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HOW ARE WE DOING? MONITORING ALASKA'S FISCAL CONDITION

By SCOTT GOLDSMITH

Alaska's government has been down on its luck this year, with low oil prices, a big deficit, and legal disputes over the budget. Despite all that, Alaska still has substantial assets.

The state's share of Alaska oil reserves is worth—even at low oil prices—about \$16 billion. The Permanent Fund has a balance of \$13 billion and earned \$1 billion last year. Alaska has more development potential. Its household tax base is almost untouched, because residents pay no personal state taxes.

But the state does have a serious money problem that's putting its assets at risk. Since 1988, revenues have fallen short of spending several times (Figure 1). In the past three years, spending has been up sharply, even as revenues declined. At first the gap was barely noticeable. In fiscal 1994, however, the state faces an estimated fiscal gap of \$1.4 billion.

The state got into trouble by continuing to spend more while relying on oil revenues for most general government income. A decade ago, oil prices and oil revenues were much higher. But in recent years, except for a brief period during the 1991 war with Iraq, oil prices have fluctuated between \$10 and \$20 per barrel. Lately they've been near the bottom of that range.

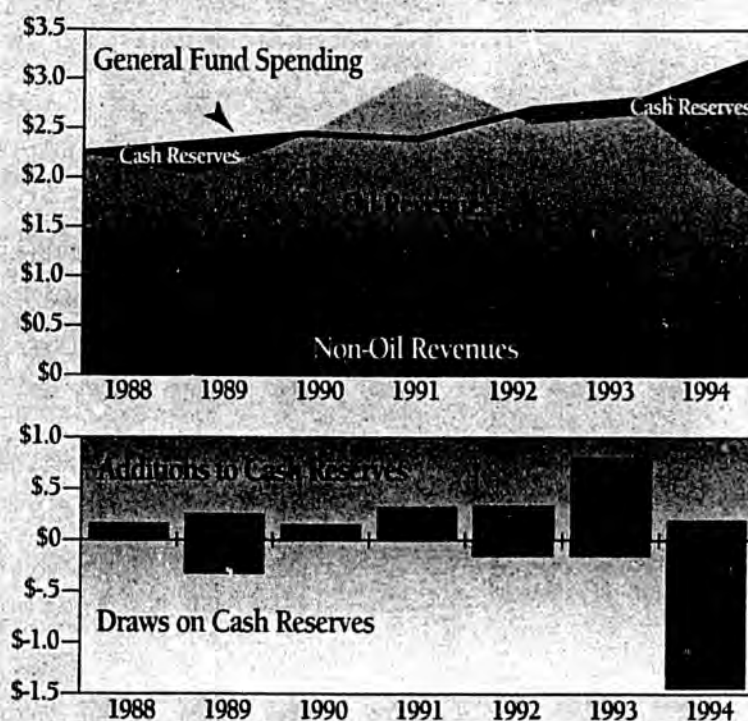
But the underlying problem—independent of oil prices—is declining production: Alaska's production has been dropping since 1988, because new discoveries haven't replaced declining production from the Prudhoe Bay field. Unexpectedly low oil prices combined with unusually high spending for capital projects created the big fiscal gap this year. But even if oil prices recover to \$18 per barrel (which some analysts think is unlikely any time soon), Alaska faces continuing budget gaps as oil production continues to decline. Aggravating the decline in revenues is continuing population growth—meaning more demand for services.

So far the state has balanced the budget mainly by using its cash reserves. The state has reserves because of settlements of tax disputes, earnings from special funds, and surplus revenues from earlier years. Closing this year's fiscal gap will take a third of the reserves, and the

remaining \$2 billion in existing reserves won't last long, if we just keep pouring them into the fiscal gap. If more tax disputes are resolved in the state's favor, new settlements would temporarily bolster the reserves. But whenever they're gone, Alaska could be left with a huge hole in the budget and disruption in the economy, which relies heavily on state money.

