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May 5, 1995

Mr. Brian Rogers, Chair
Alaska Long-Range Financial Planning Commission
P. O. Box 80690
Fairbanks, AK 99708

Re: A Statutory Budget Plan

Brian
Dear ~~Mr. Rogers~~:

Enclosed is a copy of a proposal I have developed for a statutory plan to get the state budget balanced. I know that you and the other members of the Commission are extremely busy trying to absorb the flood of information being given to you, but I ask that you at least read the 2-page "Executive Summary" of this statutory approach. Then, if you have any questions about any of the plan elements, you can look in the main body of the report for details, or you can contact me.

Most if not all of the other plans for balancing the budget involve amending the Alaska Constitution. This requires a two-thirds vote of each house of the Legislature, and it is quite possible that no plan of a constitutional nature can obtain these super-majorities. If so, then a statutory plan would be the best we can get, in terms of political reality.

Thank you for your time and consideration of this proposal. I wish you and the Commission all the best in your efforts.

Very truly yours,



Thomas K. Williams

Enclosure
TKW:lm

cc: Other Commission Members (w/ enclosure)

AVOIDING THE CRASH

**A PROPOSAL
FOR A STATUTORY PLAN
TO BALANCE STATE SPENDING WITH
SUSTAINABLE STATE REVENUES**

By Thomas K. Williams

**Submitted to the
Alaska Long-Range Financial Planning Commission**

May 5, 1995

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A STATUTORY PLAN FOR LONG-TERM SOLVENCY

by Thomas K. Williams[†]

EXECUTIVE SUMMARY

Alaska's \$600 million gap between unrestricted revenues and expenses will rise to over \$1 billion a year as North Slope oil production — which still provides nearly \$5 out of every \$6 in unrestricted revenue — continues to decline. Absent other action, state cash reserves will run out in 3 - 4 years, at which time the State faces potential insolvency.

The goal of a long-range fiscal plan is to bring spending into balance with sustainable revenues with the least amount of pain for Alaskans, while avoiding this looming threat of insolvency.

The State has five basic tools available in formulating a long-range fiscal plan:

- spending cuts
- economic development
- new or increased taxes
- using part of the Permanent Fund income
- using present cash reserves to soften the impacts of other actions

Studies show that any one of these tools, by itself, will not be sufficient to get the budget into balance and avoid the threat of insolvency. Only a combination of tools can succeed.

[†] Mr. Williams was Alaska's Commissioner of Revenue in 1979-82, when the flood of state revenue from Prudhoe Bay reached its peak. He was Governor Hammond's lead spokesman in reforming the laws for investing state funds and in significantly transforming and expanding the roles of AHFC and AIDEA. He was also one of the original Trustees of the Alaska Permanent Fund. Before serving as Commissioner, he was Director of Petroleum Revenue for the State (1975-79). He is currently Alaska Tax Counsel for BP Exploration (Alaska) Inc. Before joining BP in 1987, he was in private legal practice in Anchorage with Bogle & Gates (1983-84) and then was general counsel for Cook Inlet Region, Inc. (1984-87). Mr. Williams holds A.B. and M.A. degrees from Princeton and Harvard, respectively, and a law degree from Stanford. **All statements in this paper are solely the personal views and opinions of Mr. Williams and should in no way be construed as reflecting any view or opinion on the part of his employer. So blame him, not BP.**

The proposed plan asks voters in the 1996 general election to approve the following 12-point statutory program that addresses both the spending side and the funding side of the budget equation:

SPENDING	FUNDING
• Let state employees have part of any savings they are responsible for • Allow termination of agencies/programs by Executive Order • Require Governor to submit budgets over next 5 years that are each 5% smaller than prior year's budget • Allow impoundment of appropriated funds • Enact a "fiscal emergency" response plan • Reform state travel policies: > Use 1 travel agent > Concentrate travel on 1 airline carrier > State earns the mileage awards • Reform "merit" pay increases: > Limit to top 1/3 > One-time-only award, not permanent pay increase > Does <u>not</u> affect cost-of-living increases • Deliver public education (K-12) more efficiently, emphasizing new information technology	• Fund capital projects through bonds instead of capital appropriations • Limit use of cash reserves to \$300 million per year • Reinstate the personal income tax if "spending side" measures don't balance the budget • Reform the use of Permanent Fund income: > First call on income is for inflation-proofing > Half of remaining income is for PFDs, with fraction to be reduced (e.g. to 1/3 or 1/4) if budget not balanced after other measures > Rest of income goes into General Fund

The chief advantage of putting this plan (or a similar one) to a vote of the people is the political "cover" it can provide for elected officials. Before the election they can support the plan by saying they support the idea of letting the people vote on the plan, without having to say they agree with any unpopular points within that plan. After the election, if the plan is approved, they can take any further actions needed to carry it out and say they are merely carrying out The Will of The People.

A second advantage of having a vote is that, if the plan passes, elected officials may be less likely to try to undo it the first time it becomes inconvenient for them.

CHAPTER 1. INTRODUCTION

The gap between Alaska's unrestricted state revenues and its spending of those revenues is about \$600 million a year. It threatens to run away to over a billion dollars a year in just a few years as oil production — which accounts for \$5 out of every \$6 in unrestricted revenue — will continue to decline despite new corporate investments on a massive scale to slow the decline down.

This gap is real. This gap is serious. If it is not addressed, state government faces insolvency in just a few years. If Alaska does go broke, the lives of thousands of Alaskans will be disrupted in the wrenching of the state economy that will follow.

The purpose of a fiscal plan is to avoid those shocks, or at least to soften the blow by spreading the effects out over a reasonable time instead of getting hit all at once.

This paper does not try to re-invent the work of others in analyzing the size and growth of the fiscal gap, or in analyzing what options Alaska has and how much they could contribute toward solving the gap. Rather, it builds from the conclusions others have reached. Briefly, those are —

- Spending cuts alone won't solve the fiscal gap, although they are an integral part of any solution.
- The state's current cash reserves will be exhausted in 3 - 4 years if nothing else is done; conversely, if the draw against them were to be limited to, say, \$300 million a year, then these reserves could be available for nearly a decade or so, allowing time for other, more painful budget-balancing measures to phase in gradually.
- Some combination of revenue-enhancing measures will be necessary, in addition to spending cuts; the options so far identified for enhancing state revenues are:
 - > revenues from new economic development

(Side comments: Unfortunately, revenues from the most promising kind of new economic development that would come in time to avoid insolvency — namely, revenues from continued oil development on the North Slope outside of ANWR — are already included in state revenue forecasts, which thus understate the extent of the potential fiscal crisis if the state responds to it in a way that scares off the massive new investments needed for this development to occur.

