in income to pay dividends and inflation proofing. In addition, the Legislature may appropriate funds from the Earnings reserve for any lawful purpose. The Alaskan government currently is debating the issue of appropriation. Due to a period of lower world prices of oil and hence reduced royalties revenues, the state had posted a deficit of over a billion dollars. The government may be forced to consider the option of the APF dividend reduction paid to citizens (removing funds from the Earnings Reserve), re-introducing personal taxes in Alaska, increasing fuel taxes (which have remained at the same level since 1961), or a combination of the above. While all of these options will have political ramifications, many argue that the APF was created for just this occasion. Recent higher oil prices will permit more time to make adjustments.

In summary: Alaska formed the Permanent Fund, abolished the state income tax, lowered its fuel tax, continued to have no sales tax, and started paying its citizens "dividends". By the late 1990s, the state was entering a budget crisis because of declining oil revenues concurrent with expanding expenditures and citizen expectations. The Alaska Permanent Fund has become the focus of a major public debate in Alaska, culminating in a statewide "advisory vote" on 14 September 1999. With a nearly 95% voter turnout, more than 70% voted "no" to spending Permanent Fund earnings to balance the State budget (Anchorage Daily News, 16 September 1999). The Alaska fiscal conundrum remains unresolved.

## 5. COMPARISON OF THE TWO FUNDS

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Even after a brief review of the two funds, stark differences become clearly apparent. One began with a legislated Act of government, the other with a constitutional amendment. One has an investment portfolio structure with clear objectives for commercial returns; the other primarily was used to attempt diversification of an economy. One (AHSTF) attempted to deploy social dividends, along with financial returns; the other (APF) sought strictly financial dividends, including very low taxes. Similarities and differences will be reviewed to provide a framework to compare the two funds. While this paper focuses primarily on governance practices, financial performance also is reviewed briefly.

It is ironic that in the mid-1950s, just prior to an election, the Alberta Government of the day issued a \$25 “oil dividend” to every (adult) person in the province (Barr, 1974, p 237). Today, the State of Alaska pays a dividend to individuals but Alberta persists with the policy that government knows best. Oddities abound: Alberta was the first province in Canada to impose a sales tax; it was removed in the midst of the 1950s oil boom. Currently Alberta is the only province without a sales tax.

### 5.1 CREATION OF THE FUNDS

The first key difference between the two funds is that the Alberta Heritage Fund was an Act of government carried through the legislative process, while the Alaska Permanent Fund was created through a statewide referendum and enabling Constitutional Amendment. As noted previously, the reason that the APF required a Constitutional Amendment was the presence of “dedicated” funds. Although this provided the impetus for public debate, the differences in the creation of the funds also reflect the different political dimensions of each region.

While there was wide debate in Alberta political circles over the Heritage fund prior to its inception, it has had less public scrutiny than the APF in Alaska. After approval by state referendum, there was a three-year process of determining APF objectives. Widespread public debate was not the only cause of this delay. As Smith (1991) points out, the fragmentation of the American political system and its difficulty in resolving political differences was the primary cause of the delay.<sup>24</sup> In Alberta, the Heritage Fund had been the major topic of discussion leading up to and during the 1975 election. However, a strong party system and resounding election result meant that the Heritage Fund would find little resistance once the Progressive Conservative governing caucus of the day approved its objectives. The difference between the two funds was apparent from the beginning. In Alberta, the Heritage Fund belonged to the government. In Alaska, the Permanent Fund belonged to the people.

## 5.2 OBJECTIVES OF THE FUNDS

Perhaps because of such widespread debate in Alaska, the Permanent Fund has been operated as a trust. The APF is a portfolio of diversified investments managed by an agency at arm's length from government. It is accountable to the public indirectly through elected representatives, and legislated public reporting requirements. Many argue that economic growth and prosperity should be facilitated through market mechanisms rather than through government policy. This view is congruent with the dominant American ideology that less government involvement is better for society. In Canada, government involvement is more widely accepted and at times even solicited by the private sector.<sup>25</sup> As a result, the economic diversification argument gained acceptance more easily in Alberta. Although the Heritage Fund was to function as both a savings vehicle and an economic policy lever, the latter objective came to dominate the direction of the Fund. In Alberta it was argued that by diversifying the economy through public policy, the future of its citizens would be better protected against the volatility of a natural resource based economy.