We can avoid all that by gradually bringing spending and revenues into balance. Pages 2 and 3 examine what is happening to the state's assets—and why preserving and building them is so important. The foldout details the risks of relying exclusively on cash reserves. Page 4 provides a simple checklist for monitoring the state's progress toward the long-term budget strategy called the Safe Landing.

FIGURE 1. RELYING ON CASH RESERVES, 1988-1994
(IN BILLIONS OF DOLLARS)



This paper continues the series examining state spending and revenues and the issues Alaska faces as oil revenues decline. It is sponsored by grants from a number of Alaska businesses: National Bank of Alaska, First National Bank of Anchorage, the Anchorage Daily News, Alascom, Inc., Alaska National Insurance Company, Ketchikan Pulp Company, and Lynden Incorporated. Contributors to this paper include Lee Gorsuch, Linda Leask, Monette Dalsfoist, and Alexandra Hill.

Why Is It Important to Build Assets?

Assets are wealth. Some assets, like cash or savings accounts, are financial; some, like houses or property, are physical. Others—education, for instance—are less tangible. Generally, the more assets you have, the better the quality of your life.

The wealth of a state also consists of financial, physical, and intangible assets. One of the most important assets of a state is its tax base—because the size of the tax base determines the state's capacity to fund education and other services.

In Alaska, much of the tax base is natural resources—the most valuable of which is oil. Alaska is unique among states because it owns a good share of the state's natural resources, including the North Slope oil fields. The state therefore owns much of the tax base, and the oil reserves are treated as a state asset. In other states the tax base is mainly in private hands.

All states monitor their tax bases to gauge the health of their economies. In Alaska, because the state owns natural resources, another important measure of economic health is the value of the state's assets. Table 1 shows selected state financial assets: cash reserves, potential settlements from tax disputes, the Permanent Fund, and the state's share of oil reserves. (Examples of state assets not shown are pension funds and the Alaska Housing Finance Corporation's mortgage portfolio.)

Alaska's \$34 billion in financial assets could generate more than \$1.5 billion in annual sustainable revenues for the state. That's a large amount, but it falls far short of the \$3.75 billion the state will spend this year. In fact, the state used some of its

assets—cash reserves—to help pay for this year's spending. That's like a person without a job living off his savings and not looking for work—because even as Alaska dips into its assets to pay bills, it's not levying any new taxes or looking for other ways to increase non-oil revenues.

Use of the cash reserves is one reason the value of Alaska's assets dropped between 1993 and 1994. The more significant reason is that the value of the oil reserves declined—a result mostly of much lower oil prices, but also of ongoing production reducing the size of the known reserves.

Still, even at low oil prices, oil is Alaska's biggest asset. But we're producing more oil than we're discovering. How well Alaska maintains its assets and tax base depends on how successful the oil industry is in replacing lost oil production, and how well the state converts the declining oil reserves into a growing Permanent Fund (Figure 2).

Table 2 is a simplified 1994 financial statement for Alaska, showing revenues and expenditures from the state's major financial accounts. (These figures are estimates because fiscal 1994 is not yet complete.) Although most government activities are funded out of the General Fund, we need to look at all funds to get a clear picture of the state's fiscal condition.

- *The shortfall in all funds together (\$800 million) was less than the shortfall in just the General Fund (\$1.4 billion) because more money came into the Permanent Fund (in oil revenues and in earnings) than the state paid out in dividends.*

- *The state's investment earnings were nearly as large as its oil revenues in fiscal 1994—which underscores the importance of building state assets to help replace oil revenues.*

**TABLE 1. TRACKING THE VALUE OF
MAJOR STATE ASSETS**

(IN BILLIONS OF DOLLARS)

FISCAL YEAR	TOTAL	CASH RESERVES	POTENTIAL SETTLEMENTS	PERMANENT FUND	VALUE, STATE SHARE OIL
1988	\$34.3	\$8	\$3.3	\$8.6	\$21.6
1989	30.8	.9	3.4	9.2	17.3
1990	38.1	1.1	3.6	9.9	23.5
1991	48.1	1.4	3.6	10.9	32.2
1992	41.3	2.3	3.5	11.7	23.8
1993	41.8	3.0	3.0	12.4	23.4
1994 (est)	33.8↓	1.9↓	3.0	13.0↑	15.9↓

Cash Reserves: Includes General Fund, Constitutional Budget Reserve, and Permanent Fund Earnings Reserve

General Fund: Funds general government operations and holds cash reserves not specifically allocated to some other account. In recent years the general fund has included excess revenues from prior years and special purpose accounts, such as the Railbelt Energy Fund.

