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LONG-RANGE FINANCIAL PLANNING COMMISSION WORKBOOK

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Note: This workbook is intended to supplement, summarize and update information already provided to members of the Long-Range Financial Commission. Due to the timing of the next work session on May 19–20 and the need to get information out to Commission members ahead of time, the budget material presented herein does not contain final FY 96 numbers. These will be updated in a briefing at the upcoming work session.

APPROACHES AND OPTIONS

There are many approaches that the Commission might take to define or structure its task. Not all, obviously, would cover the same ground, or necessarily lead to the same conclusions. Some possibilities and options that the Commission may wish to consider as a means of getting started, however, are outlined below.

Broad Alternatives

Probably the most direct approach to dealing with the fiscal gap is to set about finding an acceptable mix of the fiscal tools available for dealing with the gap (reserves, spending cuts, taxes, economic development, Permanent Fund, etc.), plus an acceptable time frame for implementing the mix.

It might be productive for the Commission to consider a potential distinction between

- potential tasks and deliverables that would be appropriate for the early stages of a public discussion about the fiscal gap; and,
- those that might be appropriate for the later stages of a public discussion.

It also might be useful to consider other broad frameworks for analysis, such as:

- whether it would be better to follow a "top-down" process of developing fiscal strategies, where the public essentially reviews and comments on ideas formulated by the Commission; or a "bottom-up" process, where the public more actively contributes to the design and development of fiscal strategies;
- whether what is to be "balanced" in a fiscal plan encompasses:
 - "revenues and expenditures", or
 - "revenues, expenditures, and needs".

Key Questions

Key questions that the Commission might wish to consider at the very outset, to help in defining its approach, might include ones like the following:

- Of the more than a dozen tasks explicitly set out in HCR 1, where should the Commission focus its efforts?
- What areas of consensus exist among the Commission's members - - e.g., to potentially serve as a point of departure for the Commission's work, or as a base on which to build?
- Should the Commission orient itself more towards "solving" the fiscal gap problem, or more towards positioning and preparing state government for solving it?
- Might there be a role or roles for successor commissions? If so, how might it affect the nature of the Commission's task?
- What is an appropriate time frame for assessing strategies to close the fiscal gap?

Possible Approaches

Some approaches that the Commission might wish to consider, or explore, could include the following:

- Identify areas of relative consensus vs. areas where there is a relative lack of consensus among Commission members - - e.g., on topics such as:
 - the most important aspects of the Commission's mission;
 - deliverables for the October 1, 1995, deadline that are "must have" items, as opposed to those that would be "nice to have";
 - the conditions under which (or manner in which) particular fiscal tools should or might be used - - e.g., spending cuts, taxes, the Permanent Fund, etc.;
 - the relative priority or sequence of access to the available fiscal tools - - e.g., no taxes before certain levels of spending cuts, use of the Permanent Fund only after all other measures, etc.;
 - criteria or guidelines for deciding how much is "enough" - - e.g., in spending cuts, taxation, use of reserves, etc.;
 - the attributes of a "politically feasible" fiscal strategy, versus the attributes of one that is "politically unfeasible";

- the "first steps" that should be taken - - e.g., by the Governor, or legislators;
 - the respective fiscal roles and responsibilities of state government in Alaska versus local governments;
- Identify barriers to action; e.g.:
 - why hasn't the fiscal gap problem been solved to date?
 - what barriers or impediments exist to using the various fiscal tools?
 - Identify what is desired as an overall end-product of the Commission's work:
 - a fiscal plan?
 - a strategy for adopting a fiscal plan?
 - a strategy for developing a fiscal plan that will be politically supported?

STRATEGIES FOR DEALING WITH UNCERTAINTY

A fundamental difficulty in trying to deal with the State's projected "fiscal gap" is that it is a moving target. Sometimes it looks larger, sometimes it looks smaller. Sometimes it appears imminent (or already under way), and other times it appears years off. Every time oil prices bounce up or down, the contours of the fiscal gap - the perceived urgency for dealing with it - shift measurably, and often dramatically.

This shifting nature of the problem makes it difficult to frame - - and difficult to develop consensus for answering - - even the most basic questions; namely:

- Just what is our fiscal problem?
- Is it already here or not?
- When is it really coming?
- What should be done about it?
- What (if anything) should be done now?
- Who should do it?
- Who should go first?
- Who gets blamed if we're wrong?

Not being able to answer these questions with any degree of reliability (or consistency) creates an important risk - - namely, that a certain point may get passed, beyond which we no longer have certain fiscal options available to us. Or following which draconian measures will be available, or likely. Such a point, for example, might be "too much" (however defined) of our reserves were to get used up too soon, and prices fell precipitously, etc.

From a different perspective, not being able to reliably or consistently answer these questions also causes political problems. In particular, decision makers become understandably cautious about going out on a limb and declaring a fiscal emergency, offering a particular solution to it.

Finally, the same problem contributes to an erosion of public confidence in decision makers' ability to correctly interpret a problem and solve it.

In view of this situation, some approaches, questions and suggestions are outlined below that might help the Commission grapple with this centrally important issue.