Eventually the economic diversification objective gave way to the Alberta government's desire to reduce its need to borrow from capital markets. Instead, AHSTF funds became used for financing regular Alberta government budget expenditures. As well, a major portion of the fund was used to purchase debentures of provincial Crown corporations. Recipient Crown corporations were not necessarily instrumental in the province's economic diversification.

## 5.3 USES OF FUND ASSETS AND EARNINGS

Warrack and Fleming (1994) outline financial guidelines that managers of true endowment funds should follow in order to live up to both legal and fiduciary responsibilities.<sup>26</sup> First, a fund should maintain its purchasing power. This implies that a portion of investment income should be reinvested into the fund to provide inflation proofing. Second, once the objective (*i.e.* growth *vs* income) of the endowment fund has been established it should be adhered to preserve the capital base integrity of the fund. Finally, an endowment must have no worse than a neutral budget effect (not force future operating budget increases) on other activities within the organization that is administering such a fund.

The creation and operation of the APF is akin to a state-operated Mutual Fund. Like the Alberta Heritage Fund, externalities need to be recognized. The chief benefits of the APF to the people of Alaska are lower taxes, and dividends from the Fund (not much different from a further lowering of taxes). Investments by APF are in the private sector, so other externalities are likely small and offsetting. The result would be that the social and private rates of return would be similar in magnitudes.

### 5.3.1 Purchasing Power

The Alaska Permanent Fund reinvests a portion of its earnings back into the principal so as to provide inflation proofing for the Fund. From its inception until 1997, the Heritage Fund did not follow this practice. During much of this period inflation was very high, resulting in substantial erosion of Heritage Fund purchasing power over time.

The Fund was capped at \$12 billion in 1987, but its real worth now is much less. In contrast, the Permanent Fund has not only kept its purchasing power intact, it has increased dramatically in value due to the continued allocations of oil and gas royalties into the Fund. The different strategies clearly are apparent by looking at the growth of the two funds from inception to the present time. The Alberta Heritage Fund grew rapidly for the first decade but it has been stalled at approximately \$C12 billion in absolute value since 1987, with real value having been eroded by inflation. Meanwhile the Alaska Permanent Fund has continued to grow; its value as at early 2000 is well over \$US27 billion (Alaska Permanent Fund Website). Apart from the exchange rate, the fundamental point is that the Alaska Permanent Fund has grown significantly in the last 15 years, and the Alberta Heritage Fund has not. Clearly the different financial management approaches of the two Funds have meant widely varying results. Earnings were being taken fully by the Alberta government into general revenues, and inflation proofing was not being done. Presumably these monies were improving the ongoing standard of living of the province's citizens. However, it is difficult to determine the impact on other areas of the economy that the additional funds have provided in Alberta, or would have provided in Alaska if it had used a similar strategy.

### **5.3.2 Maintaining Integrity of Original Principles**

When the citizens and politicians of Alaska and Alberta debated the objectives of their respective funds, certain principles were agreed upon. In Alaska's case the APF was to provide a secondary source of revenue for the state, through dividends paid to its citizens. Also, in the future when oil and gas royalties would begin to wane, the state would have built up a new source of income. However, until that day arrived the dedicated funds would remain untouched by the government. This is the key objective of the APF: to save for a rainy day. In Alberta, the objectives were similar, although the provincial government would control all of the income from the fund. In 1979, the Provincial Treasurer at the time stated that the key objective of the Heritage Fund was "setting aside a portion of today's revenues to meet future needs".<sup>27</sup> In addition, he also stated that the Heritage Fund "should not only be a prudent saver but a prudent investor".<sup>28</sup> By this it was apparent that the goal was to increase the size of the fund through prudent investment policies. While the APF has maintained its objectives throughout the last couple of decades, the same cannot be said about the Heritage Fund. The objectives of the Heritage Fund have vacillated according to differing circumstances over time. Objectives have been modified or abandoned, directly or indirectly, by the Alberta government during the life of the Fund.

