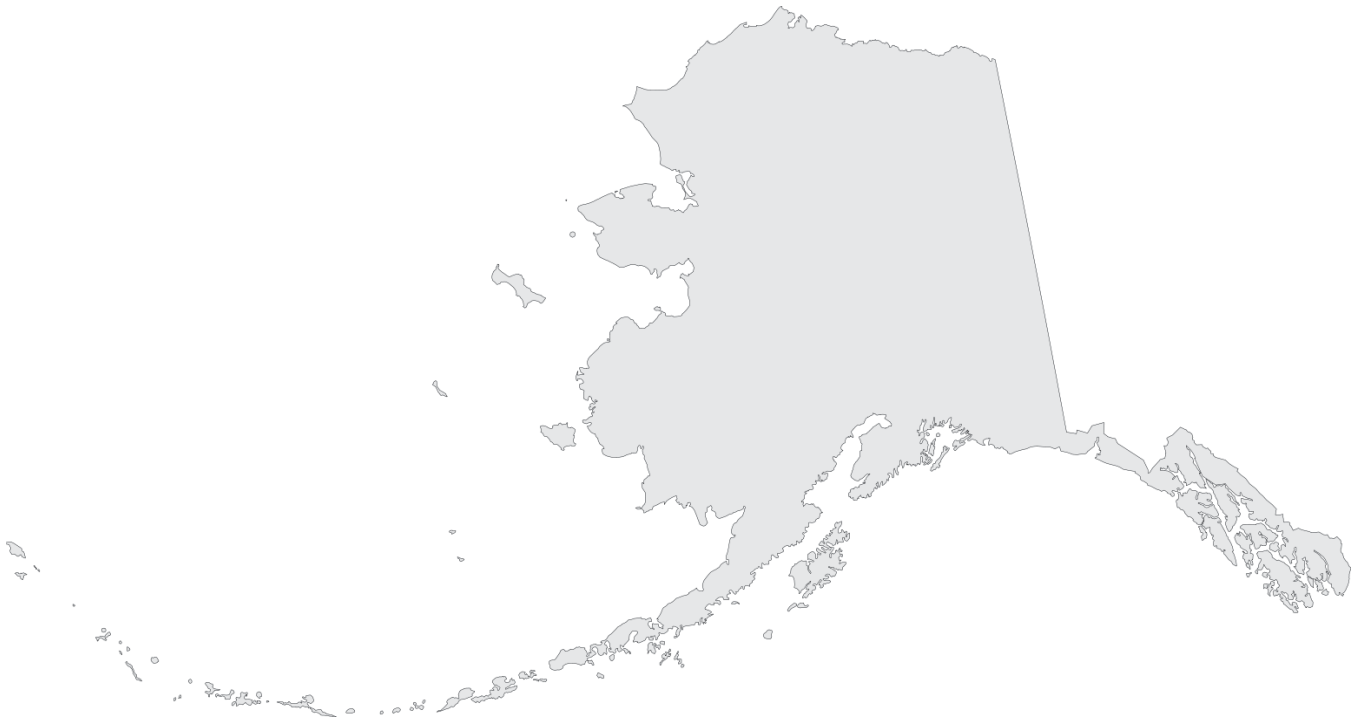


The Fiscal Year 2019 Budget:

Legislative Fiscal Analyst's Overview of the Governor's Request



Legislative Finance Division

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Introduction

As required by law, the Governor released his FY19 budget proposal to the public and the legislature on December 15, 2017. The Legislative Finance Division prepared this overview of the Governor's proposal and "Subcommittee Books" for each agency in accordance with AS 24.20.211-.231.

The overview provides a starting point for legislative debate of the Governor's spending and revenue plans. It does not discuss the merits of budget plans; it focuses on outlining the fiscal situation and presenting the budget in a way that provides simple, clear information to the legislature.