Key Questions

- How to tell when the "fiscal gap" will (really) arrive?
- When does action have to be taken to deal with it?
- What effect does revenue uncertainty have on strategies for dealing with the fiscal gap?
 - what happens to a strategy if the fiscal gap at a given point is larger (smaller) than we thought?
 - what if it occurs earlier (later) than we thought?
 - how can we develop strategies that will account for these kinds of uncertainties?
- Given that the fiscal gap seems to remain several years away, how can we identify steps that need to be taken now?
- Is it necessary to have precise estimates of the size and timing of the fiscal gap in order to deal with it effectively?
- How to gauge the fiscal effects of change in the structure of Alaska's economy?

Options For Dealing With Uncertainty

- maintain a specified level of liquid or semi-liquid reserves;
- emphasize contingency planning - - adopting measures whose use depends on the course of future events;
- define "trigger" conditions for the use of particular fiscal measures:
 - e.g., enacting legislation that calls for some version of Fiscal Tool "X" to take effect at some point in the future if revenue falls a certain percentage below FY "XX" per capita levels, and for some version of Tool "Y" to take effect if revenue falls a certain percentage further, etc.
- consider some form of contingency budgeting, perhaps for selected or non-"core" budget items or categories:
 - e.g., where the amount appropriated for an agency or program (perhaps beyond a base amount) depends in some fashion on the amount of revenue received;

Options such as these might prove useful because of being tailored more closely to the changing nature (and time table) of our fiscal gap problem. They might also prove useful in helping to alleviate decision makers' anxieties about taking a particular step now, but having it turn out to be either too much, or too little, as events unfold. In short, decision makers might feel comfortable in considering contingency approaches such as these because, if they are needed in the future, they would already be in place; but if not, they would not take effect.

Developing Base Case Assumptions

In order to have a meaningful discussion on fiscal policy, it is necessary to agree on some basic assumptions about inflation, statewide population growth, revenue and expenditure projections. The following sections attempt to lay a plausible foundation for the commission to use in constructing a long-term fiscal policy. Please note that this is only a tentative first step. Commissioners will have ample opportunity to make changes necessary to ensure that these assumptions are realistic.

Inflation and Population

Aside from legislated changes, inflation and population are the two main drivers of public service costs – even without adding any new programs or services these factors steadily add to the cost of government, particularly over the long term. Inflation is also an important factor in forecasting revenues and Permanent Fund earnings, while population growth and demographic characteristics are underlying determinants of formula program costs.¹ For purposes of the Commission, adopting consistent inflation and population conventions is probably more important than the absolute accuracy of projections.

Inflation

- The Department of Labor (DOL) has provided historical information on the Anchorage (CPIU) index.
- During the 1980s, inflation rates in Alaska diverged significantly from national rates, increasing faster during the boom years of the early '80s and then much slower than the national average during the bust years of the late '80s.
- During the '90s, national average inflation and Alaska inflation rates have tracked closely, with the Anchorage CPIU trending slightly higher during the early '90s.
- For 1994 the Anchorage CPIU increased 2.1% while the national average CPI was 2.4%, in line with the Alaska economy slowing relative to the U.S. economy as a whole.
- For future inflation, Department of Revenue (DOR) projections of national inflation rates contained in the *Spring 1995 Revenue Sources Book* have been adopted in Table 1, with inflation during the next 10 years projected at around 3%.

¹Formula programs are defined as those where distribution of funds is predetermined by a formula set in state law. In some cases like municipal assistance and revenue sharing, the legislature sets an overall funding level and the formula distributes funds to municipalities within the overall level. In others such as foundation funding for schools, the legislature determines a per unit amount and the overall level of spending is determined by enrollment.

Population

- The DOL publishes low, middle, high and zero projections of statewide population growth.
- During the 1980's, statewide population growth was very rapid during the boom years, fueled by both natural increase (more births than deaths) and net in-migration.
- During the bust years of the late '80s, the state saw four years of net out-migration, when a total of about 44,000 more people left the state than migrated in. This net out-migration was nearly offset by a 39,000 person natural increase during the same '85-'89 period.
- Migration is determined largely by economic opportunities within the state as well as economic swings in the Northwest and California, which tend to be population "feeder states" for Alaska.
- The '90s have seen a slowing of migration to Alaska, though natural increase has continued at a rate of more than 9,000 per year.
- In the workbook scenarios, the DOL middle series population projection has been used, which shows statewide population increasing from 621,300 in FY 95 at a rate of 2.5% per year and gradually slowing to a rate of 2% in FY 2005 with a total population of 780,200.
- The most expensive cohorts of the population in terms of public service costs – school age children under 18 years of age and seniors over 65 – have been projected separately in Table 1.
- The proportion of the school age population is projected to decrease slightly from 31% in FY 95 (Alaska is a young state) to 29% in FY 2005, while the proportion of seniors is expected to increase from 4 to 6% during the same period.