In the early years it became apparent that the "Prudent Investment Rule" would not always be followed in Alberta. Numerous loans were provided to provincial Crown corporations, some of which were program delivery entities and clearly would not be repayments of the "loans". In a series of studies, Mumey has recalculated the actual value of the Heritage Fund discounting these suspicious loans. For example, while Alberta Treasury calculated the value of the Heritage Fund to be \$12.1 billion, Mumey calculated it to be \$9.6 billion, a difference of over 20 percent.<sup>29</sup> Perhaps the largest departure from the Heritage Fund's objectives was to stop transferring natural resource



royalties into the fund. After 1987, the Heritage Fund no longer functioned as a savings account. It can be argued that it simply became a financial asset from which the government gleaned yearly earnings.

A new chapter is unfolding for the Alaska Permanent Fund. With state expenditures growing, and oil revenues shrinking due to declining production, a hefty and rapidly worsening deficit looms as a new reality for Alaska. In early 1999 the State Legislature rejected a plan to reintroduce income tax and tap the APF reserve fund. On 14 September 1999 an Alaska-wide “advisory vote” was held on an alternative plan that rejects income tax but would utilize the APF reserve fund and reduce the annual distribution of funds to citizens. As noted earlier, citizens voted against this plan. It remains to be seen what the State of Alaska will do now. There apparently is stiff opposition from environmentalists to future exploration and development of the oil and natural gas resources that would enhance future production and attendant revenues.

### **5.3.3 Separation of Fund Objectives and Other Government Activities**

In Alaska’s case, the establishment of an “arm’s-length” corporation allowed the fund to operate relatively independent of government. In effect, once the funds were transferred into the APF, they were severed from the state government. In Alberta, however, various divisions of the Fund (especially AID and CPD) often provided funds to projects or corporations to replace monies that would have normally come from government budgeting of General Revenues. Also, the Heritage Fund, a service more usually associated with government expenditure activities, undertook large-scale infrastructure projects. It is to be noted that part of the Heritage Fund’s objectives was to facilitate economic diversification, and the Fund did invest in diversification-related infrastructure projects. However, there were a number of other projects undertaken that had little relationship to diversification of the Alberta economy.

Ironically, and long ago (prior to the 1955 election), the Alberta government paid out an “oil dividend”. It was paid to every adult citizen of the province (Barr, 1974, p 237).

## **5.4 PUBLIC VS PRIVATE CONTROL OF EARNINGS**

Each year a portion of the Alaska Permanent Fund’s income is paid directly to Alaskan citizens through a dividend program. In Alberta all funds are directed into government General Revenues. These strategies for wealth distribution contrast sharply. The Alaskan method involves placing the funds directly into the hands of citizens, who will make their own economic decisions regarding consumption and saving/investing. These decisions will affect the wealth and future prosperity of the state, but are decided by individuals in the marketplace. This “privatized” view of how the fund should be administered closely matches the American view that market forces will provide for efficiency and economic growth. In Alberta, the “nationalized” view has prevailed. The Heritage Fund fits and reinforces the Canadian view that government must make more of these economic diversification, redistribution of wealth, and growth decisions on behalf of Canadians. Public policy determines these allocations.

## 5.5 GOVERNANCE, CONTROL AND ACCOUNTABILITY

The key to all of the previous comparisons between the two funds arises from the structure of the funds as they were created in the mid-1970s. Apparently both Alaskan voters and legislators felt that the APF should not be under the control of government. As a result, the Alaskan Permanent Fund Corporation was set up as an arm's-length body to manage the Fund and be accountable to the people of Alaska. Investment strategies are outside the control of the government. Although income can be appropriated from the Earnings reserve, it is a practice that could be undertaken at the risk of voter reprisal. Thus, it has occurred only when there has been a shortfall of income to pay dividends to Alaskan citizens. The APFC is accountable to both elected officials and to the public. Information on investment, expenditures, and future strategies is fully transparent and made available for public scrutiny. While perhaps most Alaskans keep close tabs on the Fund's performance, Albertans generally seem to be oblivious to the direction of their own Heritage Fund.

