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Safe Landing: A Fiscal Strategy for the 1990s

by Scott Goldsmith

Alaska is poised for either a safe landing or a nose dive. Whether we land safely or crash depends on how Alaskans deal with declining oil revenue.

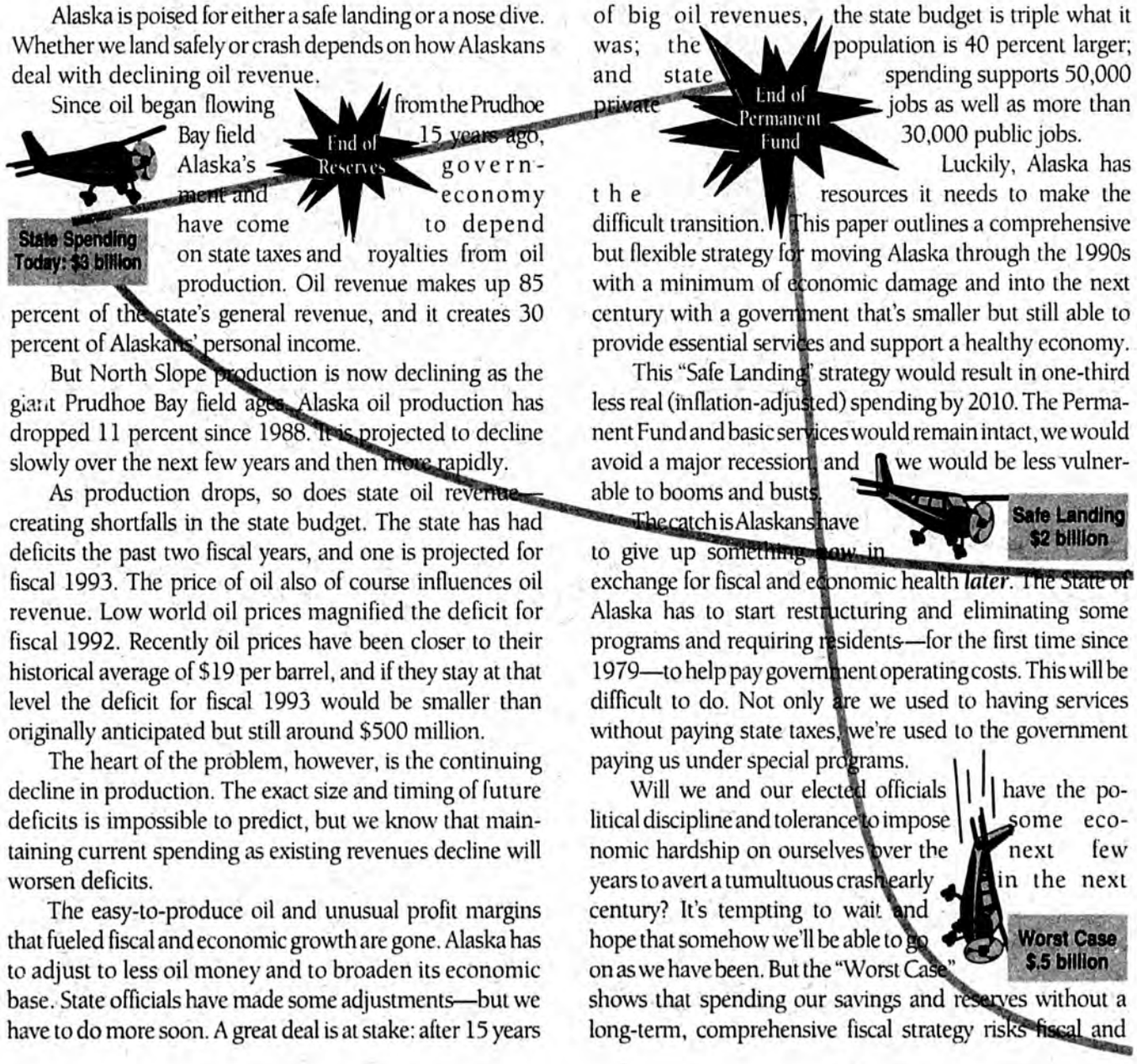
Since oil began flowing from the Prudhoe Bay field 15 years ago, Alaska's government and economy have come to depend on state taxes and royalties from oil production. Oil revenue makes up 85 percent of the state's general revenue, and it creates 30 percent of Alaskans' personal income.

But North Slope production is now declining as the giant Prudhoe Bay field ages. Alaska oil production has dropped 11 percent since 1988. It is projected to decline slowly over the next few years and then more rapidly.

As production drops, so does state oil revenue—creating shortfalls in the state budget. The state has had deficits the past two fiscal years, and one is projected for fiscal 1993. The price of oil also of course influences oil revenue. Low world oil prices magnified the deficit for fiscal 1992. Recently oil prices have been closer to their historical average of $19 per barrel, and if they stay at that level the deficit for fiscal 1993 would be smaller than originally anticipated but still around $500 million.

The heart of the problem, however, is the continuing decline in production. The exact size and timing of future deficits is impossible to predict, but we know that maintaining current spending as existing revenues decline will worsen deficits.

The easy-to-produce oil and unusual profit margins that fueled fiscal and economic growth are gone. Alaska has to adjust to less oil money and to broaden its economic base. State officials have made some adjustments—but we have to do more soon. A great deal is at stake: after 15 years of big oil revenues, the state budget is triple what it was; the population is 40 percent larger; and state spending supports 50,000 private jobs as well as more than 30,000 public jobs.



Luckily, Alaska has the resources it needs to make the difficult transition. This paper outlines a comprehensive but flexible strategy for moving Alaska through the 1990s with a minimum of economic damage and into the next century with a government that's smaller but still able to provide essential services and support a healthy economy.

This "Safe Landing" strategy would result in one-third less real (inflation-adjusted) spending by 2010. The Permanent Fund and basic services would remain intact, we would avoid a major recession, and we would be less vulnerable to booms and busts.

The catch is Alaskans have to give up something now in exchange for fiscal and economic health *later*. The State of Alaska has to start restructuring and eliminating some programs and requiring residents—for the first time since 1979—to help pay government operating costs. This will be difficult to do. Not only are we used to having services without paying state taxes, we're used to the government paying us under special programs.

Will we and our elected officials have the political discipline and tolerance to impose some economic hardship on ourselves over the next few years to avert a tumultuous crash early in the next century? It's tempting to wait and hope that somehow we'll be able to go on as we have been. But the "Worst Case" shows that spending our savings and reserves without a long-term, comprehensive fiscal strategy risks fiscal and

economic catastrophe. ISER is not forecasting that the worst will happen. But the "Worst Case" graphic on page 1 makes it clear just how low the bottom could be—and while the worst case is extreme, we can avoid it only by making some tough decisions, starting now.

Alaska has enough budget reserves to go on for a while without reducing the state budget or asking Alaskans to give up anything. But if the state tries to keep the budget at its current level or even to increase it, using just oil revenues and budget reserves, we virtually assure that when the reserves run out there will be a huge, sudden drop in the budget, likely precipitating a recession. That point is marked by the first explosion on the "Worst Case" flight path.

The only way to forestall that crisis would be a choice with disastrous implications—a raid on the principal of the Permanent Fund to keep spending up after we use the budget reserves. (Using the principal would require amending the Alaska constitution.) Even as large as the Permanent Fund is, it and dwindling oil revenues together could sustain the present level of spending for only several more years. Spending the Permanent Fund would delay the crisis but make it worse, as shown on the "Worst Case" flight path by the second explosion and the nose dive.

The longer we go without a strategy, and the bigger the fiscal gap becomes, the greater the pressure will grow to tap the Permanent Fund. The earning power of the fund is Alaska's main fiscal legacy from the years of big oil revenues and a key part of our strategy to escape the cycle of dependence on oil revenues. Dissipating the principal of the Permanent Fund would be the costliest mistake Alaska could make.

