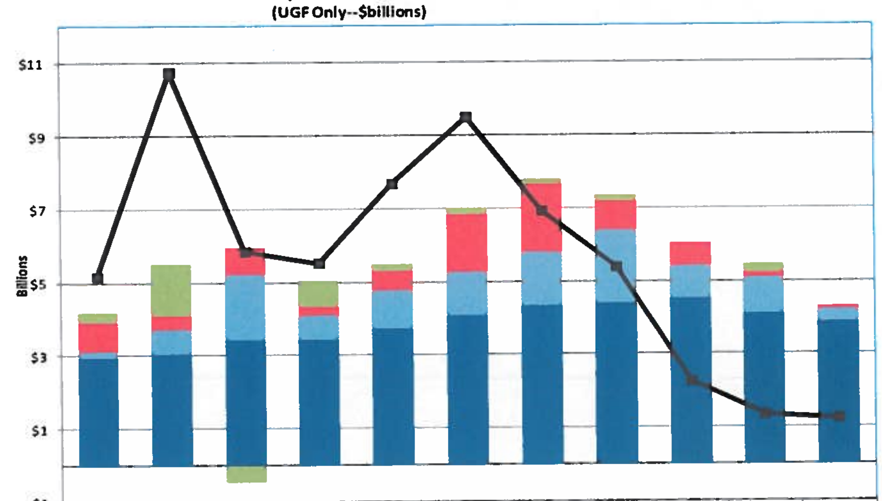
Introduction

As required by law, the Governor released his FY18 budget proposal to the public and the legislature on December 15, 2016. 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.

Alaska's Fiscal Situation

As he did a year ago, the Governor submitted a budget/plan that would radically improve Alaska's fiscal situation. For those unfamiliar with Alaska's fiscal situation, Figure 1—which was prepared for a presentation that predates the release of the FY18 revenue forecast and budget—provides a bit of history.

Figure 1: Total Agency Operating Budgets, Statewide Items and Capital Budget Compared to Revenue
(UGF Only--$billions)



	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Supplementals	0.3	1.4	(0.5)	0.7	0.2	0.2	0.1	0.1	0.0	0.2	-
Capital	0.8	0.4	0.7	0.2	0.5	1.6	1.9	0.8	0.6	0.1	0.1
Statewide Items	0.2	0.7	1.8	0.7	1.1	1.2	1.5	2.0	0.9	1.0	0.3
Agency Operations	3.0	3.0	3.4	3.4	3.7	4.1	4.3	4.4	4.5	4.1	3.9
TOTAL BUDGET	4.2	5.5	5.5	5.0	5.5	7.0	7.8	7.3	6.0	5.4	4.3
UGF Revenue	5.2	10.7	5.8	5.5	7.7	9.5	6.9	5.4	2.3	1.3	1.2
Revenue Covers % of Expenditures	123%	195%	106%	110%	140%	135%	89%	74%	38%	25%	29%

Takeaway points from Figure 1:

1. Spending (the bars) grew rapidly when revenue (the line) was high. Spending went from $4.2 billion in FY07 to $7.8 billion in FY13. That's about 9% annual growth—a rate that many knew was not sustainable.
2. Despite spending growth, budget surpluses were substantial through FY12.
3. Spending has been cut steadily since FY13. FY17 expenditures ($4.3 billion) are approximately the same level as in FY07.
4. Despite spending reductions, FY17 is the fifth consecutive year of substantial budget deficits.
5. Fiscal health is not just about spending; it also depends on how much money is available to spend.

6. Although spending in FY17 has returned to the FY07 level, revenue (the line) is far below historic levels. Revenue declined from an average of over $7 billion per year (FY07-FY13) to $1.2 billion in FY17—that's over 80%.
7. **Key point:** While spending in FY07 and FY17 are the same, there was a $1 billion surplus in FY07 and an anticipated $3.1 billion deficit in FY17.
8. Alaska saved a huge amount of money when revenue exceeded expenditures, but now revenue covers less than 30% of annual expenditures, leaving fiscal gaps that have been filled by pulling money out of reserves (primarily the Constitutional Budget Reserve fund (CBR)).
9. The CBR now holds only enough money to get through FY18.