Although there were changes made to the organizational structure of the Heritage Fund in 1997, the operation and planning of the Heritage Fund remain the responsibility of the Provincial Treasurer and department staff. As a result, the government has wide discretion as to where the funds will be directed. Although the Treasurer must provide annual reports on investments and performance, accountability remains primarily within government. In the past, there was an AHSTF Standing Committee of the Legislature, which was to provide guidance to the treasurer's office in terms of investment strategies and performance. New legislation was enacted in 1997. It has yet to be seen whether or not the new committee structure will have an effective influence on the direction of the Fund.

Regarding control of the respective funds, it is much easier for the Alberta government to change the Heritage Fund's investment policies or even the structure of the fund itself. Through an Act of the government, the Heritage Fund could even be dissolved and used to pay off government debt, an option given consideration in the 1990s.<sup>30</sup> In Alaska control issues are much more transparent to all levels of government, the public, and the media. The APF can only undergo fundamental changes through constitutional amendment. Congruent with this style of governance, in September 1999 Alaskans had an opportunity to "vote their advice". Changes to the management functions of the fund must occur through a separation of powers process in Alaska, which would be slow, open and subject to intense scrutiny, and possible veto.<sup>31</sup> Also, due to the dividend program, there is strong public interest in the performance of the APF. Through intense media and public debate, it is claimed that management of the fund is monitored constantly.<sup>32</sup>

## 5.6 FINANCIAL PERFORMANCE

Although beyond the scope of this analysis, it is recognized that the financial aspects of the two Funds are very important. Thus a brief financial analysis is included. Additional research on financial issues, regarding the management of non-renewable resource royalties in Alaska and Alberta, is needed. In the following analysis the Funds' financial performances over the past two decades are briefly evaluated and compared. A description of the performance of each fund and a comparison of some key elements are offered below. At the end of this section three charts provide a "visual" comparison of four key performance measures: year-to-year net asset value, net income, injections for inflation proofing, and outflows of income to government projects (Alberta) or directly to citizens through dividends (Alaska).

### 5.6.1 Alberta

During its 24 years, the Heritage Fund has generated over \$22 billion in income and has achieved an overall nominal return of nearly 9.5%.<sup>33</sup> The Heritage fund has not grown substantially in over 12 years, having been capped in 1987. This has severely limited its capacity to generate earnings in recent years. In fact, the income level has been declining since 1986. Figure 4 illustrates both the income decline and the stagnation of growth in the Heritage Fund.

It is apparent that the ability of the Heritage Fund to generate earnings for the province has diminished over the years, especially as a proportion of rising total government expenditures. The absence of inflation-proofing tactics, and poor investment performance, has taken its toll. More prudent investment criteria were needed. As inflation became important, there was a need to adapt financial management policies. Alas, this did not happen.

### 5.6.2 Alaska

Since its creation more than 20 years ago, the APF has grown into a \$US27-plus billion asset that has earned more than \$US20 billion in net income. Its return over the last 15 years has been 12.2%.<sup>34</sup> This represents returns well in excess of its 4% above inflation benchmark. APFC must follow the "Prudent Investors Rule"; it has been investing in top-rated US and international stocks, real estate properties, and domestic and international bonds. By pursuing such a diversification strategy the APF can achieve higher potential returns relative to risk levels. The fund has experienced volatility; total returns range from a high of 25.6 % in 1985 to a low of 1.5 % in 1994.