Along the way to the nose dive, as the state government used up the Permanent Fund at a rate approaching $2 billion per year, we would become more vulnerable to shocks from sudden drops in oil prices and less flexible in dealing with any other unexpected events. Once the budget reserves and the Permanent Fund were gone, state revenues would fall by two-thirds and the state would face a growing deficit of more than $2 billion (in 1992 dollars) a year. A drastic, precipitous drop like that would leave the state government by 2010 with less than it spends today just for schools, let alone road maintenance and Pioneers Homes and all other state programs and services. Whatever decisions state officials made about balancing the budget at that time, tens of thousands of public and private jobs would disappear in the process.

The big state spending in the 1980s ensnared us in a trap. We know that in the long run Alaska's economy will be healthier if we don't rely so much on state spending—but we have to get though the short term, and in the short term the health of the economy depends on state spending. This paper suggests a way of breaking out of that trap.

Fiscal Strategy

Alaska must take five major steps in the transition to less oil money:

- ***Cut spending***
- ***Use Permanent Fund earnings***
- ***Encourage economic development***
- ***Levy taxes***
- ***Conserve and invest windfalls***

Alaskans have choices about when to take those steps and how heavily to rely on each, but we have to take all five. This paper shows how these steps together can bring us to a safe landing.

The state can't continue to balance its budget in the 1990s just through spending cuts. Spending cuts should come first—but as oil revenues shrink more and more, the spending cuts required to balance the budget would be so large that the government would cease to function. Alaska can't afford a government as large as we have now, but we can afford an adequate level of public services. We have to decide how much is adequate, and how to preserve necessities while reducing non-essentials.

Making the transition to less oil money without major fiscal and economic disruption will require widespread public support. To gain such support will require (1) an understanding of the fiscal problem and its possible ramifications; (2) a public commitment to take the steps necessary for a safe landing; (3) a tough and open analysis

This is the final in a series of papers analyzing Alaska state government revenues and spending. For three years this series has reported on the fiscal crisis the state would face as oil revenues decline. That crisis has now arrived, and this last paper offers a strategy for getting through the crisis and into the next century with a healthy government and economy. The principal series author, Scott Goldsmith, is an ISER economist with 17 years experience analyzing state finances. Lee Gorsuch, ISER director, guided the design and presentation of the series. Other contributors include Alexandra Hill and Teresa Hull, ISER research associates, Matthew Berman, ISER economist, and Jay Hogan, former director of the Alaska Division of Budget Review. Linda Leask edited the series and Monette Dalsfoist did layout and graphics.

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of state spending to determine how to make cuts and control entitlement costs without sacrificing essential services; and (4) a strategy for taking the necessary steps.

Adopting the strategy will obviously involve getting less and paying more in the near term, but the reward will be fiscal and economic stability in the long run and a better quality of life as Alaska moves into the next century. Those of us who went through the recession of the late 1980s should be eager to avoid future recessions. Table 1 shows some of the effects of the 1986-1988 recession—as a reminder of what failure to undertake a fiscal strategy could mean in future years.

Alaska faces many economic uncertainties. The aging of the huge Prudhoe Bay field means a new game for the petroleum industry in Alaska, which must now turn to enhanced recovery at Prudhoe Bay and to smaller fields with higher production costs. We don't know how much new production to expect from the North Slope; whether development will occur in the Arctic National Wildlife Refuge; or whether oil prices will rise or fall. Still, despite declining production, and increased uncertainty about petroleum's future impact on the economy, the petroleum industry will continue to be the largest cash contributor to the Alaska economy for the foreseeable future. Compounding those uncertainties about petroleum development are questions about how Alaska's other basic industries like seafood, tourism, logging, and mining will fare in the future, or if military cutbacks will affect Alaska.

The state government can't remove those uncertainties, but it can act decisively to minimize anxiety and apprehension about the economic effects of less state spending and move Alaska toward a more stable future. Unless Alaska takes concrete steps to responsibly manage its loss of oil revenues, few new businesses will choose to invest or lend in the state, and existing businesses may reconsider their commitment to Alaska. A clear fiscal strategy is a key to Alaska's future. The discussions in this paper can help chart the course for fiscal policy—but like a good navigator, Alaska will need to adjust its course as conditions change in ways we can't foresee.

What Has the State Done So Far?

Even as the budget crisis looms, Alaskans can take heart because of important steps we've already taken.

Inflation Adjustment

Unless otherwise noted, the figures in this paper are adjusted to 1992 dollars (today's buying power) to remove the effects of inflation and thereby show real changes over time.

Table 1. Effects of 1986-88 Recession

- State job loss: 22,000 (10%)
- Anchorage population loss: 29,000 (9%)
- State wage income loss: $1.07 billion (13%)
- Decline in Anchorage assessed property value: $7.2 billion (46%)
- Residential properties foreclosed on, January 1985-March 1988: 10,429 (7% of total)
- Anchorage bankruptcies: 93 per month at worst point

• ***Creating the Permanent Fund.*** Alaska voters in 1976 approved a constitutional amendment creating a savings account called the Alaska Permanent Fund. The amendment requires that a portion of oil and other resource revenues go into that fund rather than into the general fund. The Alaska constitution prohibits spending the principal of the Permanent Fund, but allows appropriation of the earnings. During the 1980s, anticipating harder times to come, the Alaska Legislature made voluntary contributions of several billion dollars to the Permanent Fund, in addition to the required contributions. Today it has a balance of about $13 billion (including the earnings reserve). After inflation, the fund produces $500 million in annual earnings—which goes into the Alaska economy via annual dividend payments.

The economic value of the fund is impressive. We can think of it as a basic industry—one with a payroll of $500 million per year. But unlike Alaska's other basic industries (fishing, mining, logging, tourism, petroleum, and the federal government), it is not subject to the ups and downs of resource prices, national policies, and other factors beyond our control. It has been an invaluable economic stabilizer for Alaska and can continue to be, much like the military has been in years past. It can generate earnings to help pay for basic services and prevent the economic disruptions that go along with unpredictable state spending. Keeping the Permanent Fund intact has to be the cornerstone of Alaska's fiscal policy.

• ***Controlling state spending.*** Despite all the talk about out-of-control spending, state officials have made progress toward controlling state spending. Legislators cut the budget by several hundred million dollars between 1986 and 1987, after oil prices crashed and brought Alaska a glimpse of things to come. Budget growth has since resumed, but at a much slower rate than in the early

1980s. Nonetheless, inflation, population growth, and increased eligibility for benefits all exert upward pressure on the budget. Just holding spending constant, let alone reducing it, requires substantial political determination.

So it's not really surprising that in 1992 the state operating budget (not adjusted for inflation) has returned to about the level where it was in 1986. Between 1986 and 1992 some departments grew, but several—Labor, Natural Resources, Fish and Game, Transportation and Public Facilities, and Community and Regional Affairs—spend less today than they did in 1986. And if we adjust for inflation, spending in most government agencies is still below 1986 levels. Within departments whose budgets have grown fastest in recent years, most growth is in a handful of programs tied to increasing population or rising prices. Subsidies to public corporations like AHFC have been eliminated or are much smaller now than in the early 1980s. Budget requests of agencies are routinely trimmed.

In 1987 state officials made the relatively easy budget cuts—cuts that did not affect services and popular programs. To cut the budget more while retaining essential services, state officials will have to eliminate some programs and improve the efficiency of others.

The difficulty of cutting the budget was clear during the 1992 legislative session, when legislators tried unsuccessfully to cut $200 million from the budget. Although they were unable to cut that amount, legislators did make some cuts. If there are no large supplementals enacted later, inflation will translate those cuts into even bigger real cuts in future years. But the piecemeal approach to holding the line on spending is increasingly perverting allocation of funds among programs, and stopgap measures to control spending make it more difficult to cut the budget in future years.

