Journal of Financial Management and Analysis, 18(1):2005:82-83

• TOPICAL FINANCIAL MANAGEMENT ISSUES

FREE CASH FLOW IN PUBLIC GOVERNANCE IS A SOURCE OF WASTE AND INEFFICIENCY : CASE STUDY OF THE ALASKA STATE OF THE USA*

Prelude

Since oil (petroleum) was discovered at Prudhoe Bay in 1968, the Government of Alaska has received significant free cash flow. Indeed, it would be difficult to argue that the Alaskan government was underfunded before 1968.

In 1967, per capita state spending in Alaska was 2.47 times the U.S. average. Even after adjusting for Alaska's higher cost of living, this came to 1.6 times the national average.

The first large payment to the state from oil revenues was $900 million for North Slope oil leases in 1969, an amount equal to five times the total state budget in 1968. State spending almost doubled from 1969 to 1971 and increased another 46 per cent in 1972 as the legislature adjusted expenditures to expectations of greatly increased revenues once the Trans-Alaskan Oil Pipeline was completed. Despite construction delays that pushed the pipeline's completion date back several years, rapid growth in state spending continued. The state financed this spending growth by increasing the severance taxes on oil and enacting a "reserves tax" on holders of North Slope oil and gas leases. Once the pipeline was completed in 1977, state oil revenues from royalties and severance taxes (which were raised again) began increasing. This revenue increase excalated dramatically when oil prices rose to over $30 per barrel in the aftermath of the Iranian Revolution.

General fund revenue went from $1.5 billion in 1979 to $4.5 billion in 1982. State spending went from $1.4 billion in 1980 to $3.4 billion in 1981. **Over the period 1981 to 1988 total state spending came to $34 billion, or about $70,000 per Alaskan resident. By 1990 per capita state spending was almost four times the national average and nearly two-and-a-half times more than in Wyoming (Alaska's closest rival).**

Non-Productive (Wasteful Expenditure)

- The State spent more than $50 million trying to promote **Alaskan barley farming.** This money went to loans that were seldom repaid, and for roads, rail lines, hopper cars, and grain elevators to facilitate far more barley than was ever grown. An aborted barley-processing facility in Seward could have processed all the barley grown in Alaska's peak year of production in four and-a-half hours. **It was common for Alaskan farmers to take money from the state to grow barley while simultaneously taking money from the Federal Government not to grow barley.**
- **Field trips for public-school students** were lavishly funded. For example, the Bering Strait School District received a $300,000 grant from the Alaska Department of Education in 1980 to fund a tour to Europe for high-school students as part of an "adventure-based" education program. The travel costs came to $88,414, but the largest expense was the $106,034 paid to the adventure-based education "specialists" who arranged the trip and accompanied the students to Europe.
- The state gave away over 14,000 acres of land and made $20 million in loans – virtually none of which were repaid – in a failed attempt to launch an **Alaskan dairy industry**. To provide Alaskan dairy farmers with a profitable market, the state began operating a creamery and promised to pay above-market prices for milk produced in Alaska. But this price support soon collapsed since Alaskans could buy milk cheaper from Seattle. The state-run creamery still struggles along with the help of tax revenue, but it now buys most of its milk from Washington state.
- **The Alaska Renewable Resources Corporation (ARRC) was established in 1978** to provide venture capital for

*On a related topic, readers may refer to : "Avoidable Financial Waste in Natural Resource Endowed Countries", **Journal of Financial Management and Analysis**: Vol. 12, No.1 (January-June 1999).

promoting businesses using Alaska renewable resources. Some rather bizarre projects have received ARRC loans. Probably the most bizarre project, out of a field of strong contenders, was for **dog-powered washing machines**. In 1987, three years after the legislature voted to terminate the program. **ARRC had written off $13 million in bad loans and the legislative auditor had classified another $16 million as "doubtful collection."** The success of Alaska's overall state loan programs (of which ARRC is but a small part) has also been dismal. For example, by the end of the 1980s the state had lost over $1.1 billion in mortgage foreclosures.

- **The State has spent enormous sums for building performing arts centers, convention centers, and sports arenas** in small towns and cities throughout the State. Even in the most populated cities these structures stand as monuments to government profligacy. **The $70 million Performing Arts Centers constructed with State money in Anchorage, for example, loses over $ 1million annually even when all of the capital cost of the centers is ignored.**

There are several other instances of misuse of FCF resulting from Alaska oil revenues. One private sector example is the **Sohio Company** (known as Standard Oil Company after 1985), which was a recipient of Prudhoe Bay revenues between the late 1970s and the 1980s. During the 1978-86 period, Sohio's principal shareholder was British Petroleum, whose principal shareholders were the **Bank of England and the British Government**. Under relatively new management with considerable autonomy. **Sohio engaged in a series of substantive new projects,** including additional gas and oil exploration (partly in Alaska), diversification into non-oil, *albeit* natural resource projects, and acquisition at a huge premium of Kennecott, a troubled copper producer. During this period, **Sohio's stock significantly underperformed both the broad market and other oil company stocks**. Ultimately, **management was replaced and the remainder of Sohio (now Standard Oil) was acquired by BP, but not before significant value had been destroyed.** The Sohio case provides clear evidence of the agency costs of FCF in the private sector, in this case resulting from FCF generated by the Alaskan oil discovery. But because the loss was reflected in transferable stock market, forces were brought into play that corrected the problem.

Institutional Problems

The large revenue flows generated by the discovery of oil in Alaska precipitated a dispute over claims to revenue and to land ownership by native Alaskans (Indians, Eskimos, and Aleuts). To settle the dispute, the Alaska Native Claims Settlement Act (ANCS)) in 1971 established **13 native corporations with rights to nearly $1 billion and 40 million acres of land.** These funds and rights were given to the corporations, which were to be exclusively owned, monitored, and managed by native Alaskans, with no rights to transfer or sell ownership shares to non-natives. These corporations were established as a way of settling any possible future claims on Alaska resources since ANCSA required that all future claims to land in Alaska be forfeited. These 13 native corporations **have been substantial underperformers in traditional financial terms, experiencing lower profitability, with significant unrelated diversification and high operating costs** owing to inappropriate organizational form, share transfer restrictions and lack of ownership trading in securities markets. In the final analysis, the native Alaskan wealth was dissipated, not enhanced, by the mechanisms used to distribute their claim to the FCF.

In summary, with a state population of a little under 600,000 in 1993 (a population more than double its 1967 level, largely because of inducements related to the oil discovery), there is no way that all of the oil-tax revenues going to the Alaskan Government could be put to their most valuable use within the State. The residents of Alaska would have been better served by receiving a "dividend" paid from a large portion of the State oil revenues so they could spend and invest it on products and projects outside the State.

Whenever a country or group is the recipient of something for which little or no efforts is expended, there exists the strong probability that those resources will be wasted on unproductive and profligate activities. As one example, the large gold bullion inflow into Spain in the 16th century was largely spent on luxury goods and war efforts that weakened its economy and left the country in financial difficulty when the inflow ended. **More recently, the huge windfalls enjoyed by the oil-rich countries have been devoted to questionable public investments and to finance exorbitant personal spending, by those who are well connected politically.**

Source : Lee, D. and Verbrugge, J., Free Cash Flow and Public Governance : The Case of Alaska, **Journal of Applied Corporate Finance** (Fall 2000)