Alaska's *Other* Oil Spill

by Stephen L. Jackstadt and Dwight R. Lee

The Exxon oil spill in the Prince William Sound of Alaska was a terrible waste. An area of enormous natural beauty was polluted, large numbers of animals were killed, and hundreds of millions of dollars have been spent on the cleanup, not to mention the loss of 11 million gallons of petroleum. Media coverage of the spill as a major event is understandable.

Yet, by far the greatest destruction of wealth associated with Alaskan oil has gone entirely unnoticed. As a direct result of the actions of the Alaskan state government, a significant portion of the net value of Alaska's petroleum reserves has been wasted just as surely as if it were being deliberately spilled into Prince William Sound. This waste continues without attracting the slightest attention from the press.

Interestingly, the explanation for governmental spillage of Alaska's oil wealth is closely tied to the explanation for the Exxon oil spill. That explanation comes from the perverse incentives resulting from the use of property that is commonly, rather than privately, owned. In the absence of well-defined private property rights to a valuable resource, no one has much incentive to exercise proper care and restraint in the use of that resource. Those who make careless and excessive use of a common property resource capture all the benefits from that use, with the costs deferred in time and diffused over the general public.

Prince William Sound is a clear example of a common property resource. It is commonly owned by the entire American public, with no one individual having either the motivation to incur a cost to protect it from abuse or the legal right to charge others for its use. Therefore, the savings the oil companies realize from exercising insufficient care in shipping oil through the Sound, or being inadequately prepared to respond to an accident, are captured completely by the oil companies. On the other hand, the environmental damage to the Sound from an oil spill will be imposed on the general public, with the oil companies being less than fully responsible for this cost.

The common property problem can also motivate wasteful oil company decisions at the northern end of the Alaskan pipeline. With several companies pumping from common petroleum pools on the North Slope, the temptation facing each is to pump as quickly as possible with little regard for the adverse effects of excessive pumping on the total petroleum that can be recovered. Each company captures all the gain from its excessive pumping, with the costs of reduced future recovery being spread over all the companies. The company that takes the long-run view by moderating its current pumping risks losing out to the excessive pumping of others.

Fortunately these common property problems are well recognized, and steps have been taken to reduce their wasteful consequences. Exxon is being required by the threat of legal action, government sanctions, and by the pressure of public opinion, to pay for much, even though not all, of the costs of its carelessness. The bearing of this cost will certainly serve as a strong incentive for Exxon, and other oil companies, to exercise more

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caution in the future. Also, the oil companies operating on the North Slope have largely solved the common property problem of excessive recovery rates by forming a consortium in which the ownership shares of the petroleum recovered from a pool are determined independently of the recovery rate, with one company making the decision on that rate.

Government Revenue as a Common Property Resource

It is widely, and correctly, recognized that government action is required if common property problems are to be adequately overcome. Government plays an important role by enforcing private property right arrangements when they emerge (as in the case of the North Slope oil fields) and by imposing sensible restrictions on the use, and penalties on the abuse, of resources when private ownership is impractical (as in the case with Prince William Sound). But what has not been widely recognized is that government is often the major source of common property problems and, as a consequence, the greatest threat to the value of our natural resources.

A significant portion of the value of natural resources goes to government in the form of royalty and severance taxes. The burden of these taxes affects how much of a resource can be recovered profitably, and the use of the tax revenue affects the value derived from the resource. And both the tax burden and the use of the tax revenue are determined in a common property setting every bit as destructive of resource wealth as any other uncontrolled common property setting.

The ownership of government revenue is not determined by well-defined property rights. Instead it is a common property resource which is allocated on the basis of political competition among various interest groups. This competition favors relatively small groups, actively organized around a narrowly focused interest which is, or can be, served by some government program.