• ***Attempting to broaden the economic base.*** Over the years the state government has often used oil money to encourage other kinds of development. The results have sometimes been impressive, but many attempts at a wide variety of ventures failed—demonstrating that neither subsidies nor outright grants can guarantee success or overcome market forces. One of the more successful ventures is the Red Dog mine in northwest Alaska, where the state (through the Alaska Industrial Development and Export Authority) loaned a private corporation money to build a road and port needed for mining a large zinc deposit. In general, when the state has succeeded it has been in support of industries that already have strong economic foundations in the state.

Elements of Strategy

There's much the state has left undone. Most important is adopting a comprehensive fiscal strategy. We can not hope to make up for dwindling oil revenues with piecemeal budget cuts and budget reserves, unless we want to confront major fiscal and economic problems later. We need to adopt a multi-year spending plan that includes examining the structure of state spending to determine how the government can deliver services for less and then setting real targets for reducing state spending over the next several years. At the same time, the plan should integrate optimal use of all available resources and the resumed collection of personal income taxes when existing taxes can no longer support essential services.

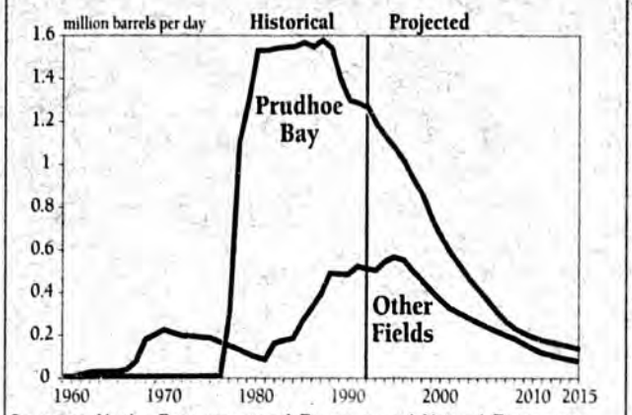
Working Together

A family or a business faced with the prospect of reduced income will cut costs, eliminate unnecessary expenses, and make the most of its remaining resources—to put itself in the best economic position to survive and to try to minimize the pain of shifting to a smaller income. It's much more difficult for a government to behave that way, and especially difficult for Alaska's state government—because of uncertainty, lack of concern, and ignorance; because we have become accustomed to receiving services without paying for them ourselves; and because we all own our oil revenues in common.

The magnitude and timing of future deficits is uncertain. We have been lucky several times in the past when unexpected increases in oil prices wiped out projected deficits—so many Alaskans tend to discount predictions of fiscal crisis and to hope for another bailout. Some residents are not worried about potential deficits—either because they think the fiscal concerns of the state government don't affect them, or because they don't intend to stay in Alaska very long. Also, many people don't understand how much the state budget depends on oil production and what a vulnerable and precarious position that puts Alaska in. They don't yet acknowledge that the state can no longer undertake new functions without dramatically reducing what it currently does.

The biggest obstacle to solving the budget crisis is persuading Alaskans that the time has come when they have to give up some of the benefits of oil money. State oil revenues are common property resources, belonging to all Alaskans. So no one is willing to be the first to give up his share today for the benefit of the future, because it's likely special interests would simply cancel out that altruism by taking the savings and spending them for their

Figure 1. Alaska Oil Production



Sources: Alaska Departments of Revenue and Natural Resources

own benefit. What Alaskan is willing to voluntarily give up any of the benefits of oil revenues, only to see someone else come forward to take them?

One way we can deal with this problem is to reach a broad agreement that *everyone* give up something for the benefit of future generations of Alaskans: that we all restrain our short-term special interests to achieve our long-term self-interests. Fairness and public purpose should guide us. Alaskans have to acknowledge that we face a serious problem—one that we can solve only by working together.

Facing the Facts

Even though many Alaskans agree that we need to constrain or reduce spending as oil revenues shrink, some still think that (1) *higher oil production or prices will erase the problem,* or (2) *the economy can quickly grow out of the problem,* or (3) *the state government can deal with any deficit by cutting the budget but still leaving all popular programs (in particular the Permanent Fund dividend program) intact and the economy unaffected.*

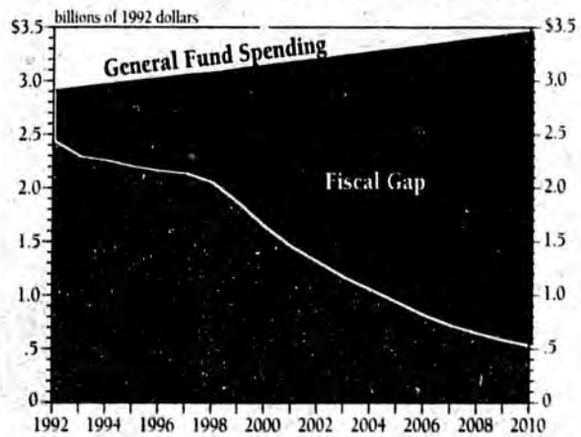
These beliefs are false and dangerous. Production will drop sharply in the 1990s because the huge Prudhoe Bay oil field is producing less oil now than a few years ago, and the production decline will accelerate as time goes on. (See Figure 1.) Although other fields continue to produce, new fields will come into production, and improved technology and higher prices could enhance the recovery of Prudhoe Bay oil, those factors together over the next 10 years can't replace the enormous loss of production from Prudhoe Bay. At its peak production in 1987, Prudhoe Bay alone was responsible for more than 80 percent of Alaska production and 20 percent of all the oil produced in the U.S. Fields of that size are rare in the world, and none other as large has been discovered in North America.

Higher oil prices would alleviate but not erase the budget deficits created by falling production. Since oil production will decline on average about 7 percent annually through this decade, the price of oil would have to increase 7 percent every year—after inflation—to offset that decline and maintain state oil revenues at their current level. A sustained price increase of that magnitude would be unprecedented.

Figure 2 estimates the gap, with current spending and existing revenues, assuming an oil price of $19 per barrel, which has been the average for the past six years. Higher or lower oil prices and more or less new production would change the gap figures, but the pattern is clear: declining production will sharply cut oil revenues, which supply 85 percent of state government income. Since the gap will grow slowly over the next few years, attention will continue to focus on higher oil prices as a solution to the problem. But later in the decade, the production decline will overwhelm price fluctuations. Current price and production forecasts put the gap between current spending and existing revenues at $1.5 billion by 2000.

Alaska can not quickly grow out of the fiscal and economic problems posed by declining oil revenues. We do expect growth in Alaska's basic industries over the next decade, but under even optimistic assumptions, the tax base represented by that growth can't come even close to replacing billions of dollars in lost oil revenues. And although the state can encourage responsible economic development, Alaska's past attempts to use oil money to foster other kinds of economic development have shown that economic diversification will be a gradual process, and that some kinds of development are not feasible in Alaska.

Figure 2. Estimated State Fiscal Gap



Estimated gap assuming current spending trend (constant real per capita) with no new revenue sources and oil prices at $19 per barrel.

The state government can't make sudden, enormous budget cuts without affecting essential government operations or hurting the Alaska economy. On page 8 we show how the state spends its money. It's clear that attempting to cut something in the range of $1 billion or more out of the budget in a short time would leave the government crippled.

And as for the effect on private industry of big, sudden budget cuts, remember that state government money supports 50,000 private jobs in Alaska. The construction, transportation, utilities, services, finance, and trade industries all depend heavily on state spending.

There is no single, painless solution to the fiscal crisis. Big resource projects, surges in oil prices, economic diversification, or spending cuts by themselves can't erase the problem—but fortunately they can all be part of the solution. How can we combine all the elements of a successful fiscal strategy and get a commitment to action?

Planning, Educating, and Analyzing

To get Alaska moving toward a fiscal strategy, we also need (1) broad public acknowledgment of the problem and agreement on the need to solve it; (2) a plan for balancing the budget in the 1990s and creating a legacy of stability for the next generation of Alaskans; (3) a detailed analysis of state spending.