ALASKA'S FISCAL SITUATION

1. Excluding potential transfers from Permanent Fund earnings, FY19 unrestricted general fund (UGF) revenue is projected to be approximately \$2.1 billion while proposed UGF spending is nearly \$4.6 billion. That leaves a deficit of approximately \$2.5 billion.
2. While the magnitude of the deficit is smaller than the average for the past four years, the legislature no longer has the option it has exercised in the past. That option is to fill the deficit by drawing money from the Constitutional Budget Reserve Fund (CBR). After years of massive draws, the projected end-of-FY18 balance of the CBR (approximately \$2.2 billion) is no longer sufficient to fill the projected \$2.5 billion FY19 deficit.
3. The Governor intends to reduce the deficit to approximately \$600 million by transferring money from the Permanent Fund Earnings Reserve Account (ERA) to the general fund.
4. The Governor proposes filling the remaining deficit with appropriations from the CBR and the Statutory Budget Reserve Fund (SBR).
5. The Governor proposes both a new (payroll) tax and an increase in motor fuels taxes, but the Governor's spending plan—under which all payroll tax receipts go toward capital projects—still leaves projected deficits of approximately \$600 million annually for the next several years.
6. Filling future deficits with "oversized" draws from the ERA would reduce the real value of the Permanent Fund, leading to declining dividends and to greater difficulty in balancing future budgets. In this context, "oversized" refers to draws that exceed a payout designed to inflation-proof the fund—sometimes referred to as "sustainable draws."

THE FY19 BUDGET

Despite past efforts to improve budget presentation—including producing reports at various levels of detail and splitting appropriations into four categories of funds—there are people who denounce budget reports as “fake news” designed to make budgets appear smaller than they really are.

There is a grain of truth in their concern that budgets are distorted. It is fair to say that budget comparisons between fiscal years are rarely *undistorted*. It is also fair to say that distortions generally work themselves out over time. For example, using \$100 million from the Higher Education Fund to pay retirement costs reduces unrestricted general fund (UGF) spending by \$100 million. But when the Higher Education Fund can no longer be used in lieu of UGF, the strategy comes back to haunt us: UGF spending increases by \$100 million.

In September of 2017, the Legislative Finance Division advised the Finance Committee Chairs that budget choices made during the 2017 legislative session would make it difficult to achieve spending reductions during the 2018 session. Maintaining the level of services provided during FY18 could increase spending (and the FY19 deficit) by over \$300 million.

The Legislative Finance Division did not say that (assuming maintenance of service levels) the FY19 budget *must* increase; it said that unrestricted general fund spending *would* increase unless use of distortion-inducing choices continued into FY19. The primary distortion-inducing choices are:

1. using money from one fiscal year to fund things in another fiscal year and
2. using non-replenishing funds for ongoing expenses.

The Governor recognized the budgetary holes (and that some non-replenishing funds were no longer available), understood the conflict between submitting a straightforward budget and taking heat for increasing apparent spending, and appeared to be committed to presenting the budget in a more transparent way. The Legislative Finance Division was, quite naturally, interested to see how the Governor addressed the situation.

The Governor released a “transparent” budget that shows a reduction of \$150 million from the FY18 budget (unrestricted general funds, with dividends and transfers excluded). Does this mean the Governor found a way to fill the holes and reduce spending by an additional \$150 million? Not exactly. The Governor’s budget misses the mark on transparency; proposed UGF spending in FY19 exceeds UGF spending in FY18.

“Transparency” is in the eye of the beholder, but perhaps all can agree on a few simple goals. The public and the legislature should know

1. how much money is available on a cash flow basis,
2. how much of that available cash is spent (and how much money is added to—or taken from—various savings/reserve/special accounts) and
3. the amount of surplus or deficit, both on a cash flow basis and after transfers to or from reserve accounts.

Arguably, the fiscal summary can, and does, meet these goals. But fiscal summaries are weak in their ability to highlight budget choices that undermine the overarching goal of budget transparency. Appropriations that

1. cross fiscal years,
2. use non-replenishing money for ongoing expenses, or
3. use designated funds for non-designated purposes

are lost in the detail.

The Governor's FY19 budget request contains examples of all these distortion-inducing elements. In addition, the Governor's presentation is complicated by inclusion of revenue measures and fiscal notes (for bills not yet enacted) that make it difficult to separate the budget bills from the Governor's budget plan.

After spending many hours last year explaining the difference between the FY18 budget bill and the budget plan (especially a plan to increase motor fuels taxes), the Legislative Finance Division informed the Office of Management and Budget that the FY19 budget presentation would be different—the fiscal summary would differentiate the budget bills from the budget plan.

The rules for the fiscal summary are simple:

1. The traditional fiscal summary will reflect those items that can/will occur on the basis of a simple majority vote on appropriation bills. (Note that this rule does not prevent the inclusion of supplemental appropriations, use of non-replenishing money or use of designated funds for nondesignated purposes. Those choices can be highlighted but nothing can stop the Governor or the legislature from making them.)
2. A separate section of the fiscal summary will make adjustments for “budget items” that require additional action such as a supermajority vote or enactment of legislation. These items might be more properly termed “budget plans” rather than simple appropriations.