Table 1

Basic Inflation and Demographic Assumptions						
	*Anchorage	Percent	**Statewide	Percent	Percentage	Percentage
Fiscal	CPI	Change	Population	Change	Statewide	Statewide
Yr.	FY Avg.		Total		Population	Population
					<18 Yrs	>65 Yrs.
60			230,400			
61	34.4		236,700	2.7%	39.3%	2.4%
62	34.7	0.9%	242,800	2.6%		
63	34.8	0.1%	249,900	2.9%		
64	34.9	0.3%	253,200	1.3%		
65	35.3	1.1%	265,200	4.7%	39.7%	2.3%
66	35.6	1.0%	271,500	2.4%		
67	36.8	3.4%	277,900	2.4%		
68	37.7	2.3%	284,900	2.5%		
69	38.9	3.4%	294,600	3.4%		
70	40.2	3.2%	308,500	4.7%	40.0%	2.3%
71	41.6	3.6%	319,600	3.6%		
72	42.8	2.9%	329,800	3.2%		
73	43.9	2.5%	336,400	2.0%		
74	46.8	6.7%	348,100	3.5%		
75	53.1	13.5%	384,100	10.3%	35.6%	2.6%
76	59.2	11.4%	409,600	6.7%		
77	63.2	6.8%	418,000	2.0%		
78	67.3	6.6%	411,600	-1.5%		
79	73.6	9.3%	413,700	0.5%		
80	81.3	10.5%	419,800	1.5%	32.5%	2.9%
81	88.8	9.1%	434,300	3.5%		
82	95.4	7.4%	464,300	6.9%		
83	97.8	2.5%	499,100	7.5%		
84	101.0	3.3%	524,000	5.0%		
85	104.3	3.3%	543,900	3.8%	31.4%	3.1%
86	107.6	3.2%	550,700	1.3%		
87	107.9	0.2%	541,300	-1.7%		
88	108.3	0.4%	535,000	-1.2%		
89	109.9	1.5%	538,900	0.7%		
90	114.7	4.4%	553,600	2.7%	31.3%	4.1%
91	121.9	6.2%	570,300	3.0%		
92	126.0	3.4%	586,900	2.9%		
93	130.3	3.4%	599,200	2.1%		
94	133.6	2.5%	606,300	1.2%		
95	137.4	2.9%	621,300	2.5%	30.7%	4.8%
96	141.5	3.0%	636,600	2.5%		
97	146.0	3.2%	652,000	2.4%		
98	150.7	3.2%	667,900	2.4%		
99	155.5	3.2%	684,000	2.4%		
2000	160.4	3.2%	700,500	2.4%	29.9%	5.7%
1	165.5	3.2%	716,800	2.3%		
2	170.8	3.2%	733,000	2.3%		
3	176.2	3.2%	748,900	2.2%		
4	181.8	3.2%	764,700	2.1%		
5	187.6	3.2%	780,200	2.0%	29.1%	5.9%

*Inflation: FY 61 - 94 provided by DOL; FY 94 and beyond estimated by DOR - Spring 1995 Revenue Sources Book.						
**Population: Historical data provided by DOL; projections are middle series.						

Revenues and Expenditures

Realistic revenue and expenditure projections are crucial to the work of the Commission. However, great uncertainty is associated with projections of either. In this respect, it is probably more important to reach a comfort level with the relationship between revenues and expenditures than to focus on balancing the numbers themselves, i.e., to approach the problem from a strategic perspective rather than as an accounting exercise. The purpose of the following sections is to suggest a plausible base case from which to start. These notes explain Tables 2 and 3.

Revenues

- The basic source of production, price and revenue projections is the spring revenue forecast contained in the DOR *Revenue Sources Book*. The mid-case projection could be used as the convention for Commission purposes.
- Because petroleum revenues account for the vast majority of state general fund unrestricted revenues (78% in FY 94), the main variables in determining revenues are the price of oil and production volume.
- In FY 78 when oil first began flowing through TAPS, the price for ANS crude was \$13.12 /bbl.. Since then prices have been extremely volatile due to a host of market and political factors varying from \$34.92/bbl. in FY 81 to \$14.22 in FY 94.
- Prices are projected to increase from \$16.84 per barrel in FY 95 (as of April) to \$22.39 in FY 2005.
- Alaska production peaked in FY 89 at 2.1 million barrels per day and has since declined at an average rate of about 4% per year to 1.574 million in FY 95. Future production is projected to continue to decline to 1.103 million barrels per day in FY 2005.
- Experience has shown that the Department of Natural Resources (DNR) and DOR have consistently underestimated future production and reserves for a variety of reasons.² Thus later forecasts have tended to revise revenue projections upward – a primary cause of the "mirage" or moving target aspect to the fiscal gap problem. (The production forecast is discussed in some detail in Appendix II.)
- Unrestricted general fund revenues are projected to range from \$1.885 billion in FY 95 to \$1.948 billion in 2005.

²The state's production projections are based on information received from the producers themselves. For competitive reasons they tend to be very conservative in publicizing their development plans. Technological change also tends to increase ultimate recovery and as existing investments are paid off, new investments in enhanced recovery become economic. All of these factors contribute to conservative forecasts.

Expenditures

- To provide realistic projections of the actual costs of running state programs so that the fiscal gap can be fully appreciated, agency operations expenditures are projected to grow by inflation and one half of the projected statewide population increase, which takes into account the primary drivers of government costs while reflecting some efficiencies and economies of scale.
- Under this approach, expenditure projections start from an estimated FY 96 budget of \$2.5 billion and increase to \$3.4 billion in FY 2005.
- The long-term effects of high cost operations items such as presumptive sentencing laws and unfunded maintenance of the state's infrastructure are not included in operations projections, though they are likely to show up as capital costs in the future.³ (The deferred maintenance issue is discussed in some detail in a later section.)
- Formula programs, listed in Table 3, make up the largest and fastest growing proportion of the operating budget.
- Projected growth in formula program costs varies widely from the Longevity Bonus program which has been capped and is declining to Medicaid which has been growing at a rate of 15.5% per year.
- Formula program growth will be greatly affected by changes at the federal level during the next few years, which are likely to shift additional costs to the state particularly for welfare and health programs.
- Education, which is also a formula program, is the biggest single piece of the operating budget and is often singled out for special consideration in the fiscal planning process.
- The debt service schedule assumes no additional debt is issued. (see Table 4.) A more detailed discussion of debt policy is included in a later section.
- Capital budget projections are tentative Knowles administration targets. Table 5 provides a snapshot of how capital spending is currently distributed.