Constitutional Budget Reserve: Established by the legislature to hold cash received from settlements of tax and royalty disputes with oil companies; to be used when regular revenues fall below the previous year's spending. In early 1994 the Alaska Supreme Court ruled that the legislature had illegally appropriated money that should

have gone into this account. Recently the legislature reached a tentative agreement to satisfy the court order and re-appropriate the money.

Permanent Fund Earnings Reserve: Holds earnings not needed to pay dividends or inflation-proof the Permanent Fund. Money in this account is available to be spent on government programs or redeposited in the Permanent Fund. This reserve grows when the earnings of the Permanent Fund are large.

Potential Settlements: An estimate of the value today of payments the state might receive from future settlements of tax and other disputes about past oil production and bonus sales. It is a subjective estimate which assumes that the state will receive 50 cents for every dollar claimed. This account declines as disputes are settled and the proceeds are deposited in the cash reserves.

Permanent Fund: By law a portion of royalties from the sale of state-owned natural resources goes into this fund. Most growth now results from reinvestment of a portion of the fund's earnings, which is known as inflation-proofing. In earlier years, special legislative appropriations were important sources of growth. This figure excludes unrealized capital gains and the earnings reserve.

Value of State Share, Oil Reserves: The value today of tax and royalty payments the state can expect to receive in future years, based on oil prices and state estimates of current oil reserves. The balance falls as oil is produced and sold, and increases when new reserves are discovered. Since the start of North Slope production, the state has added about one barrel of oil to reserves for every two barrels produced.

TABLE 2. WHAT HAPPENED THIS YEAR?

An Abbreviated, Consolidated Financial Statement, 1994 (Billions of Dollars)

	GENERAL FUND	ALL FUNDS ^b	
REVENUES			
Current Oil Production	\$1.35	\$1.55	Investment earnings from the Permanent Fund, cash reserves, and other accounts produced almost as much revenue as the sale of oil. Oil revenues were down an estimated 40 percent between 1993 and 1994. All other revenue sources contributed about 10 percent of the total; such revenues have been flat in recent years.
Net Investment Earnings ^a	0.05	1.00	
All Other Sources	0.40	0.40	
Total Revenues	1.80	2.95	
SPENDING			
General Fund Operating	\$2.40	\$2.40	The operating budget was unchanged but the capital budget was up about \$300 million in 1994, resulting in a \$3.2 billion state general fund budget. Spending for Permanent Fund dividends will be about \$550 million, up about \$50 million from last year.
General Fund Capital	0.80	0.80	
Permanent Fund Dividend		0.55	
Total Spending	3.20	3.75	
ASSETS			
Oil Reserves: State Share		\$15.90	The value of Alaska's assets dropped about \$8 billion between 1993 and 1994, mostly because the value of the state's share of oil reserves was down—because of lower oil prices but also because the size of the reserves fell. The draw on cash reserves necessary to fill the general fund fiscal gap was partially offset by an increase in the Permanent Fund balance. The value of potential settlements was unchanged, because interest on disputed amounts offset settlements realized.
Cash Reserves		1.90	
Permanent Fund Principal		13.00	
Potential Settlements		3.00	
Total Assets		33.80	

^aExcludes \$350 million in Permanent Fund earnings needed to inflation proof the fund.