Each of these interest groups is in a position completely analogous to that of an individual exploiting a common property resource. The interest group that manages to pump more out of the public treasury secures all of the benefits, but pays only a miniscule portion of the costs. The incentive for an interest group to moderate its demands on the public treasury for the long-run good of all is lacking completely. Such moderation will not be rewarded with reciprocal moderation on the part of other interest groups, and will be seen as a useless sacrifice. The result is a wasteful special-interest race for more government spending now, with little thought given to its long-run consequences.

Typically, special-interest waste in government spending is moderated somewhat by the resistance of the taxpaying public. The "somewhat" has to be emphasized here since taxpayers consist of such a large and diverse group of individuals with no one taxpayer likely to be heavily burdened by the costs of any particular government program. For this reason, it is difficult to mobilize taxpayers in order to resist any given program, no matter how wasteful it may be. But taxpayers are aware of their tax burdens and, without explicitly organizing, can send politicians a clear message at the polls that there are limits to the tax burdens that will be tolerated.

The Alaskan Case

In Alaska, however, taxpayers have little motivation to resist the transfer of private wealth into common property state revenue. Since the discovery of oil on Alaska's North Slope in the late 1960s, well over 80 percent of the state's tax revenue has come from taxes on oil. These taxes are paid almost entirely by consumers and investors who do not live in Alaska. Not surprisingly, fiscal restraint is an alien concept to Alaskan politicians. When faced with constituent pressures to increase spending, politicians in Juneau have seen little reason to resist. Why risk aggravating those who can vote you out of office when they can be accommodated by increasing the taxes of those who cannot?

Since 1968 the Alaskan legislature has increased taxes on oil 12 times. Even though Alaska had by far the highest taxes in the nation on oil production, the 1989 state legislature increased the state taxes on Prudhoe Bay production by 25 percent, and by about 60 percent on production out of the nearby Kuparuk oil field. The Alaskan state government is capturing over 50 percent of the net return generated by the recovery of North Slope oil, which is 70 percent more than the share received by the oil industry.

These oil revenues are fueling state spending at unprecedented rates. Alaska is far out in front of the rest of the nation in per capita state spending. In 1986 per capita state spending in Alaska was $7,309—two-and-a-half times that of its nearest rival, Wyoming, and nearly five times the national average. The higher cost of living in Alaska can account for only a relatively small share of these differences.

The wealth contained in North Slope oil has been treated as a vast common property resource by Alaska's politicians and their special-interest clients. Predictably, the motivation has been to grab as much as possible with little worry about waste or regard for the future.

The politicians and special interests are surely aware that the oil fields are a depleting resource, and that current rates of state spending cannot long be continued. They must be aware that the long-run advantage of all would be served by reducing spending today so more could be saved to finance the continuation of reasonable spending levels in the future. Indeed, if state spending had been kept at a reasonable level over the last 20 years, that level could by now be maintained indefinitely from the interest on what would have been saved. But each special interest also knows, as does every exploiter of a common property resource, that the money it does not capture today for its spending program will instead be captured, and immediately spent, by another special interest.

