Introduction

The Legislative Finance Division typically spends the weeks just before legislative sessions preparing material designed to help legislators make budget/policy decisions. Gubernatorial transition years often force an abbreviated analysis of the Governor's budget proposal. FY20 is no exception; Governor Dunleavy has clearly stated that the December 15 budget is a placeholder that will lose relevancy during the amendment process as his policies and priorities replace those of Governor Walker.

The Legislative Finance Division reviews items contained in appropriation bills; we avoid discussion of campaign promises and press releases, just as we avoid speculation regarding the reception budget proposals might receive in the legislature. That policy leaves few specific budget items to analyze at this time.

The December 15 budget submitted by Governor Dunleavy for FY20 is identical to the budget Governor Walker released in late November with two exceptions:

1. the December budget contains a $1.6 billion unallocated reduction; and
2. the November budget proposed permanent fund dividends (PFDs) of $1,800 per citizen while the December budget increased that amount to approximately $3,000. The estimated cost of paying PFDs at Governor Dunleavy's proposed level is $1.944 billion, just over $920 million more than was paid out in FY19.

In addition to reviewing appropriation bills, the Legislative Finance Division analyzes revenue projections and both the short- and long-term fiscal outlook. We find the Fall 2018 revenue forecast to be reasonable. The November forecast released by the Walker administration was based on information gathered in early October, when prices had recently jumped from the mid $70 range to the mid $80 range. The price forecast— $77 for FY19 and $75 for FY20—appears unreasonably optimistic in retrospect, and the Dunleavy administration quickly revised prices downward to match those projected in the Spring: $68 for FY19 and $64 for FY20.

Barely a month later, some might claim the revised revenue forecast is also optimistic—if oil remains at the current level (in the mid $50 range) for the remainder of FY19, the average price for the year would be near the $63 level forecast last Spring. The implication of unexpectedly low current prices is that the FY20 revenue forecast may be optimistic. We have neither the data nor expertise to challenge the many assumptions—Alaska production, world supply and demand, capital expenditures, tax credits, etc.—that generate the Department of Revenue's forecast. As in the past, we will use the official revenue forecast in our two-year fiscal summary—see page 10—and in our long-term fiscal model.

The fiscal model uses revenue and expenditure forecasts to project budget surpluses/deficits through FY28. It also generates projections for dividends and balances of the permanent fund and various reserve accounts. The model is ready to produce scenarios to help analyze policy/spending/revenue options.

There is, however, one huge caveat regarding model output: the model's long-term expenditure plan was prepared by the Walker administration. The Governor is required by AS 37.07.020(b) to submit a ten-year expenditure plan to the legislature. If the Dunleavy administration intends to change the path of expenditures, the Governor must provide a new spending plan that reflects the fiscal future he envisions.

A lack of formal spending plans—both for FY20 and the long-term—limits our ability to provide comprehensive fiscal analysis of the Governor's intentions. It does not, however, preclude discussion of Alaska's fiscal situation. We can discuss a few issues that will help readers grasp linkages between budget/policy decisions and the State's fiscal future.

Alaska's fiscal situation

Casual observers of the fiscal landscape may conclude that everything appears much as it has for years: spending exceeds revenue and the legislature will argue inconclusively about whether new revenue is needed to fill the deficit and discuss how—and how much—spending should be cut. In the end, draws from reserves will fill the deficit and everyone will hope for higher oil prices in the future.

More astute observers see a landscape very unlike the past and wonder how casual observers can fail to conclude that we live in different fiscal world.

Spending in excess of revenue is not a small, temporary problem; we have faced multi-billion dollar deficits for six consecutive years and projections show continued large deficits. Legislators and citizens have lived with deficits for so long—with no ill effects—that they justifiably ask "Why are deficits a problem?"

The fiscal impact of deficits has been hidden by our ability to draw from reserves. When deficits can be filled by budget language that simply fills the deficit regardless of revenue or expenditure levels, no other action is required. When revenue sets no limit on expenditures, is it any wonder that some people believe expenditures spun out of control? Yet deficits persist and life goes on. The conclusion is that deficits are not a problem as long as savings balances are able to fill them for many years into the future.