Rather than attempt a line-by-line comparison of the Governor's and the Legislative Finance Division's versions of the fiscal summary, it is more productive to present the Legislative Finance Division's version of the Governor's request, as described by the rules above. The traditional parts of the fiscal summary

1. replace direct expenditures from the constitutional budget reserve fund (CBR) with expenditures from the UGF on grounds that direct spending from the CBR requires a supermajority vote, and
2. remove both revenue and expenditures that require adoption of non-appropriation bills.

This approach improves the ability to see the cash flow deficit as it has traditionally been displayed, as well as providing a clear break between what can be accomplished via standard appropriations and what plans require additional action.

Is spending up or down?

The Governor posed this question and answered it by reporting that the methodology proposed in his Budget Transparency Report shows the FY19 budget is \$4.68 billion, down \$150 million from FY18's \$4.83 billion budget. The Governor's fiscal summary apparently does not follow the rules of the Budget Transparency Report; it shows a \$316 million reduction (from \$4.50 billion to \$4.18 billion). Considering the \$300+ million in budget holes left after the FY17 legislative session, a \$316 million reduction would be nothing short of amazing.

The Legislative Finance Division's version of the fiscal summary (page 8) shows that proposed unrestricted general fund (UGF) spending (before accounting for dividends and transfers) is up \$228 million—from \$4.35 billion in FY18 to \$4.58 billion in FY19 (line 36).

If the legislature were to appropriate the Department of Revenue's FY19 projection of \$206 million to purchase oil and gas tax credits, the increase in UGF spending would be over \$430 million. That number is far more in line with expectations regarding a \$300+ million hole plus a Public Safety Action Plan that increases spending by \$16 million (plus \$18 million as a FY18 supplemental appropriation).

What is the projected cash-flow deficit and how is it filled?

The projected (post dividend, post transfer) deficit for FY19 is \$563 million (line 52). While that is a huge improvement over the \$2.2 billion deficit in FY18, the improvement is due to a \$1.9 billion payout (net of dividends) from the permanent fund earnings reserve account to the general fund.

Normally, the deficit would be the bottom line of the fiscal summary, with an assumption that the deficit would be filled with draws from the CBR and/or the statutory budget reserve fund (SBR) as approved by the legislature. The Governor chose to request \$425 million from the CBR for specific purposes, leaving a deficit of \$138 million to be filled from the \$172 million balance of the SBR. Given the volatility of oil revenue and the potential for FY19 supplemental requests, many people would say the margin of error is too slim for comfort.

That is where the “new” part of the fiscal summary comes into play. It reflects fiscal notes and revenue measures that have been removed from the traditional part of the summary because they are part of the “budget plan” that requires more than simple majority approval of appropriation bills.

A proposed payroll tax and a proposed motor fuels tax increase may seem to provide an adequate safety margin by generating an additional \$200 million in revenue in FY19. However, fiscal notes for proposed legislation would add nearly \$30 million to operating spending, and the proposed economic recovery plan would appropriate \$280 million for capital projects in FY19. In total, the plans erase the slim margin of error and leave an unfunded gap of \$74 million (before FY19 supplemental appropriations) (line 83).

In brief, the payroll tax—originally proposed as a means to reduce the deficit—is now designed solely to increase capital spending. As outlined by the Governor, the economic recovery plan would increase the FY19 deficit—it brings in revenue of \$160 million and appropriates \$280 million—but is deficit neutral over its three-year life.

What's missing from the Governor's proposal?

1. Community Assistance

The legislature revised statutory guidelines (Chapter 43, SLA 2016 (SB 196)) for using earnings of the Power Cost Equalization (PCE) Endowment Fund in order to make excess earnings available for Community Assistance. The revisions said that if endowment earnings in the prior closed fiscal year exceed anticipated PCE program costs, then up to \$30 million of endowment earnings may be appropriated for Community Assistance.

FY16 endowment earnings—potentially available for Community Assistance in FY18—of \$8.9 million were insufficient for FY18 PCE program costs, so no PCE earnings were available for Community Assistance in FY18. Last session, the Governor failed to request—and the legislature failed to add—an alternative \$30 million appropriation required to provide a \$30 million payout to communities in FY19. Without a \$30 million deposit in FY18, the FY19 distribution will be \$20 million.

FY17 endowment earnings were \$112.3 million, making \$30 million available for Community Assistance funding in FY19 (affecting distribution during FY20).

