Reducing the Deficit: A glide path forward using Alaska's vast cash reserves

Senate Bill 114

Senator Lesil McGuire

Senate State Affairs

2/4/16

A $3.5-4Billion Deficit

- The legislature has enacted heavy spending cuts over the last 2 years
- The state has several savings accounts, but
  - Revenue models show that if oil prices do not rebound,
    - Those savings will be gone in about 2 years
- We cannot wait and hope for high oil prices
- The price of inaction now could be disastrous for the state’s future

A $3.5-4Billion Deficit

We have seen this before

For decades

Oil Price x Volume = State Budget

This has been Volatile and Unstable

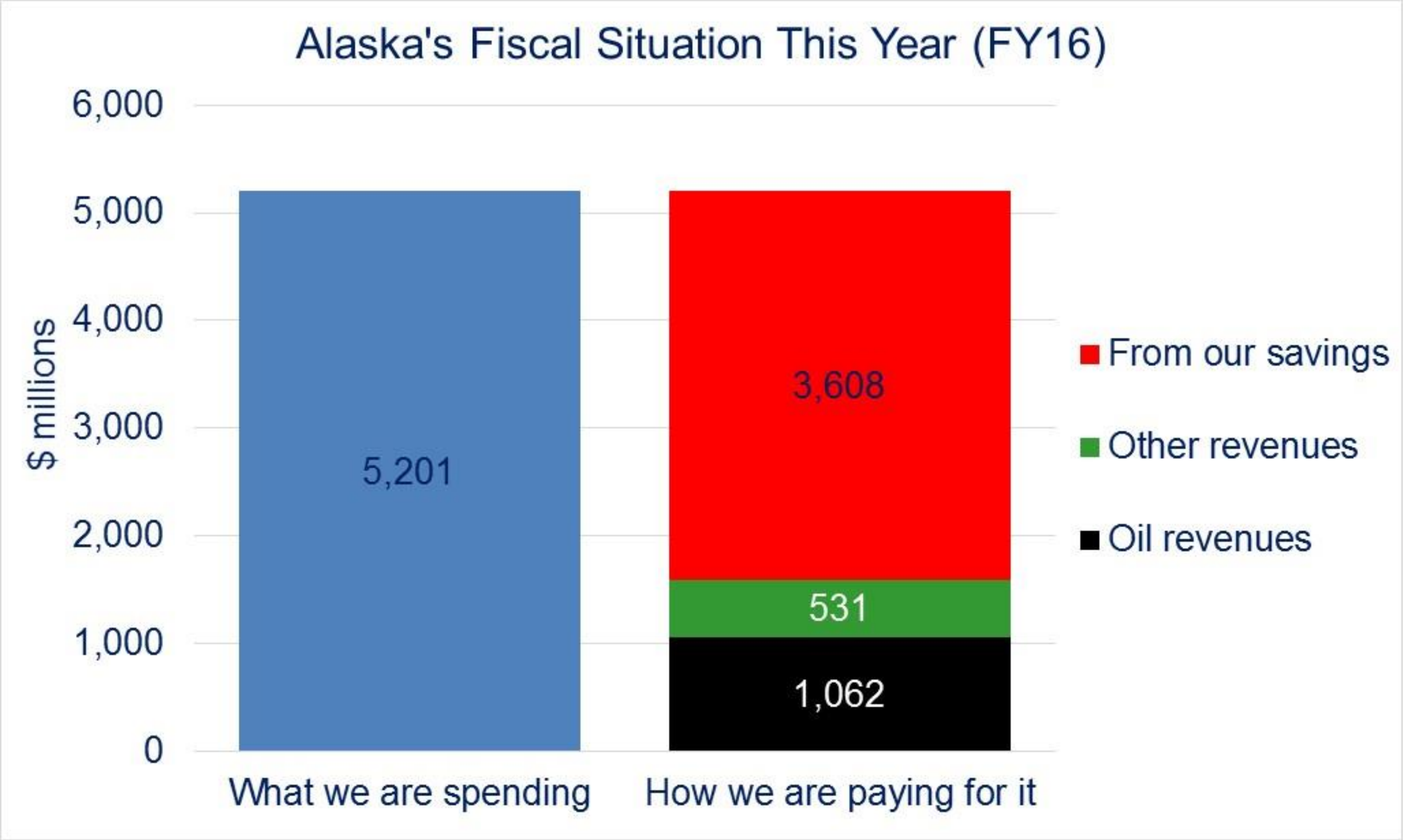
We have been saved in the past by rebounding oil prices

What is different today is:

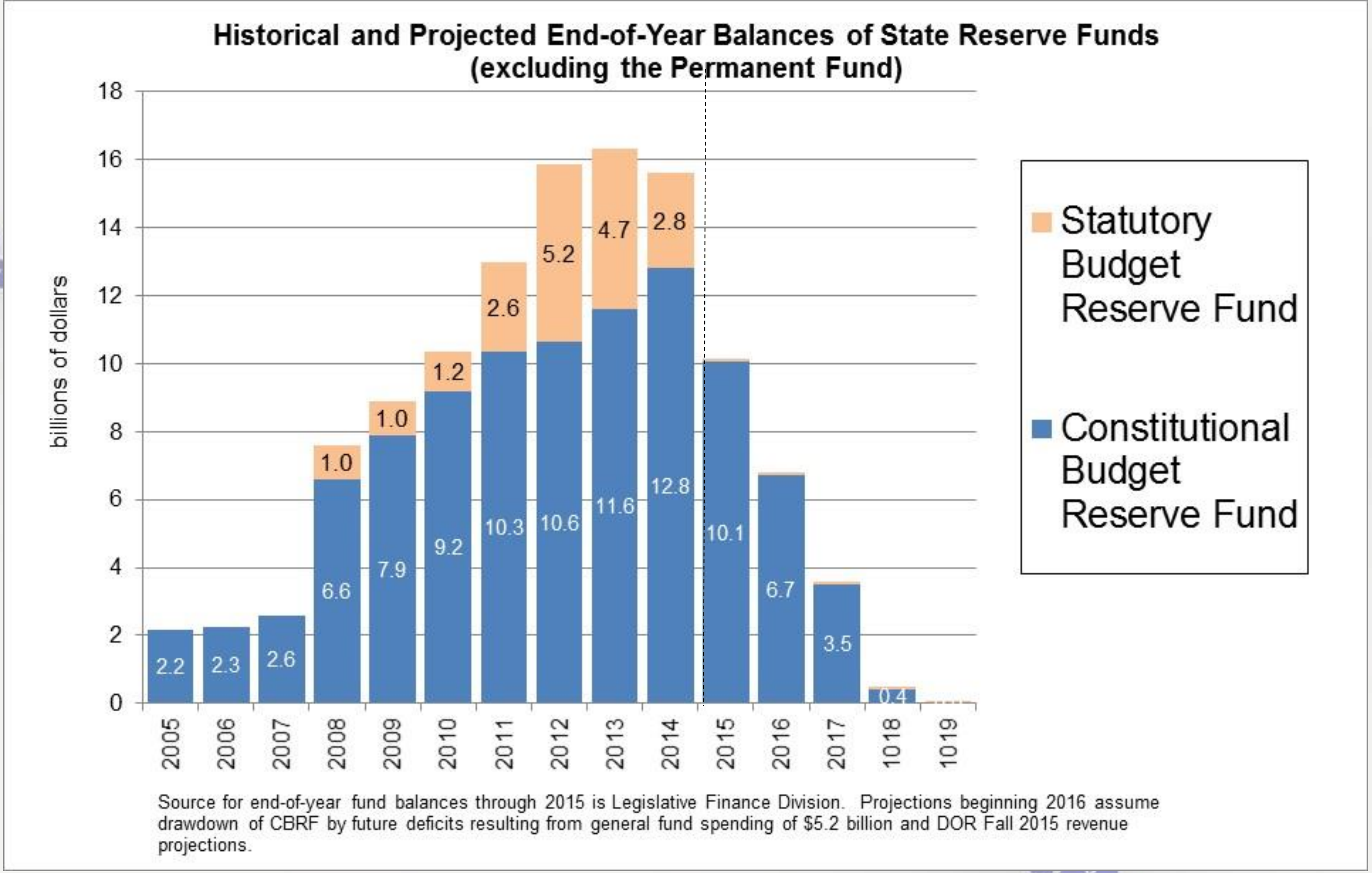
We no longer have the volume

(oil would need to be over $108bbl to balance the budget)

Einstein said "We cannot solve our problems with the same level of thinking that created them."