Budgetary Black Holes

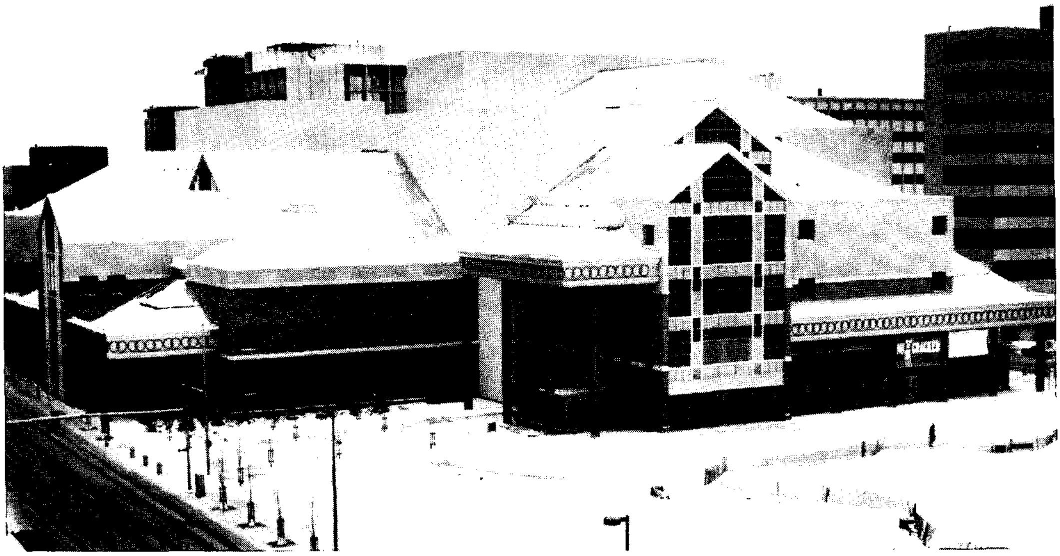
There is no way the Alaskan state government can spend the tremendous oil revenues on programs that make sense economically. But given the huge common property pool of oil revenues at their disposal, the politicians in Juneau are well aware that spending vast amounts on wasteful programs makes sense politically. Not surprisingly, the state of Alaska is literally spilling oil wealth throughout the state on one economic black hole after another. Consider some examples.

In 1978 the state initiated a program to promote barley farming in Alaska. Over $50 million has been spent by the state on the project, providing farmers with loans that were not repaid, building access roads to the anticipated barley fields, purchasing railroad hopper cars to transport the barley, and constructing grain elevators to store the anticipated barley production, most of which was never grown. While taking money from the state government for the purpose of growing barley, Alaskan farmers were at the same time taking money from the federal government in return for *not* growing barley. The state spent $5.8 million on a barley processing terminal in the town of Seward before halting construction. If the terminal had been completed, at a projected cost of $8.2 million, it could have processed all the barley grown in Alaska during its peak production year in 4.5 hours.

While public school students in other states are taking an occasional field trip to a nearby attraction, many Alaskan students are flying off to Europe at public expense. The Bering Strait School District, for example, received a $300,000 grant from the Alaskan Department of Education in 1980 under a program that sponsors what are known as adventure-based education projects. This grant was used to provide students with a European tour. While the $88,414 travel cost for the trip was expensive, it was less than the $106,034 spent on "consultant fees" paid to the adventure-based educational "specialists" who arranged the trip and accompanied the students to Europe.

The Alaskan state government has become an active supplier of below-cost and poorly collected loans. The Alaska Renewable Resources Corporation (ARRC) played a minor, but interesting, role in this loan activity. Established in 1978, the stated purpose of ARRC was to provide venture capital to those who attempted to utilize Alaska's renewable resources to develop such businesses as timber harvesting, seafood, fur farming, and wild berry candy. Being reluctant to discriminate against proposals just because they may be considered a bit bizarre, the ARRC has made loans for such purposes as developing dog-powered washing machines. It should come as no surprise that as of 1985, ARRC had written off $13 million in bad loans and investments, and a report by the legislative auditor classified another $16 million in loans as of "doubtful collection."

Unfortunately, ARRC loans make up only a small percentage of subsidized loans the state of Alaska uses in its effort to promote economic development. The success of Alaska's overall loan program offers little encouragement for those who see industrial planning by government as the



Center for the Performing Arts, Anchorage.

best way to channel investment funds to emerging growth industries. As of the end of 1987, over $233 million in loans made by the Alaskan state government were in default and another $1 billion were delinquent.

The state of Alaska has not been content to confine its industrial efforts merely to making loans. The state acquired a meat plant for $3.5 million in the mid-1980s—and it has been losing money ever since. A state-owned dairy is another financial black hole. Despite the fact that the Anchorage School District is required to purchase milk from the state dairy at a price which is 7 percent above the prevailing market price (a markup which costs the school district approximately $25,000 per year), the dairy is persistently in the red (it lost $887,000 in 1987 alone).