One way of informing the public and developing a plan would be through an appointed fact-finding commission. The commission should represent a broad spectrum of Alaska leadership—heads of industries, public and private organizations, profit and non-profit groups. We hope the broad membership of such a commission would win the public's trust and confidence.

A public information campaign under the auspices of the commission would include workshops throughout the state, explaining the causes of the fiscal crisis and asking the public for its preferred choices for solving it. It would be an opportunity for all Alaskans to get involved.

The plan developed by the commission would start with a picture of what government should look like after Prudhoe Bay. It would propose a broad strategy for reaching the target and specific tactics to begin moving us toward the target now. These tactics would be based on a review of our institutions and processes for making budget decisions.

State officials also need to look carefully at existing spending. Why does the State of Alaska spend so much, and how can it spend less? The answers are not as obvious as some people think. Certainly the state needs to cut spending, but many things have combined to push up spending in ways that need to be understood. Otherwise, we risk harming traditional programs through piecemeal, incremental cuts as oil revenues dwindle.

Table 2. Why State Spending Grew in the 1980s

- More people (40% larger population)
- Higher prices (45% increase)
- Broader eligibility for programs
- More infrastructure to maintain
- Federal cost-shifting to state
- Generosity to individuals and local governments
- More expensive service delivery
- Permanent Fund dividend and other special programs

Table 2 shows the major factors that have contributed to higher state spending over the past decade, including everything from more people and higher prices to creation of new programs. These factors are in addition to the ones that have historically made Alaska's government large—special needs related to state ownership of resources, underdevelopment of local governments, and high costs.

All those factors don't mean that the state can't cut spending more: it will have no choice. But it cannot continue to cut traditional programs incrementally without analyzing how to maintain—with less money—the quality of services Alaskans regard as essential. The government needs to become more efficient and more discriminating in its spending. It needs to analyze and re-structure its spending after assessing many questions: Which subsidized programs and loans can Alaska still afford? Where can we narrow program eligibility? Are there ways we can provide quality education for our children for less? Can we afford to operate all the facilities we added in the 1980s? Answers to these and many more spending questions are critical to reducing spending but continuing to provide for the public good.

Putting It All Together

Alaska has some choices about how to deal with the budget crisis, but those choices come down to how and when the state will use available resources and for what purposes. The state can (1) cut spending; (2) use Permanent Fund earnings; (3) expand the economy and tax base by fostering development; (4) reimpose taxes on households; and (5) conserve windfalls, which include budget reserves, anticipated settlement payments, and any unex-

pected revenues. The "Safe Landing" strategy outlines one way of putting all those steps together in a comprehensive fiscal plan. What would be the advantages of a broadly accepted, comprehensive plan? It would:

- ***Reduce uncertainty,*** thereby increasing economic stability and instilling confidence in the general public and the business community that the state government recognizes and is addressing the problem.

- ***Enable Alaskans to plan*** their own futures with more certainty about government's role and what to expect from government in future years.

- ***Provide a framework for downsizing*** government in a way that retains essential programs.

- ***Establish a means to minimize*** the adverse economic effects of balancing the budget.

A comprehensive plan would be based on several presumptions—the presumptions that:

- ***Current state spending exceeds*** what we can afford or are willing to pay for.

- ***We need to decide what level of spending*** is appropriate, given our income and willingness to pay.

- ***We can't count on economic diversification*** or the serendipitous arrival of megaprojects to forestall the need to reduce state spending or the need for new taxes.

- ***A healthy and robust economy is possible*** in the era after Prudhoe Bay, and having state fiscal affairs in order greatly enhances its likelihood.

- ***Current Alaskans must take into account*** the needs of future generations, because our current wealth is temporary.

- ***The proper functions of state government*** are to provide basic public services, to assist the needy, to manage public resources for the benefit of all, and to promote a healthy economic climate.

With those presumptions as a base, Table 3 suggests a number of principles to guide a budget plan. Pages 8 through 14 outline the five essential steps for balancing the budget, and one potential method for implementing each of the steps. We look at how much each of the five could contribute, under reasonable assumptions. Taken together, these steps show that by 2000 we could have in place the foundation for a healthy and stable public sector that would contribute to Alaska's economic health and benefit Alaskans. We are not suggesting that this is the only way the state could put together the available resources. But it is one reasonable way that can provide a useful guideline for state officials. At the end of the paper we discuss why we are optimistic that Alaska can, despite the political obstacles, adopt a fiscal policy that will bring us safely into the next century.

Table 3. Principles for Comprehensive Budget Plan

- Think ahead
- Consider needs and resources of future generations
- Base all payment programs on need
- Do more with less, and re-consider unique programs
- Promote public welfare
- Minimize economic hardships caused by reduced state spending
- Tax according to ability to pay
- Equalize local tax effort
- Demand returns on state investments
- Use willingness to pay as criteria to determine benefits of public programs
- Monitor progress and be flexible

Assumptions in Safe Landing Strategy

Oil Production: As projected by Alaska Department of Revenue, Fall 1991

Oil Price: $19 per barrel, in 1992 dollars

Permanent Fund: 4 percent real rate of return, net of inflation

State Spending: 1 percent real annual growth (same as projected population growth)

Existing Revenues: As projected by the Alaska Department of Revenue, Fall 1991

Transition Fund: Initial balance (in 1992) of $2 billion

Oil Windfalls: $1.7 billion collected between 1992 and 1997

Step 1: Budget Cuts

The State of Alaska spends three times the national average per resident, even after we adjust for Alaska's higher living costs. We can no longer afford it, and have to (1) re-structure programs to provide more services for less; and (2) reduce or eliminate programs, based on a detailed analysis of which programs best provide for the public good.

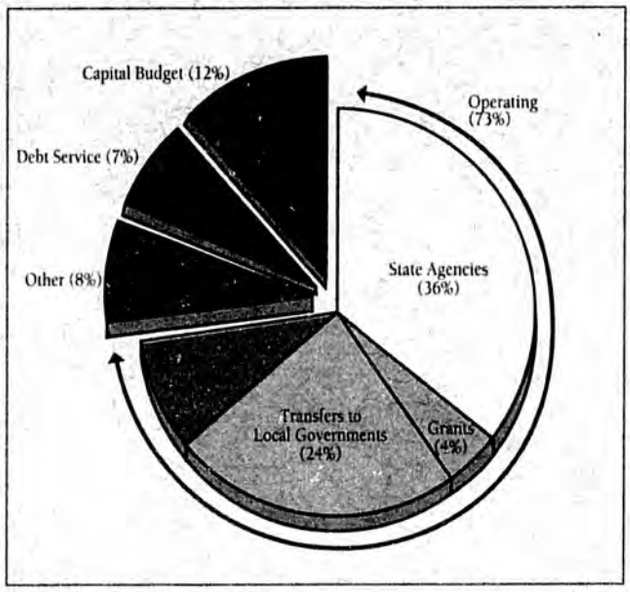
What Did the State Pay for in FY 1992?

(State General Fund Budget[a], in millions of dollars)

Total General Fund Budget		**$2,920**
Operating Budget		**$2,125**
Formula Transfers to Local Govt.	**$691**	
School Foundation	514	
Rev Sharing and Muni Assist	85	
Pupil Transportation	29	
Other	63	
Formula Transfers to Individuals	**262**	
Medicaid	93	
Longevity Bonus	62	
AFDC	39	
Adult Public Assistance	23	
Power Cost Equalization	15	
Other	30	
Grants	**133**	
Health & Social Service Grants	65	
Child Assistance	23	
Other	45	
Direct Service Delivery	**820**	
University of Alaska	158	
Health and Social Services	91	
Highways	85	
Prisons	80	
Public Safety	77	
Resource Management	76	
Marine Highway	64	
Courts	52	
Pioneers' Homes	30	
Legislature and Governor	27	
Business Regulation	24	
Business Development	21	
Environmental Conservation	17	
Other	19	
Support and Administration	**219**	
Debt Service		**$209**
Local School Debt	129	
Other	80	
Capital Budget		**$352**
Other[b]		**$234**

[a] *Excludes Permanent Fund dividends and various restricted accounts.*
[b] *Supplementals of $100 million, loans of $12 million, oil and hazardous waste fund of $29 million, and employee retirement fund indemnification of $93 million.*

How Was it Distributed?