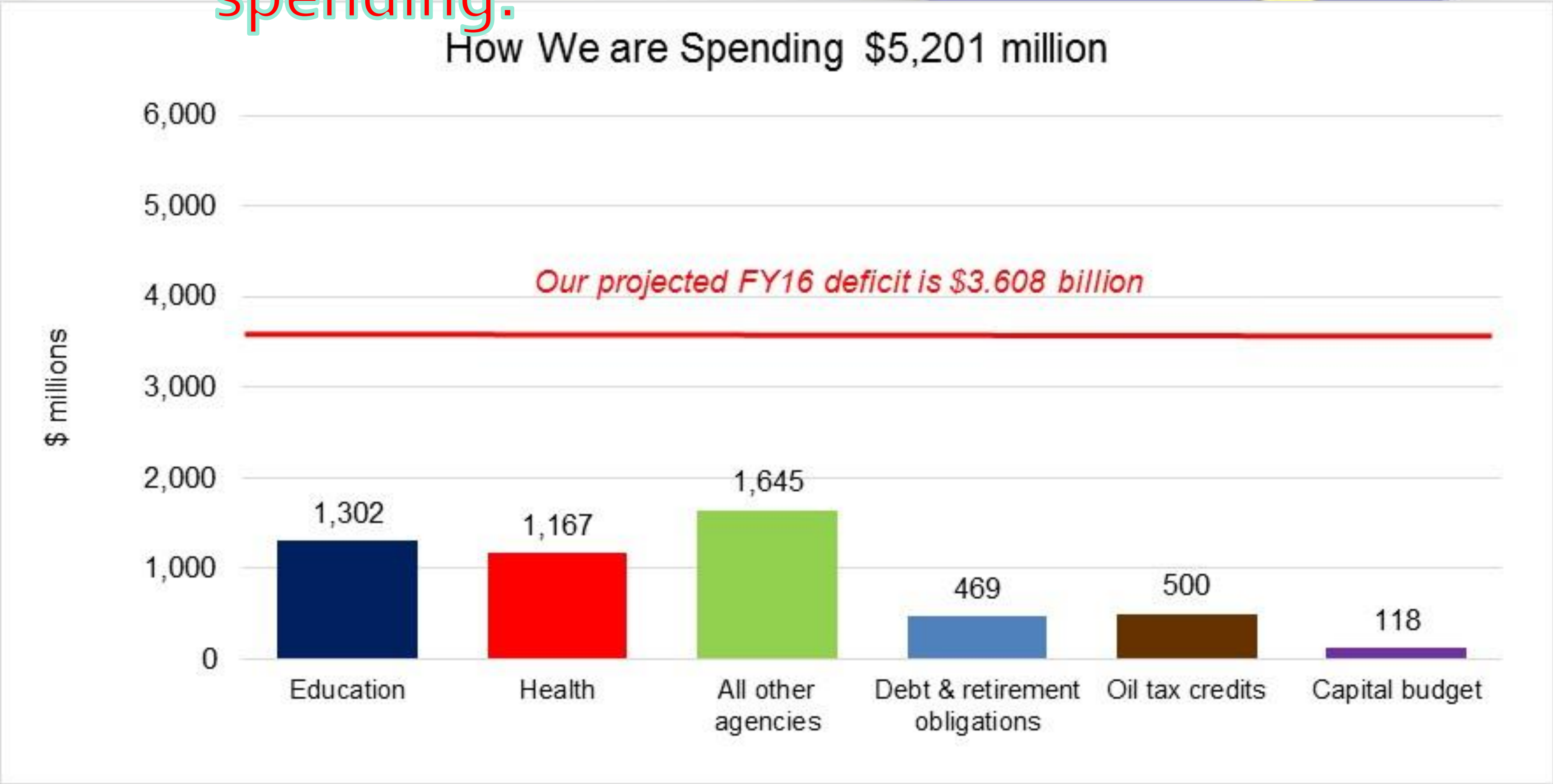
Gunnar Knapp- ISER



Gunnar Knapp- ISER

- 2008-09: Record high oil prices under ACES
- 2013: Low price and low volume- began draw down of SBR
- 2018: We cannot pay our bills with savings

It would be very difficult to close our funding gap by only cutting spending.



Gunnar Knapp- ISER

Most cuts would have to come from state agencies—including education & health

It would be very difficult to cut debt & retirement spending

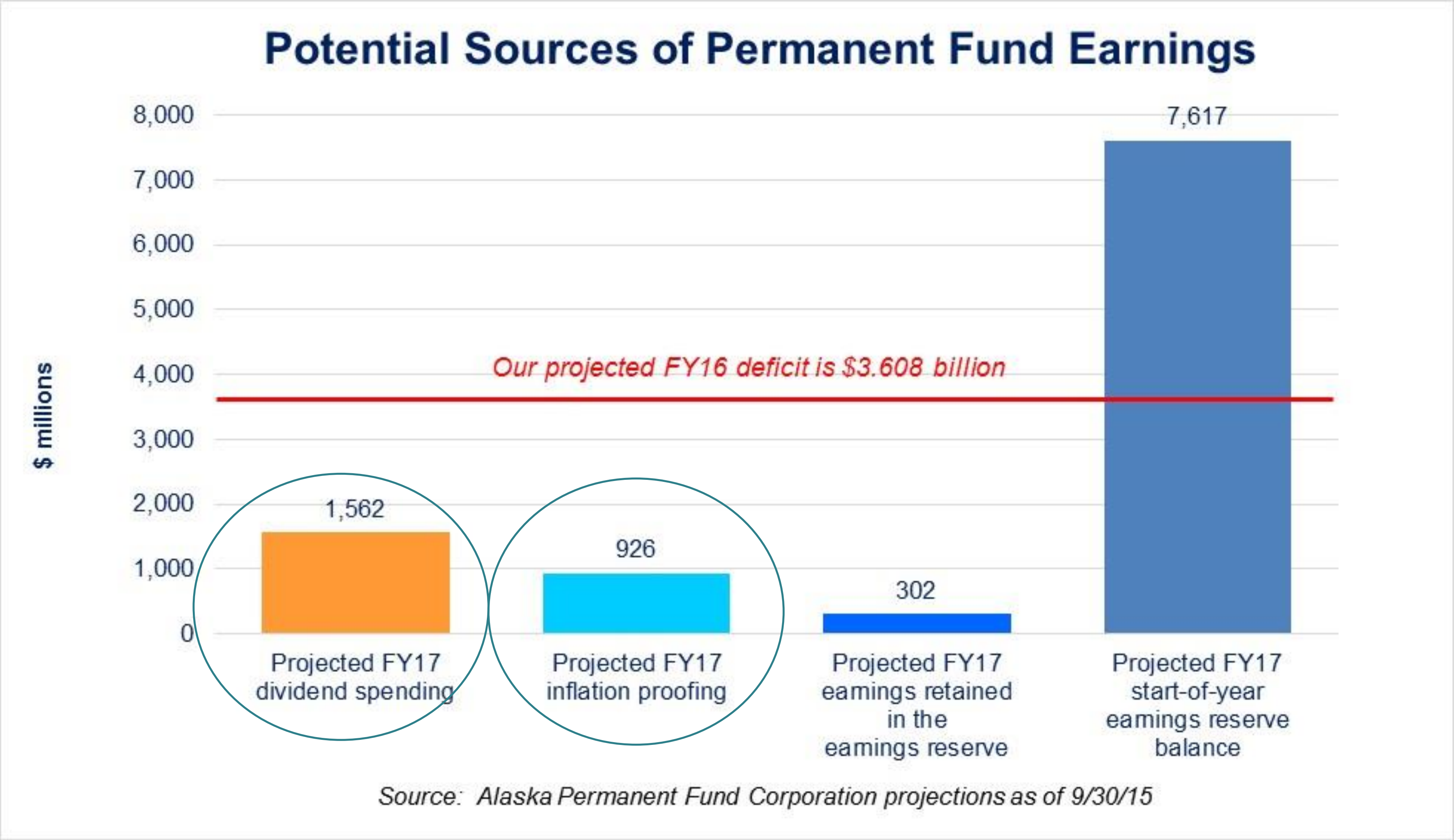
Cutting oil tax credits could affect future production and revenues

Very little capital spending is left to cut


Potential New Revenue From Sustainable Alaska Plan
There are many potential options for New State Revenues
- But none would be enough to close the funding gap
$ MILLIONS
4000
3500
3000
2500
2000
1500
1000
500
0
$6
$18
$15
$49
$40
$29
$100
$200
$457
3600
Mining
Fishing
Tourism
Motor Fuel
Alcohol
Tobacco
Oil and Gas
Income Tax
TOTAL
DEFICIT

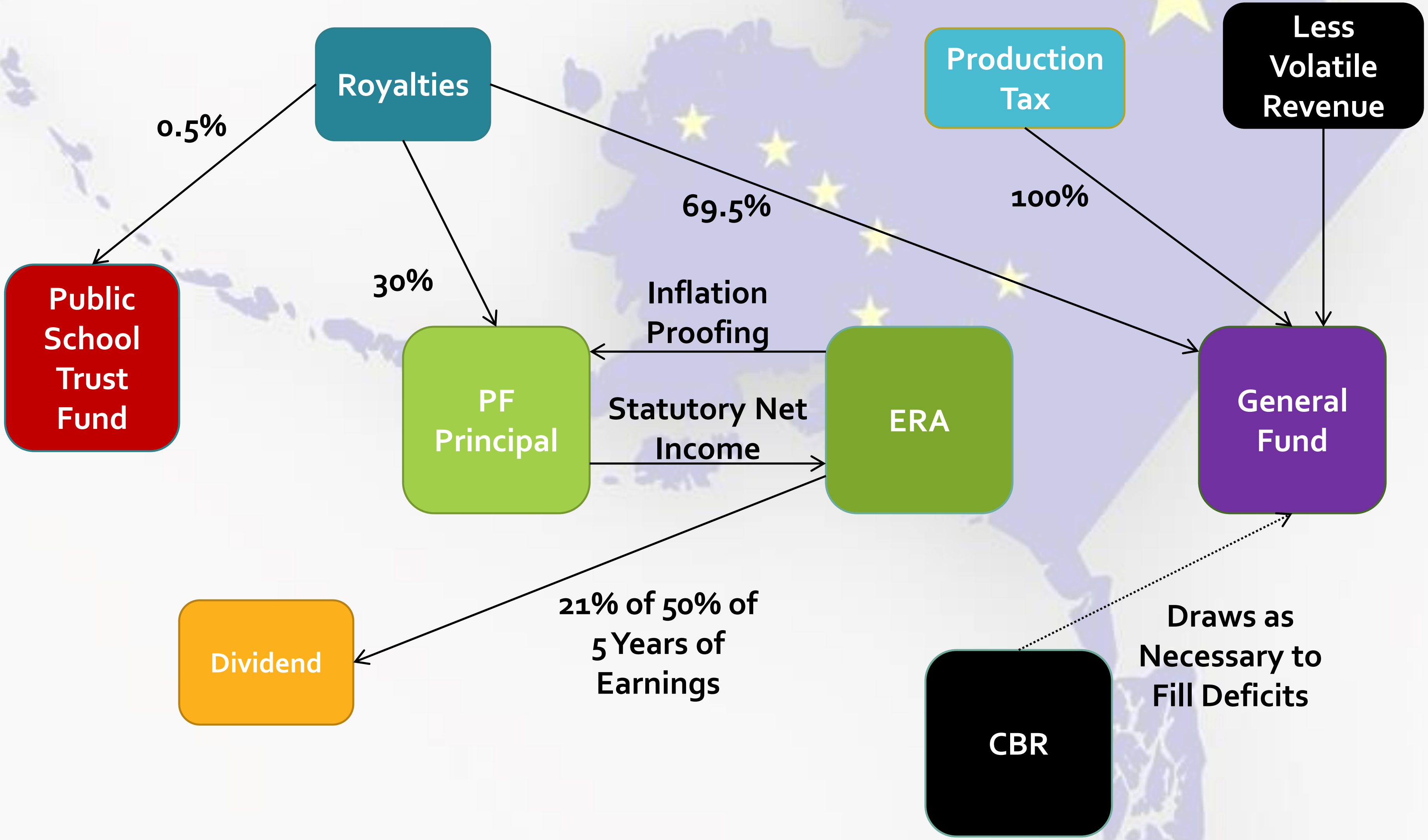
We cannot close the gap with <u>cuts</u> or new <u>broad-based revenue</u> ALONE