Performing arts centers, sports arenas, and convention centers, built in towns and cities throughout the state, do little more than stand as monuments to government extravagance and waste. An example is the $70 million performing arts center constructed with state money in Anchorage. Independent auditors say, that under the rosiest of revenue projections, the center will lose over $1 million annually. This projection considers only operating costs, ignoring completely the capital cost of the facility.

There are an almost inexhaustible number of examples that could be given of wasteful spending by the Alaskan state government. The above examples, along with the figures presented earlier on per capita state spending, are compelling evidence that the state of Alaska distinguishes itself in terms of the sheer magnitude of governmentally induced waste. When it comes to wasteful government spending, no other state in the United States can challenge Alaska.

The explanation for Alaska's wastefulness is not to be found in the venality of Alaskan politicians and officials, any more than the oil spill in Prince William Sound can be blamed on the corruption of oil industry executives. In both cases, the outcomes are the result of people responding in predictable ways to the incentives that exist in the presence of common property resources.

If there is a difference between the consequences of decisions on the transportation of petroleum by oil industry executives and decisions on the use of petroleum wealth by Alaskan politicians, it comes from the fact the former are far more subject to the constraints of public opinion than are the latter. Almost everyone is aware of the waste resulting from the Exxon oil spill, as they will be of the waste from any future spill; and this public awareness serves as a powerful incentive for the oil industry to make careful use of our oceans and waterways. Almost no one is aware of the far greater waste resulting from the political exploitation of Alaska's oil wealth. And because this Alaskan oil spill is going unnoticed by the media, and therefore by the public, the politicians responsible for it continue their improvident ways with impunity. □

The Investor as Hero

by William B. Irvine

Recent stock market crashes have been a disaster for American investors. In the Crash of '87, they saw the aggregate value of their investments fall by $1 trillion in less than a month; and in the Friday the 13th crash of last October, their investments sustained a $200 billion loss in a single hour.

How did investors respond to these crises? For the most part, with silence. What is striking about this reaction is what investors did *not* do. They did not ask the government to return the money they had lost. They did not complain that the system had treated them unfairly. They did not ask that the markets be closed to prevent similar disasters in the future. What they did (in all but a few cases) was accept their losses as part of the price of risk-taking.

This attitude used to be common among Americans: If you take risks, you have to take an occasional loss. Although this attitude still predominates among American investors, they are unusual in this respect. More and more, Americans are willing to accept the rewards of risk-taking but not the costs. Consider some illustrations.

When several state-insured thrifts collapsed in Ohio a few years back, savers—who for years had been happy to accept the above-average interest payments of these institutions—were confronted with the downside of their risk-taking. How did they respond to their losses? They petitioned the State of Ohio to bail them out. The state was glad to comply with their request. It not only made good their losses, but let them keep the rewards (i.e., the above-average interest payments) that their years of risk-taking had earned them.

North of Los Angeles one finds a rather special breed of risk-takers: people who own million-dollar homes on Malibu Beach. There is strong evidence that Mother Nature does not want houses built on Malibu Beach. In one season she sends down boulders and mud slides to crush the houses, and in another she sends massive waves to wash them away. The residents of Malibu Beach are content to accept the rewards of their risk-taking, but no sooner are they asked to pay a price for it than they request various forms of government assistance—funded, one should note, by people who cannot afford million-dollar homes.

Farming is by its very nature a risky business, and one would assume that farmers realize as much. In this century, though, farmers have shown themselves to be far more adept at banking the profits of good years than they are at absorbing the losses of bad years. As a group, farmers are notorious for their willingness to turn to the government for subsidies in times of adversity and for their unwillingness to relinquish these subsidies when adversity is conquered. A point of interest: Five decades later, farmers are still benefiting from programs created to deal with the drought conditions of the 1930s.

Businessmen, too, have a tendency to run to the government when they gamble and lose. For years bankers have been trying to palm off their bad Third World loans onto America's taxpayers. The bankers would have resented it if, in the 1970s, a government official had advised against

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