Revenue Sources Book

Alaska Department of Revenue – Tax Division

FALL 2009

3. The Constitutional Budget Reserve Fund: Its Purpose, History and Use

Boom and Bust History of Natural Resource Revenues

For all of recorded history, Alaska has been a resource extraction state. From sea otter fur to timber, to gold, and finally to oil and natural gas, Alaskans have relied on natural resources as the major economic driver in the state. Because of its economic dependence on natural resources, Alaska has had a long history of boom and bust cycles.

As early as 1778, Captain Cook observed that traders would likely find a lucrative market for sea otter pelts or "sea-beaver" as they were called at the time. In fact, Captain Cook went so far as to call the sea otter pelts "soft gold."[1] Fur from sea otters and seals did indeed become a major source of revenue for Alaskan traders. Yet less than fifty years after Captain Cook correctly predicted the value of the sea otter trade in Alaska, a "fur boom" ensued and sea otters were hunted to virtual extinction.[2] This pattern of discovery of a resource in commercial quantities, followed by a subsequent rush to harvest the resource and ultimately the depletion of the resource, sadly played out again and again in Alaska over the next hundred years. Gold caused the next natural major resource boom for Alaska only to crash in the early 1940s. Fishing, specifically salmon, was a leading source of revenue for the Alaskan economy during World War II.

Another significant source of revenue in Alaska is federal spending, especially military spending. During World War II, over a billion dollars in federal money flowed into the state over a relatively short period of time, leading some to refer to the period as a "defense rush." Yet Alaska experienced a painful contraction within a few years of the end of World War II.

While federal revenues were flowing into the state at a record pace, tax revenues from the two leading sources of government revenue, fishing and mining, were dropping. Revenues from fishing and mining dropped so dramatically in the 1940s that by 1948, alcohol taxes had overtaken fishing and mining to become Alaska's main source of revenue.[3] At the same time, spending for state services skyrocketed, leaving Alaska with a multi-million dollar budget shortfall in 1947.

[1] Barnett, James K. *Captain Cook in Alaska and the North Pacific*, Todd Communications, Anchorage, Alaska, 2008.
[2] ibid.
[3] Cole, Terrance. *Blinded by Riches: The Permanent Funding Problem and the Prudhoe Bay Effect.* University of Alaska Institute of Social and Economic Research. Anchorage, Alaska, 2004.

Over the years there were numerous discussions of the need to stabilize revenues and protect Alaska from the boom and bust cycles associated with reliance on natural resources, but there never seemed to be enough of a surplus or a willingness to save until oil was discovered in Alaska in world-class quantities.

The Permanent Fund

By the late 1970s, numerous groups and individuals had pointed out the need for Alaska to establish a savings fund to protect against swings in commodity prices for natural resources. As early as 1941, then Territorial Governor Ernest Gruening called for a budget stabilization fund to guard against the revenue volatility experienced by a natural resources dependent economy.[4]

Gruening's dream of an "Alaska fund" came true in the form of the Alaska Permanent Fund. While one purpose of the Permanent Fund was arguably to create a "rainy day account" for government spending when oil revenues dwindled, it has not been used for that purpose. Former Governor Jay Hammond is credited with the idea of generating public support for protecting the Alaska Permanent Fund by paying out dividends to Alaskans. The idea has been quite effective.

While legislators may appropriate money from the earnings of the Alaska Permanent Fund for government projects, the dividend program has made any dipping into the Alaska Permanent Fund for purposes other than dividends extremely controversial.

The 1980s Bust and Impetus for CBR

In the mid-1980s, roughly a decade after the Alaska Permanent Fund was established, Alaska experienced another severe resource bust as the price of oil dropped to roughly $10 per barrel, bringing widespread foreclosures and bankruptcies to Alaska.