A sound fiscal solution will necessarily involve using the Permanent Fund

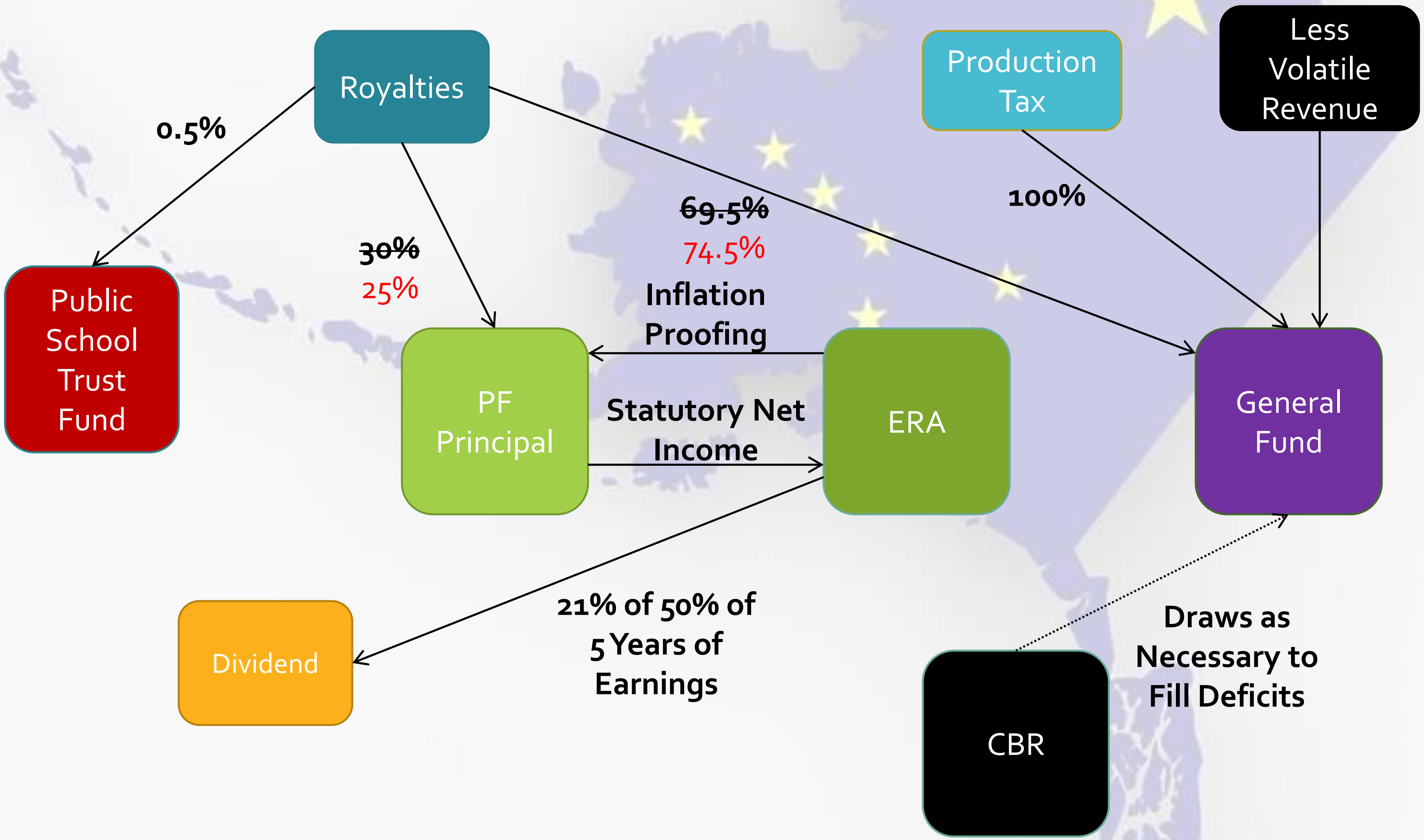


If you consider the PF Dividend and Inflation proofing as spending-
It is our SINGLE LARGEST budget item