(Revenues from the Gas Pipeline or from possible petroleum development in ANWR would come too late to meet the immediate solvency crisis, although they could make a material contribution in the long term if either or both of them come about.

(Nonpetroleum development will be too little and too late to make a significant contribution to solving the short-term solvency crisis.

(Under current state law, only petroleum development "pays its way" in the sense of paying more into the state treasury than is paid out of the treasury for increased government services caused by that development)

- > new or increased taxes (e.g., personal income tax, state sales tax, "user fees;" increased taxes on motor fuel, alcohol, tobacco, etc.)
- > to use some of the Permanent Fund income

It currently appears that all three kinds of "revenue enhancements" — revenues from new development, new or increased taxes, and using some Permanent Fund income — will need to be used, in addition to spending cuts and conserving cash reserves, if the state budget is to be brought into balance for the long term.

The purpose of this paper is to describe how these elements could be combined into a statutory plan to balance the budget. The details about how much of each element should be used in the plan lie outside the scope of this paper, and are ultimately matters for the Legislature to decide if it moves forward with a statutory plan. The objective for now is to outline the framework or skeleton that such a plan should have.

Of course, the primary drawback to any plan of a statutory nature is that it is not binding on future Legislatures, which can simply repeal or rewrite the statutes containing the plan. However, the plan proposed below addresses this shortcoming of statutes, by infusing its statutory provisions with an aura of sanctity arising from a vote of the people. If the people vote on a statutory plan and approve it, then elected officials should be less inclined to dismantle it the first time it becomes inconvenient for them.¹

On the other hand, the principal advantage of a statutory plan is purely pragmatic — it only takes a simple majority of each house in the Legislature to enact it.

¹ This disinclination to overturn the plan should arise in two ways. First, overturning the plan would look like defiance of The Will of The People. Such defiance usually comes across as arrogance and has been the ruin of more than one political career in the past. Second, it provides "political cover" for refusing to undo the plan. The elected official can gain this cover by listening sympathetically to an aggrieved constituent's complaints about the plan, and then saying some variation of "I really understand your problem and personally I may even agree with you, but my duty is to carry out The Will of The People."

In contrast, any plan embodied in a constitutional amendment would require a two-thirds vote of each house in order to be put before the people for a vote. While a constitutional plan offers the advantage of being mandatory for future Legislatures, that very same mandatory nature makes it difficult to obtain the requisite two-thirds votes in the Legislature.²

Advocates of a fiscal plan might prefer to see it enshrined in the Alaska Constitution to ensure that it will be followed. But political realities may dictate, and Alaska's failure to adopt any constitutional plan over the last decade strongly suggests, that the only type of plan that can actually get through the legislative process is a statutory one. If that turns out to be the case, then Alaska will need the strongest kind of statutory plan that it can get.

² Another reason why it will be hard to get the two-thirds votes for a constitutional plan is the lack of flexibility to change it if it needs to be changed. Any such change would itself need to receive two-thirds votes in the Legislature as well as a majority of the voters. And constitutional amendments can be voted on only in general elections, which are held only once every two years. By the time such a plan could be changed, it might have wrought disaster on the state. So unless there are provisions to "bail out" of a plan if it goes bad, legislators may be reluctant to vote for it as a constitutional amendment even though they approve of the elements of the plan. But once such "bail out" provisions are introduced into a proposed constitutional amendment, they will tend to end up being broadly drafted by the time the Legislature approves the amendment even if they were narrowly drafted to begin with. Thus, because of the "bail out" provisions, a constitutional plan, while supposedly mandatory in nature, could turn out in practice to have even less binding effect on future legislatures than a voter-approved statutory plan.

CHAPTER 2. ELEMENTS OF THE PLAN FOR THE SPENDING SIDE OF THE BUDGET EQUATION

The proposals below for the spending side of the budget equation group themselves into two basic varieties. In the first variety are proposals to create processes that lead to answers about how to save money. In the second are several specific answers.

Processes. Cutting state spending has two parts. One is to eliminate agencies and programs, or phase them out. The other is to do things more efficiently.

One of the difficulties in eliminating agencies and programs is that there is little consensus among Alaskans about which ones to cut out first. Every program and agency has its own constituency of people who enjoy it or benefit from it, and who stand to suffer, be injured or become unhappy if it is not continued. These people naturally rush to the foreground to protest when their program or agency is threatened. It's the "don't gore my ox!" or DoGMO syndrome, the elder brother of NIMBY.³

Wouldn't things be easier and less rancorous if we started by identifying the agencies and programs we most need to keep? Unlike the question of what to eliminate, Alaskans largely agree on what is most important for government to be doing. They want it to provide the basics— things like public education, public safety, jails, a system of justice to protect our rights and freedom, facilitating trade and travel. So why not start with these programs, agree to continue them, figure out what they cost, and then move on to progressively less essential or less urgent programs until the available money is used up? Then what's left can either be eliminated, or the people who want those programs can be asked to pay taxes or user fees to cover the costs of keeping them. That's just a suggestion to any legislator or Governor who reads this, and there's no good way to put it into statute. It just seems like a better way to frame the debate.

Efficiency — that is the second side of spending cuts. Here there are a number of things that could be done statutorily to save money without sacrificing what we get from government.

One of the most important lessons learned by private enterprise in its drive for greater and greater efficiency during the last few years is this: No one knows better what's useless, unnecessary or wasteful on the job than the person doing that job. From this homely, obvious truth flows an equally compelling corollary: The way to achieve the greatest increase in efficiency and productivity is to give employees the freedom and authority to change the way they do

³ "Not in my back yard!"

their jobs, so long as they achieve what they're supposed to achieve in performing their jobs.⁴

There is no intrinsic reason why the lessons learned in the private sector cannot be applied in government. Contrary to the stereotypes of them, state employees are not inferior to their counterparts in business, nor are they lazier or less motivated.