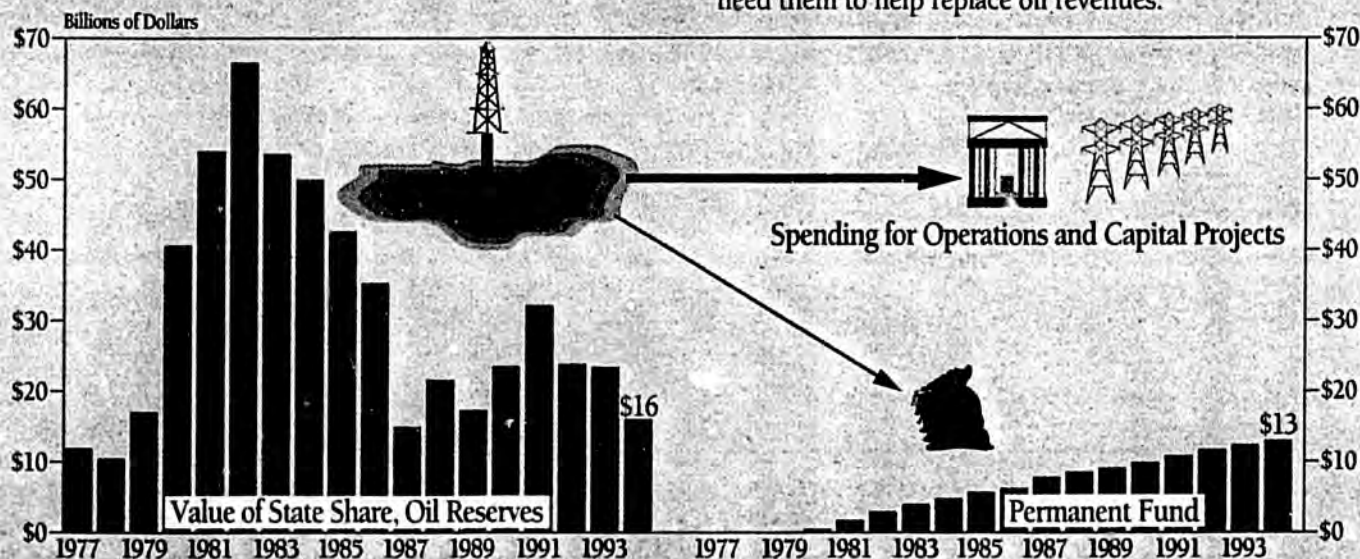
^bIncludes the Unrestricted General Fund, Constitutional Budget Reserve, Permanent Fund Earnings Reserve, State Share of Oil Reserves, Potential Settlements, and Permanent Fund.

FIGURE 2. TRANSFORMING OIL RESERVES INTO SUSTAINABLE ASSETS

Alaska's oil reserves are getting smaller. Since North Slope production began in 1977, roughly one barrel in new discoveries has been added for every two barrels produced. Alaskans recognized in the 1970s that oil wealth wouldn't last forever. One of the reasons they voted to create the Permanent Fund was to convert part of that oil wealth into an asset that could help sustain essential government services when the oil was gone. The graphs show progress toward that goal over the past 15 years. In any given year, most oil revenues go into current spending, but a percentage goes into the Permanent Fund. In the past the legislature also made special appropriations to the fund.

The value of the state's share of oil reserves is shown as estimated future royalties and taxes. That value has fluctuated with oil prices. It was \$50 billion through the early 1980s, when the reserves were larger and oil prices tripled—creating huge increases in the state's potential royalties and taxes. Today, with diminished reserves and low oil prices, the value to the state is about \$16 billion.