The 1980s bust was the same painful story Alaskans weathered through for over a century: resources flowed in and government spending grew, resources played out or values dropped and suddenly Alaskans were faced with a tremendous shortfall. As the individual income tax and several other state taxes were repealed in 1979-1980 as a result of soaring oil revenues, taxes paid by Alaskan residents plummeted. As Stephen Jackstadt and Dwight Lee noted, "real taxes paid to the state by individual Alaskans after 1980 were only 14 to 16 percent of the real taxes they paid during fiscal year 1976."[5]

Revenues were declining and state spending was expanding. Over the seven years from 1981 to 1988, state spending increased almost 2,000% with state spending representing approximately $70,000 per Alaskan.[6]

Statutory Budget Reserve

In 1986 as the Alaskan economy cratered under the pressure of $10 per barrel oil, the legislature created another "rainy day" account: the Statutory Budget Reserve. The Statutory Budget Reserve was created to cover General Fund shortfalls using "excess revenues" from more profitable years.

The Alaska Legislature seeded the Statutory Budget Reserve with the balance of the remaining General Funds at the end of fiscal year 1991, $696.3 million.[7] By fiscal year 1994, the legislature had appropriated all of the money in the Statutory Budget Reserve leaving it with a zero balance. However, in 2008 the Legislature deposited approximately $1 billion in the Statutory Budget Reserve, which remains in the account today.

The Statutory Budget Reserve served its purpose for a short period of time before lying empty for over a decade. There was concern among some state legislators that the problem with the Statutory Budget Reserve was that funds were available through a simple majority vote. Some felt the Statutory Budget Reserve was doomed to fail because the money in the fund was simply too easy to spend.

Constitutional Budget Reserve History and Passage

The statutory reserve fund alone was not sufficient to protect Alaska from declining oil production and volatile prices. In the late 1980s, Alaskan legislators began discussing the idea of creating another budget reserve to be enshrined in the Alaska Constitution. The concept of the Constitutional Budget Reserve (CBR) as we know it today (an account containing oil and

[4] Cole, Terrance. *Blinded by Riches: The Permanent Funding Problem and the Prudhoe Bay Effect.* University of Alaska Institute of Social and Economic Research. Anchorage, Alaska, 2004.
[5] Jackstadt, Stephen L., and Dwight R. Lee. "Economic Sustainability: The Sad Case of Alaska." *Society.* Vol. 32 Issue 3. 1995.
[6] ibid.
[7] State of Alaska, Department of Revenue, Treasury Division. *Investment Policies and Procedures.* Ver. 3.0. Juneau, Alaska. 2007.

gas settlements from which appropriations generally require a three-quarter majority vote) came about as the state was considering the possibility of a large windfall from an oil settlement. Currently, CBR funds consist of revenues from the settlement of litigation over mineral taxes and royalties and the interest earned on those funds.

The legislation that created the CBR was sponsored by Senator Jan Faiks. Senator Faiks was the Chair of the Senate Judiciary Committee at the time and had just finished two years as the first female president of the Alaska State Senate from 1987 to 1988. Although Senator Faiks was the prime sponsor of the bill that created the CBR, the legislature changed the bill, which was ultimately combined with elements of a House Finance bill shepherded by Representative Kay Brown.

Originally, Senator Faiks' bill contained a number of provisions related to budgeting, one of which was labeled the Budget Stabilization Fund. Several other major sections in Faiks' bill were removed through the committee process including a constitutional spending limit to accompany the budget stabilization fund.

Today, under most circumstances the legislature can appropriate funds from the CBR only with a three-quarters majority vote. However, it is possible to make appropriations from the CBR with a simple majority vote under certain circumstances as provided in section 17(b) of the Constitution, and the legislature did so in 2003. Withdrawals from the CBR are required to be repaid.

The CBR was established in 1991, and since that time more than a dozen pieces of legislation have been introduced that would amend or change the CBR. However, the only significant changes to the CBR have been the asset allocation and the establishment of the CBR sub-account, a separate fund invested and managed with a longer time horizon than the main fund.

The CBR has been used heavily since 1991 and its exhaustion date is regularly forecasted as part of the official fall revenue forecast each year. There have been warnings that the State of Alaska will face a "fiscal gap" when the CBR is exhausted.