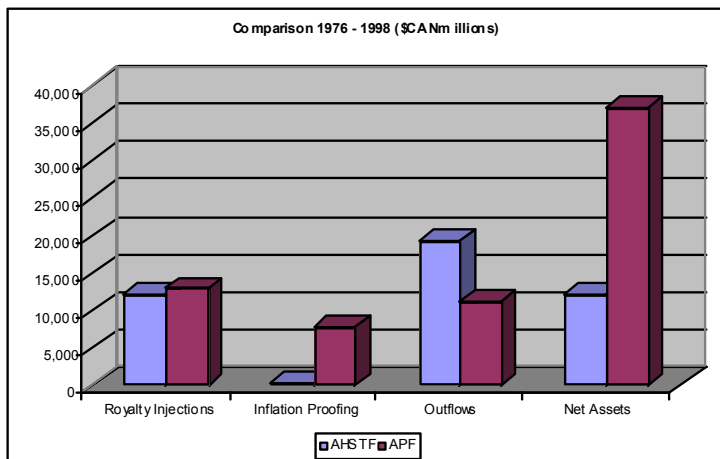
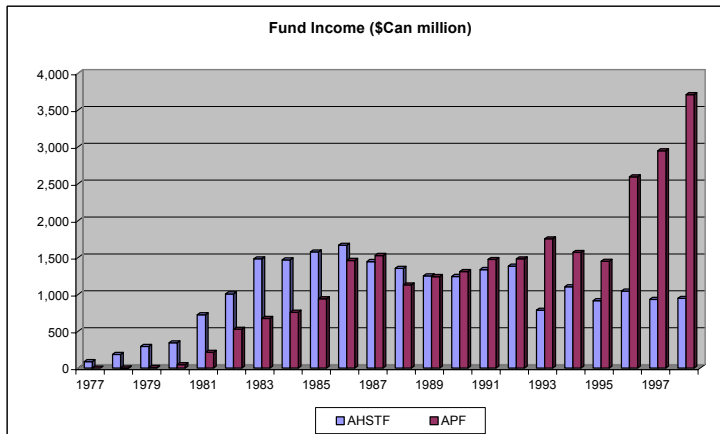
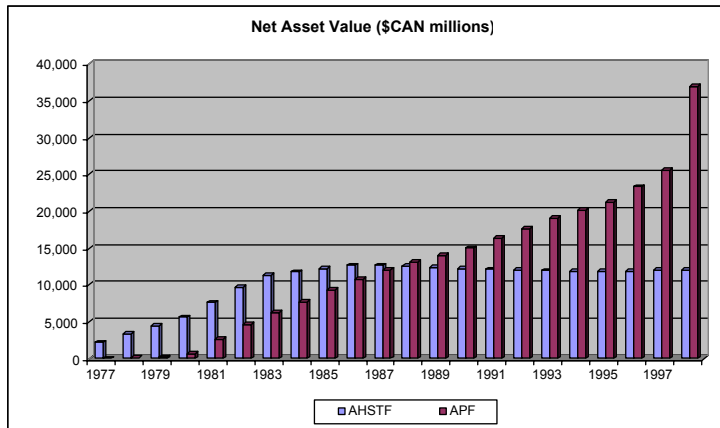
While both funds have performed reasonably well in financial terms, the APF's investment strategies have ensured its continuous growth both in terms of its asset base and its ability to earn revenues. Comparisons of governance and financial/economic performance are of renewed interest both in Alaska and in Alberta.

Further research could model how the Alberta Heritage Fund would have performed if it had followed the Alaskan practices of endowment fund financial management.

### 5.6.3 Comparison Charts

The following charts have been developed using data from the annual reports of both funds. To provide a meaningful and uncomplicated comparison, a constant exchange rate of \$0.70 Can/US was used to translate US in to Canadian dollars. Net Asset Value is compared in the first chart; APF has grown substantially but AHSTF has not. Due to its much larger size, it can be seen that APF income is far higher. The final chart particularly is worthy of note – with similar royalty revenue injections, outflows (and no inflation proofing) from the Alberta Fund have been far larger and the assets of the Alaska Fund are comparatively even larger. Recalling that the Alaska population is only 20% that of Alberta, the assets per capita held by the Alaska Permanent Fund are vastly more significant. Alaska's Fund continues to be very important to Alaskans, with a major capacity to buffer the state from economic cycles. On the other hand, Alberta's Fund has become relatively minor to the province.