³For example, the three strikes provision in criminal sentencing would effectively increase prison terms of certain felons from an average of 12.5 years to 40 years. The true cost of this legislation will not show up for several years but is projected to result in 450 more long-term prisoners (on top of an 8% projected increase in prisoners) before leveling off and is likely to require an additional \$80 million prison. Likewise the Department of Transportation has consistently requested \$2 million for maintenance of additional lane miles added during the past two years, which the Legislature has not funded. The cost of unfunded maintenance will inevitably show up in a capital request at a later date.

Constitutional Budget Reserve

- The base case scenario shows the impact of continuing current spending patterns without any new revenue sources. The difference between revenues and expenditures would be made up entirely from the Constitutional Budget Reserve (CBR).
- Oil and gas tax and royalty settlements go into the CBR. They are conservatively estimated at \$150 million per year during FY 97 – 2000. No additional CBR revenues from settlements are anticipated after this period. (Outstanding oil and gas tax and royalty disputes are discussed in Appendix I.)
- Absent any significant changes in the state's revenue or expenditure outlook, a fiscal gap of \$573 million in FY 96 would continue to steadily increase each year and the CBR would be drained by FY 2000.
- If the state were to continue deficit spending and drawing down of reserve funds, the state's cash flow situation would become an issue as well as the availability of additional liquid reserves. These issues are specifically addressed in later sections.

The three framed columns in Table 2 below, correspond to the specific time horizon benchmarks set for the Commission in its enabling resolution (SCS CSHCR 1).

Table 2

"BUSINESS AS USUAL" PROJECTION - BASE CASE

NOTE: This projection does not reflect any out year decisions by the legislature or administration; it is intended to illustrate the potential fiscal gap in the absence of budget or revenue adjustments, and the fiscal effects of relying on reserve funds to balance the budget. The FY 95 budget is that approved last spring plus supplementals of \$43.6 million. The FY 96 budget is an estimate of what will be approved by the Legislature.

This scenario has no new revenues, major budget changes, or sale of assets (e.g. AHFC portfolio). Status Quo Budget/Uses Constitutional Budget Reserve to fill the fiscal gap.

	FY 95	FY 96	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05
Average Oil Price (\$/bbl.)	16.84	16.52	16.62	17.42	17.97	18.64	19.34	20.06	20.81	21.59	22.39
Oil Production (MMbbl/day)	1.574	1.503	1.457	1.418	1.375	1.342	1.304	1.246	1.195	1.146	1.103
REVENUES (\$ Millions):											
RECURRING-PETROLEUM	1,580.8	1,477.7	1,540.2	1,622.3	1,653.8	1,668.3	1,680.3	1,647.0	1,627.1	1,611.5	1,587.8
RECURRING-OTHER SOURCES	312.2	301.3	292.8	299.8	309.4	318.4	327.4	336.7	345.7	355.0	364.7
*NONRECURRING SOURCES	379.7	154.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0
TOTAL UNRESTRICTED GENERAL FUND REVENUES	2,272.7	1,933.0	1,923.0	2,012.1	2,053.1	2,076.6	2,097.8	2,073.7	2,062.8	2,056.5	2,042.5
EXPENDITURES (\$ Millions):											
**OPERATING	2,197.0	2,228.6	2,322.8	2,425.4	2,532.6	2,644.5	2,759.9	2,880.4	3,004.7	3,132.8	3,264.8
DEBT SERVICE	133.0	100.3	86.6	81.5	72.8	50.8	33.4	20.5	16.5	15.2	14.4
CAPITAL	100.4	135.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0	125.0
LOANS/TRANSFERS/SUPPS.	130.9	42.5	29.5	29.5	29.5	29.5	29.5	29.5	29.5	29.5	29.5
TOTAL EXPENDITURES	2,561.3	2,506.4	2,563.9	2,661.4	2,759.9	2,849.8	2,947.8	3,055.4	3,175.7	3,302.5	3,433.7
PROJECTED FISCAL GAP	-242.1	-573.4	-640.9	-649.3	-706.7	-773.1	-850.1	-981.8	-1,112.9	-1,246.0	-1,391.1
CONSTITUTIONAL BUDGET RESERVE											
***BALANCE IF FISCAL GAP FILLED ENTIRELY WITH CBR	1,965.3	1,741.9	1,601.0	1,101.7	545.0	0.0	0.0	0.0	0.0	0.0	0.0
REMAINING FISCAL GAP						78.1	850.1	981.8	1,112.9	1,246.0	1,391.1

*FY 96 = \$38.2 Rev. Adj. + \$70 AHFC + \$45.8 Exec Life. FY 97 - 2005 assumes \$40 revenue adjustments + \$50 AHFC dividend each year.