We no longer live in that fiscal world. Using the constitutional budget reserve fund (CBR) to fill massive, persistent deficits has depleted reserves. Because the CBR has insufficient money to continue filling deficits, we can no longer ignore deficits. In the long-term, revenue and expenditures must balance.

How can we balance the budget?

The passage of SB26 (during the 2018 legislative session) was a huge step toward balancing the budget. Alaska has traditionally relied upon oil production—almost exclusively—as a source of revenue. Traditional revenue sources cover about one-third of expenditures (excluding unallocated reductions) in the December 15 budget. Under SB26, a percentage of the market value of the permanent fund contributes to revenue.

The contribution is massive; at $2.9 billion, the FY20 payout from the permanent fund exceeds the $2.3 billion expected from traditional sources. Yet, in the absence of additional revenue or reductions from FY19 spending, a $1.6 billion deficit remains.

How to fill deficits is a policy decision

With the depletion of reserve balances, Alaska has only the standard tools other states use to bring the budget into balance. The tools are:

1. increasing revenue and
2. reducing expenditures.

Some would include borrowing as a tool on the revenue side, but borrowing does not offer a long-term solution. Some would add shifting costs to local governments or to citizens as a tool on the expenditure side. But there is a distinction between shifting a problem and solving a problem.

Alaska was fortunate to have a third budget-balancing tool: using reserves to fill deficits. We used the tool very effectively—meaning we saved a good portion of surpluses and then drew money from reserves when oil revenue could not balance the budget. Establishing a large reserve balance was not an accident, we knew that reserves are essential when revenue is volatile.

The constitutional budget reserve fund (CBR) is not empty, but years of drawing money means the fund can serve only as a shock absorber that allows us to avoid the painful process of mid-year budget reductions in response to unanticipated revenue shortfalls. It can no longer serve as a tool to address massive long-term deficits.

Increasing revenue is an effective way to address long-term deficits, but is generally not an effective tool if the time horizon is short. It often takes a year or more to implement tax changes. Further, if the Governor and/or the legislature insist that tax increases are off the table, then the only remaining budget-balancing tool is reducing expenditures.

Decision time—where can cuts occur?

The correct answer—anywhere the legislature and Governor agree upon—is not very helpful. It may be more practical to paraphrase Willie Sutton, who—when asked by a journalist why he robbed banks—replied "Because that's where the money is." In our case, the lesson may be that we have to cut where the money is.

The blue bars in Figure 1 show where Alaska spends its unrestricted general funds (UGF). The red bars show how much money would be available for various expenditure items if cuts were the only tool used to balance the budget. Takeaway points include:

1. Permanent fund dividends are the largest single expenditure item, consuming 37% of projected revenue.
2. Adding departments that oversee the two big formula programs—K-12 education and Medicaid—brings expenditures to 86% of revenue.
3. If items were eliminated (from smallest to largest, with the exception of capital projects and statewide items) to produce a balanced budget, there would be no money available for any agencies except those that oversee K-12 education and Medicaid.
4. Eliminating unrestricted general funds in agencies (as indicated by "missing" red bars) to balance the budget would reduce total UGF expenditures by about 25%.
5. The figure describes a hypothetical situation that is intended only to show the relative size of spending on various items. In the real world, cuts to criminal justice agencies—and many other items—could not legally occur as shown.