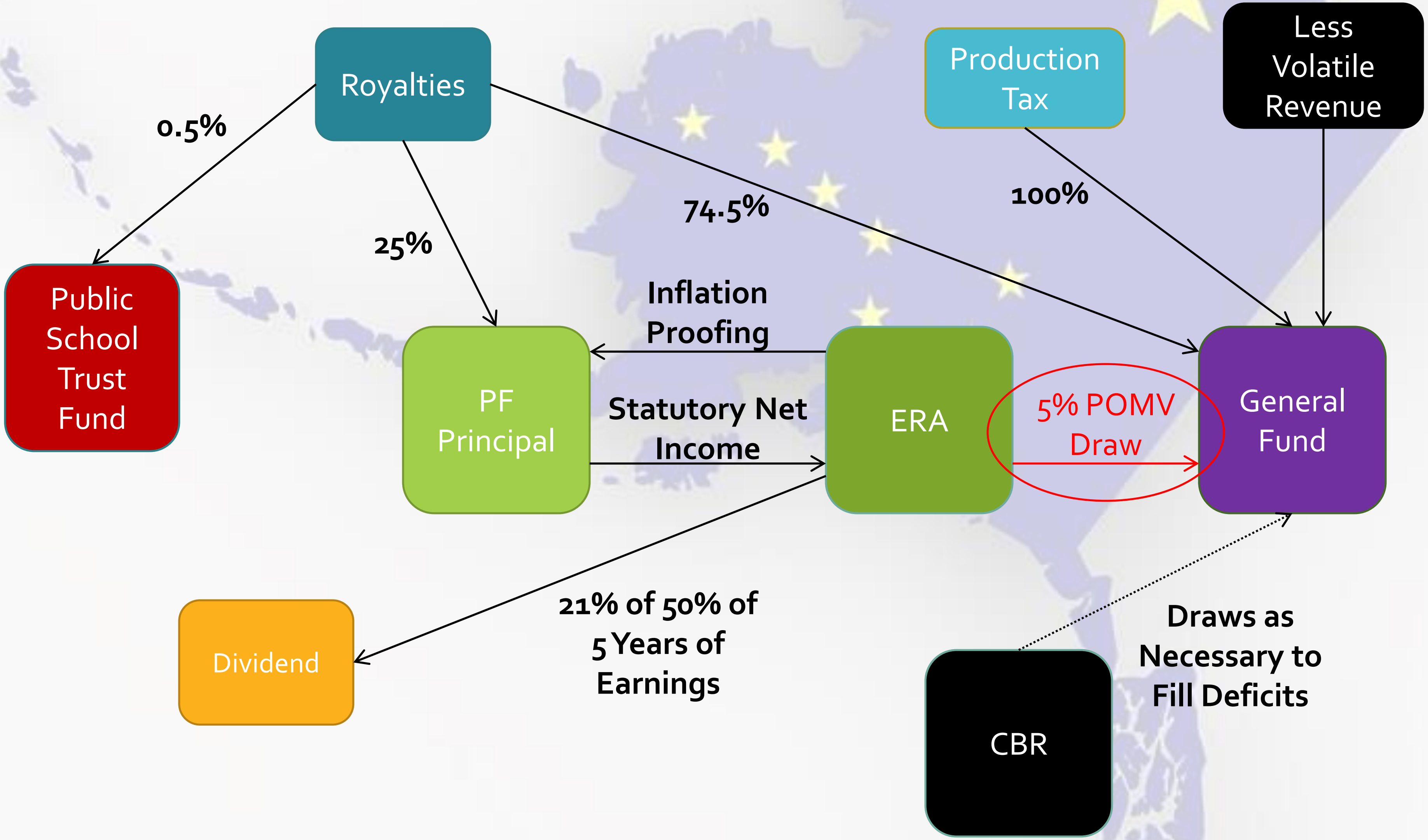
Current Cash Flow



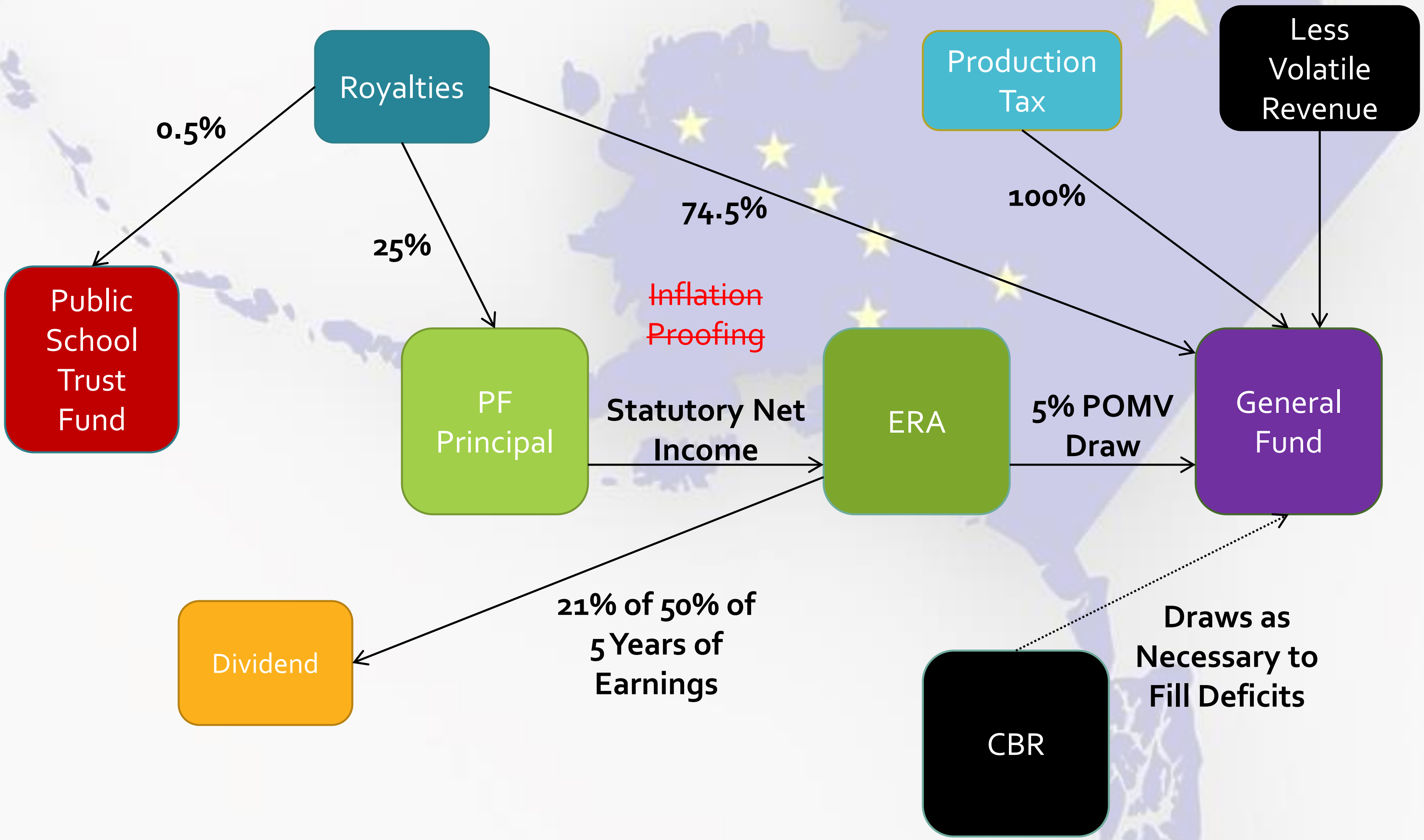
1. Change Royalty Percentage



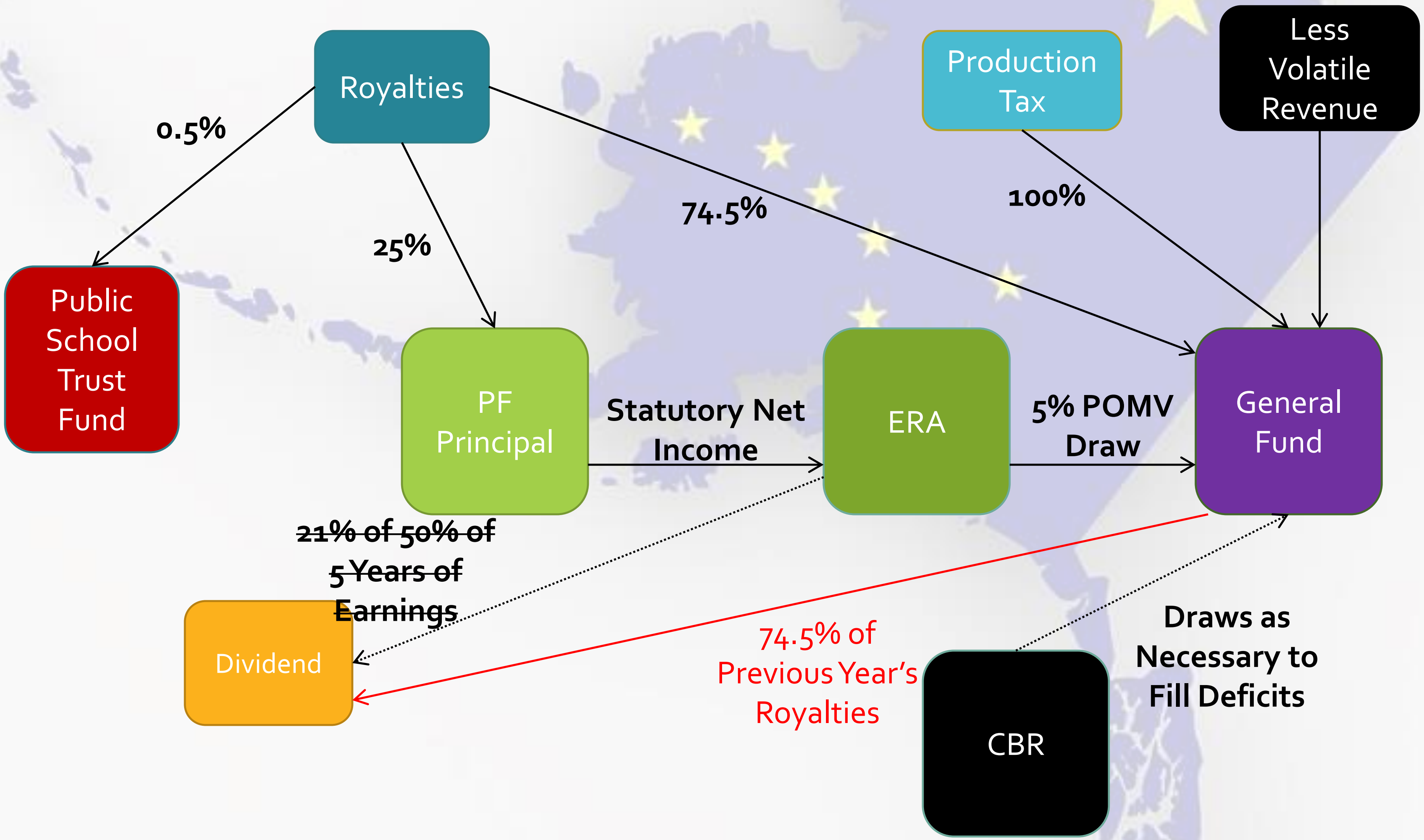
2. Add POMV Payout



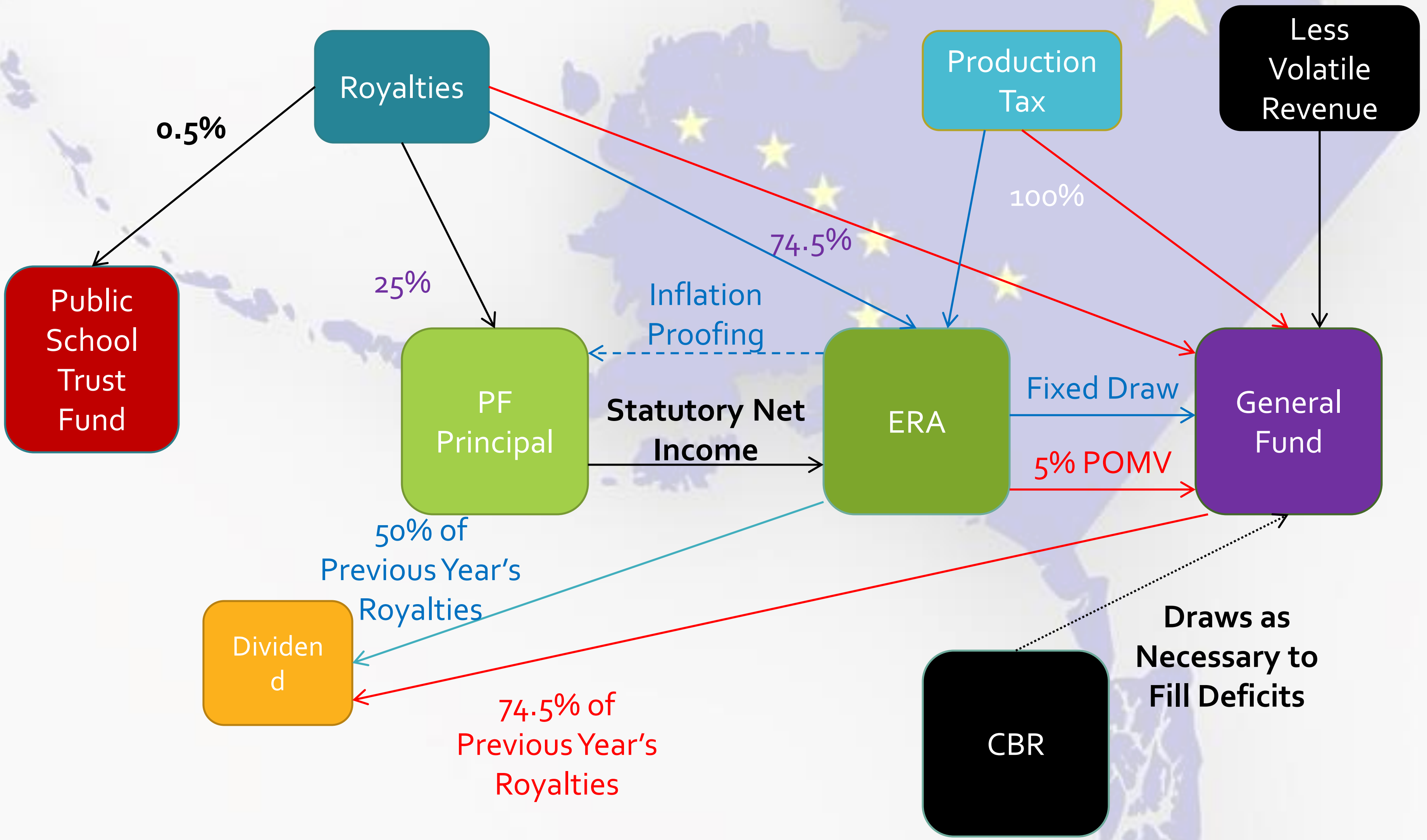
3. Remove Inflation Proofing



4. Change Dividend Source and Calculation



PFPA vs. SB 114



Walker's Proposal vs SB 114

Key Elements

- *Royalties go to Dividend under both plans*
  - *Gov's = 50% of Royalties (~$1,000 dividend and falling)*
  - *SB 114= 74.5% of Royalties (Higher Dividend)*

- *Gov's plan moves CBR and Oil tax revenue into Earnings Reserve Account*

- *Gov's plan is NOT a POMV*
  - *Targets a set number ($3.3B) for withdrawal and spending*
    - *This is telling the legislature you have "x" amount to spend every year*

- *SB 114 does not change oil tax revenue (still straight to GF)*

SB 114: The SWAP- Rents and Royalties

- Currently,
  - 30% of all Royalties and Rents from
    - Oil, Gas and Federal Mining revenue
      - Deposited into the Permanent Fund corpus
  - 0.5% of R & R to School Trust Fund
  - 69.5% deposited to General Fund

SB 114: Rents and Royalties to Dividend

- 74.5% of all R&R would be deposited into the Dividend Fund
- No Permanent Fund Earnings would be used for Dividend
- SB 114: puts a floor (guarantee) of $1,000 Dividends

SB 114: PF Reserve Earnings Account and the General Fund

- The exchange for R&R to Dividend Fund:
  - 5% of the total value of the Permanent Fund (Corpus + ERA)
    - Withdrawn from ERA
    - Deposited into General Fund

    - This is often called a Percent of Market Value (POMV) concept
    - Returns on PF investments average more than 5%
      - Thus you inflation proof the PF plus the 25% R&R deposit
        - The PF continues to grow

SB 114: PF Reserve Earnings Account and the General Fund
Inflation Proofing?