**FY 97-2005 agency operations projected to increase with inflation and 1/2 population growth.

***FY 96 & 97 include \$350/yr. BP settlement; FY 97 - 2000 assumes an additional \$150/yr. in settlements.

Table 3

MODEL FOR ASSESSING FORMULA PROGRAM GROWTH FY 95 - 2000

GENERAL FUNDS (\$ thousands)

Does not include policy decisions beyond those made in the FY 96 budget.

AGENCY / PROGRAM	FY95	FY96	FY97	FY98	FY99	FY2000	NOTES
ADMINISTRATION							
-Leases and Facilities	24,863.1	24,390.5	24,888.3	25,814.3	26,339.2	32,816.2	FY 95 includes shortfall/supplemental of \$63.3. FY 97 and beyond = 3% inflation, 3% replacement and standard CPI adjust
-Longevity Bonus (ALB)	72,709.9	72,602.8	71,223.1	69,994.8	62,304.3	57,715.9	Projections based on 1994 entrants @ \$200/mo, 1995 @ \$150/mo, 1996 @ \$100/mo. No new applications after 12/31/96
-Elected Officials Retirement	844.9	818.1	875.5	1,021.0	1,080.3	1,085.5	Salaries estimated @ current level. Health insurance increases @ 7%/yr and prospective retirees enter @ 60. No deaths
DOA AGENCY TOTAL GENERAL FUNDS	98,257.9	97,809.2	97,087.9	95,599.9	89,723.8	91,427.6	
COMMUNITY AND REGIONAL AFFAIRS							
-Day Care Assistance	484.4	508.8	534.1	580.8	588.8	618.2	Growth projected at 3%/yr
-Revenue Sharing	28,249.1	27,888.2	28,249.1	28,249.1	28,249.1	28,249.1	
-Municipal Assistance	34,364.4	33,825.8	34,364.4	34,364.4	34,364.4	34,364.4	
-Power Cost Equalization	19,835.0	19,907.7	19,987.8	19,775.8	20,171.1	20,574.5	From return on PCE Capitalization Fund = 3%/yr and assumes program growth of 3%/yr - not general fund
DCRA AGENCY GENERAL FUND TOTAL	81,732.9	81,330.3	82,535.4	82,849.9	83,373.4	83,806.2	
EDUCATION							
-K - 12 Support							
-Foundation Program	800,715.3	817,216.2	832,848.6	848,482.8	864,874.3	881,291.2	Assumes an annual enrollment increase of 2.5%
-Tuition Students	1,731.2	1,731.2	1,774.5	1,818.8	1,864.3	1,910.9	
-Boarding Home Grants	355.0	185.9	180.5	185.3	200.2	205.2	
-Youth in Detention	800.0	800.0	800.0	800.0	800.0	800.0	Status quo program with no growth
-Schools for the Handicapped	3,447.6	3,705.2	3,797.8	3,892.8	3,990.1	4,089.6	Assumes an annual student enrollment increase of 2.5%
-Pupil Transportation	31,544.8	32,842.2	33,991.7	35,181.4	36,412.7	37,687.2	Growth estimated at 3.5%/yr based on COLA and other contract issues
-School Debt Refinancing	103,345.3	90,322.4	54,825.0	51,956.2	49,485.2	39,587.4	Assumes no additional school debt is incurred
-Community Schools	800.0	800.0	800.0	800.0	800.0	800.0	Status quo program with no growth
DOE AGENCY GENERAL FUND TOTAL	742,558.2	737,403.1	728,826.1	742,807.3	758,006.8	768,151.7	
HEALTH AND SOCIAL SERVICES							
-Assistance Payments							
-AFDC	59,435.4	58,906.8	64,048.0	67,848.3	71,248.8	74,849.0	Assumes historical average caseload increase of 6%/yr and no increase to current maximum payment
-Adult Public Assistance	35,848.7	38,818.5	41,788.8	44,997.5	48,522.8	49,081.8	Growth projected at 5.5%/yr
-General Relief Assistance	991.9	991.9	1,051.4	1,114.5	1,181.4	1,252.3	Underfunded in FY 95 resulting in 11.6% increase for FY 96. Growth from FY 96 on estimated at 6%
-Old Age Assist ALB Hold Harmlsses	2,402.1	2,298.1	2,148.1	1,999.1	1,848.1	1,699.1	Reflects current law that classes ALB to new participants after 12/31/96
-Admin/Child Care Benefits	2,094.2	2,227.2	2,380.8	2,502.4	2,652.8	2,811.7	Projected at 3% annual growth
-PFD Hold Harmlsses	21,955.0	22,318.1	23,431.9	24,803.5	25,833.7	27,125.4	Paid by Permanent Fund
-Medical Assistance							
-Medicaid Facilities	62,825.4	73,710.1	81,818.2	90,818.2	100,808.2	111,897.1	Health care expenditures assumed to increase at 11%/yr growth for FY 96. Historical average is 15.5%/yr
-Medicaid Non-Facility	67,580.7	71,870.2	83,010.1	95,878.8	110,737.5	127,901.8	
-Medicaid State Programs	2,081.7	3,898.2	3,809.1	3,923.4	4,011.1	4,162.4	Assumed to grow at 3% rate of inflation
-ALB Hold Harmlsses	85.7	25.7	25.7	25.7	25.7	25.7	Hold harmlsses programs expected to remain relatively constant
-General Relief Medical	8,584.5	7,348.5	8,783.9	10,145.4	11,717.9	13,534.2	
-Waiver Services	2,384.8	3,740.8	8,898.8	10,142.1	12,370.1	14,598.0	Home and Community Based Waivers projected to increase rapidly thru FY 97 and then slow to MA rate
-Purchased Services							
-Foster Care	8,973.4	7,887.1	10,085.2	10,387.8	10,699.4	11,020.4	
-Subsidized Adoptions/Guardians	3,093.3	4,178.8	4,389.0	4,363.0	4,369.0	4,369.0	Projected at 3% annual growth
-Social Services Block Grant	6,394.7	6,310.8	6,394.7	6,394.7	6,394.7	6,394.7	This expenditure is offset by federal funds for social services programs
DHSS AGENCY GENERAL FUND TOTAL	292,591.5	305,131.5	342,031.3	374,047.3	410,450.8	450,721.4	
MILITARY AND VETERANS AFFAIRS							
National Guard Retirement Benefits	1,104.4	1,104.4	1,104.4	1,104.4	1,104.4	1,104.4	Assumes stability in National Guard and accuracy of actuarial estimates
FORMULA PROGRAM TOTAL OF	1,288,240.9	1,222,878.8	1,281,388.2	1,294,888.7	1,342,889.3	1,389,211.3	
FORMULA PROGRAM TOTAL FUNDS	1,527,757.1	1,565,490.3	1,631,459.6	1,715,557.9	1,810,551.1	1,913,888.3	Includes federal and other funds