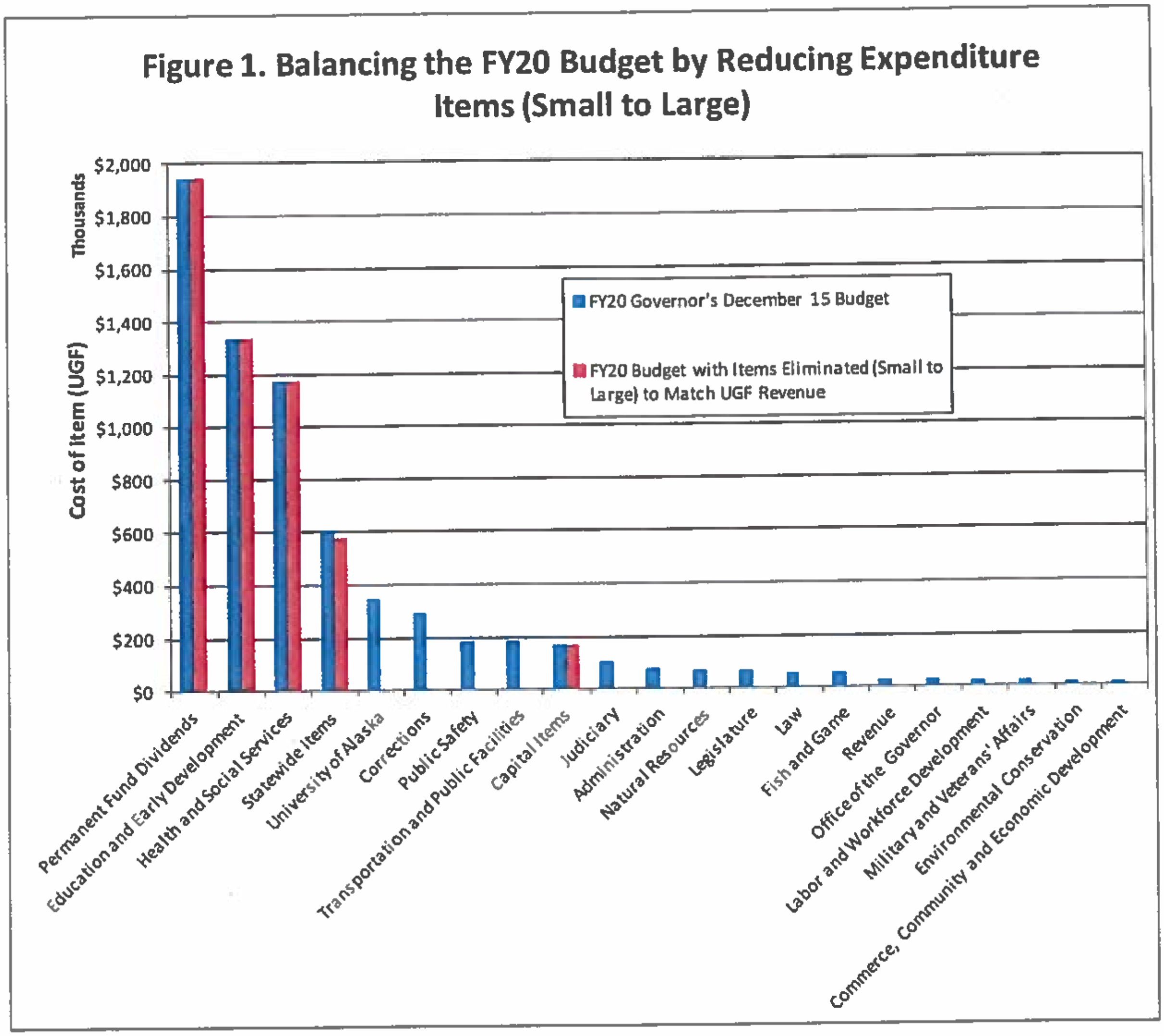