Moody's Est. Return on Permanent Fund Investments = 6.8%

POMV Draw = <u>5%</u>

To the Earnings Reserve Account = 1.8%

To the Corpus of the Permanent Fund = 25% of Royalties

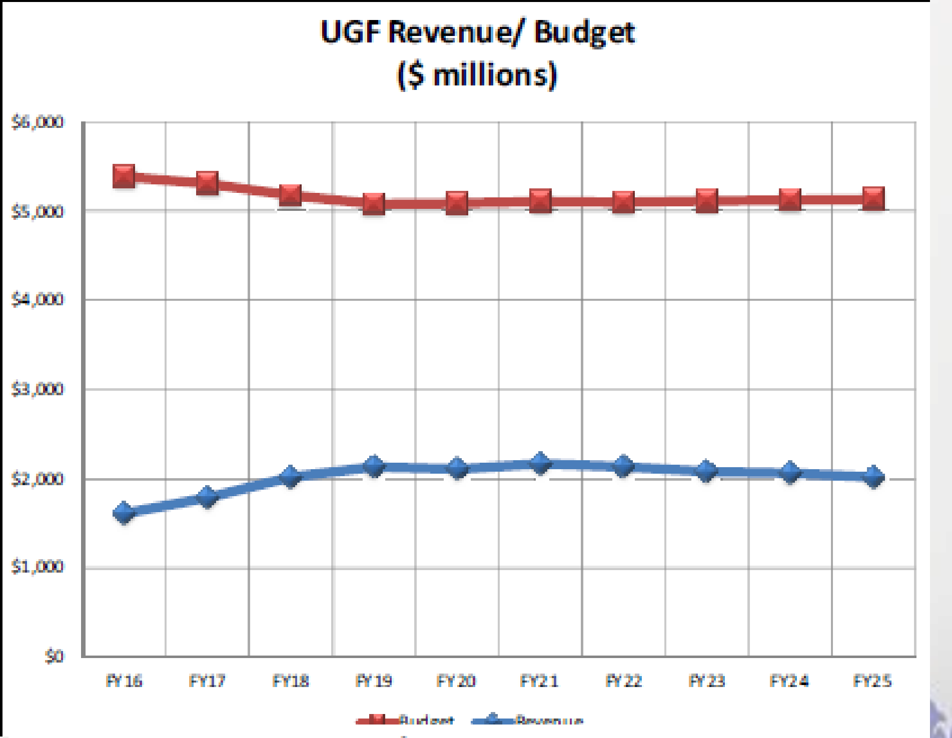
SB 114: R&R vs. POMV Swap
The effect is $2Billion reduction to deficit

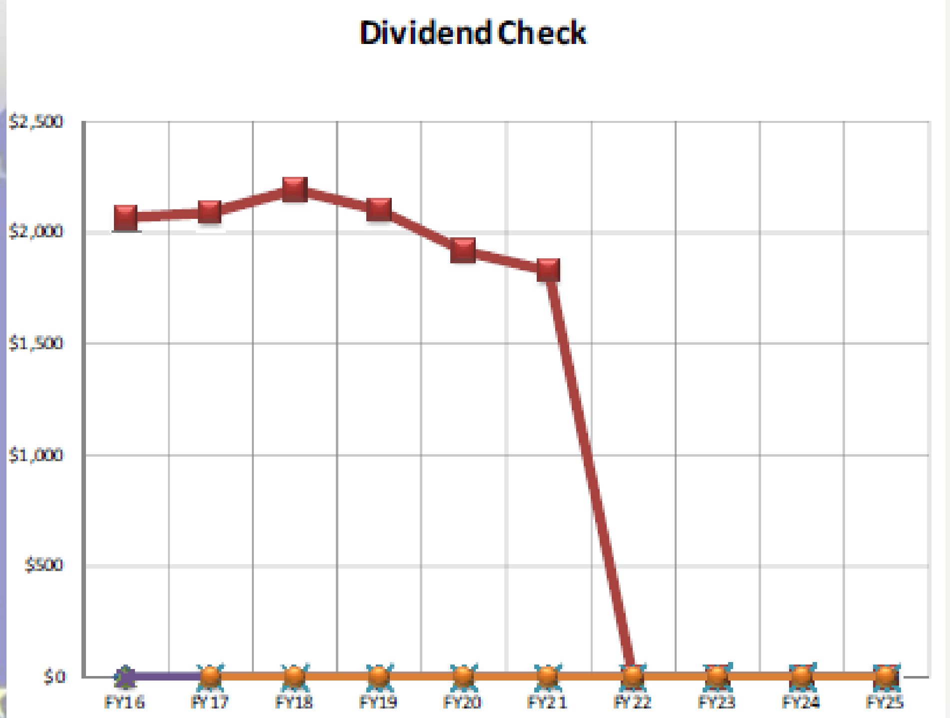
- 74.5% of R&R to Dividend Fund for equal Distribution
  - **2016= ~$2,000 Dividend (status Quo)**
  - **2017= ~$1,150 Dividend (Revenue Source Book Fall 2015)**
- 5% of Permanent Fund ($51B) goes to General Fund
  - FY17= **<u>$2Billion NET INCREASE TO GENERAL FUND</u>**

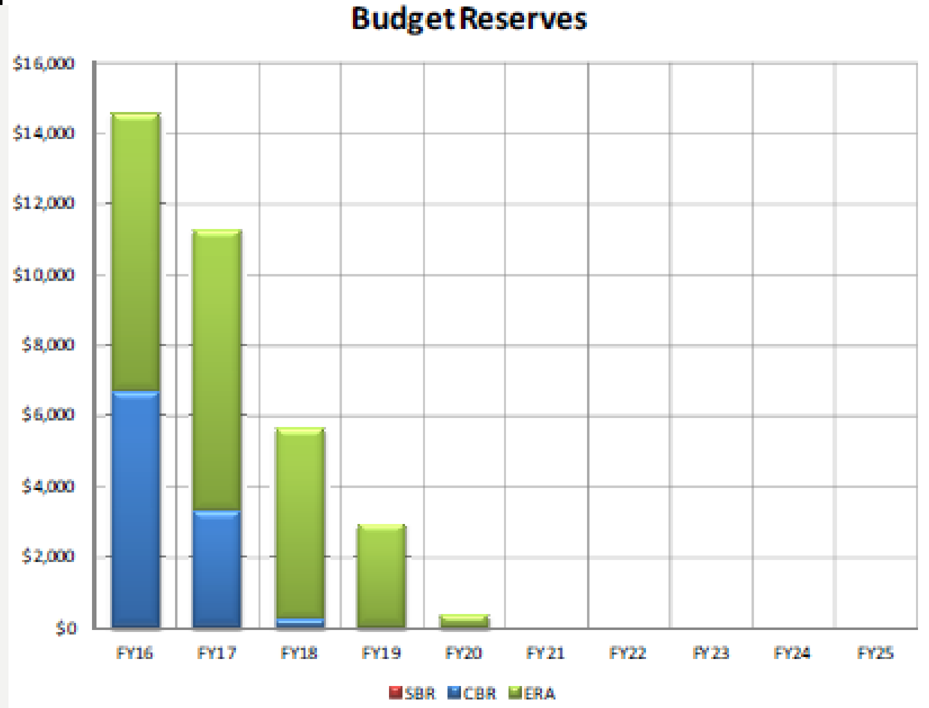
<u>This cuts the Deficit in HALF</u>

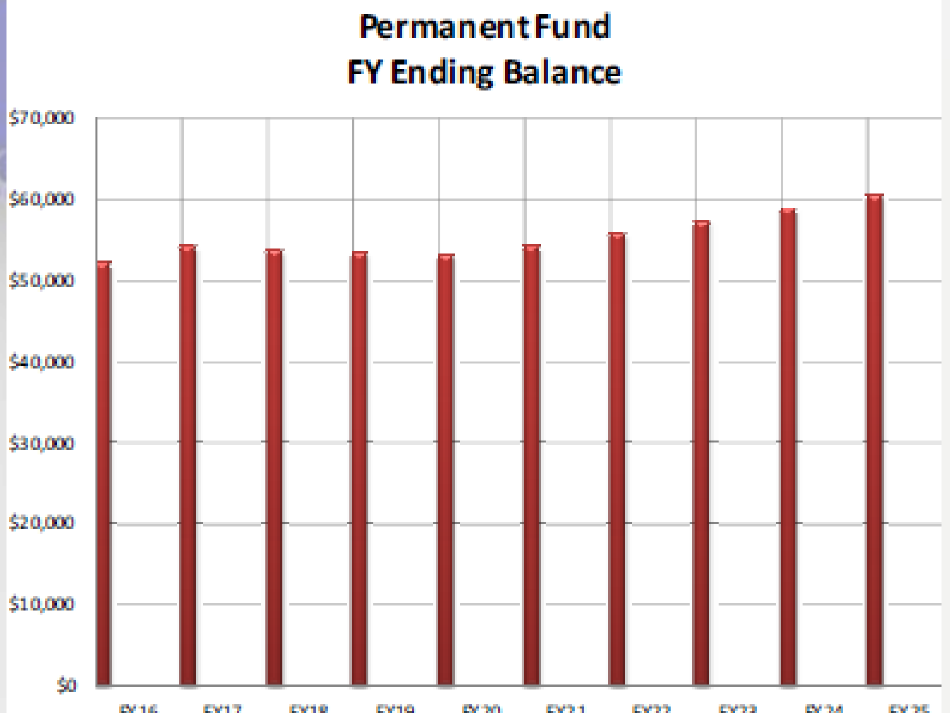
What is the cost of doing nothing?