Some Issues Relating to Base Case Projections

Debt Policy Issues

The state, agencies such as Alaska Housing Finance Corporation (AHFC) and Alaska Industrial Development and Export Authority (AIDEA), and municipalities in Alaska sell bonds in the national financial markets. In general, the credit rating for these bonds will be higher and the interest rate will be lower, and the national financial markets will respond more positively to the issuance of Alaska public debt if a comprehensive long range plan has been adopted and is being implemented.

Bond Funding of State Capital Expenditures

- Forty-one states issue general obligation debt to fund capital expenditures.
- General obligation bonds are the least costly type of debt financing for a state.
- Issuance of general obligation debt requires approval of the voters of the state.
- About \$1.4 billion of Alaska G.O. bonds were issued between 1958 and 1984, when the last bond issue was made. Currently outstanding G.O. bonds total \$58 million.

Debt Maturity Policy and Debt Capacity

- The computation of state debt capacity includes the annual debt service on all state G.O. and state-supported debt (e.g., school construction debt).
- The general guideline followed by rating agencies is that debt service payments should not exceed 5% of revenues to maintain a AA rating, although Alaska has exceeded this guideline in the past.
- Past policy has been generally to restrict maturities to the Prudhoe Bay revenue curve.
- The credit rating services have insisted on this debt maturity policy in order to maintain the State's AA bond rating.
- Debt maturities could be extended beyond the Prudhoe curve if new sustainable revenues are implemented by the State.
- Table 4 shows that under the 5% guideline, the state will not be able to issue any new debt until FY 97.

Table 4

DEBT SERVICE PROJECTION FY 95 - 2005Includes only debt issued as of 4/95
(\$ Millions)

TYPE OF DEBT	FY 95	FY 96	FY 97	FY 98	FY 99	FY 2000	FY 01	FY 02	FY 03	FY 04	FY 05
Lease/Finance											
Alaska State Housing Authority	1.5										
Spring Creek		4.2	4.2	4.2	4.1	4.2					
Seward Student Ctr.		0.7	0.7	0.7	0.7	0.7					
Palmer Courthouse		0.4	0.4	0.4	0.4	0.4					
Kenai Courthouse		0.6	0.6	0.6	0.6	0.6					
Wildwood Aquisition		1.0	1.0	1.0	1.0	1.0					
Wildwood Improvements		1.0	1.0	1.0	1.0						
Court Plaza		1.0	1.0	1.0	1.0	1.0					
Anchorage Times		0.8	0.8	0.8	0.8	0.8					
Total Lease/Finance	10.2	9.6	9.5	9.5	9.5	8.6	6.4	5.9	5.9	4.9	4.1
State General Obligation	22.9	21.3	16.5	14.2	8.8	2.4					
School Debt - State Portion	103.3	79.1	54.8	52.0	49.5	39.6	26.8	14.4	10.4	10.1	10.1
University - State Supported	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Total Debt Service	136.6	110.2	81.1	75.9	68.0	50.8	33.4	20.5	16.5	15.2	14.4
Remaining Debt Capacity											
- At 5% of GF Revenues	0.0	0.0	27.5	51.4	61.0	131.7	104.9	66.5	22.5	5.6	0.6
- At 8%	101.2	135.6	102.4	64.8	68.0	135.7	108.5	62.4	22.4	4.5	0.0

Capital Spending

- Historically, the capital budget has been the most volatile element in state spending.
- During the oil revenues era, the general fund capital budget has varied from \$92 million in FY 80 to \$1.2 billion in FY 85. It was \$100.4 million in FY 95.
- During the past 17 fiscal years, the average Alaska general fund capital budget has been \$436 million.
- There are a number of large segments of the state's capital spending plans that have acted as a floor for a minimal level of capital spending totaling perhaps \$125 million. These are:
 - The school construction funding priority list – \$25 million;
 - Local sanitation construction priority list – \$40 million;
 - Municipal and unincorporated community matching grants – \$20 million;
 - Transportation funding to match federal dollars – \$40 million.
- During the past several years, much of the capital budget has become depoliticized and disbursed according to objective criteria and priority lists.