CBR Legislative and Balance History

Mary Halloran of the Governor's Office of Management and Budget summed up the impetus for the legislation in her comments before the Senate Finance Committee, which ultimately authorized the Constitutional Budget Reserve: "In mentioning the outstanding oil and gas litigation, [Halloran] said that, though the timeline is uncertain, it looks like the State could have some 'windfalls' during the next five years. [Halloran] said the Legislature has taken some very strong steps over the last couple of years to try to stabilize the spending limit, but there are still a number of programs 'out of control.'"[8]

Former Senator Jan Faiks recalled the passage of Senate Joint Resolution 5 (SJR 5) and creation of the CBR reserve as a bipartisan effort: "The decision was contentious because hardly anyone wanted to change the terms and conditions of the original Permanent Fund without approval from the people. So most Senators... insisted on another statewide vote and I think most House members agreed; thus, it was a bipartisan decision to propose a constitutional amendment. The Governor [Cowper] gets credit for recognizing the state had a real financial problem and he wanted to find a permanent solution. We knew the current situation of relying on the ups and downs of oil revenues was not good for either state or local governments. A bipartisan solution had to be found."[9]

Originally, SJR 5 was an updated version of a bill that had passed the Senate nearly unanimously in 1987. The bill called for a 50-30-20 distribution of the income of the Permanent Fund. Fifty percent of the Permanent Fund's earnings would have gone to the payment of dividends, thirty percent to inflation proofing and twenty percent to a budget stabilization fund. The twenty percent of earnings in Senator Faiks' bill as originally introduced eventually became the CBR as we know it today. One major piece of Senator Faiks' bill that was removed in the process was an appropriation limit. Another was a sunset clause under which the constitutional amendment would have expired after five years.

Just getting the bill out of the Senate was a challenge, even for the former Senate President Faiks. After failing to pass once and being returned to the Rules Committee on a motion by Senator Arliss Sturgulewski, SJR 5 was reported out of the Rules Committee and brought to the Senate Floor under a supplemental calendar on April 18,

[8] Testimony of Mary Halloran. 16th Alaska State Legislature, Senate Finance Committee. February 2, 1990. Transcribed by Alaska Legislative Records Dept.
[9] Faiks, Jan. "CBR." Email to Department of Revenue. November 10, 2009.

1990. The bill passed the Senate by a vote of 15-5 with Senators John Binkley and Michael Szymanski switching their votes to support passage.

Meanwhile, in the State House of Representatives, a bill with similar intent was making progress. House Joint Resolution 66 (HJR 66), while nominally sponsored by the House Finance Committee, was heavily supported by Representative Kay Brown. In fact, the legislative record describes Representative Brown as the Prime Sponsor of HJR 66. Co-Chairman of the House Finance Committee Ron Larson explained that the bill, "...evolved from the House Finance Fiscal Policy Subcommittee, chaired by Representative Brown, and was modified by the House Judiciary Committee."[10] The two bills (SJR 5 and HJR 66) finally collided in May of 1990 in the House Finance Committee.