Government is not efficient primarily because the incentives for its employees run the wrong way. Instead of being rewarded, efficiency is punished. For example, if an agency saves money by being more efficient and turns that money in, unspent, to the treasury at the end of the fiscal year, there is a real risk that its next budget will be cut since it obviously "doesn't need the money." The more money being turned in, or "lapsed," the greater this risk becomes.

Such a cut is seen by the agency as something bad, something punitive, and hence something to be avoided. Why is it seen this way? In large part it's because the hierarchical structure of government leads agency managers to think that having a larger and larger budget and increasing the number of employees under their supervision will cause them to be promoted or upgraded into higher positions in the hierarchy, where the pay is higher as well as the status. Cutting an agency's budget after it has been efficient and not spent all its money works against these ambitions of the agency's management. The cut sets them back in their ambitions.⁵ The managers' resulting anger, disappointment or frustration will be taken out in turn on the people working for them — perhaps especially those who saved the money — since the agency management cannot hurt their superiors in the bureaucracy or the legislators who do the actual cutting of the agency's budget. So everyone in the agency suffers: the managers who are at least temporarily frustrated in their ambitions, and the staff feel the managers' response.

Every manager and supervisor in the state government has learned this lesson.

⁴ Of course, success in giving this freedom and authority to employees depends on each employee's knowing exactly what the targets are that he or she supposed to achieve in the job. Without this, individual efforts can be at cross-purposes, and instead of pulling together to achieve a common goal, employees end up pulling in different directions — and efficiency is lost instead of being gained.

⁵ In fairness one must point out that many managers resist budget cuts for less selfish reasons. Often they believe a cut in their budget would reduce the agency's flexibility to deal with unforeseen situations. When the unexpected happens, it is much easier and faster to respond to it by using some money that was "in reserve" instead of trying to get funds from another agency or through a supplemental appropriation. But the point is not about the motivation of the managers, but about the fact that they almost universally won't cut their budgets unless they are ordered to, and even then they are reluctant to do so.

For precisely similar reasons many agency managers are loathe to eliminate staff even when they clearly are no longer needed.⁶ Reducing staff means having less justification for moving to that next higher position; and in terms of status among one's peers at a given level of the pyramid, having fewer employees makes one less powerful and with less status. For other managers the reason for their resistance to cutting staff is more "humanitarian" — they don't want to cause hardship for the employees and their families by firing them, or they want to avoid the unpleasant, often emotional meetings face-to-face with the employees to give them the bad news.

Plan Element No. 1. *Let state employees have part of any savings that they are responsible for.*

The first step in breaking the "bureaucratic" mind-set and achieving greater efficiency in government is to reverse the incentives. Agency managers and their staff must be rewarded for saving money, and the rewards must be sufficient to overcome management's reluctance to cut staff. If efficiency improves by 25%, for example, then it does no good to have a 12-person staff working only 75% of the time and sitting idle, waiting to go home, for the other 25%. For the full savings to be realized, the staff needs to be reduced to nine who are working with no idle time.

Letting people share in the savings they're responsible for creating is a simple, direct incentive. Its simplicity and directness ensure that it would motivate people in the right direction.

But, like many "simple" ideas, the devil with this one is in the details. What is to keep an agency from padding its budget, so everyone in it can share in a windfall (for the first year at least)? What about an agency that stays within its budget but gets saddled with new functions by new legislation? How high up from an agency can the savings be shared? for example, if there are savings by two divisions out of three in a department, can the Commissioner's Office share in the savings of the two? If the Legislature appropriates less money to an agency than there was in the Governor's budget, do the agency's employees share in the difference between the Legislature's budget for them and the Governor's if they come in below the Legislature's appropriation, or do they only share to the extent they're below the appropriation? The following answers most of these questions about details.

First of all, the rewards should flow from the bottom up. That is, starting in the lowest-level governmental unit, when such a unit lapses money in its budget, the staff in that unit would share among themselves 5% of the amount so lapsed (as to the determination of the size of this "lapsed" amount, see below).

⁶ A case in point was when Alaska repealed the personal income tax in 1980. Not a single state income tax auditor was fired. One or two in the Seattle office may have resigned instead of relocating to Alaska, but the rest were all reassigned to work on other taxes. The author was, at the time, quite proud of this achievement in "protecting the staff."

This reflects the fact that the people "in the trenches" doing the actual work generally know better than their supervisors how to do that work more effectively or more efficiently. By giving them the primary incentive to be more efficient, the enormous potential of the "bureaucracy" will be harnessed for the goal of efficiency.⁷

Next, at the next tier up — let's say sections are the bottom level and the next level up is a division — the management and division-level staff (i.e., staff not assigned to any particular section within the division) would divide among themselves 2.5% of the amount lapsed by each section within that division.⁸ In other words, for a given lapse by a section within the division, the total amount being divided at the division level would be half as much as the pool that is divided up among the staff in the section that caused the savings. Of course, no one in a division would share in any lapse originating in a different division; they only share in the savings arising within their own division.

For the next tier up — from the division level, this might be the commissioner and department-level staff — the amount to be divided among them from a unit's lapsed funds would again be half of what it is at the next level down, or 1.25% in this example. Each tier up would divide half as much, in total, of a given lapse as the tier immediately below it. And again, of course, no commissioner or department-level staff would share in any money lapsed by a unit in another department.⁹

⁷ If the savings were to come as the result of eliminating positions within a group, those who lose their positions should share in the "lapse pool" in proportion to the amount of time that they were working with that group during the year.

⁸ The reason for sharing with the higher-ups in the department is obvious. If they didn't share, they would have little incentive to allow the troops in the trenches to make the savings, especially those savings would reduce the size or apparent status of the higher-ups' domains. But under this proposal, the higher-ups potentially have very strong incentives to encourage savings by those below them. This is because, even though the pool to be shared gets halved in size for each level up in government one goes, the number of people in each level of government to share in that reduced pool will be getting smaller even faster (unless managers at each level have, on average, only two units or less reporting to them from the next level down, in which case that hierarchy should be reorganized to have fewer managers with broader areas of responsibility). This faster shrinkage in the number of people up the chain of command who share in a savings means the per-capita amount at a higher level will be greater than the per-capita amount in the next level down. In addition, a higher-up would stand to share in lapsed funds from each of the bottom-level units within his or her span of authority, further increasing the higher-up's incentive to encourage all units within his or her control to become more efficient.