(Note that the figures presented in Table 5 are for illustrative purposes only – to show conceptually how capital spending is prioritized by category. At this writing the capital budget is a moving target. The actual capital budget passed by the Legislature is likely to be significantly different than what is presented below. Also the amount presented herein does not correspond to that shown in the Base Case due to differing funding source definitions.)

Table 5
FY 96 Capital Projects Proposed by Governor
(\$ thousands)

Category	General Funds	Federal and Federal/Other Funds	Total
Education (K - 12 and University)	27,257.1	1,540.0	28,797.1
Social Services		72,563.3	72,563.3
Health and Safety	44,141.0	30,353.0	74,494.0
Natural Resource Management and Environmental Conservation	5,150.0	7,678.9	12,828.9
Public Protection		1,700.0	1,700.0
Administration of Justice	13,967.2	8,880.0	22,847.2
Economic Development	2,163.0	16,600.0	18,763.0
Transportation	40,800.0	343,103.0	383,903.0
General Government	3,586.5	5,179.7	8,766.2
Capital Matching Grants for Communities	20,000.0		20,000
 Grand Total	 157,064.8	 487,597	 644,662.7

Operation and Maintenance Costs of Alaska's Public Infrastructure

The complete cost of maintaining public infrastructure is not included in the Base Case projections provided to the Commission. However, a good argument could be made that unfunded or deferred maintenance is a cost to the public that ought to be included as part of the "true fiscal gap."

Public Buildings

As of the end of FY 94, Alaska's public buildings were valued at \$2.9 billion. The true cost of maintaining our 1,805 public buildings is \$64 million per year, as enumerated in Table 6. Several issues related to maintaining public infrastructure are discussed below:

Operations Costs

- Operations costs are fixed costs associated with the day to day operation of a public facility. Personnel costs, utilities, janitorial, grounds maintenance and risk management fees are basic costs of operations and are funded as such in each agency's budget.

- Operational expenses generally take precedence over other expenses. However, maintenance and repair and renewal and replacement costs are just as tangible in the life cycle of public buildings but are often not adequately funded.

Routine Maintenance and Repair

- Routine maintenance is the day-to-day scheduled and preventative maintenance required to keep buildings operational and in a continual state of readiness. Minor repair is also included in this category.
- Routine maintenance costs for Alaska's public buildings is estimated at \$35 million per year.
- The average age of Alaska's public buildings is 23 years old; many of the facilities built during the 80s boom years are now reaching the expensive stage of their useful life.

Renewal and Replacement

- Renewal and replacement covers the scheduled replacement of worn out major building components and the retrofitting or replacement of obsolete or inefficient building systems. Upgrading to current codes is also included in this category. Renewal and replacement funding maintains and in some instances extends the useful life of facilities.
- Renewal and replacement costs for Alaska's public buildings is estimated at \$29 million.

Deferred Maintenance

- Institutions do not normally program for deferred maintenance but it becomes a fact of life when annual resources are not sufficient to complete the work required to keep facilities in optimal condition.
- Over the long term, it is much less costly to maintain facilities than to let them deteriorate to the point where it is not cost effective to keep them operational and new construction is required. Thus deferred maintenance is a real measure of the cost of neglect.
- The deferred maintenance backlog is estimated at \$251 million.

Table 6
Facilities Maintenance Model

Agency	No. of Bldgs.	Square Feet	Average Age	Replacement Value	(1) Maintenance & Repair	(2) Renewal & Replacement	Required O & M, Repair & Replace Budget	Deferred Maintenance Backlog	Percent of Replacement Value
Courts	11	64,087	19.5	102,285,829	1,534,287	1,173,279	2,707,566	1,755,300	1.7%
DCED	12	16,970	11.8	3,108,015	46,620	21,573	68,194	0	0.0%
ADFG	304	518,785	24.1	104,183,442	1,562,752	1,476,954	3,039,705	3,702,000	3.6%
DHSS	36	538,779	16.0	203,939,469	3,059,092	1,919,430	4,978,522	13,552,500	6.6%
DMVA	82	593,598	23.8	82,999,492	1,244,992	1,152,228	2,397,221	2,905,952	3.5%
DNR	151	288,938	22.8	23,627,196	354,408	316,882	671,290	2,860,100	12.5%
DOA	12	492,327	21.2	118,580,047	1,778,701	1,478,763	3,257,464	9,838,300	8.3%
DOC	82	1,034,379	17.0	320,740,575	4,811,109	3,207,406	8,018,514	12,365,000	3.9%
DOE	28	380,909	33.5	63,626,885	954,403	1,253,824	2,208,227	4,500,000	7.1%
DOT/PF	651	2,461,945	21.6	357,181,516	5,357,723	4,538,306	9,896,029	44,281,000	12.4%
DPS	62	270,259	19.9	76,102,155	1,141,532	890,843	2,032,375	1,199,900	1.6%
Legislature	2	118,540	46.0	32,815,230	492,228	887,942	1,380,170	385,000	1.2%
University	372	4,860,691	21.8	847,542,799	12,713,142	10,868,490	23,581,632	153,923,585	18.2%
Total	1,805	11,640,207	23.0	\$2,336,732,650	\$35,050,990	\$29,185,920	\$64,236,909	\$251,368,637	10.8%

Notes: (1) Association of Physical Plant Administrators Formula = $0.015 \times \text{Replacement Value}$.
(2) Modified Sherman - Dergis Formula = $0.75 \times \text{Replacement Value} \times \text{Age} / 1,275$.