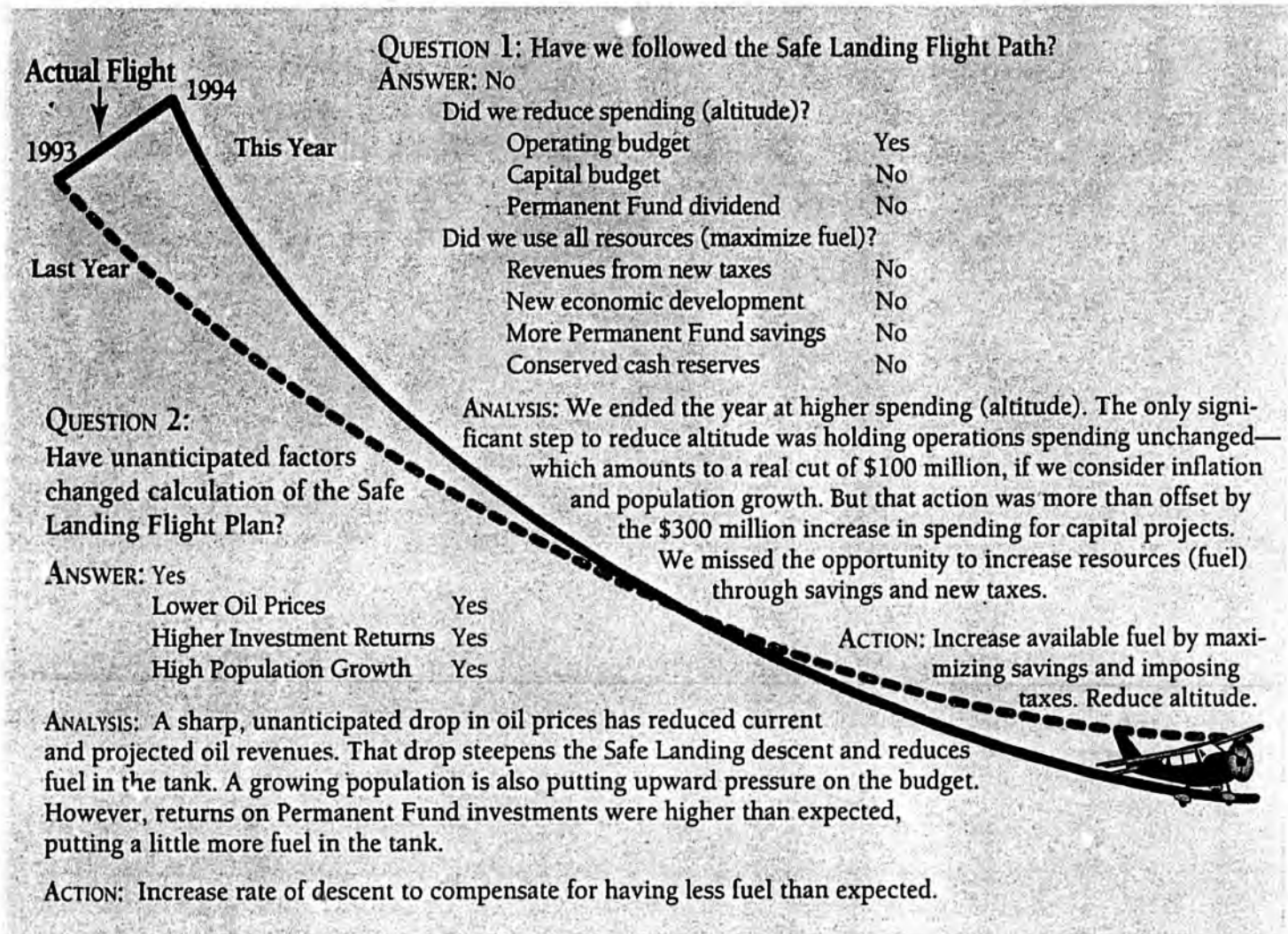
The Permanent Fund has been more stable but smaller. Today, however, with a principal of \$13 billion, it is nearly as valuable as the oil reserves—and soon it will overtake oil as the state's biggest asset. If we put more money into the fund now, its future earnings will be higher—when we'll need them to help replace oil revenues.