Operating Budget: Largest part of general fund spending. About half is transfers to individuals and local governments—mostly entitlements, which are automatic payments to qualifying individuals or communities. The other half is what state agencies spend for direct service delivery and support and administration.

Capital Budget and Debt Service: Includes money for new capital projects and re-payment for projects financed by bonds in previous years.

Other: Funding for special one-time items and supplemental appropriations for ongoing programs.

What Kinds of Spending Are There?

Some spending is required by federal mandate (Medicaid) or by law (debt on bonds). Some spending is required by the constitution (the court system, for instance) although the level of funding is discretionary. A large share of the budget consists of entitlements; the allocation for these items is automatically determined by the number of eligible persons or communities. Only a small part of spending is truly discretionary.

How Has the Budget Changed?

In the early 1980s the budget contained many discretionary items such as municipal capital grants and transfers to public corporations. Such expendi-

Step 1: Budget Cuts

tures have been reduced or eliminated. In fiscal 1987, when state revenues fell by $1.3 billion, the operating budget was significantly cut for the first time—resulting in reduced transfers, program cutbacks, and layoffs.

What Are The Budget Busters, 1986-1992?

Most recent budget growth has been in transfer payments that are tied to inflation or population growth. Real budgets of many state agencies have declined. Budgets have become increasingly skewed—compared to earlier years—as some programs have continued to grow and others have been squeezed. For example, between 1986 and 1992 the Longevity Bonus program increased 39 percent while Municipal Assistance declined 43 percent (in nominal dollars). Programs that grew the most are:

Department of Health and Social Services: Grew $150 million. AFDC and Medicaid federally required; courts ordered more mental health spending.

Education: School foundation grew $40 million, driven by growing enrollment. School aid is so large that small percentage increases cost millions of dollars.

Corrections: Spending for prisons increased $22 million. The prison population increased about 20 percent, and per prisoner spending increased slightly due to court decisions mandating better conditions.

Longevity Bonus: Increased $17.5 million. The number of Alaskans over 65 doubled in the 1980s.

How Could We Cut $1 Billion?

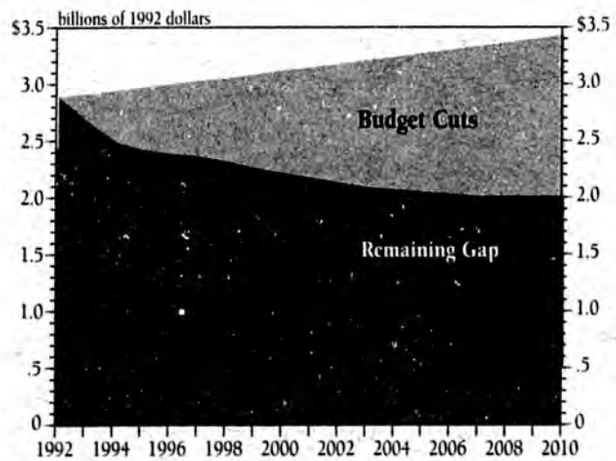
One billion dollars is an estimate of the magnitude of required budget cuts, if we assume that the state will also take the other steps in the Safe Landing strategy. The so-called "easy" solutions—eliminating redundant bureaucrats, reducing excess regulation, delivering services more efficiently, reducing employee compensation—can't possibly save $1 billion. We'll have to review and possibly reduce all state programs.

What's the Alternative?

In 1987 the cuts came all in one year. This time we can estimate needed cuts in advance and implement them gradually, limiting their economic effects. Everyone will know what to expect. The sense of stability will promote a positive economic environment, even as public spending shrinks. Gradual cuts will also allow time to improve efficiency and reach consensus on service cuts. This time, however, the cuts will more directly affect individuals, local governments, and non-profits as well as state agencies. But ignoring the need to make cuts, or making token adjustments, creates a worse situation. And making very deep cuts in just a single year could throw the economy into a recession. Misguided state policy (together with other factors) helped create the 1986 recession.

The example below shows how an overall spending freeze could contribute to filling the fiscal gap.

Step 1. Budget Cuts



- Initially freeze budget growth and then constrain the increase at less than the rate of inflation throughout the 1990s, effectively shrinking real state purchasing power 20 percent—to $2.2 billion— by 2000. Because of continued population growth, that implies a reduction of 25 percent in state per capita spending by 2000—but per capita spending would remain considerably above the current national average.
- Develop a set of criteria for choosing where to reduce or eliminate programs—based on which are not necessities, which could pay for themselves but don't, and which we're paying more for than we should.
- Re-structure inefficient programs to provide services with less money. Program managers should be given the flexibility to re-shape their own programs.
- Re-structure payment programs based on need.

Step 2: Earnings of Permanent Fund

Keeping the Permanent Fund intact and managed as an investment fund should be Alaska's priority. Ideas for using the fund will become commonplace as the budget crisis deepens, but we must stick with sound investment principles.

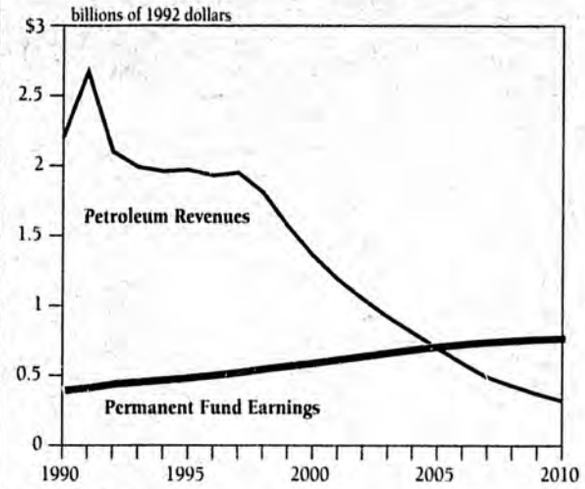
The fund's real sustainable earnings (earnings after adjusting for inflation) of $500 million per year exceed the payrolls of each of Alaska's commodity-producing industries except petroleum and seafood. The larger the fund grows, the greater this flow of earnings becomes.

The state should develop a plan to phase out Permanent Fund dividends and schedule the use of earnings to help pay for basic services—which was one of the rationales for creation of the fund in 1976. We do not suggest eliminating dividends to prop up current levels of spending. But budget cuts alone, with no new revenue sources, would leave the government unable to provide a reasonable level of services in the future.

We suggest using the earnings as one of three new revenue sources (the others are taxes and economic development) to help pay for basic government necessities. The adjacent figure shows that earnings can't replace oil dollars, but can fill part of the gap left as oil revenues decline. However, fund earnings can only support basic services if the dividend program is reduced or eliminated. Permanent Fund earnings should replace oil dollars only after oil production has fallen below some floor—perhaps 1 million barrels per day. Before that, earnings should be reinvested to build up the fund's earning power.