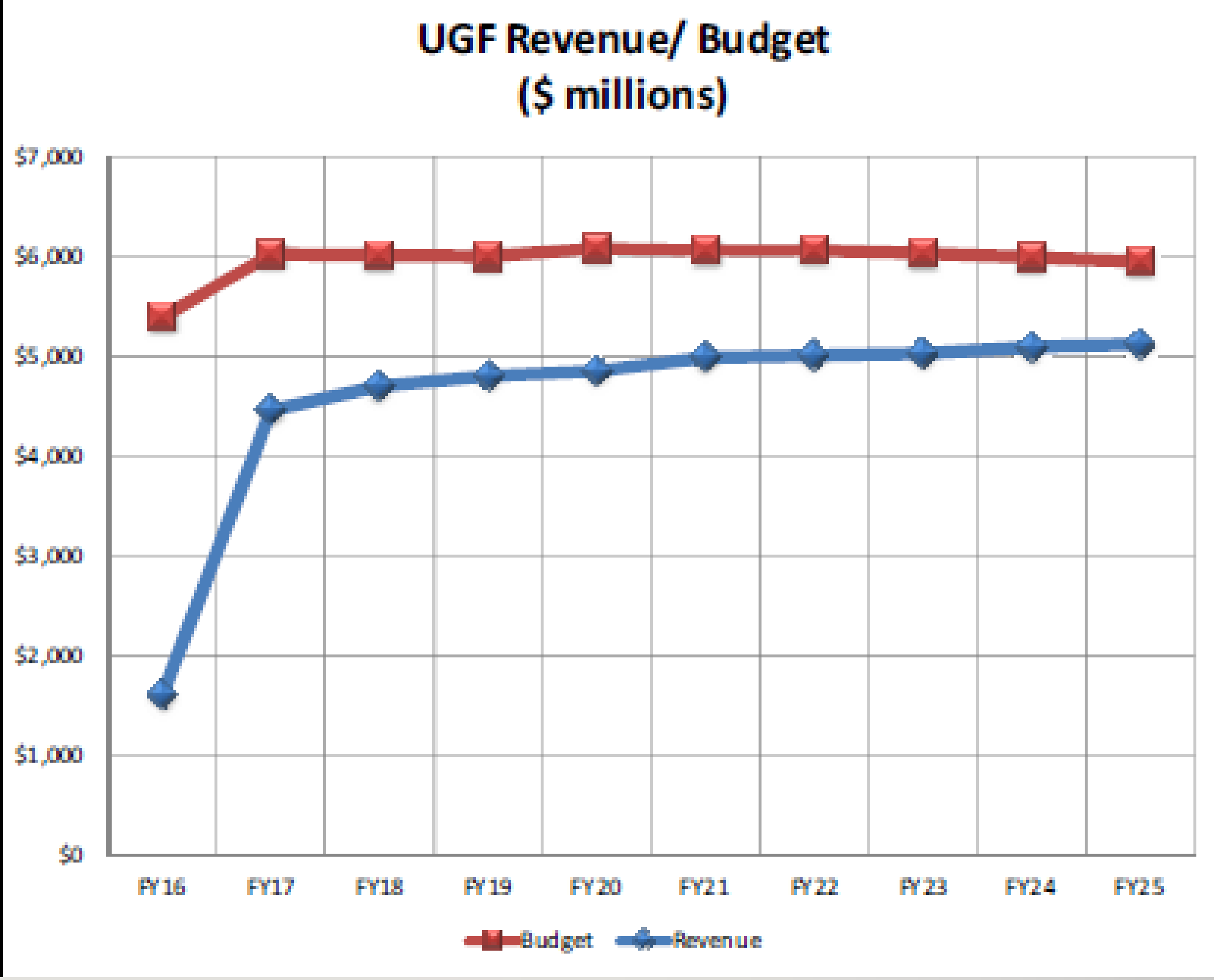
Status Quo

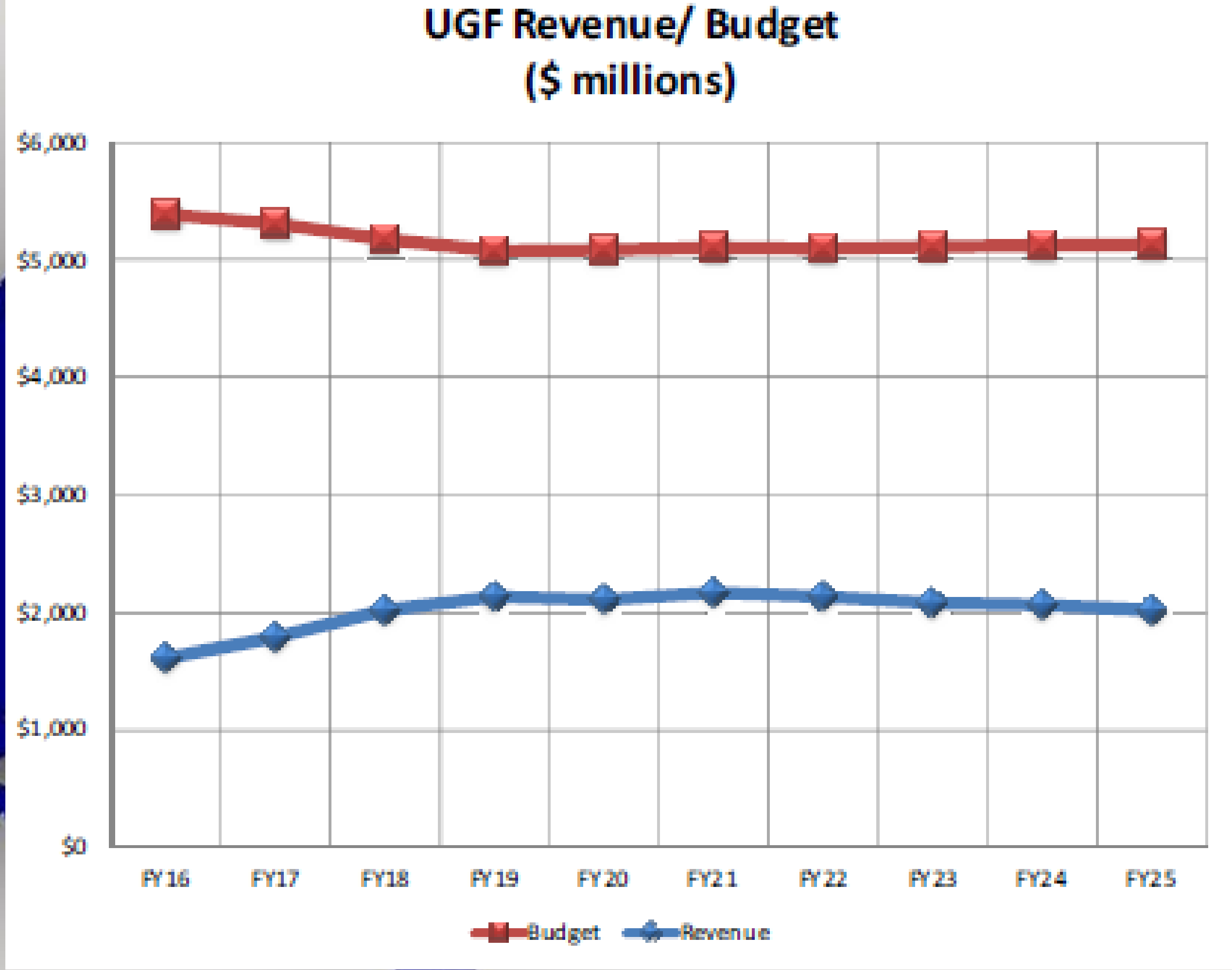

UGF Revenue/ Budget
($ millions)
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
FY16
FY17
FY18
FY19
FY20
FY21
FY22
FY23
FY24
FY25


Dividend Check
$2,500
$2,000
$1,500
$1,000
$500
$0
FY16
FY17
FY18
FY19
FY20
FY21
FY22
FY23
FY24
FY25


Budget Reserves
$16,000
$14,000
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
$0
FY16
FY17
FY18
FY19
FY20
FY21
FY22
FY23
FY24
FY25
SBR
CBR
ERA

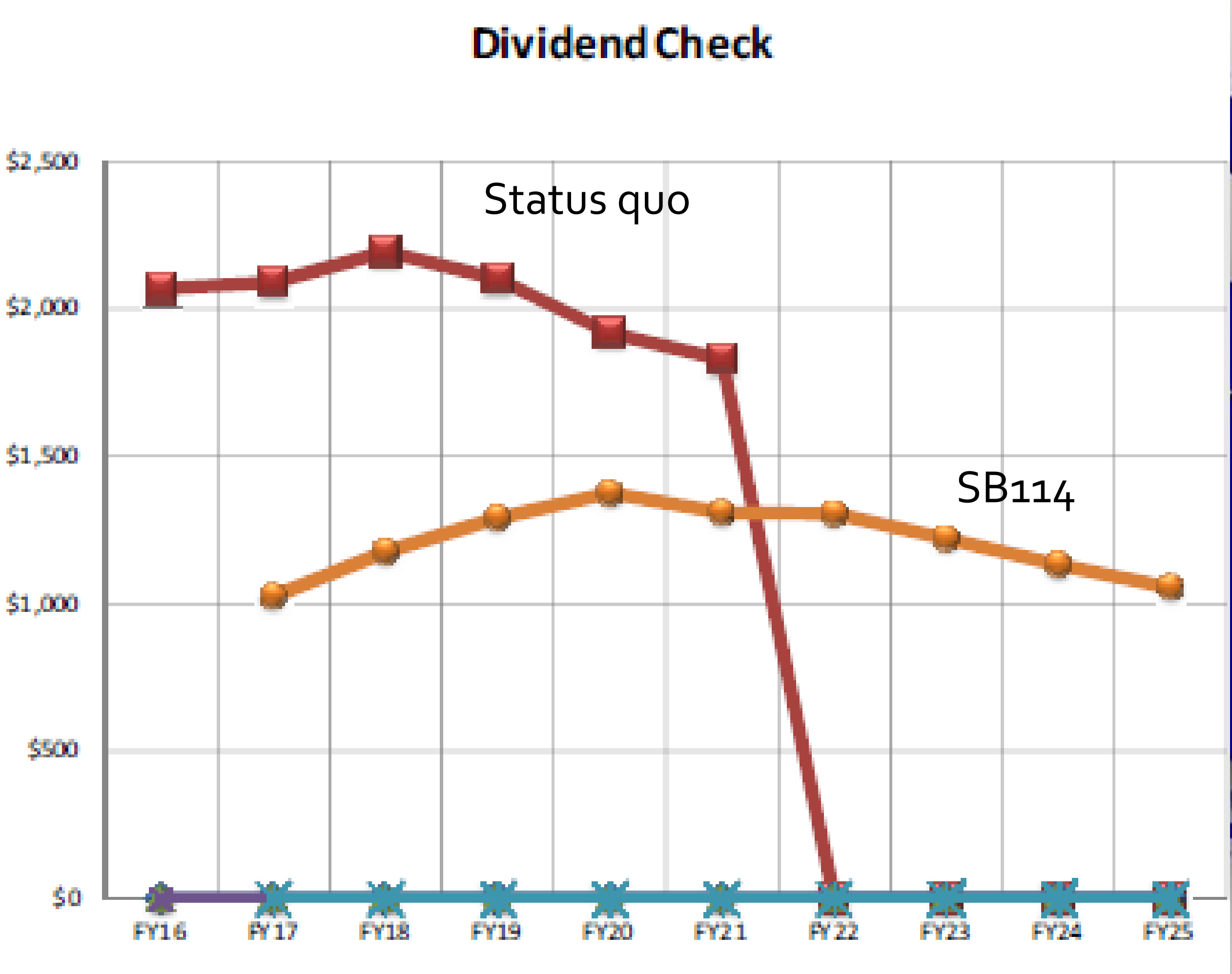

Permanent Fund
FY Ending Balance
$70,000
$60,000
$50,000
$40,000
$30,000
$20,000
$10,000
$0