MONITORING OUR PROGRESS TOWARD A SAFE LANDING IN 1994

In 1992, *Fiscal Policy Paper 7* used the analogy of a flight path—the Safe Landing—to describe how Alaska could gradually reduce spending (altitude) and make the most of its resources (fuel in the tank) to carry the state to a Safe Landing (a level of spending it can afford over the long run). What progress did we make toward a Safe Landing in fiscal 1994? As the graphic

shows, the state failed to reduce altitude or maximize fuel—which means calculation of a new flight path, with a steeper descent and less fuel in the tank. Aggravating the problem is the recent unanticipated sharp drop in oil prices, which further steepens the descent and reduces fuel. Oil prices or other factors outside the state's control can force a change in course.



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Why Not Use the Cash Reserves First?

Why should we worry about the state using cash reserves to balance the budget, instead of doing other things like spending less or collecting more taxes? Some Alaskans wonder why they should give up any benefits, or pay any new taxes, while the state government still has money in reserve accounts. It's a reasonable question.

The answer is illustrated in the adjacent table and in the graphs below. Using the cash reserves and doing little else is masking the problem and setting us up for a very tough situation when the reserves run out—which they will sometime in the next few years. When the reserves are gone, Alaska could find itself with a huge hole in the budget, programs and services it can't pay for, and disruption in the economy, which relies heavily on government spending. That's the Hard Landing scenario.

How much longer the reserves can last is uncertain. First, it depends on how much the budget grows and on oil prices. Second, it depends on whether settlements of tax disputes and additions to the Permanent Fund Earnings Reserve add to the cash reserves.

The state legislature based the fiscal 1994 budget on an anticipated oil price of \$18 per barrel. But in recent months the price of oil has been at its lowest since the 1986 price crash, pulling oil prices \$5 per barrel below the earlier projection. That big difference between projected and actual oil prices—together with a larger than normal capital budget—have made this year's fiscal gap in the General Fund, measured as expenditures minus current revenues, an estimated \$1.4 billion.

To illustrate the potential size of the gap in future years, the adjacent table projects what could happen if spending grows at the combined rate of inflation and population growth; if oil prices stay low (consistent with the Department of Revenue's Fall 1993 low

and Spring 1994 mid case projections); and if no new money flows into the cash reserves. Under those circumstances, the fiscal gap could eat up the existing \$2 billion in reserves by fiscal 1997. It's likely that Alaska will collect some settlement money in the next few years, making it possible to keep going as we have been for a little longer. But the amount and timing of settlements is uncertain.

And the longer Alaska balances its budget with cash reserves, the worse off we'll be when they run out. Also, as the fiscal gap widens and the reserves dwindle, we are becoming more vulnerable to fluctuating oil prices.

There is another choice—a Safe Landing. Under that scenario, Alaska would hold the line on spending, increase revenues from sources other than oil, and conserve the cash reserves—so they can continue to help cushion Alaska from fluctuating oil revenues. The state would also encourage economic activities that not only create jobs, but also generate revenues to help pay for public services. Eventually, Permanent Fund earnings would replace a large part of the lost oil revenues. Below is one possible combination of steps to balance the budget. It's not the only way. But to avoid the Hard Landing, state officials need to make a plan that incorporates all the resources Alaska has for balancing the budget—and start putting that plan into effect now.

Inflated Versus Constant Dollars

In this publication, all the dollar amounts for future years are inflated to show the likely effects of increasing prices, assuming 4 percent annual inflation. This method is different from the one we used in earlier Fiscal Policy Papers, where we removed the effects of inflation and put all the figures in constant dollars—that is, in today's purchasing power. Many readers told us that they find it easier to understand possible future changes in revenues and spending if we include the effects of inflation.