⁹ For political and public-policy reasons, the Governor's staff should share only in savings originating within their ranks as if they were a separate department, while the Governor should not share at all in any savings even though that position embodies the executive power of the state and all departments report to the Governor. Similarly, judges and justices should not share in savings arising in the Judicial Branch, although the Court Administrator and support staff should, assuming this system were extended beyond the Executive Branch. However, this system would be inappropriate for the Legislative Branch (except possibly the Ombuds-

(footnote continues on next page)

Under this proposal, for any given lapse of funds, the total amount distributed to state employees would have to be less than 10% of the lapsed amount, no matter how many levels of government may end up sharing in it, because the pool being shared at any given level is half of the pool for the level below it.¹⁰ This means that at least 90% of the savings will always be realized, despite the fact that employees up and down the line who are responsible for that savings would share in it.

To avoid "games" with agency budgets, the amount of lapsed funds available for sharing should be measured from the lesser of the Governor's budget requests (including supplemental requests) for that unit and the amount actually appropriated (including supplemental appropriations¹¹) for it. For a few units or programs — such as fighting forest fires, or responding to a disaster — the amount spent each year depends primarily on factors beyond their control, and so authority would have to be given to the Governor to authorize adjustments to eliminate the unfair effects of those uncontrollable factors.

The important thing about this proposal is that, for the first time, it would create an incentive for government to become smaller and do things better, on its own initiative. In the past, state government has shown enormous knowledge, tenacity, resilience and creativity in thwarting the efforts of Legislatures and Governors alike to reduce its size. Now it is necessary to harness these vast abilities to a different end, and we can!

Plan Element No. 2. Enact legislation allowing the termination of state agencies and programs by Executive Order.

Having given people the incentive to be more efficient, it is necessary to give them the authority to act in order to achieve that efficiency. One of the key ways to do this is to abolish those parts of state government that aren't working or don't make sense to keep any longer.

By using the Executive Order procedure, the Governor can act decisively and immediately to eliminate such programs and agencies. If in doing so, the Governor makes a mistake or the Legislature simply disagrees with the deci-

man's office) because the Legislature makes all the appropriations and there would be far too many conflicts of interest, either in fact or in appearance.

¹⁰ For the mathematically inclined, $1 + 1/2 + 1/4 + 1/8 + \dots + 1/(2^n) = 1 + (2^n - 1)/(2^n)$. As "n" approaches infinity, $(2^n - 1)/(2^n)$ approaches 1, and hence the total for the series of fractions approaches $1 + 1$, or 2. Thus, if the bottom-level unit shares 5%, then the total for all levels can approach, but can never actually reach or exceed, two times that amount, or 10%, no matter how many levels of government there actually are above that unit which are sharing in its lapsed funds.

¹¹ "Supplemental" appropriations would include not only additional funds appropriated during the fiscal year at the request of the agency, but also any additional funds appropriated to an agency because of a non-zero fiscal note for new legislation that affects that agency.

sion, the Legislature retains the power to disapprove and annul the Executive Order by adopting a resolution to that effect.

The problem with the present system for eliminating programs and agencies is that it has failed miserably. There are over 20,000 state employees for a populace of 600,000; in other words, out of every 30 men, women, children and infants in Alaska, one is a state employee. In large part the reason for this failure is in the nature of the Legislature, which creates the programs and agencies where all these people are working. The legislative process is simply ill-suited to eliminate programs because sometimes all it takes to save a program is just one legislator in a key committee position who wants that program to continue. That legislator might use his or her position to smother legislation to repeal that program by not letting it advance out of committee, or, equally effective, could use that position to hold up other legislation in order to bargain for votes from other members to defeat or amend the legislation.

In order to ensure that Executive Orders could be used effectively, it may also be necessary to amend the State Personnel Act to ensure that there are no problems under any of the state collective bargaining agreements in laying people off or firing them and eliminating their positions. For collective bargaining agreements that are already in place, the state would have to respect the terms of those agreements until they expire or come up for renegotiation, at which time the new statute would be applied in the new contracts for those bargaining units.

Plan Element No. 3. *Require the Governor to submit budgets for each of the next five fiscal years that are 5% smaller than the budget in the preceding year; and if it isn't, automatically cut the salary of every non-clerical and non-secretarial position in the Governor's Office and everyone in a division-director level position or higher in the rest of the Executive Branch, by 5% for that fiscal year.*

Fitting closely with Plan Element No. 2, this proposal would tend to force the Governor to use the authority conferred under that Element. If the Governor has to shrink the budget, he or she is going to have to look for ways to make government smaller. And again, with Element No. 1 giving the state civil service a powerful financial incentive to save money, the Governor should be able to mobilize the "bureaucracy" to look for ways to make itself smaller, even at the expense of some of its members.

In any event, it is surely better to give the people running the programs a target to meet in reducing their expenses, and to force them to look for ways to reduce costs, instead of having less informed "outsiders" — be they legislators, the Long-Range Financial Planning Commission, or the author of this paper — try to prescribe what programs to reduce or eliminate.

The "in terrorem" threat to people's salaries might seem excessive to some, but it would surely motivate the state's top management to meet the 5% target. Without this extra push, it is doubtful that the sharing in lapsed funds

under Plan Element No. 1 would be sufficient to ensure that this target would actually be met each year.

Plan Element No. 4. *Allow impoundment of appropriated funds.*

It seems foolish and wasteful to require the Executive Branch to spend money that it doesn't want to spend. The strongest case for not allowing impoundment is where the appropriation is for a program enacted into law over the Governor's veto. In terms of respect for the Separation of Powers between the branches of state government, allowing impoundment for such a veto-overridden program would largely frustrate the Legislature's act of overriding the veto because the Governor, having lost the contest over whether the program should be enacted or not, would nevertheless be able snatch "victory" from the Legislature by impounding the money to implement the program.

There are two ways to accommodate this Separation of Powers issue. One is to allow impoundment except for programs that have been vetoed and overridden into law. This would preserve the Legislature's "victory" in overriding a veto while still giving Governors latitude to act in the great majority of cases. The second is to recognize that the emergency of the looming fiscal crisis outweighs the Separation of Powers issue for the time being. Such a recognition could be in the form of a general power to impound that sunsets after a specified period — say, five years.