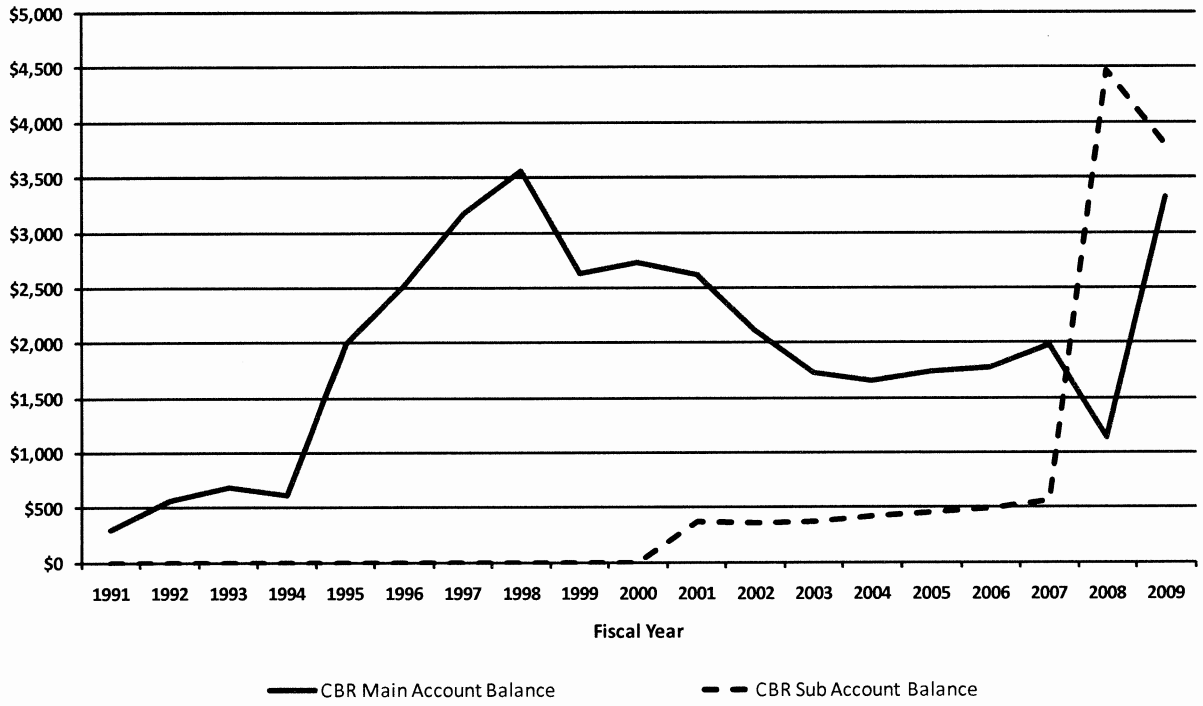
As is often the case with two pieces of similar legislation introduced separately in the House and Senate, the first bill to pass its respective house of origin typically becomes the "vehicle" or version to pass into law. In this case, SJR 5 by Senator Faiks had already passed the Senate and was assigned to the House Finance Committee for a hearing. HJR 66 never passed the House. However, the language from HJR 66 relating to the budget reserve, including the use of the term "budget reserve" rather than "budget stabilization fund" as it was referred to in SJR 5, was incorporated into SJR 5. Representative Brown testified before the House Finance Committee that the language in SJR 5 was nearly identical to the language in HJR 66 after the House Finance Committee had amended SJR 5.

In essence, SJR 5 was amended in the House to reflect the language of HJR 66. In the process, the spending limit in SJR 5 was eliminated. Numerous legislators and the Alaska Public Employees Association, a public employees union, opposed the constitutional spending limit.[11] Because the spending limit was deemed not politically viable, it was removed.

The Senate concurred with the House in a vote of 15-5 on May 8, 1990. The bill was sent to the governor on May 24, 1990, for signature. Governor Steve Cowper signed the bill almost exactly two months later on July 23, 1990.

Despite the passage of SJR 5 and the creation of the CBR, some question

Figure 3-1. Balance of the Constitutional Budget Reserve Main Account and Sub Account ($ million)



[10] Testimony of Ron Larson. 16th Alaska State Legislature, Senate Finance Committee. May 1, 1990. Transcribed by Alaska Legislative Records Dept.
[11] Testimony of Margaret Branson and Fran Ulmer. 16th Alaska State Legislature, Senate Finance Committee. May 1, 1990. Transcribed by Alaska Legislative Records Dept.

remained about which funds were to be deposited into the CBR. Former Governor Cowper and a number of legislators sued then Governor Wally Hickel, Department of Revenue Commissioner Darrel Rexwinkle and the State of Alaska in 1993 to dispute the State's interpretation of "administrative proceeding." Former Governor Cowper and the legislators argued that the State had been improperly depositing funds received during the informal conference stage of dispute[12] into the General Fund when they should have been deposited into the CBR. The Alaska Superior Court ruled in favor of former Governor Cowper and required the state to properly fund the CBR, with interest and foregone earnings, by the end of the regular session of the 18th Alaska Legislature in 1994.[13]

In another instance, nearly a billion dollars in funds which should have been deposited in the CBR were spent instead. When oil companies ARCO, Unocal, BP Exploration and Chevron agreed to pay the state $1.7 billion to settle long-running disputes over payments of back taxes and royalties in 1992 and 1993, the governor and legislature appropriated over half the amount. By spending this settlement rather than saving it, the state was able to maintain overall spending and more than double capital spending, from $300 million to $616 million.[14]