Statutory guidelines suggest the Governor would request

- a supplemental FY18 appropriation of unrestricted general funds to allow a \$30 million community payout in FY19 and
- a \$30 million FY19 appropriation from the PCE endowment to the Community Assistance Fund to provide certainty as communities develop their FY20 budgets.

Instead, the Governor requested a \$30 million FY18 appropriation from the PCE Endowment. While that appropriation provides for a \$30 million community assistance payout in FY19, the FY18 appropriation is unrelated to PCE earnings available in FY19. The Governor's request simply appropriates money from the PCE Endowment, which is use of a designated fund for a non-designated purpose.

The Governor did not appropriate excess FY17 PCE earnings for Community Assistance in FY19, per statutory intent. Without a FY19 appropriation this session, the FY20 payout could fall to \$20 million, so communities would once again be uncertain of the amount of assistance they can build into their FY20 budgets.

2. Retirement Contributions

The Governor requested less for state contributions to retirement systems than was recommended in the actuarial valuation applicable to FY19 contributions. There are well-established actuarial methods for responding to events such as great investment returns and a potential reduction in health care costs. It appears that the Governor's budget accelerated the anticipated benefits of favorable news; requested contributions were reduced by \$25 million for medical cost savings not yet achieved and by an unknown amount for other events. The legislature may wish to explore this issue early in the session.

What's new?

1. The Governor's **Public Safety Action Plan** (PSAP) focuses efforts in four areas:

1. Improving outcomes in the criminal justice system;
2. Identifying public safety resource needs;
3. Improving access to mental health and substance abuse treatment; and
4. Addressing the opioid epidemic and drug trafficking.

The Governor's budget includes \$33.5 million to fund PSAP efforts, \$18 million of which is classified as supplemental spending. Details of the PSAP are presented in the narratives for the departments of Corrections, Public Safety, Law, and Health and Social Services.

2. The Governor proposes two procedural changes:

1. Appropriations of \$425 million (made in section 28) from the **Constitutional Budget Reserve fund** require a supermajority vote. If the required supermajority vote fails, the appropriations are invalid.

The Governor indicated that placing items in section 28 is part of a plan to address the threat of government shutdown due to delay in passing the budget. A simple majority vote on the operating budget will fund core government services. The Governor identified the items in section 28 as minimally disruptive in the event of a supermajority vote failure relatively early in the budget process.

The specific, limited draw from the CBR leaves core services vulnerable if anticipated revenue does not materialize. That situation could require a special legislative session to debate spending reductions versus a second supermajority vote.

2. **Biennial budgeting** has several theoretical advantages over annual budgeting. Experience in other states indicates that the advantages may be more theoretical than practical. Adopting biennial budgeting would require legislation.

3. The Governor proposes legislation for a method of **debt financing for purchases of Oil and Gas Tax Credits** that would replace annual statutory minimum purchases of tax credits—potentially reducing FY19 costs from \$206 million for purchases to \$27 million for debt service costs. The Legislative Finance Division has insufficient information to comment on the merits of debt financing versus cash purchases.
4. The Governor proposes an **Economic Recovery Plan** that spends \$800 million on capital projects during the next three years. The plan is contingent on implementing a broad-based tax that would generate at least \$800 million in revenue during the next three years. See the capital budget overview in this publication for more details.

WHAT IS THE LONG-TERM VIEW?

For those whose focus is on FY19, the fiscal summary (on page 8) provides a concise statement (and comparison) of projected revenue, appropriations and the size of the anticipated deficit. It has the limitation of offering only a short-term view of the budget.

The Legislative Finance Division has developed a model that allows evaluation of spending and revenue options under various assumptions. The model can be used to project long-term impacts of FY19 (and later) budget and revenue actions.

With the understanding that model results are dependent on the revenue, expenditure and earnings assumptions that comprise a scenario, the legislature should be aware that the “base scenario” projects continued deficits of \$600 million or more annually. This *Overview* is not the best venue for reviewing model input or output. The model is mentioned here only to make the point that it is available to legislators—individually or in committees—so that they can become more familiar with long-term fiscal projections and how their actions can affect those projections.

This *Overview* contains more detailed discussions of the proposed FY19 budget:

- Operating budget on page 15 and capital budget on page 89.
- Language sections of operating and capital bills (with analysis) begin on pages 24 and 97, respectively.
- Narratives on individual agency operating budgets begin on page 106.

“Subcommittee Books” and detailed agency binders are available in the Finance Committee rooms.