Either way, the point is this: If the Executive Branch is going to do a half-hearted job implementing a program, there is no point in wasting money by requiring the Executive to spend all the money appropriated for that program. Instead, where there is such a strong disagreement between the Executive and Legislative Branches over a program, it is the responsibility of both sides to try to compromise so that each can live with the result. At least for now, Alaska simply cannot afford the luxury of indulging in inter-Branch contests of will over programs that are not going to be effectively and efficiently implemented.

Plan Element No. 5 *Enact a "fiscal-emergency response plan" — that is, a clear, detailed plan for suspending non-essential government functions if a fiscal emergency suddenly develops.*

In 1986 a sudden and dramatic collapse in world oil prices put Alaska into a potentially catastrophic fiscal emergency, which fortunately disappeared when prices rebounded a little later. Today Alaska remains just as vulnerable to oil prices as it was then. Alaska also remains vulnerable to any extended disruption in the flow of oil from the North Slope. A natural disaster like the 1964 earthquake could require massive state expenditures to cope with the emergency. Any of these types of events could destroy or gravely damage the state's fiscal footings.

To be prepared for the unexpected, Alaska needs to have a plan for the orderly shut-down of non-essential state functions if an major fiscal emergency were suddenly to develop. Such a plan should provide for different degrees of

shut-down depending on how severe the fiscal emergency is. For example, it might say that if a "hole" in the state budget suddenly opens up that is over "X" million dollars, the Governor will take Steps A, B and C; if the hole is "X plus Y" million dollars, then Steps D, E, F and G will be taken in addition to the first three; and so on.

As with recommendations about permanently eliminating particular state programs and agencies, it is beyond the scope of this paper to suggest which state functions should be shut down, and in what order, if there were a sudden fiscal emergency. Rather, the Governor should develop such a plan in cooperation with the Legislature. Legislation (or a legislative resolution) should be passed now, calling for the Governor to develop the statutory aspects of such a fiscal-emergency plan and to submit them to the Legislature as soon as possible.

Non-Process Actions. As noted at the outset of this chapter, two types of proposals are being offered. The first group, above, is comprised of proposals for new processes that will result in savings to the state. The second group, below, has specific cost-saving actions. However, none of the proposals below relates to any specific agency or program.

Plan Element No. 6. *Reform state travel policies by: (1) concentrating state travel onto a single airline carrier as much as possible, in order to bargain for special fares from the airline, (2) consolidating all travel reservations through a single travel agency, which wins the business through competitive bid on the commission to be charged, and (3) putting all "frequent flier" mileage onto one general account in the state's name, so the mileage awards go to the state instead of the individual employee.*

The first two parts of this Plan Element would realize savings in travel costs by exploiting the huge volume of travel done by state employees. The first part — concentration of travel onto a single airline — is feasible because the largest part of state travel is over a fairly small number of routes: between Anchorage and Juneau, or Anchorage and Fairbanks, for example. Guaranteeing a large monthly volume of passengers on each route should get the state a significant discount from the normal airfares for those routes. Similarly, having one state travel agency should save in commissions because the agency can make up in volume what it would give up on each individual booking. This saving could be augmented by also requiring state contractors to book their employees' reservations through the state's travel agent.

The frequent-flier mileage proposal is probably the most controversial — particularly with state employees. But there are two solid reasons for doing it. First, the frequent-flier mileage is not a benefit of state employment; it is a consequence of travel on state business. The state should get the benefits of its expenses for travel, instead of giving those benefits to employees.

Second, the IRS is taking the position that travel mileage awards are taxable income of the employee receiving such an award as the result of traveling on business. To the extent one disagrees with the first reason and contends instead that airline mileage is some sort of compensation to state employees for being away from home on state business, one is simply making the IRS's case for it on the issue of taxability. In light of the likely taxability of frequent-flier benefits, the state is an obvious target for the IRS because they can pick up a lot of currently untaxed "income" of state employees without a lot of time or effort by IRS agents. So it is only a matter of time before the state has to include the value of airline mileage as part of the employee's gross income reported to the IRS. This, in turn, will mean extra costs to keep track of the mileage each employee earns. It probably will also mean additional withholding tax being taken out of the pay checks of frequent-flier state employees.

Plan Element No. 7. *Reform "merit" pay increases for state employees by: (1) allowing each supervisor to give merit awards only to the top third of employees working for that supervisor, and (2) making the merit award a one-time bonus or a temporary one-year raise.*

There are two things wrong with the present system of "merit" increases in pay for state employees. One is that the idea of "merit" has been so watered down that state employees are given this pay raise each year even for mediocre performance. Indeed, withholding a "merit" increase from an employee has come to be seen as a form of discipline for inferior performance, so that it is all but automatically given to employees whose work is not so bad as to deserve punishment.

The second problem with "merit" increases is that, even if they were truly given for merit, they reward employees during the rest of their careers with the state for doing a good job during just the one year for which the increase is granted. This happens because the increase moves them into a higher step within the pay range for their position, and that becomes their new base-line for pay. An award for merit in the following year simply compounds the increase for the first year, by moving employees into the next higher step in the pay range, where they will then remain until the next merit increase.¹²

The reward for superior performance in any given year should not be an annuity for the rest of the employee's career. It should be something to be re-earned each year, and if it isn't earned in any particular year, no reward should be given that year.

¹² This progression into the higher end of the pay range stops when the employee reaches "Step F." See AS 39.27.011(a). Steps beyond "F" are "longevity" steps, and one moves from one step into the next higher one simply by spending a certain number of years in the lower step with a rating of "good" or better. For instance, it takes two years in "Step F" to move into the first "longevity" step, called "Step J." To move from "J" to "K" takes two more years, from "K" to "L" five years, and from "L" to "M" four years. See AS 39.27.022(a) and (b).