In recognition of an unsustainable fiscal situation, the Governor's FY17 budget included a plan that did three things:

1. cut government spending (including Permanent Fund dividends (PFDs)),
2. increased revenue (income tax and some other, smaller taxes), and
3. used some earnings of the Permanent Fund to support government spending.

The Governor said that if the legislature didn't do all three, and do them soon, PFDs might go away and Alaskans would still have to pay taxes and experience service reductions.

The Governor's plan was not adopted by the legislature, and the fiscal situation is little changed from last year.

1. Government spending was reduced in FY17, both by the legislature and via the Governor's vetoes. But requested FY18 unrestricted general fund (UGF) spending is down less than $50 million from FY17. After adjusting for fund source changes and for items that the legislature may wish to add to the Governor's budget, FY18 UGF spending could be higher than last year.
2. None of the Governor's FY17 tax bills made it very far through the committee process. The Governor introduced a motor fuel tax bill that would increase FY18 revenue by about $35 million. According to the Fall Revenue Sources Book, the Department of Revenue has been working on an income tax bill that would generate about $500 million annually. Income taxes are not discussed in this overview because the Governor did not introduce that bill as part of his budget package.
3. As he did last year, the Governor proposed the use of Permanent Fund earnings to help balance the budget. The bill/plan he introduced is not the plan he submitted last year; it is similar to the bill (SB 128) that was adopted by the Senate during the 2016 session.

It is item 3 that would radically reduce Alaska's fiscal deficits—both short- and long-term. The Governor's budget includes a $2.5 billion payout from the Earnings Reserve Account (ERA) of the Permanent Fund. After using $700 million of that amount to pay dividends, the net revenue increase is $1.8 billion. After the Governor's proposed expenditures and revenue measures, the FY18 deficit is about $840 million.

That is a huge deficit, with revenue covering less than 85% of expenditures. It is, however, a huge improvement from the $3 billion to $4 billion deficits of the past three years.

The Governor's plan to include some Permanent Fund earnings in unrestricted general fund revenue is not only a radical departure from past practice, it literally changes history. The Permanent Fund has effectively been "off budget" since its inception—earnings have been omitted from unrestricted general fund (UGF) revenue, so spending of Permanent Fund earnings was also excluded from reported UGF expenditures.

Traditional treatment of Permanent Fund earnings—not counting them as either UGF revenue or UGF expenditures—is attributable to statutory formulas for dividends and inflation proofing. When statutes specify purposes/uses of a fund source (that would otherwise be classified as UGF) the fund source is classified as "designated general funds" (DGF). The DGF category of funds does not affect the deficit and is often omitted from reports of state spending.

In the proposed FY18 budget, classification of Permanent Fund earnings as "designated for purposes of inflation proofing and paying dividends" is no longer justifiable—

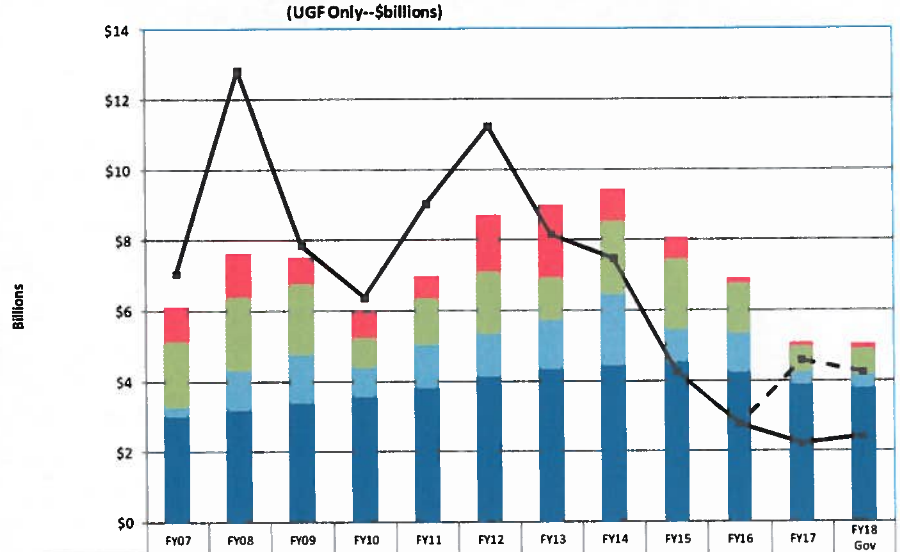
1. there is no inflation proofing in the Governor's budget,
2. dividends are paid from the unrestricted general fund, and
3. the only significant use of earnings is a payout to the unrestricted general fund.