Historically, funds from the CBR were usually appropriated for general purposes. However, the CBR has also been used to fund specific programs in a number of instances. For example, a 2004 legislative research report listed the following expenditures from the CBR for specific programs: expenditures for oil and gas litigation and state title to oil and gas lands, capitalization of the Alaska Mental Health Trust, Y2K assessment, compliance, and remediation, and establishment of the Power Cost Equalization endowment fund.[15]

Figure 3-1 illustrates the history of the balances in the Constitutional Budget Reserve and the sub-account of the CBR from the first deposit through fiscal year 2009. Figures 3-2 and 3-3 illustrate the balance of each the Constitutional Budget Reserve and the Constitutional Budget Reserve sub-account with contributions and withdrawals by year. Figure 3-4 presents this information in tabular form.

CBR as a Stabilization Fund or Alternative to Hedging

The CBR as it exists today functions as a budget stabilization fund in the same manner as funds in many other states and oil producing nations. Like many resource producing states, the State of Alaska is exposed to tremendous commodity price risk. This is a difficult position for a government as expenses typically cannot be scaled back as quickly as revenues fall.

As a result of commodity price exposure, a number of resource producing states and nations from Texas to Mexico have actively hedged oil prices. The State of Alaska has studied hedging oil prices on a number of occasions with the most detailed discussion occurring in 2002 under the direction of Department of Revenue Commissioner Wilson Condon. In its hedging report, the Department of Revenue raised some concerns with using the CBR to protect the State from commodity price volatility, but also recognized the role the CBR plays in smoothing state revenues. However, because the CBR already insulates the state from the volatility of commodity prices, the report concluded that hedging oil prices was not ideal until the CBR was depleted or nearly depleted.[16]

"Alaska has not yet needed to pay the costs or take the risks of hedging its future oil revenues because our cushion against fluctuating oil prices for the past decade has been the Constitutional Budget Reserve Fund (CBRF). The fund was established a decade ago for exactly that purpose — to fill the gap between a fluctuating revenue source and a constant need for public services," wrote the Department in 2002.[17]

[12] The informal conference stage is the appeal to the regulatory agency.
[13] State of Alaska, Legislative Audit Division. Audit of Natural Resources and Department of Revenue: Constitutional Budget Reserve Fund. By Welker Randy. Juneau, Alaska. 1994.
[14] Jackstadt, Stephen L., and Dwight R. Lee. "Economic Sustainability: The Sad Case of Alaska." *Society*. Vol. 32, No. 3. March 1995.
[15] State of Alaska, Legislative Research Division. Appropriations from the Constitutional Budget Reserve Fund for Special Purposes. By Kathleen Wakefield. Juneau, Alaska. 2004.
[16] State of Alaska, Department of Revenue. *Hedging Oil Revenues: What Is It? When Should Alaska Do It, If At All? Why Should Alaska Consider It?* Juneau, Alaska. 2002.
[17] State of Alaska, Department of Revenue. *Oil Hedging Summary*. Juneau, Alaska. 2002.

Conclusion

Alaska's economy has always been at the mercy of commodity production and prices. After centuries of exhilarating resource booms followed all too regularly by severe busts, the State of Alaska created a budget stabilization fund in 1990: Alaska's Constitutional Budget Reserve. The CBR was created shortly after a time of economic crisis and with a view toward several large windfall settlements for the state.

Over nearly two decades, the CBR has almost single-handedly staved off massive budget shortfalls. In some years, withdrawals from the CBR reached a billion dollars in nominal terms. Yet the CBR remains vulnerable to prolonged overspending and the potential that oil prices may fall.

While the CBR is still vulnerable to overspending, and has at times appeared on the verge of exhaustion, the fund has acted as a buffer against commodity price volatility for almost two decades and can be expected to do so for the near future.