Let it be clearly understood that "merit" increases are not increases to offset increases in the cost of living. Cost-of-living increases are made from time to time to the whole salary structure. So if an employee is in, for example, Step B of Range 16, he or she can remain in that step and will receive the appropriate increase in pay to compensate for increases in the cost of living when the salary structure is adjusted. There is no justification to move this employee to Step C of Range 16 because of increases in the cost of living, so long as the whole salary structure is adjusted for cost-of-living increases on a timely basis in order to be fair to state employees.¹³

Some may object to this Plan Element on the ground that employees gain value as they gain experience, and so they should be paid more. "Merit" increases do this, they say. The response to this objection is simple: True, many people can and do get more valuable over time, but not everyone does. A few actually get worse. Moreover, even for those who do become more valuable with experience, they do not materially gain in value with every second or minute of experience. It takes time before there consistently is a material improvement in the quality of their performance. How long it takes to gain this improvement depends on the individual. But however long it takes for any given individual, as people gain enough experience to become materially more valuable, they can and should be promoted into higher, more responsible positions. This way, the work they do is indeed more valuable, and they are entitled to be paid more for doing it. But (apart from cost-of-living increases) no one should be paid more simply to keep doing the same work, because the work being done does not increase in value.¹⁴

Plan Element No. 8. *Deliver public education more efficiently, by aggressively exploiting developments in information technology.*

One third of the state operating budget — some \$0.75 billion out of \$2.35 billion — goes to pay for the costs of public education for kindergarten through 12th grade. This is the largest single spending component in the state budget.

¹³ Cost-of-living increases should not be confused with location differentials. Cost-of-living increases are to offset the effects of inflation on the buying power of employees' salaries. Location differentials reflect the fact that some places in Alaska are more expensive to live than others, regardless of the rate of inflation in the economy. Thus, a position that begins at Step A of Range 18 in Anchorage might begin at Step F of Range 18 in Nome, which historically has been a more expensive place to live than Anchorage. Governor Knowles has recently proposed a reform of the present system of location differentials.

¹⁴ The exception to this is where greater experience means a person can perform a greater volume of work — for example, processing 10 Permanent Fund Dividend applications an hour, instead of six. But, for this type of job, the base rate of pay should be set at a reasonable level reflecting the value of processing six PFD applications an hour, with a premium based on output over this norm of six per hour. In this way the reward (increased salary) is paid only as long as the employee earns it, and it doesn't get built into his or her base-line where it will be paid for the rest of his or her career with the state.

No one wants to short-change Alaska's children when it comes to education, yet this area of expenditure is simply too large not to be addressed in any comprehensive plan to bring the budget into long-term balance.

One of the most promising areas in which education might be delivered with considerably greater efficiency is in information technology.¹⁵ Why should there be a physics teacher in every high school in Anchorage, for example, when an interactive information system could allow a single teacher to teach physics in all of the high schools, either at once or in rotation? In fact, one can readily expand this question and ask why there should be more than one or two physics teachers statewide, if Alaska were appropriately hooked up to an information system.¹⁶

Alaska right now has a particularly interesting opportunity to get hooked up. AT&T is one of the leaders in developing the new information technology, and it is now directly entering the Alaska market through its acquisition of Alascom. Why not approach AT&T¹⁷ and ask them to use Alaska and its school system statewide as a full-scale demonstration project for the latest in this technology? The challenges that Alaska presents would provide a rigorous test of the technology. And, because it is coming into the state for the first time, AT&T might be more eager than usual to do this, in order to gain a good reputation here in its own right. The State might want to sweeten the deal by offering to co-venture up to, say, \$100 million in capital funds over the next three or four years to help AT&T install or upgrade the statewide infrastructure to make the system work.¹⁸

¹⁵ A proposal along these lines was made during the last Hickel Administration, but little came of it.

¹⁶ Obviously, physics is not the only course that could be taught this way. Indeed, this approach might be extendible all the way down to first grade. Although young students need an adult physically present in the classroom to maintain discipline and order, it might be possible that such supervision could be provided by someone who does not have the high credentials necessary to teach but still has enough experience and/or training to be effective with the children. In rural schools, if this supervision came from someone already living in the village, this approach could reduce the number of teachers and their families that the State has to support in outlying schools, with potentially significant savings in costs. But real savings could also be realized under such a program even in urban school districts.

¹⁷ Nothing in this proposal would prevent the State from approaching any other leader in the field at the same time it approaches AT&T. But going to only one company first could allow a deeper and stronger relationship to be established for the long term — one that could ultimately be less costly overall than the initial gain that might be realized by having companies compete to win the State's business.

¹⁸ The infrastructure for delivering this information technology to schools statewide would have numerous side benefits, once it is installed. For instance, it could facilitate teleconferencing of legislative and administrative hearings. Although the State does have such a network already, it is quite primitive and outdated. There is no capacity to transmit pictures or live video,

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CHAPTER 3. ELEMENTS OF THE PLAN FOR THE "FUNDING" SIDE OF THE BUDGET EQUATION

Plan Element No. 9. *Fund capital projects through bonds instead of capital appropriations.*

Among states the conventional way to pay for new capital projects is to issue bonds. Alaska has not had a state bond sale since 1984. In part this was due to concern that the "Prudhoe curve" for state revenues might lead to a downgrading of the State's bond rating by the rating agencies if the State kept issuing bonds farther and farther into that "curve." A lowered state rating would tend, in turn, to lower the ratings of state agencies like AHFC, raising the interest rates they would have to pay on their own bonds. It was also likely that there would be a similar lowering of the bond ratings for most, if not all, municipalities in Alaska if the State's own rating went down, raising their interest costs, too. Moreover, for a long time the State could afford to avoid taking these risks because it had the cash resources on hand to pay for new capital projects simply by appropriating the money. But no more.

Using bonds for new capital projects has a short-term advantage of allowing those projects to be built with less state money up front. For a state facing a fiscal crisis while numerous needs for capital infrastructure are still unmet, issuing bonds is a godsend. The projects can go forward, yet at the same time precious cash resources can be conserved to cover the transition to a balanced budget.¹⁹

This does not mean the State should go on a bonding spree, however. Each bond sale entails a commitment to repay those bonds over a period of time. If new bond sales occur faster than old bonds are paid off, the total obligation to pay the "debt service" on all the outstanding bonds will increase. If people aren't careful, the total debt service could rise to the \$150 million a year that we're now spending under the state capital budget.²⁰ Should we get to that

for example, and even voice communication can involve a lot of manual switching of microphones on and off.

¹⁹ For example, a \$100 million project that is financed by 10-year bonds payable semiannually at 8% annual interest would have debt service of \$14.7 million a year to repay those bonds. Instead of spending \$100 million now, the Legislature could get this project and spend only \$14.7 million right away, freeing up over \$85 million. Actually, because voters first have to approve the bonds before they would be issued, legislators could take credit for the capital project right away, but even the \$14.7 million wouldn't become payable until after the election approving the bonds and after the bonds are actually issued. So the full \$100 million could be conserved for perhaps up to two years or a little more, while political benefits from the capital project would inure immediately.