Figure 4. Comparison Charts



## CONCLUSION

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In comparing the Alberta Heritage Fund with the Alaska Permanent Fund, there are similarities. Yet there are very significant differences. It remains for debate whether one fund should have been managed like the other, or vice versa. The primary point of this paper has been to identify major similarities and differences, and thus contribute to the better understanding of each of the funds. Figure 5 is an attempt to summarize the most important comparative dimensions.

As evident in Figure 5, dominant similarities are the time era and the resources base from which monies are forthcoming. In fact, both the Alberta Heritage Trust Fund and the Alaska Permanent Fund came into being in 1976. A minor difference regarding resource base is that Alaska's revenue is from crude oil while that of Alberta is predominantly crude oil and natural gas, with minor amounts from coal and bitumen (tar sands) royalties.

There is a deep philosophical distinction embedded between the two Funds. Alaskan monies are paid directly to eligible persons. Thus individual citizens and their families in Alaska have the freedom to make their own spending/savings decisions (privatization). Alberta allocation decisions have been made by the government (nationalization), presumably reflecting a belief that government is wiser and can make better decisions. Indeed, technically the Alberta Heritage Savings Trust Fund is a Crown corporation. A good debate would be whether the collective results of individual decisions are better ones on behalf of society.

The Alberta Fund came into being via an Act of the Legislature for the province. Despite extensive debate and hearings at the time, it remains the case that the AHSTF can be changed by the Legislature. Moreover, until very recently the management of the funds was strictly within the government bureaucracy, side by side with the conventional treasury department responsibilities. Consistent with an Alaska public referendum to bring its Fund into being, a separate Alaska Permanent Fund Corporation was formed to manage the entity. An arms-length body of Trustees governs it. Once the State Legislature allocates funds to the Alaska Fund, they are in the hands of the Trustees.

Economic and social development: these directives were included in the Alberta Heritage Fund (especially the Capital Projects Division), but were not objectives explicit for the Alaska Permanent Fund. To be sure, investment choices made by Alaska citizens would have economic development implications, and their consumption choices could have both economic and social impact. However, the point here is that these impacts are outcomes of individual decisions rather than being guided or even forced by government.

Since inception, fundamentally the Alaska Permanent Fund has been managed like an endowment. Thus inflation proofing is a top priority, so that the purchasing power of the capital base is preserved. If all income yield is taken, as was been the case in Alberta for a decade, the real value of the capital is eroded. During the period of time noted, there was substantial inflation. Because the endowment concept infers permanence of value over time, it must hold stocks (typically 60-65%) to access capital gains as well as

income. APF has done this all along, but AHSTF is just beginning to do so. This is reflected by the financial results shown in Figure 4. A further aspect of funds management, and another major difference, is the investment profile. Investment diversity is essential in any portfolio management strategy, but it is even more so for smaller and remote jurisdictions with a narrow economic base such as Alaska and Alberta.

**Figure 5. Comparisons: Alberta Heritage Fund vs Alaska Permanent Fund**

	AHSTF	APF
Time Era	Mid-1970s	Mid-1970s
Resources Base	Hydrocarbons	Hydrocarbons
Philosophy	Nationalization	Privatization
Establishment	Legislation	Referendum
Governance	Bureaucracy	Trustees
Economic Development	Yes	No
Social Dividends	Yes	No
Financial Management	Income	Endowment
Stocks Holdings	No/Changing (1997)	Yes
Inflation Proofing	No/Changing (1997)	Yes
Investment Profile	Inward/Changing (1997)	Outward
Fund Size	Smaller	Larger
Fund Growth	No	Yes

Finally, comparing the current size and pace of growth of the respective funds, the results of the foregoing differences are stark. The Alberta Heritage Savings Trust Fund is much smaller; its size has not changed for many years and it is not now growing. The Alaska Permanent Fund has become much larger, and it continues to grow. There is a need for further research that identifies the parameters of how the financial results of these funds became so different. This is the direction of expected further research that can build on the results of this paper.<sup>35</sup>

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