Figure 3-2. Constitutional Budget Reserve Main Account Contributions/Withdrawals and Balance ($ million)

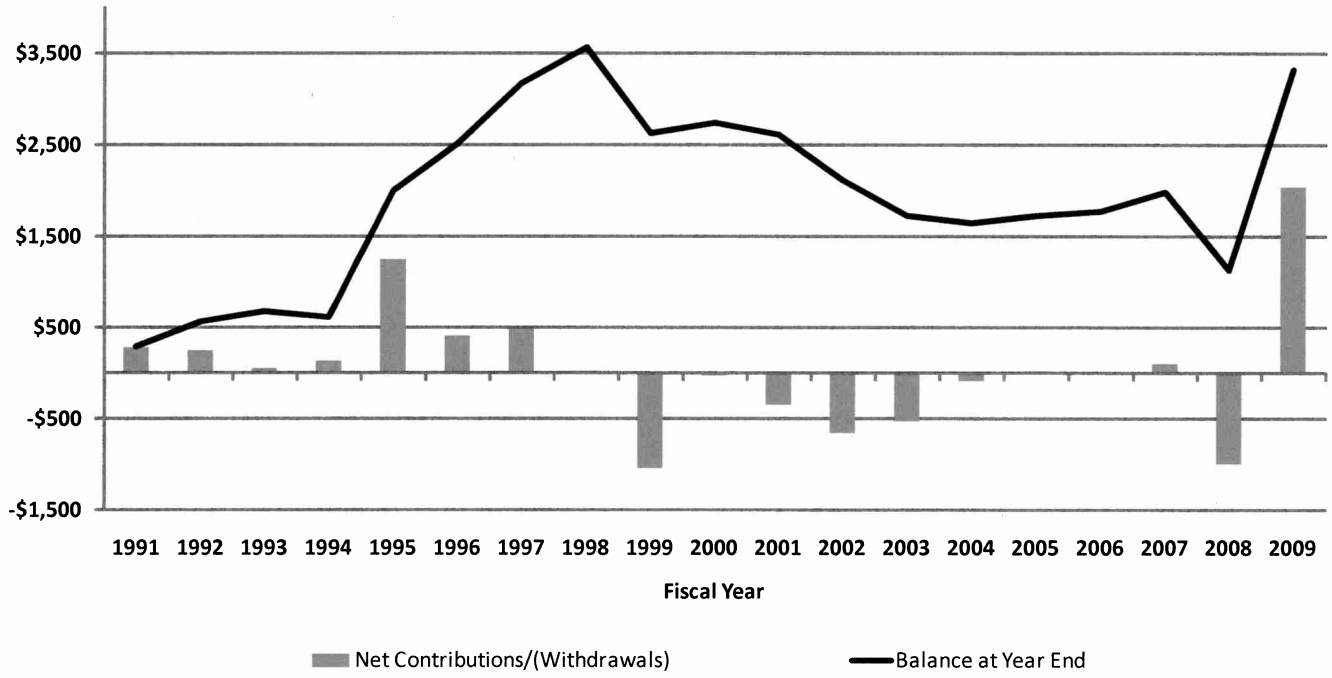


Figure 3-3. Constitutional Budget Reserve Sub-Account Contributions/Withdrawals and Balance ($ million)