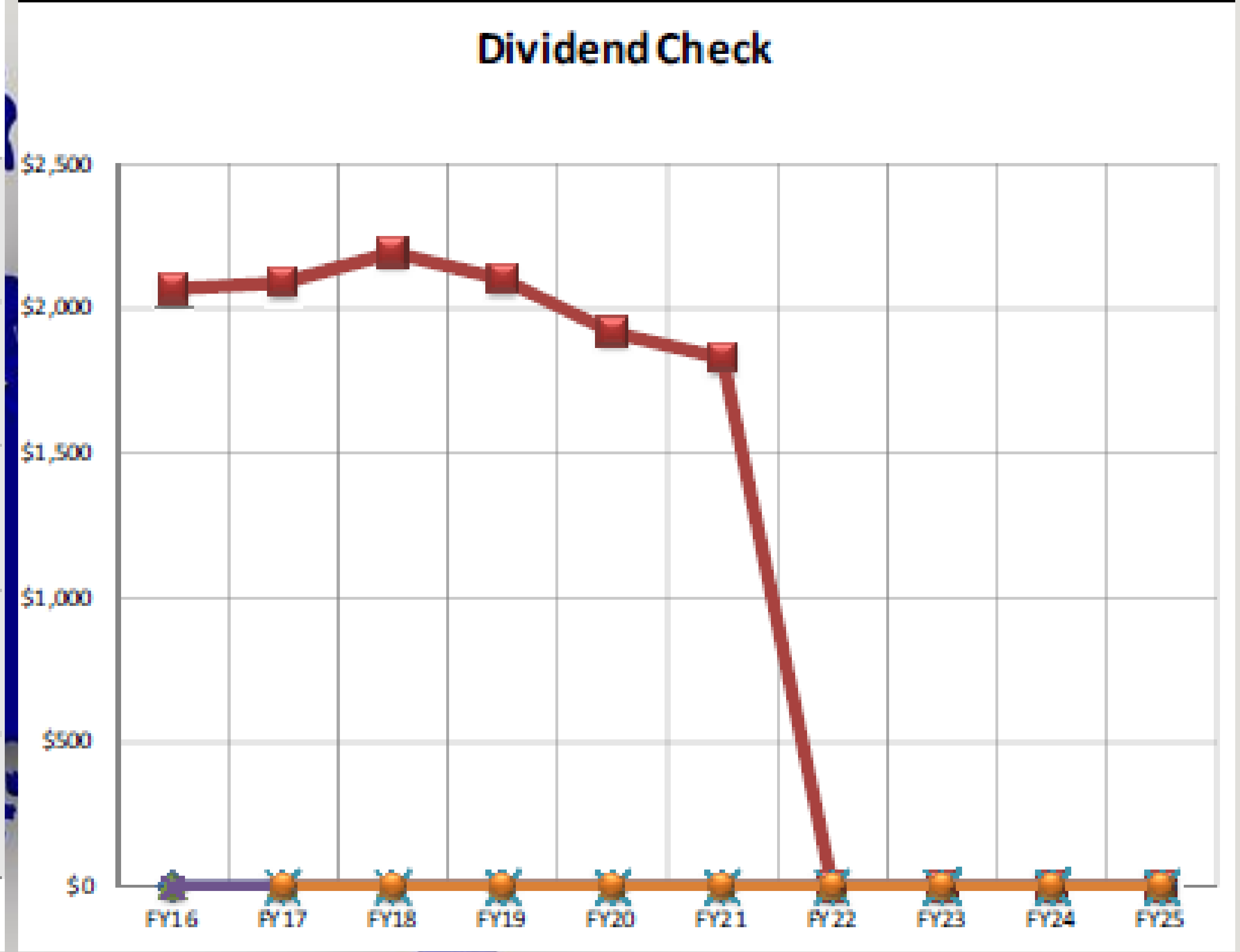




SB114

Status Quo





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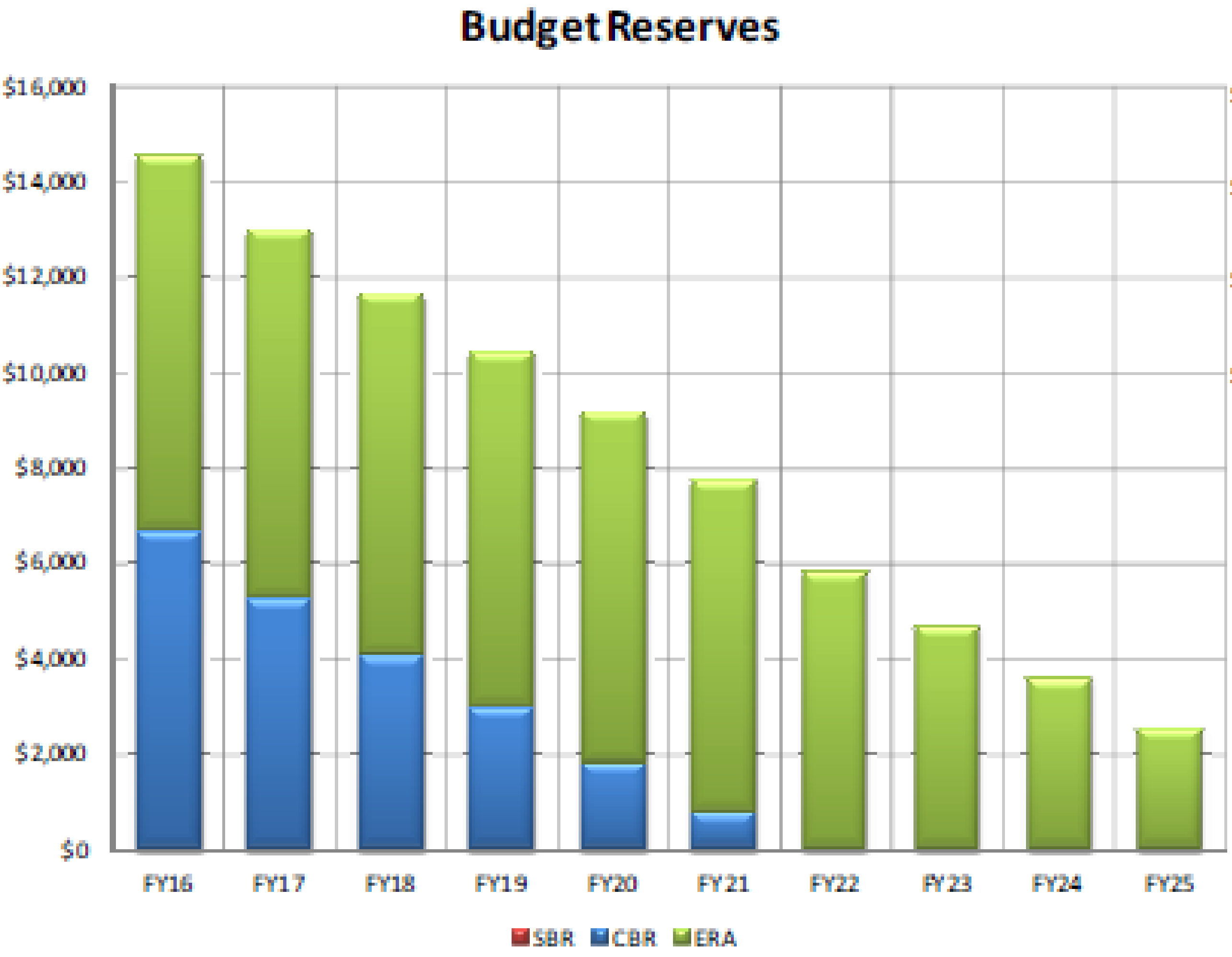