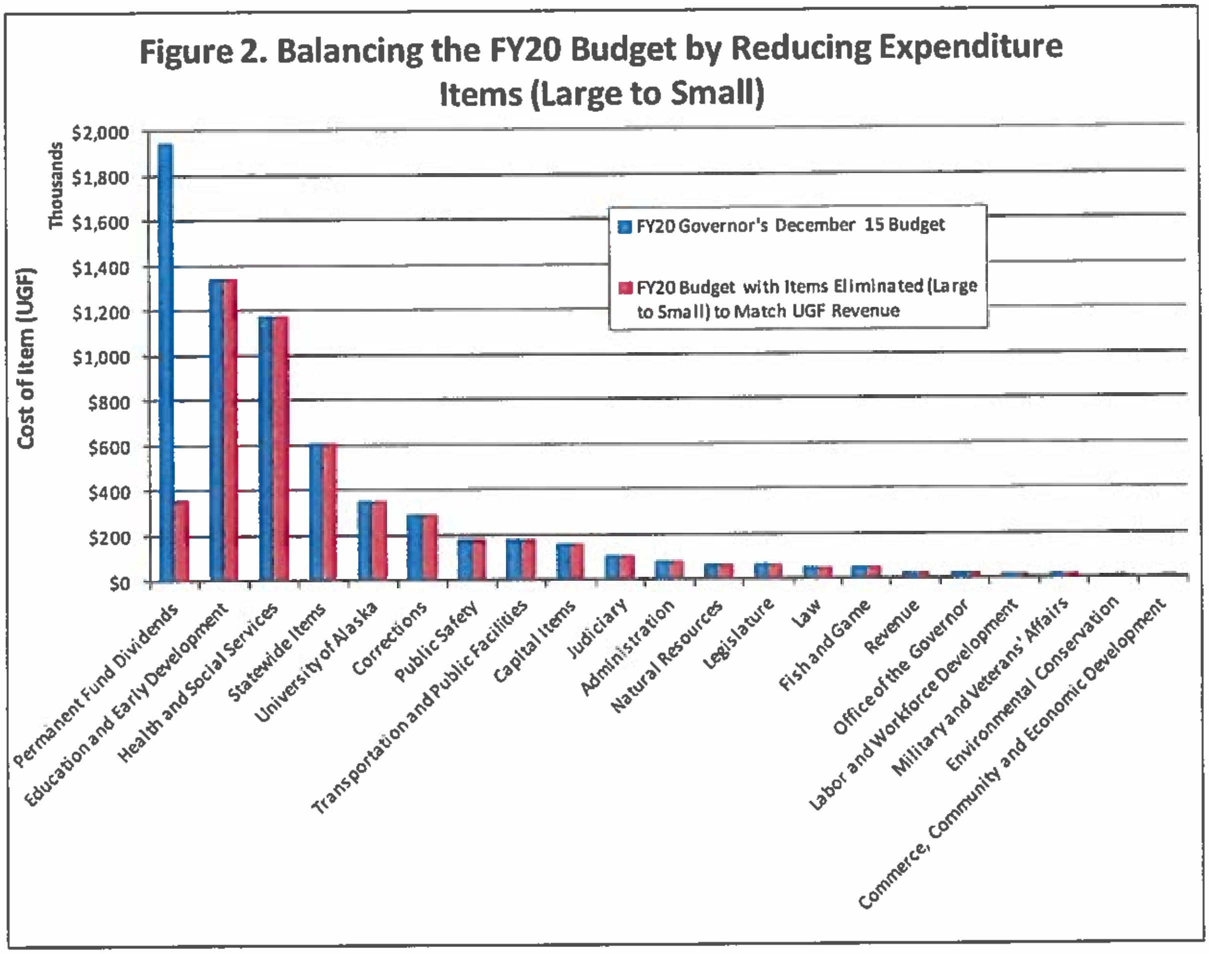