WHAT WILL HAPPEN WHEN THE CASH RESERVES ARE GONE? (IN MILLIONS OF DOLLARS)

FISCAL YEAR	STATUS QUO GEN FUND SPENDING ^a	GENERAL FUND NON-OIL REVENUES ^b	GENERAL FUND OIL REVENUES ^c	FILLING THE FISCAL GAP FILL GAP WITH CASH RESERVES ^d	ESTIMATED REMAINING GAP ^e
1988	\$2,255	\$441	\$1,811	\$3	—
1989	2,350	431	1,598	321	—
1990	2,450	476	1,970	4	—
1991	2,400	508	2,567	(675)	—
1992	2,700	552	1,999	150	—
1993	2,800	497	2,155	148	—
1994 (Est)	3,200	400	1,360	1,440	—
1995	2,600	372	1,564	664	—
1996	2,727	377	1,559	791	—
1997	2,859	411	1,565	820	—
1998	2,999	423	1,578	End of Reserves	997
1999	3,145	436	1,456	—	1,253
2000	3,298	448	1,301	—	1,548
2005	4,191	513	750	—	2,927
2010	5,326	595	400	—	4,331

^a HISTORICAL: State of Alaska, Executive Budget.

PROJECTION: FY 1995 budget level assumed by author. Subsequent growth at rate of inflation (Alaska Department of Revenue) plus 1% population growth.

^b HISTORICAL AND PROJECTION: Department of Revenue Fall 1993 low case non-oil revenues including general fund interest, plus author estimate of program receipts. The Fall 1993 low case projection is similar to the recently released Spring 1994 mid case projection.

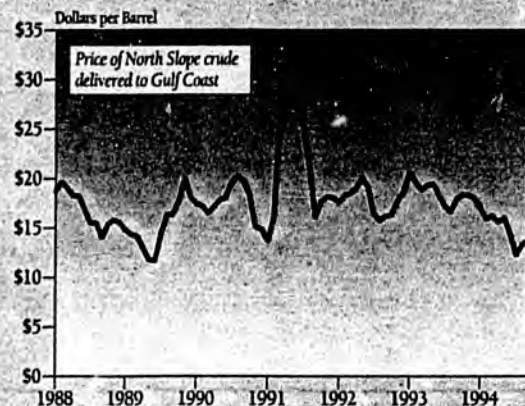
^c HISTORICAL: Calculated by author from Alaska Department of Revenue, Revenue Sources Book. Includes revenues from current production. PROJECTION: 1994 by author, subsequently DOR Fall 1993 low case which assumes average Lower 48 oil prices as follows: \$15 in 1995, increasing to \$17.80 in 2000, and \$20 in 2005. This projection is similar to the recently released Spring 1994 mid case projection.

^d Assumes combined cash reserves of \$2 billion at start of FY 1995 in General Fund, Constitutional Budget Reserve, and Earnings Reserve of Permanent Fund. No additions in later years except earnings on balances.

^e Budget reductions, new taxes, Permanent Fund earnings, and revenues from economic development that more than pays its own way.

What Has Happened?

Oil Prices Flat...



Since falling sharply in 1986, oil prices have fluctuated between \$10 and \$20 per barrel, except for a brief period during the 1991 Iraqi war. Recently prices have hovered near the lower end of that range.

Oil Production Down...



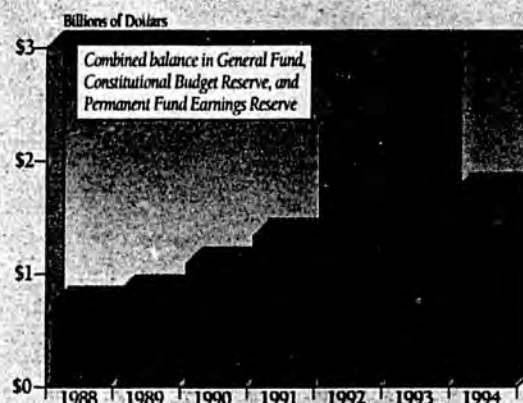
Oil production has declined from a peak of over 2 million barrels per day in 1988. The increase at the start of fiscal 1994 is temporary, reflecting new production from the Point McIntyre field and enhanced recovery at Prudhoe Bay.

Revenues Down, Spending Up...



While oil revenues have fluctuated, recurring non-oil revenues have remained flat. Spending has increased with population and inflation, and general fund deficits—evidence of a fiscal gap—have occurred in several recent years.