The danger in any plan that eliminates dividends is that Alaskans will have less incentive to protect the fund's principal, once the dividends are gone. However, an effective public education campaign could make it clear that the fund still provides enormous although different

Permanent Fund Earnings Compared to Petroleum Revenues

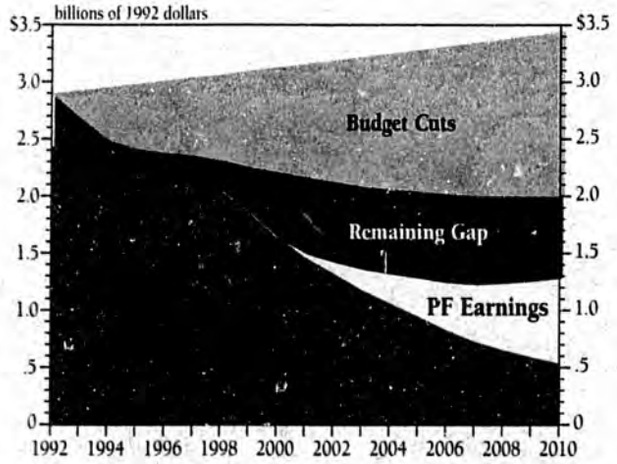


Source: ISER estimates

benefits—by helping to stabilize the government and the economy, and helping to pay for basic services that would otherwise have to be eliminated or paid for through taxes.

Getting the highest return on the fund means moving prudently toward an investment policy with higher but variable returns from stocks. Investing more in stocks would also reduce the need for the current method of inflation-proofing, since the value of stocks increases over time with inflation. Below we see how fund earnings could help reduce the budget gap.

Step. 2. Use Permanent Fund Earnings



- Phase out the dividend program, by reducing the portion of earnings used to fund dividends 10 percent each year, beginning in 1994 and continuing until dividends are eliminated in 2003.
- Add the earnings not paid out in dividends to the principal of the fund until 2001, to build up its future earning power. These retained earnings would add over $2.5 billion to the value of the fund.
- Use a portion of earnings to pay for general government, beginning in 2002, and increase proportion as petroleum production falls.
- Maximize the long-term rate of return on the fund's investments by shifting the investment portfolio into stocks.

Step 3: Economic Development

The most important contribution the state government can make to the continued health of the Alaska economy is to begin actively managing the fiscal crisis now.

Alaska Tax Base
Commodity Producing Industries:
Alaska Gross Product in 1989
(In Million Dollars)

Oil and Gas	$11,118
Seafood	789
Forest Products	477
Tourism	319
Mining*	82

**Prior to first full year of operation of Red Dog and Greens Creek Mines.*
Source: ISER estimates

Acting now will help create confidence in industry that the state government is dealing with the economic instability created by dependence on state spending and by budgeting based on unpredictable oil prices.

Growth in mining, tourism, and other industries will increase the Alaska tax base in the 1990s. But even though production will be declining, petroleum will continue to provide the largest tax base for the foreseeable future. The higher costs of development and production for new fields and enhanced recovery mean Alaska, as a resource owner, must develop flexible policies to assure the state a fair share of the value of production without jeopardizing development.

Megaprojects like the proposed gas pipeline or oil development in ANWR are uncertain and in any case can contribute little to the tax base in the 1990s. If completed, they could make substantial but unpredictable contributions somewhere in the range of $100 to $400 million annually by around 2005.

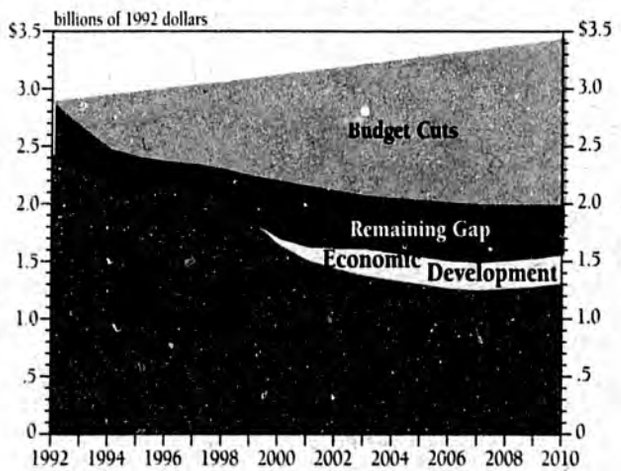
The state government should develop well-defined criteria for fostering economic development. The state should give priority to projects yielding real long-run returns. In the past, much of what was called investment in fact yielded only temporary employment gains.

Reducing the size of state government will not necessarily stimulate the private economy. Some people argue that reducing government automatically frees up money for the private economy to grow. But that isn't entirely true in Alaska, because state spending comes largely from petroleum revenues and not from taxes on other industries and individuals. If the state government did not collect petroleum revenues, the oil industry would re-invest part in Alaska but part would bypass Alaska.

Low taxes are not the only criterion for creating a favorable business climate. The tax burden on non-petroleum commodities is relatively light now, but that burden needs to be periodically reviewed in light of the need for public services. Taxes help pay for education and productive workers, provide infrastructure, and maintain the amenities that make Alaska an attractive place to live and work—amenities that ultimately reduce business costs.

The example below shows one way economic development could contribute to balancing the budget.

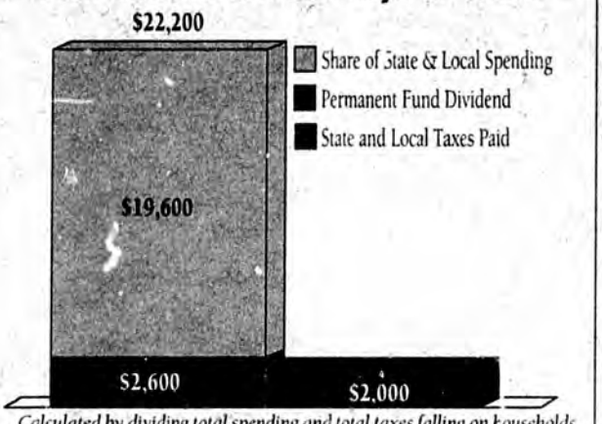
Step 3. Economic Development



- Foster positive economic environment by adopting a Safe Landing strategy.
- Adopt stable yet flexible tax and royalty policies that assure fair share for state without inhibiting development of resources.
- Coordinate all investment policy—through an agency like AIDEA—to foster long-term, sustainable development.
- Don't compromise the Permanent Fund by redirecting its investment policy to subsidize in-state development schemes.

Step 4: Taxes

The state government can no longer afford to pay Alaskans more than they pay in taxes. Alaska households pay virtually no state taxes, and the typical household receives more in Permanent Fund dividends than it pays in combined state and local taxes.



Calculated by dividing total spending and total taxes falling on households by the population and multiplying by 2.8 (average household size).

The figure above shows that the average household receives more in dividends than it pays in state and local taxes, and that the estimated value of state and local services households receive is more than 10 times larger than the average tax bill. It is clear that individual taxes do not support government spending in Alaska.

Cuts should be the first means of balancing the budget, but taxes should be introduced as early as is feasible because:

(1) The longer we delay paying any taxes, the longer we continue depleting our savings accounts to pay ongoing costs of government and the lower our sustainable revenue flow in future years will be. We'll need the cushion our savings can provide more urgently in the future.

(2) Paying taxes will help us set priorities for budget cutting: if we are paying the costs ourselves, it will be easier to identify what we're willing to pay for. Under the current system, we take whatever is provided, regardless of cost.

State personal taxes are not intended to allow government spending to grow, but rather to help pay for necessities, in conjunction with budget cuts. Taxes can fill just part of the gap left behind by falling petroleum revenues.

New taxes will increase the cost of doing business—but we have to weigh that increase against the value of having a stable government able to provide services that individuals and businesses need. Failure to impose taxes, if it leads to the deterioration of necessary public services, will just as surely increase the cost of doing business. Taxes on households will reduce their buying power and hurt businesses that depend on household spending but support businesses that depend on public spending.

The income tax is preferable to a sales tax because:

(1) Taxpayers nationwide believe that state income taxes are more fair than property or sales taxes.

(2) Non-residents who work here would pay part.