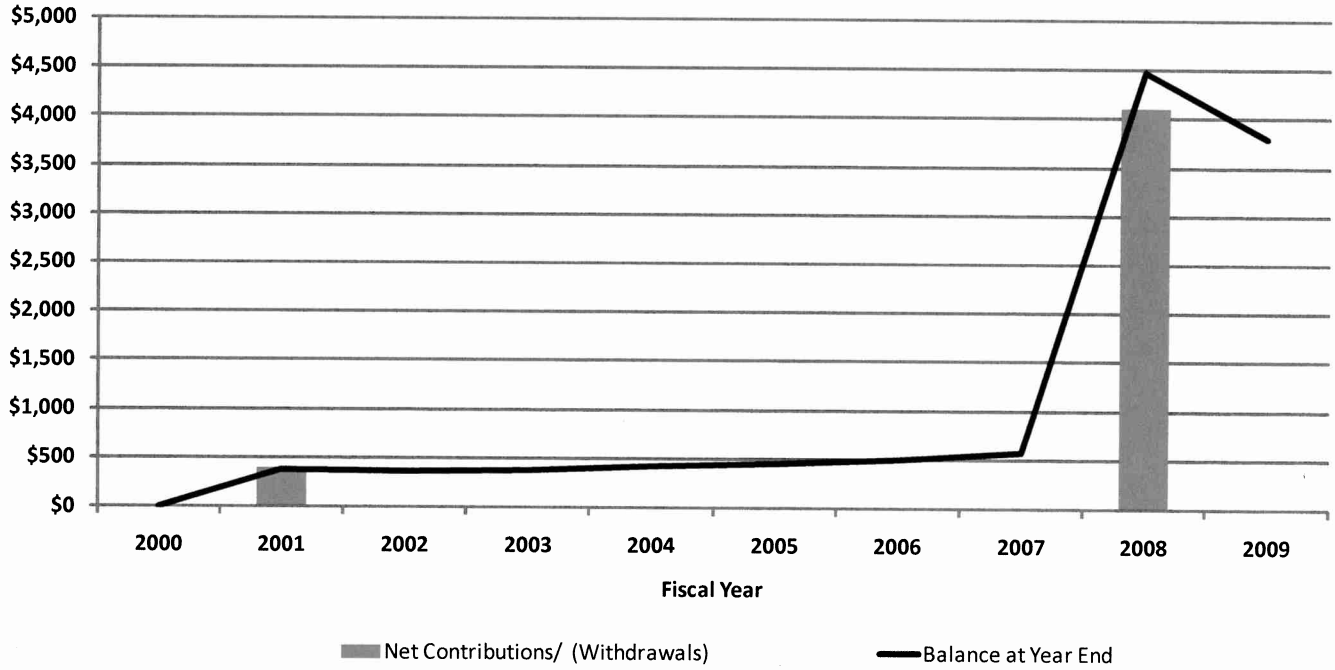


Figure 3-4. Constitutional Budget Reserve Main & Sub-Account Contributions/Withdrawals and Balance ($ million)

	MAIN ACCOUNT				SUB-ACCOUNT			
Fiscal Year	Beginning Balance	Net Contributions (Withdraws)	Investment Income	Ending Balance	Beginning Balance	Net Contributions (Withdraws)	Investment Income	Ending Balance
1991	0.0	291.0	6.0	297.0	0	0.0	0	0.0
1992	297.0	247.0	19.0	563.0	0.0	0.0	0	0.0
1993	563.0	65.0	57.0	685.0	0.0	0.0	0	0.0
1994	685.0	132.0	61.0	614.0	0.0	0.0	0	0.0
1995	614.0	1,258.0	122.0	1,994.0	0.0	0.0	0	0.0
1996	1,994.0	413.0	111.0	2,518.0	0.0	0.0	0	0.0
1997	2,518.0	487.0	167.0	3,172.0	0.0	0.0	0	0.0
1998	3,172.0	18.0	369.0	3,559.0	0.0	0.0	0	0.0
1999	3,559.0	(1,045.0)	114.0	2,628.0	0.0	0.0	0	0.0
2000	2,628.0	(9.0)	115.0	2,734.0	0.0	0.0	0	0.0
2001	2,734.0	(342.0)	227.0	2,619.0	0.0	400.0	(24)	376.0
2002	2,619.0	(648.0)	143.0	2,114.0	376.0	0.0	(21)	355.0
2003	2,114.0	(521.0)	127.0	1,720.0	355.0	0.0	18	373.0
2004	1,720.0	(81.0)	8.0	1,646.0	373.0	0.0	45	418.0
2005	1,646.0	23.0	62.0	1,731.0	418.0	0.0	36	454.0
2006	1,731.0	9.0	34.0	1,774.0	454.0	0.0	39	493.0
2007	1,774.0	101.0	106.0	1,981.0	493.0	0.0	75	568.0
2008	1,981.0	(987.0)	140.0	1,134.0	568.0	4,100.0	(200)	4,467.0
2009	1,134.0	2,040.0	144.0	3,317.0	4,467.0	0.0	(670)	3,797.0