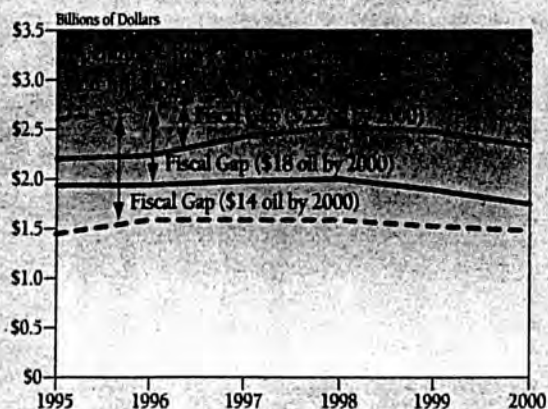
Reserves Close the Gap



Growing cash reserves easily closed the fiscal gap for several years. But the estimated \$1.4 billion needed to close the gap in 1994 will take a third of the remaining reserves.

Where Are We Heading?

An Expanding Fiscal Gap...



Even with a drop in spending in fiscal 1995, a \$500 million fiscal gap will remain. Depending on oil prices, the gap could range between \$500 million and \$1.5 billion annually between now and the end of the decade.

Closed With Cash Reserves...



Cash reserves in hand can close the fiscal gap through 1997 if oil prices rebound. New cash settlements (shown above), higher oil prices, or additions to the Permanent Fund Earnings Reserve would extend the life of the cash reserves.

Leads To A Hard Landing, Sooner...



Relying on cash reserves could precipitate a Hard Landing as early as 1998, if oil prices rise only moderately and if no new settlements augment the cash reserves.

...Or A Harder Landing Later



Higher oil prices, new settlements, and growing balances in the Permanent Fund Earnings Reserve can postpone the Hard Landing, but at the risk of making it worse.

What's the Alternative?

Hold the Line on Spending...



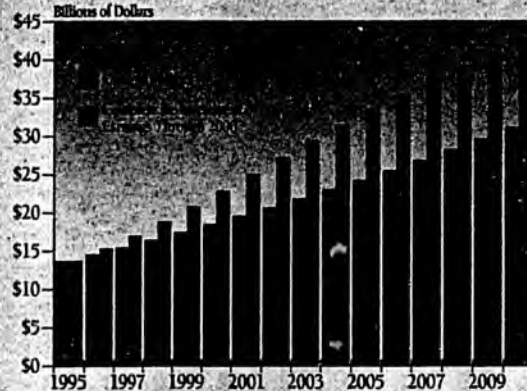
If the state does not increase the budget with inflation, spending is effectively cut over time, because a dollar won't buy as much tomorrow. Spending includes both general spending and dividends; if the state keeps paying dividends, it will have to cut more general spending.

Re-introduce Income Taxes

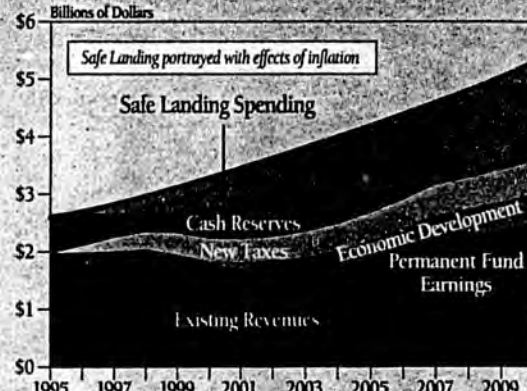


Collecting revenues from sources other than oil would make the cash reserves last longer—and make individual Alaskans more aware of the price tag on public services. A personal income tax, for instance, could add \$250 to \$300 million to annual revenues today.

Maximize Growth of Permanent Fund... And Make A Safe Landing



If Alaska annually reinvested in the Permanent Fund an amount equal to what is now paid in dividends (whether dividends were eliminated or the money came from some other source), it could sharply increase earnings available to contribute to the Safe Landing.



A Safe Landing is possible through a combination of constrained spending, cash reserves (including potential new settlements), new non-oil revenues, Permanent Fund earnings, and revenues from development that more than pays its own way.