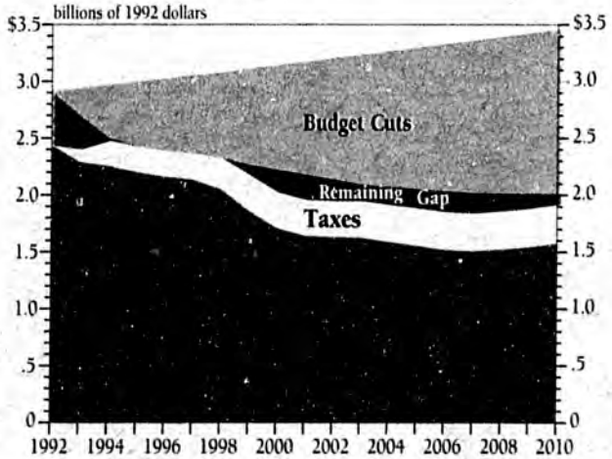
(3) It would be deductible on federal tax returns.

(3) Unlike sales taxes, income taxes do not fall most heavily on the poor but rather can be designed to allocate the burden among income groups in a number of ways.

(4) Reinstituting the state income tax would leave administration of sales taxes to local governments.

The example below shows how a personal income tax could help fill the fiscal gap.

Step 4. Impose Taxes



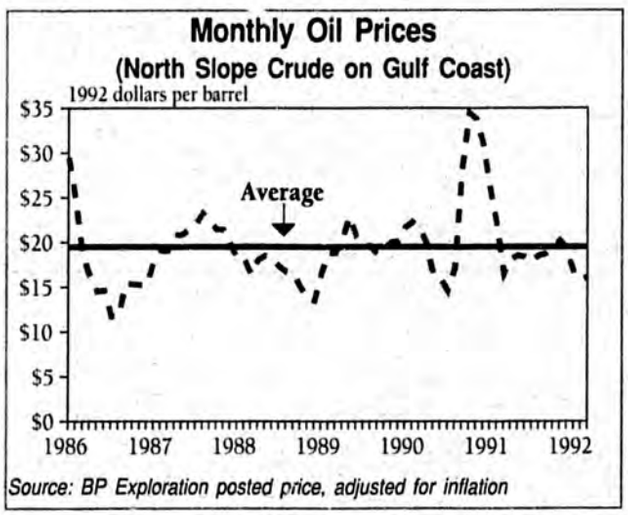
- Impose a personal income tax in calendar 1993 and increase other taxes to bring Alaska in line with the national average. Such changes could contribute $350 million annually.
- Allow local governments to continue to control sales and property taxes. If they choose to increase local tax rates to the national average, they could offset $150 million of reductions in state transfers.
- Consider promoting taxpayer equity by collecting sales and property taxes in the unorganized borough, where residents pay no local taxes.

Step 5: Transition Funds

The state government's reserve accounts and anticipated settlement payments should serve two functions in a fiscal strategy: (1) help cushion the long-term transition to a smaller government, and (2) act as a shock absorber when normal, year-to-year fluctuations in the price of oil affect state revenues.

The State of Alaska now has about $2 billion in various reserve accounts and will also likely collect an undetermined but substantial sum this decade in settlement of tax and royalty disputes with the oil companies. Using these assets only as needed and in conjunction with an overall strategy—including budget cuts, use of Permanent Fund earnings, and taxes—is crucial. We should plan to use these assets only to cushion an otherwise too sudden decline in the budget, but never simply to prop up the budget.

It is tempting to rely on the reserves before we take other measures to deal with the fiscal gap. But by doing so we would be using funds that we'll need more urgently when oil revenues are smaller, and we would be needlessly exposing ourselves to budget gyrations caused by fluctuating oil prices.

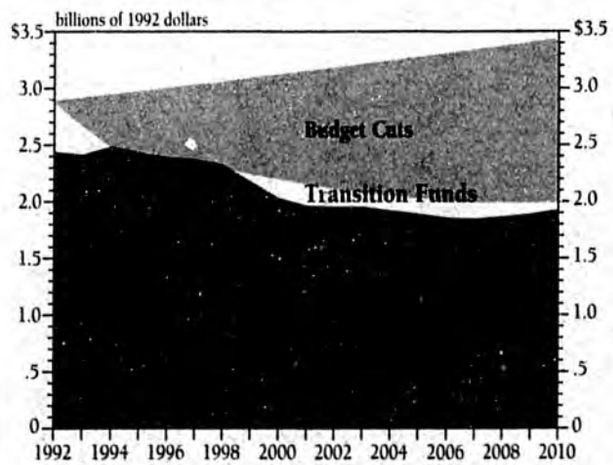


The state's reserve assets could serve as a buffer in the coming years for oil price fluctuations. Oil revenues fluctuate because of both price and production changes. Declining production in the coming years will steadily reduce oil revenues. But prices will continue to fluctuate, causing oil revenues to jump up or down and confounding attempts to accurately predict revenues from year to year.

State officials try to guess the price of oil when budgeting for the coming year—but as the adjacent figure shows, the only thing constant about oil prices is change. Budgetmakers react to every change in oil prices with budget revisions—with the result that we are held hostage to oil price changes. We could save ourselves from the ups and downs associated with volatile oil prices by basing budgets on average oil prices from recent years—drawing on the transition funds when prices fall below the average and replenishing the fund when prices exceed the average. The fiscal year oil price has been within the range of $17 to $20 per barrel in five of the last six years. A $300 million buffer account would have countervailed all the price fluctuations over the past six years.

The example below shows one way reserves and settlements could cushion the transition to a smaller government while also absorbing shocks from fluctuating prices.

Step 5. Use Transition Fund



- Deposit all available state money (except the principal of the Permanent Fund), as well as any unanticipated excess revenues in future years, into accounts managed as transition funds.
- Draw on reserves in these transition funds when budget cuts (Step 1) and revenue enhancements (Steps 2 through 4) imposed according to the budget strategy still leave a deficit in the current year.
- In some years the transition funds will be needed if the price of oil drops below the historical average.

Putting It All Together

Together the five steps of the Safe Landing strategy can move state government spending to a balanced and sustainable level by 2000 and simultaneously bring Alaska substantial benefits: keep essential state programs and services intact, avert a major recession, and preserve the principal of the Permanent Fund so it can continue to generate earnings far into the future.

• ***Budget cuts are by far the biggest contributor*** to the strategy over the next two decades. As the figure below shows, cutting real spending by 20 percent from the current level over the next decade could eliminate half the projected fiscal gap in 2000.

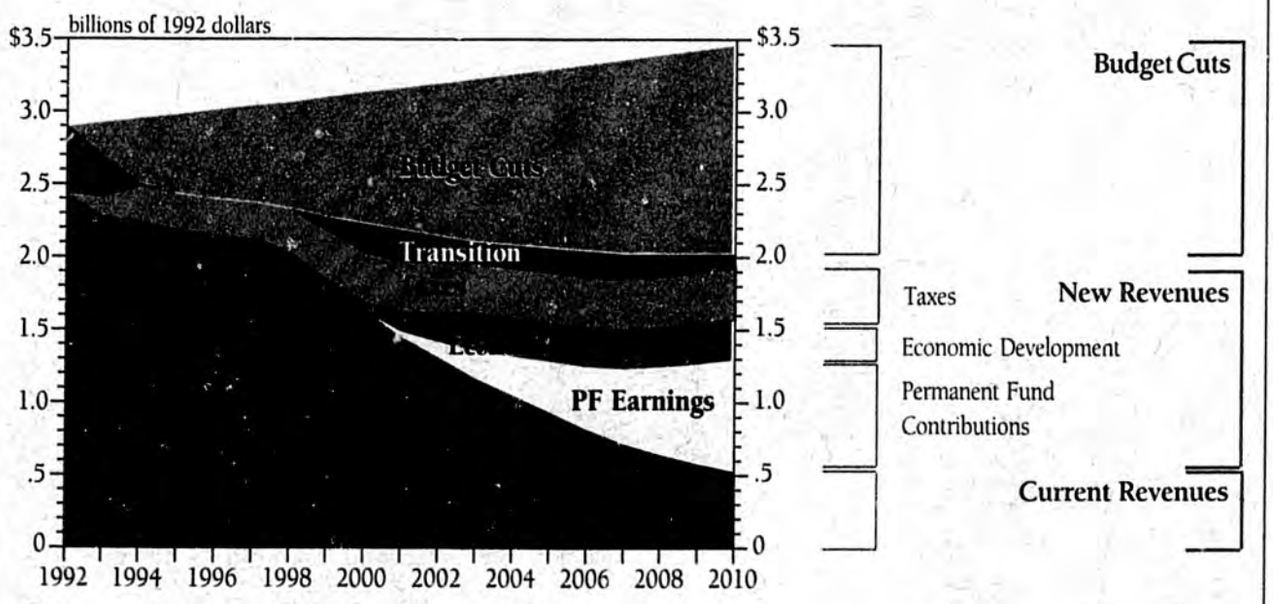
• ***Permanent Fund earnings can contribute more*** to the state budget than petroleum revenues, personal income taxes, or new economic development by 2010. Because fund earnings could contribute so much toward filling the fiscal gap after the turn of the century, conserving the Permanent Fund is critical to the future of the state.