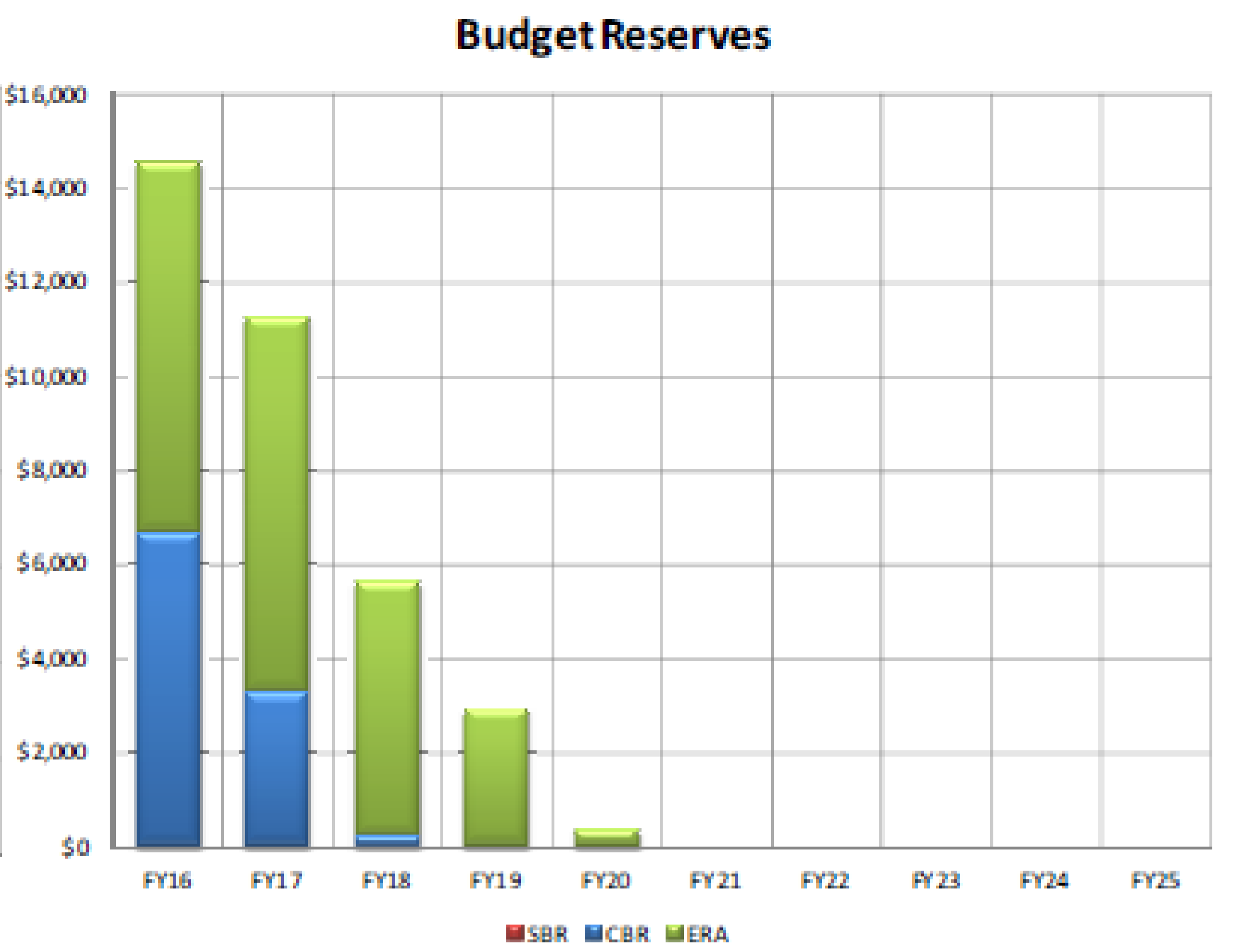

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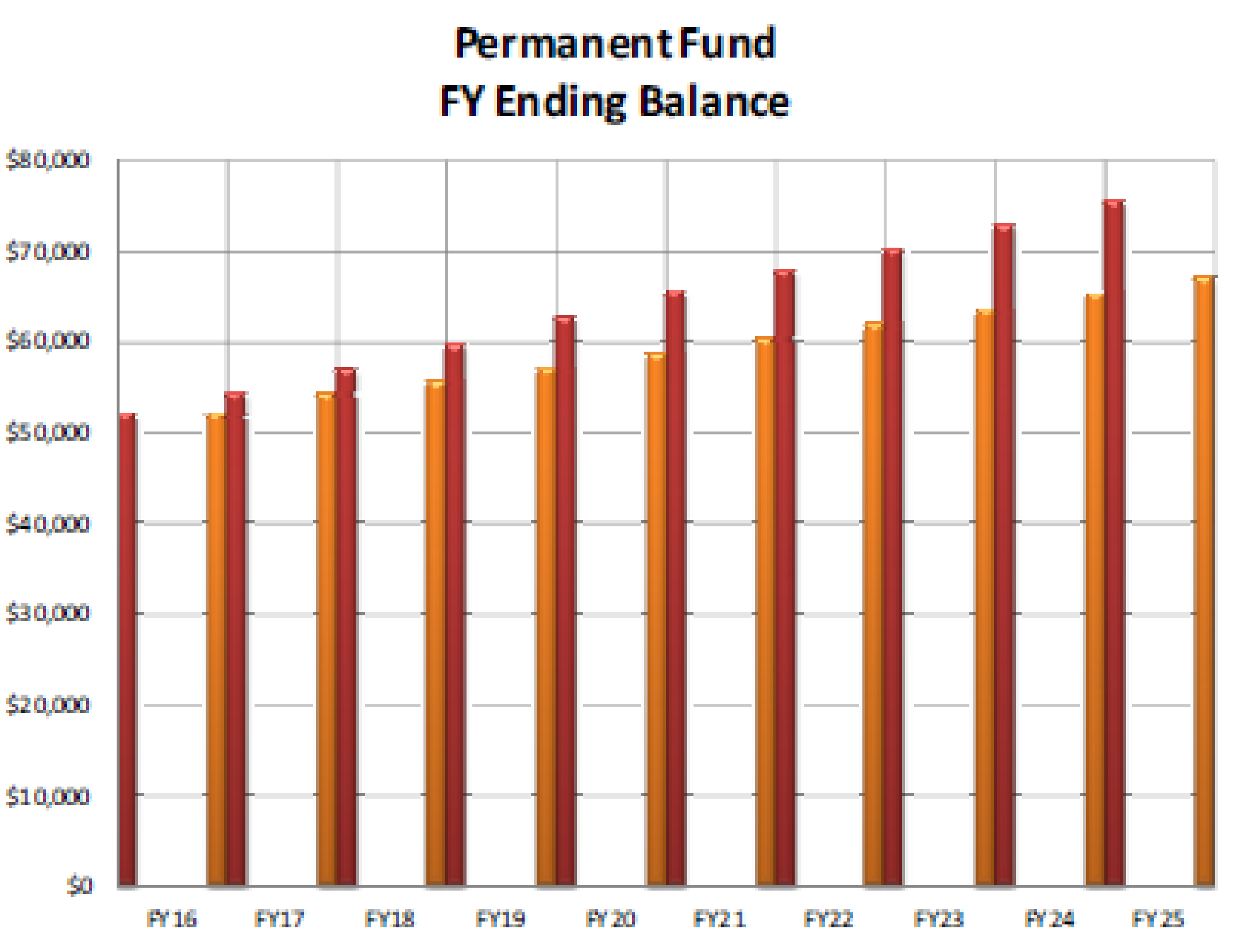

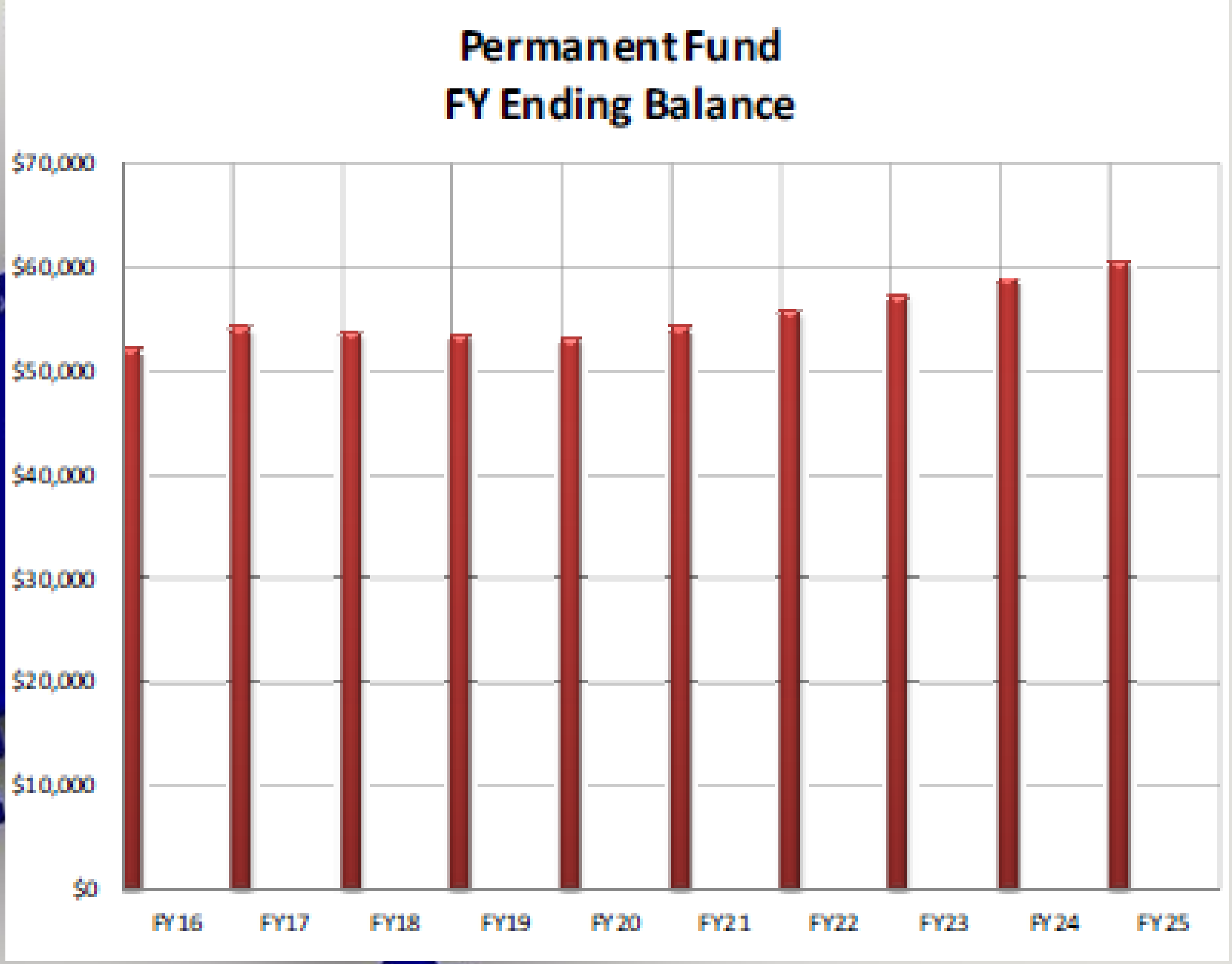

SB114

Status Quo

A Glide Path Forward

We need a plan to address this problem

> "If I had one hour to solve a problem, I would spend 55 minutes thinking about the problem and 5 minutes thinking about the solution."
>
> \- *Albert Einstein*

In crafting SB114 I had these principles in mind:

1) The solution needed to retain a dividend
2) The solution needed to reduce the volatility in the state budget
3) The solution needed to clearly expose the size and cost of government so that downward pressure would ensure that Alaskans could begin an honest assessment of needs vs. wants
4) The solution needed to be enduring to allow maximum use of our wealth over generations so that benefits and burdens are shared
5) The solution needed to be Simple and Easy to Implement

SB 114: The overall effect

- **Ties the Dividend directly to Oil & Gas and Mineral production**
  - **Currently structured to pay a dividend with a floor of $1,000**
  - **Can be structured to pay a dividend of the average of last 5 years ~ $1,300**
  - **Protects the Dividend for future generations**

- **Reduces the CBR draw to cover deficit**
  - **This will extend the life of the CBR several years**

- **Gives the legislature "Glide Path" (breathing room) to consider**
  - **Additional budget cuts**
  - **New sources of revenue**
- **Maintains downward pressure on the operating budget- by not closing the gap**

This is considered "best practices" by other large endowment funds

SB 114: Our Glide Path