²⁰ Suppose, for example, that the State went on a program of issuing each year \$100 million of 10-year bonds like those described in the preceding footnote. In the first year the debt service is \$14.7 million, reflecting the fact that one series of bonds is outstanding. In Year 2 it is

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situation, we would have no net advantage over where we are now, in terms of solving the fiscal gap. Indeed, we'd have a disadvantage, because interest on the borrowed money makes bonds more expensive over their lifetime than an up-front cash appropriation.

Using bonds also has an advantage in the sense that they have to be put to a vote of the people before the capital projects can proceed. This isn't the case when the projects are funded by appropriations, and there are many examples that could be offered of projects that went forward in the past that would not have been approved if they had been put to a vote.

Plan Element No. 10. *Enact legislation limiting the total draw against state cash reserves to \$300 million in any fiscal year, with an exception to allow a greater draw if needed to respond to a true emergency.*

Currently the state's cash reserves are simply being drawn down by whatever amount is needed to fill the gap between estimated revenues and the amount being appropriated by the Legislature. But if this continues there simply won't be any cash reserves left in just three or four years.

It seems a much more prudent idea to try to use the cash reserves over a longer period of time and thereby allow other, more painful measures to be phased in gradually, so that the state economy doesn't take the full force of the blow all at once. With the proposed limit of \$300 million on the annual draw on these reserves, they should last for 10 years or so (barring emergencies).

This is one Plan Element that has no chance of working unless it is submitted to the voters and approved. Even so, it won't work unless other Elements of a comprehensive plan are already enacted before the 1996 election or are approved in that election and put into action at the same time. The "moral persuasion" from a vote of the people for it won't be enough to ensure that this Plan Element will be followed if there's a gap between revenues and expenses and no other measure is available to bridge it.

\$29.4 million — \$14.7 million for the first year's bond issue and another \$14.7 million for the new bond issue. In Year 3 it's \$44.1 million, as there are now three bond issues outstanding. By Year 10 it is \$147 million, as the last \$14.7 million is paid for the first year's bonds and there are nine other bond issues in various stages of being paid off. In Year 11 a new bond issue replaces the bonds issued for Year 1, which are now paid off, so the total debt service remains \$147 million for the 10 series of bonds that are outstanding. In Year 12 new bonds replace the bonds for Year 2, and the debt service is still \$147 million. In this way the State could build up its debt service to \$147 million and could then stay at that level indefinitely, so long as it continues to issue similar new bonds to replace those that have just been paid off. This would correspond to the present situation in which Alaska spends \$150 million a year on its capital budget. Of course, if the State issued bonds at a faster rate, then the debt service would become greater than the current spending level of \$150 million a year for capital projects.

Adopting Plan Element No. 9 would take some of the pressure off from this 10th Element because cash that would have been spent on capital projects will be conserved.

Plan Element No. 11. Reimpose the personal income tax, but only if Plan Elements 1 - 9 are adopted and fail to solve the fiscal gap.

A lot has already been said about reimposing the personal income tax. It has the advantage of taxing income of many non-residents who earn money in Alaska and create a demand for government services here, but who currently do not pay anything to cover the extra cost of providing those services. In fact, this is also true for Alaska residents who don't work in the petroleum industry. They create a demand for government services, but they and their industry only pay a fraction of the costs of providing those services.

Another advantage of the income tax is that it is deductible for federal income tax purposes.²¹

Perhaps the biggest advantage of the income tax over the other major tax option²² — a state sales tax — is that the income tax won't interfere with the system of taxation set up by local governments, many of which rely on a local sales tax. If the State imposed a sales tax of its own, the total sales tax burden in some localities would become as almost heavy as that in New York City, perhaps even heavier. Such a burden would be a direct weight on economic activity there, stifling it.

No new tax may be desirable, but some new tax is inevitable. The personal income tax is the least of evils in this area.²³

²¹ This deduction is available only for those who itemize deductions on their federal tax returns, not for those taking the standard deduction. If Congress adopts a flat-rate tax to replace the present federal income tax, the deduction for state income taxes may or may not carry over into the new tax.

²² According to the Governor's Office of Management and Budget in 1993, the personal income tax would yield \$250 - \$400 million a year, while a state sales tax would yield \$125 million a year for each 1% in the tax rate. In contrast, each 1¢ increase in motor fuel taxes would yield a little less than \$5 million a year, while a 5% fish landing tax would yield \$14 million a year. Increased "sin" taxes on alcohol and tobacco would also make only small contributions to solving the fiscal gap.

²³ To date most discussions of the income tax assume that it would be reimposed at the same rates as the old tax before it was repealed. These ranged from 3% to 14.5% for individuals, depending on their income-bracket and filing status (single, head of household, or married filing jointly). See AS 43.20.011(a) - (c) (1977 version of AS 43). However, the tax could be reimposed at any other rates that seem appropriate to meet the demands of the budget situation. The matter of the precise tax rates to use is a detail, albeit an important one, for the Legislature and the Governor to resolve as the legislative package for this plan moves forward.

Plan Element No. 12. *Reform the use of Permanent Fund income by: (1) giving highest priority to inflation-proofing the Fund, (2) dedicating one-half of the Fund's real income (i.e., income left over after inflation-proofing) for Permanent Fund Dividends at first, but if Plan Elements 1 - 9 and 11 are adopted and fail to solve the fiscal gap, reducing this fraction (e.g., to one-third or one-quarter), and (3) dedicating the remainder of the Fund's real income to the General Fund.*

Without inflation-proofing, the Permanent Fund will be merely the "Temporary Fund." Inflation will steal it away like a thief in the night. The loss of value in the Fund's principal that is caused by inflation should be seen as negative income. Then the real "income" is the income that is left over after this negative income.

Currently the highest priority for Permanent Fund income is to pay Permanent Fund Dividends (PFDs), with only second priority for inflation-proofing. This needs to be reversed, or else we could end up unintentionally consuming the Fund to pay PFDs to ourselves.