• ***New economic development could contribute*** as much as several hundred million dollars annually to the state treasury by 2010, but relatively little within the next decade. This source of revenues is the most uncertain.

• ***Personal income taxes could begin*** to contribute immediately to reducing the fiscal gap. Not only would a tax permit the state to save reserves that will be needed more later, the tax would also instill discipline in spending by putting a price on it.

• ***Transition funds would cushion the move*** to a smaller state government by controlling the decline in spending. Such funds would also eliminate fluctuations caused by variations in oil prices.

Summary: Safe Landing Strategy



Conclusions

Many political obstacles stand in the way of a fiscal strategy for Alaska, but for several reasons we believe those obstacles can be overcome.

First, we've done it before. Alaska and its elected officials have, within the past two decades, taken extraordinary measures to preserve the state's financial future. In 1976 Alaska voters enacted a constitutional provision to set aside a percentage of oil revenues in a permanent investment fund. This constitutional provision demonstrated considerable public foresight as well as a commitment to the future of the state.

Similarly, in the early 1980s—when state spending began to run amuck—state lawmakers recognized the need to curtail spending and made the difficult political decision to voluntarily place an additional $4 billion in the Permanent Fund. Lawmakers made those special deposits, despite enormous pressure to continue spending all the available revenues.

This year state lawmakers passed a budget that was not only lower than the rate of inflation but less than last year's budget. Barring any large supplemental appropriations later, and if similar but not even as stringent budgetary discipline can be exercised over the next several years, we could achieve the budget cutting goals suggested here.

So we have reason to believe that when confronted with difficult choices, both the Alaska public and its elected leaders have demonstrated their willingness and commitment to do what needs to be done. What has been lacking is the persevering, year-to-year commitment to specific fiscal goals over a longer period.

Second, we have what we need to make a Safe Landing. Alaska has a reasonably robust economy with promise for continued growth in many of its economic sectors. The issue is how we can wean ourselves from overdependence on oil revenues. The Alaska economy need not go into a deep recession as we go about implementing the Safe Landing fiscal strategy. Yes, we will all experience some economic hardships as we return to paying personal incomes taxes, receiving less or giving up state dividend payments, and paying more for the state and local services we receive. But these are all burdens common in most other states.

If Alaska implemented this fiscal strategy, it would finance services more the way other states do. We would no longer pay ourselves $500 million each year in dividends—which no other state does. We wouldn't give ourselves a tax break equivalent to another $500 million. We would cut about $800 million in public goods and services we can no longer afford.

Third, enacting a strategy is in our self-interest. For those Alaskans who want to stay in the state, and want the state to provide opportunities for their children and future generations, adopting the Safe Landing fiscal strategy is in both our individual and collective self-interest—even though in the short run it will impose economic hardships.

Alaskans who expect to move out within the next five to ten years may prefer to see the state liquidate its savings to prop up the economy until they leave. However, that segment of the population is a minority, and many who leave will have friends and family members who remain.

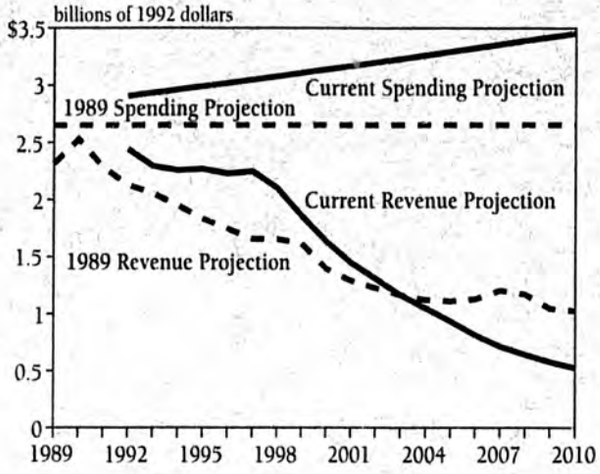
Overall then, we have reason to be optimistic that Alaska will take responsibility for its financial future and enact measures to bring us to a safe landing. We have an opportunity to join together to do something about the looming fiscal crisis. But we all need to accept that there is a problem, and be willing to give up some of the very generous programs and payments oil revenues have made possible. And if we make some sacrifices now, we will enjoy the benefits in the years to come. If we adopt the Safe Landing or a similar fiscal strategy:

- ***We can look forward to a healthy economy based on our traditional export industries.*** Economic growth will come from private industry rather than from government. We can't expect a continuation of the rapid economic expansion fueled by government spending in the past. There may be times when less state spending will result in a stagnant economy, but the Safe Landing strategy can minimize the possibility of a recession and attendant loss of jobs and property values.

- ***Alaskans will still enjoy good incomes in the future***—but not as much above the national average as they have been when we take into account the low taxes, Permanent Fund dividends, and high government spending we have enjoyed in the past 15 years.

- ***Alaska and Alaskans will still be in an enviable situation a decade from now***. The Safe Landing strategy will mean less government and higher taxes than in the past 15 years, but we will still have a great deal as compared with the period before Prudhoe Bay and with other states. Not only will we have the Permanent Fund offsetting a large share of government costs, we will have all the physical improvements oil wealth allowed us to create. These improvements not only enhance the quality of life, they also reduce the relative cost of living and thereby make Alaska more attractive for economic development.

Estimating the Fiscal Gap, 1989 and 1992



In *Fiscal Policy Paper No. 1* (August 1989), we projected a fiscal gap of $400 million in 1992, under a scenario in which the state government tried to maintain current spending for as long as possible by using available fund balances. The actual 1992 shortfall, which the state covered by using a reserve and through other means, was about $600 million. The assumptions we made in 1989 were not accurate, but our forecast still proved a good one.

Revenues have been higher than we anticipated, because both oil prices and oil production have been higher. Oil prices have averaged $19.43 per barrel since January 1986 (or $18.61 per barrel, if we net out the period of the Iraqi war), compared with our estimate of $15 per barrel in 1989 dollars ($17.30 in 1992 dollars). But more significant for oil revenues than price fluctuations has been the upward revision in the Department of Revenue's estimate of oil production—an increase of about 150,000 barrels per day for the rest of the decade. Assuming the increase reflects more ultimate recovery rather than just faster depletion of North Slope oil, higher production gives the state more resources and time to deal with the transition to the post-Prudhoe Bay world.

It's fortunate that we underestimated revenues, because we also underestimated expenditure growth—driven not only by inflation and population increases but also by the dynamics of entitlement programs and by newly identified needs. Those factors added $200 million to the budget by 1992.

Note: If no significant supplemental appropriations are enacted later, fiscal year 1993 spending will fall below the current projection.

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