In short, the Governor's budget formalizes what has been true since the Permanent Fund was established: the legislature can appropriate from the Earning Reserve Account (ERA) for any purpose. Based on the proposed use of the ERA—which is limited to a payout to the UGF—appropriations of Permanent Fund earnings are now classified as unrestricted general fund expenditures. As with every fund source reclassification, past appropriations are also reclassified in order to allow meaningful comparisons across fiscal years.

Figure 2 updates UGF revenue and expenditures to reflect the reclassification of Permanent Fund earnings. Appropriations for dividends and inflation proofing are added to the expenditure bars. UGF revenue for each year (the solid line) is adjusted upward by the amount of dividends and inflation proofing. The identical additions to revenue and expenditures leaves deficits unchanged.

The dashed revenue line for FY17 and FY18 shows the impact of percent of market value (POMV) payments from the Permanent Fund ERA to the general fund. The payments are based on a POMV of the Permanent Fund. The net payouts—the amounts by which the payouts exceed appropriations for dividends and inflation proofing—show as increases in UGF revenue.

Figure 2: Total Agency Operating Budgets, Statewide Items and Capital Budget Compared to Revenue
(UGF Only--$billions)



	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18 Gov
Capital	1.0	1.2	0.8	0.8	0.6	1.6	2.1	0.9	0.6	0.1	0.1	0.1
PF ERA Approps	1.9	2.1	2.0	0.8	1.3	1.7	1.2	2.1	2.0	1.4	0.7	0.7
Statewide Items	0.3	1.1	1.4	0.9	1.2	1.2	1.4	2.0	0.9	1.1	0.4	0.4
Agency Operations	3.0	3.2	3.3	3.5	3.8	4.1	4.3	4.4	4.5	4.2	3.9	3.8
TOTAL BUDGET	6.1	7.6	7.5	6.0	7.0	8.7	9.0	9.4	8.0	6.9	5.1	5.0
Total Revenue (Including POMV Payout)	7.0	12.8	7.9	6.4	9.0	11.2	8.2	7.5	4.2	2.8	4.6	4.2
Revenue Covers % of Expenditures	115%	168%	104%	106%	129%	129%	91%	79%	53%	40%	90%	84%
UGF Revenue (Status Quo)	7.0	12.8	7.9	6.4	9.0	11.2	8.2	7.5	4.2	2.8	2.2	2.4

Takeaway points from Figure 2:

1. POMV payments close a large part of the deficit in FY17 and FY18
   a. The anticipated FY17 deficit is reduced from $2.9 billion to $537 million. Note that the proposed POMV payment is arguably too high because it fails to deduct the $700 million that was paid as dividends directly from the ERA in FY17.
   b. The anticipated FY18 deficit is reduced from $2.7 billion to $840 million.
2. A deficit remains in both FY17 and FY18 despite the POMV payment.

Given the fact that the Governor's budget/plan does not close the deficit, a key question remains: "How does the Governor's budget/plan affect Alaska's fiscal future—what happens to reserve balances and dividends?" Figures 3 and 4 can help answer this question. The two figures are generated by a model created by the Legislative Finance Division.

Figure 3 is a "business as usual" scenario. It assumes that

1. expenditures follow a "no growth" scenario,
2. traditional sources of revenue remain the only sources of revenue,
3. Permanent Fund earnings are used directly for dividends and inflation proofing, and
4. deficits are filled from the CBR until it is depleted, and are then filled from the ERA.