Figure 2 uses the same data, but balances the budget by cutting items from largest to smallest. The major points are:

1. If dividends were eliminated and all other items were funded as requested on December 15, there would be a budget surplus of about $300 million; and
2. As the largest single expenditure, dividends are sure to be a fundamental topic during any discussion of cutting enough money to balance the budget.



Figures 1 and 2 are intended not only to show the range of outcomes associated with budget reductions, but also to highlight the difficulty of balancing the budget via reducing spending for agency operations. Other than Education and HSS, expenditure of unrestricted general funds in agencies comprises 23% of total expenditures and no individual agency accounts for more than 5% of total spending. As a basis of comparison, the budget deficit is equivalent to 24% of expenditures.

As a practical matter, balancing the budget with cuts alone requires cutting where the money is: dividends, K-12 and Medicaid. The choices are divisive, and decisions are certain to be difficult.

How much the legislature spends on dividends—or anything else—is a policy decision

When it comes to appropriations, the legislature must follow the constitution. However, the power of appropriation supersedes statute. For example, if a law were to increase the Base

Student Allocation (generally known as the BSA, which is a primary factor in determining K-12 spending) in each of the following three years, appropriations for K-12 spending might not increase. The changes to the BSA would occur, but the legislature is not required to fully fund the statutory formula. Similarly, the law provides a formula for permanent fund dividends (PFDs), but the legislature can appropriate any amount it chooses. That conclusion is not personal opinion; it is the ruling of the Alaska Supreme Court (*Wielechowski v State*, August 2017).

So why bother with statutory formulas? Accepting the guidance provided by law means sitting legislators don't have to argue every year about how much to spend on programs like education, Community Assistance, retirement contributions and power cost equalization. Statutory guidance makes it less likely that the Governor/legislature will shift costs from the State to local governments, businesses or to the people. In short, statutory guidance makes it easier to adopt a budget and plan for the future.

Arguments supporting statutory guidance prompt questions: We have statutory guidance on PFDs, so why argue about the amount paid as dividends? Why doesn't the legislature simply pay the amount determined by statute? Alternately, if the legislature is not going to follow statutes, why doesn't the legislature change the statutes?

Answering those questions can lead to discussion of complex issues like individual versus common rights to Alaska's resource wealth, distribution of income, and the extent to which the people of Alaska understand the fiscal situation. While we do not deny the importance of those issues, we tend to see the situation in terms of mathematical relationships.

There is a dollar-for-dollar trade-off between dividends and revenue, dividends and deficits, and dividends and government services

For those who doubt that dividends affect deficits, or that there is a dollar-for-dollar trade-off between dividends and government services, just look at the math. To simplify, let's assume the annual POMV (percent of market value, per SB26) payout from the permanent fund earnings reserve account (ERA) is $3 billion. If $1 billion goes to dividends, then $2 billion is available for government services. Let's also assume that the budget is balanced in those circumstances. If dividends take $2 billion of the payout from the ERA, then there is only $1 billion left as revenue to the general fund and we face a $1 billion deficit. In the absence of additional revenue, government services must be reduced by $1 billion.

To say that increasing dividends takes money from education or other government services would reveal a biased perspective. It is just as accurate to say that spending money on government services takes money from dividends. It is fair to say that dividends compete with government services for available revenue. It is also fair to say that the competition during the

FY20 budget process is likely to be fierce, particularly if oil prices remain low and use of savings to balance the budget is minimal. In those circumstances, a FY20 deficit is possible/probable.

Reexamining the availability of budget-balancing tools

Legislators face numerous difficult choices. Perhaps the most difficult choice will be the selection of tools to balance the budget. Enhancing revenue is a difficult path, made more difficult because Alaskans are not accustomed to paying the cost of government.

Elementary math shows that cutting expenditures is also a difficult path, particularly when public expectations and legal requirements to provide essential state services and protect economic stability are considered.

The easy path is to balance the budget by drawing money from the permanent fund earnings reserve account (ERA), just as we used to draw money from the constitutional budget reserve fund (CBR). The dangers of this path may not be apparent until we have taken it for a few years.

Before choosing this path, Alaskans should consider the following scenario:

1. Drawing more from the ERA than envisioned under statutory guidelines reduces the real value of the permanent fund.
2. Lower permanent fund balances reduce future earnings and reduce both dividends and the payout to the general fund.
3. Reduced payout to the general fund increases deficits, which cause ever-increasing draws from the ERA.
4. The ERA goes the way of the CBR, shrinking to the point that a poor investment year leaves no money for either dividends or a payout to the general fund.

While legislators always face decisions that shape Alaska's future, the decisions they face this year are as tough and pivotal as any they are ever likely to make. The Legislative Finance Division offers our fiscal model and budget expertise to help legislators make informed decisions.

Published Analysis

The Legislative Finance Division typically publishes "subcommittee books" and narratives that are intended to help legislators understand the Governor's budget proposals. Reports presenting the December 15 budget submittal are posted on our website, but we do not intend to publish subcommittee materials until the Governor submits amendments.