Of the real income of the Fund — that is, the income left over after inflation-proofing — a portion can continue to be used for PFDs, while part of it should put into the General Fund where it can be used to pay some the costs of government. It is appropriate to dedicate at least some of the Permanent Fund's real income to cover the costs of government because the Fund was originally proposed and approved by the voters for this purpose — to be a source of state income to replace the oil revenues when the oil is gone. While the oil isn't completely gone yet, production for several years already has been below the point where petroleum revenues were sufficient to cover the costs of government. As petroleum revenues decline yet further, it is time to put the Permanent Fund to its original purpose.

This being the case, then why should we continue to pay PFDs, especially if we also reinstate the personal income tax? Why pay ourselves money and then tax it back?

There are two reasons to continue the PFDs, even with a personal income tax. One is that taking away the PFDs is equivalent to a tax, but its effects are hardest on those with the least amount of other resources. In other words, this "tax" falls hardest on those least able to pay. That is unfair and regressive. Conversely, if we keep the PFDs and reimpose the income tax, those who will lose their PFDs to the tax will be those who can most easily afford to lose them, while at the same time those who are least able will pay little tax and thus will keep their PFDs. This is fairer and progressive.

The second reason to continue PFDs is to keep the people of Alaska as a constituency to protect the Permanent Fund. Currently there are two things, and two things only, that determine how much the PFDs are: how well the Fund did in its investments, and how many eligible Alaska residents there are. If PFDs

were eliminated or capped at some arbitrary dollar amount, the people's direct stake in how well the Fund is invested would be broken. In the past it has been powerful public opinion that protected the Fund against attempts to "raid" it by subverting its investment powers to political ends. If Alaskans lose their direct personal stake in how well the Fund performs, then public opinion will weaken and may become inadequate to protect the Fund. The sorry story of the Alberta Heritage Fund in Canada shows what happens when a large governmental fund is allowed to invest in politically-driven "investments" at less-than-market rates. Alaska must not repeat Alberta's mistake, and keeping PFDs will help keep us on the right track.

At some point it may well be necessary to reduce the fraction of real income that goes for PFDs, in order to avoid taking even more drastic budgetary actions. However, until then, the proposal would set the fraction at 50% of the Permanent Fund's income, which is almost the same as it is now.²⁴ Later, if it becomes necessary, the fraction could be reduced to a third or perhaps even a quarter. But it should not go below a quarter because then the PFDs to each person are likely to be too small to make enough difference to people to keep them mobilized to protect the Permanent Fund and its fiduciary²⁵ investment policies.

²⁴ The amount that is deposited into the PFD distribution account each year is half of the "income available for distribution." AS 37.13.145(b). This "income available for distribution" in turn equals 21% of the Permanent Fund's total income over the five most recent fiscal years. AS 37.13.140. If this percentage were 20% instead of 21%, then one-fifth (20%) of the five-year total of Fund income would be "income available for distribution," and over time the PFDs would take exactly half of the Fund's income. However, since this percentage is one percentage point over one-fifth, the PFD program uses up 52.5% of the Fund's income over time instead of half.

²⁵ A fiduciary is one who acts in a position of trust for the benefit of another. It is no accident that the Legislature chose to use the term "trustee" as the title for the members of the governing board of the Alaska Permanent Fund Corporation. See AS 37.13.040. The Permanent Fund is a public trust for the benefit of all Alaskans, present and future (see AS 37.13.020(1)); and it has been invested for a decade and a half under a standard consistent with that trust. See AS 37.13.120 (holding the Fund's investments to a "prudent-investor" standard of care and diligence).

CHAPTER 4. A VOTE IN 1996, THE LINCHPIN OF THE PLAN

While some of the Plan Elements could be enacted by the Legislature on a stand-alone basis, they should instead be assembled into a package to be submitted to the voters in the 1996 general election for approval.

Polls repeatedly show that Alaskans are willing to entertain the prospect of increased taxes or giving up some of their Permanent Fund Dividends only after serious cuts are made in state spending. The public has the perception that there is a lot of waste in state spending, and they don't want to give the government any tax money or Permanent Fund income if it will only allow that waste to continue.

As seen from the 12 Plan Elements, most of the statutory plan focuses on ways to reduce spending by making government more efficient. By combining them with proposals about taxes, Permanent Fund income and conserving the state's cash reserves, a balanced package can be presented to satisfy the public's demand for spending cuts before any "revenue enhancements."

The legislative package would consist of a number of bills for the various Plan Elements.²⁶ Each bill would have a section in it saying that the bill will not become effective unless the voters approve a spending-plan proposition on the ballot in the 1996 general election. If the voters approve the plan, then each bill in the package would take effect. If they reject the plan, then none of the bills would take effect because the precondition for becoming effective would not be met. In order to have the spending-plan vote in 1996, there would also have to be one additional bill, placing the question on the ballot and setting out the exact wording of the ballot proposition to describe the plan which people will be voting on.

If the voters approve the plan, then some of the Plan Elements would take effect immediately. These could include all of the "spending side" measures, as well as the Elements for using bonds, for limiting the annual draw against cash reserves, and for making inflation-proofing the first use of Permanent Fund income. Other Plan Elements would not take effect immediately after the election because they would have further preconditions that would have to be met. These delayed Elements include reimposing the personal income tax²⁷ and reducing the fraction of Permanent Fund income dedicated for PFDs.

²⁶ It would be simplest if all the Plan Elements could be rolled into one single bill. However, the Alaska Constitution requires that each bill be limited to a single subject. Even though all the Plan Elements address the subject of "balancing the state budget," this is probably not good enough to satisfy the Constitution's single-subject requirement. So, instead of one bill, there would be several bills, each one dealing with one of the "subjects" in the Plan Elements.

²⁷ The precondition on reimposing the income tax is that there still be a budget gap after the "spending side" measures have been tried. Most analyses predict that the "spending side"

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By putting its Elements into effect automatically after approval — either immediately or on a delayed basis when other preconditions are met — the plan minimizes the amount of further legislation that legislators would have to pass to implement it after the vote. Of course, they will still have to pass budgets that follow the plan, but a favorable vote of the people and the measures put in place as a result of that vote should make it easier for future Legislatures to do so.

measures won't be sufficient by themselves to bridge the annual budget gap. If so, then the income tax will come back into effect right after the election. But it would be possible, under the right set of circumstances, for an unexpected rise in oil prices to temporarily fill the gap and delay the time when the personal income tax would be needed. So a precondition that the income tax be needed is not an idle or meaningless gesture to gain public support for the plan.