Figure 3: A "Business as Usual" Scenario

	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Reserves	13,191	11,076	9,062	6,982	4,922	2,784	591	0	0
Deficit	-2,758	-2,709	-2,663	-2,635	-2,574	-2,559	-2,527	-2,441	-2,403
Years to Exhaust	5	4	3	3	2	1	0	0	0

Takeaway points from Figure 3:

1. The CBR is exhausted by FY19.
2. The ERA is exhausted by FY25.
3. The scenario is not sustainable—beginning in FY25
    a. Permanent Fund earnings are insufficient to continue dividends and inflation proofing, and
    b. deficits cannot be filled from reserves.

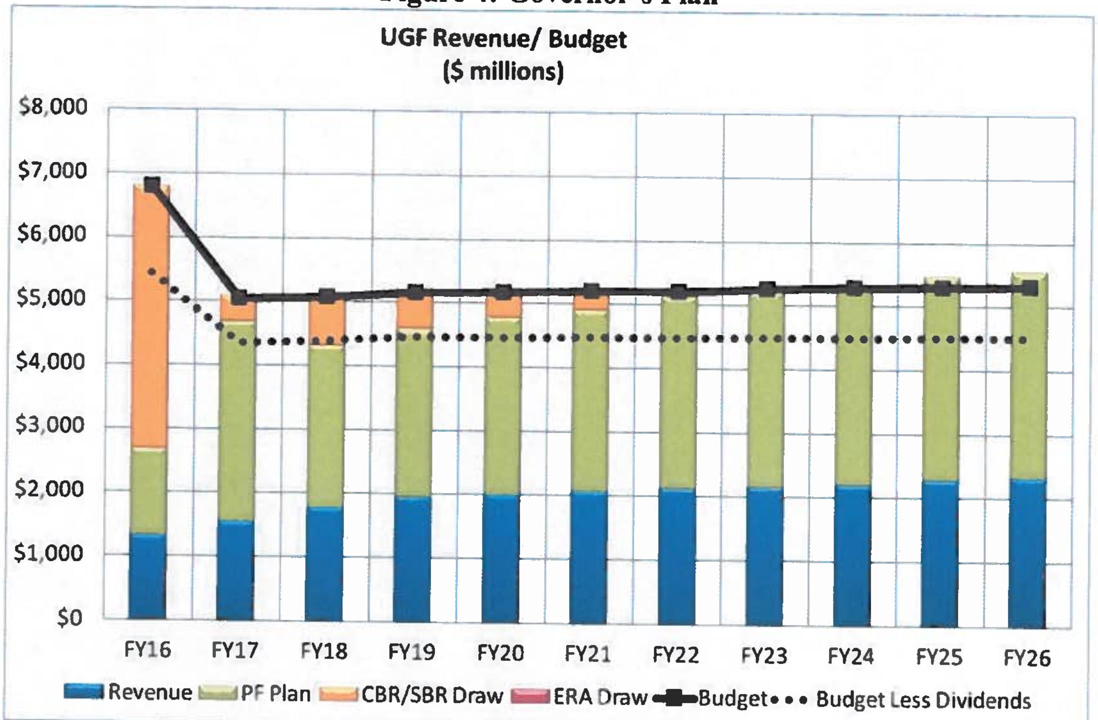
Figure 4 provides projections under the Governor's plan. It assumes that:

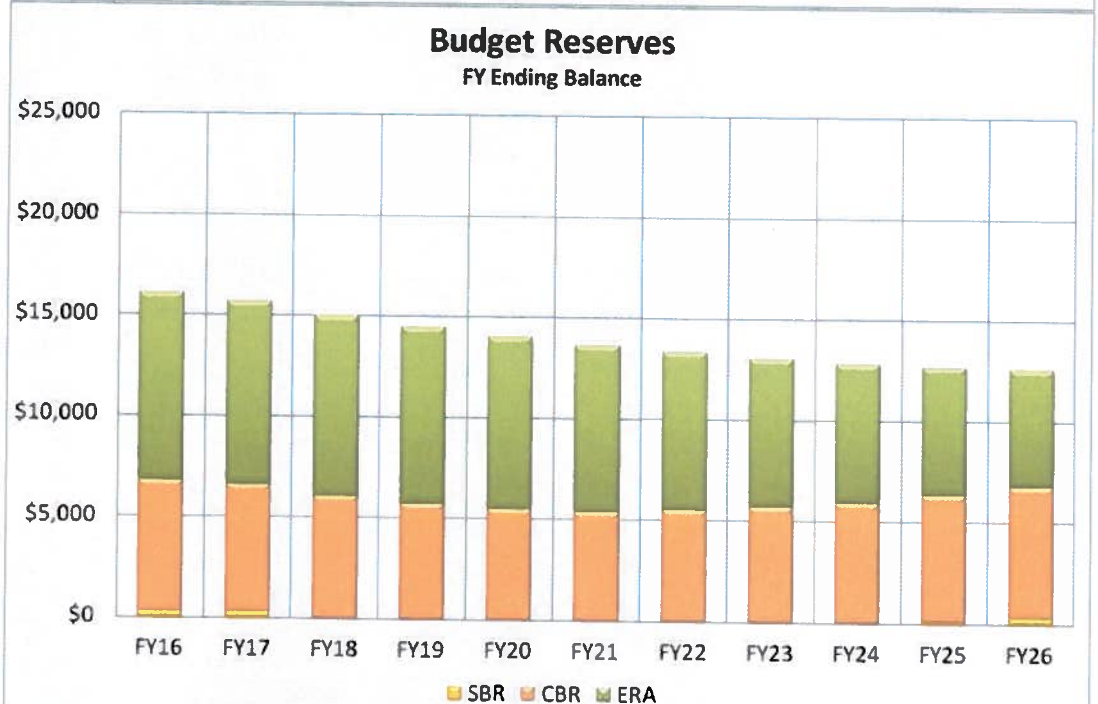
1. Expenditures follow a "no growth" scenario.
2. Traditional sources of revenue are supplemented by
    a. an annual POMV payout equal to 5.25% of prior balances of the Permanent Fund,
    b. additional royalty revenue that otherwise would be going to the Permanent Fund, and
    c. an increase to the motor fuel tax.
3. Permanent Fund earnings are no longer directly used for dividends or inflation proofing; earnings are used only for annual deposits to the general fund.
4. Dividends are
    a. based on Permanent Fund balances and on royalty income,
    b. paid from the general fund, and
    c. are roughly half of the amounts under a "business as usual" scenario.
5. Deficits are filled from the CBR. If that fund is depleted, deficits are filled from the ERA.

Takeaway points from Figure 4:

1. If expenditures—including dividends of about $1,000 per capita—remain as shown in Figure 4, budget surpluses are projected after FY24.
2. The CBR balance remains above $5 billion.
3. Total reserve balances decline slowly but remain above $12 billion.
4. The plan does not include an income or other broad-based tax, revenue from which could permit higher expenditures (including higher dividends) or increases to reserve balances.

Figure 4: Governor's Plan





	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Reserves	14,979	14,444	13,992	13,607	13,310	13,022	12,784	12,651	12,582
Deficit	-832	-631	-458	-345	-130	-93	-21	104	191
Years to Exhaust	18	23	31	39	102	140	599	*	*

Further Analysis

The model—which is available to legislators—allows evaluation of spending and revenue options under various assumptions. The model can be used to project long-term impacts of FY18 (and later) budget actions.

For those whose focus is on FY18, the fiscal summary (on page 10) provides a concise statement (and comparison) of projected revenue, appropriations and the size of the anticipated deficit. It has the limitation of being short on explanation.

Some legislators will undoubtedly be disappointed to see that proposed UGF expenditures are less than $50 million below the FY17 budget. Those that hope to end the session with a larger reduction will be disappointed to discover several items that may tend to push the FY18 UGF budget higher than proposed. These include:

Failure to Increase Motor Fuel Tax Rates	$70	million
UGF for Community Assistance	$30	million
UGF for Retirement Assistance	$58	million
UA and DEED capital projects	$21	million
Total	$180	million

Filling the holes listed above would increase the deficit from about $840 million to about $1 billion.

This *Overview* contains more detailed discussions of the proposed FY18 budget:

- Agency summaries (operating budget on pages 22 & 23 and capital budget beginning on page 83) provide a quick comparison of the Governor's proposed budget with FY17 spending.
- Narratives on individual agency operating budgets begin on page 94.
- Language sections of both operating and capital bills (with analysis) begin on pages 25 and 84, respectively.

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