Source: "Alaska's State Owned Buildings: An Inventory and Assessment," U of A Statewide Facilities Office, February 1995.

Alaska's Transportation Network: Highways, Airports, Harbors and Ferries

The state maintains 16,715 miles of public roads, 258 airports, 97 harbor facilities and 8 ferries. The state equipment fleet maintains 6,500 vehicles with an annual maintenance budget of \$20.2 million. Deterioration of the state's transportation network due to underfunding of annual maintenance is a significant cost to the economy. Standard engineering estimates provide the basis for the table below. These estimates are for facilities maintained by the state only – municipalities are responsible for maintenance of some portions of the road system, a few airports and several harbors, while the two international airports in Anchorage and Fairbanks have their own program receipts funding.

- Alaska is a growing state with massive infrastructure needs. The fundamental problem is to strike a sustainable balance in our capital and maintenance spending that allows for upkeep of existing infrastructure while continuing to build to support a growing economy.
- Experience has shown that when maintenance of public infrastructure is neglected for a period of years, political pressure builds and the result is likely to be a very large capital spending spree when revenues become available as was the case in FY 94 when \$606 million in state general funds was spent on capital projects, much of it to address deferred maintenance needs.

Table 7
DOTPF Estimated Maintenance Needs
(\$ thousands)

	Highways	Aviation	Harbors	Ferries	Total
Current M & O Funding	57,000	16,200	100	28,397	101,697
Additional Annual M & O Needed to Properly Maintain the System	16,000	4,500	4,000	2,603	27,103
Total Annual M & O Needed	73,000	20,700	4,100	31,000	128,800
Capital Infusion Needed to Eliminate Deferred Maintenance Backlog	30,000	12,000	30,000	8,000	80,000

Cash Flow Considerations

Cash flow is defined as the daily receipt and disbursement of cash into and out of the state's general fund. There is a distinction between the state's cash flow and its annual budget. That is, there is usually a timing difference between cash receipts and cash disbursements during any day, month or year even if the budget is balanced over the entire year.

Why is Cash Flow a Problem?

- The timing of cash receipts is fairly even over the year, based on oil revenue receipts. However, the timing of cash disbursements varies within each month and seasonally.
- Over the past five years, disbursements exceeded revenues by an average of \$340 million during the first quarter of each year due to the timing of the disbursal of state grants and capital expenditures.
- Capital expenditures, approved in one year, typically have a multi-year cash expenditures pattern. This is a particular problem for large spikes in capital spending as in FY 94, which is still affecting the state's first quarter cash flow.
- The state's general fund cash balance has been depleted because of continued budget deficits.
- Additionally, there has been a tremendous growth of separate funds created by statute, which means that previous pools of available cash are no longer available in the general fund.
- The implication for reserves policy is that not only does the state need to maintain a reasonable balance of liquid reserves to deal with potential oil price fluctuations, it also must take cash flow considerations into account. (A more detailed discussion of reserves policy is included in the "Tools" section.)
 - For example, adopting a reserves policy to protect against a \$3/bbl. swing in the annual average price of oil would require about a \$450 million minimum balance in liquid reserves;
 - An additional \$350 million cushion might be needed to accommodate an anticipated first quarter cash flow bulge;
 - Added together these requirements would argue for an \$800 million minimum liquid reserve balance to meet potential contingencies.

- Possible alternatives to maintaining a large liquid reserve balance include:
 - Short-term borrowing from the CBR (as long as it lasts);
 - Short-term borrowing from the Permanent Fund Earnings Reserve Account (ERA);
 - Short-term borrowing from the commercial market, through sale of taxable notes;
 - Short-term borrowing from the municipal market, on a tax-exempt basis; (This alternative is available only if there are no other state funds available for appropriation.)
 - Permanent infusion of cash into the general fund (from the CBRF, ERA, sale of state assets, etc.).

Forward Funding / Cash-Based Budgeting

Forward funding has been proposed and debated in Alaska state government for the better part of fifteen years. The concept — also known as cash-based budgeting — has been advocated as a means to add stability and certainty to the state budget process. As the term cash-based budgeting suggests, under this system some (e.g., education) or all of the state budget would be based on cash on hand, rather than on projected revenues during the coming year.

Prior proposals to adopt cash-based budgeting have not been able to overcome concerns about whether the gain in budgeting certainty is worth the opportunity cost of the revenue or reserves that must be diverted to achieve that certainty. There is also a question of whether budgeting certainty and fiscal stability can be equally or better achieved through the use of reserve funds, spending limits, and other such fiscal mechanisms.

Key Policy Issues

- Cash-based budgeting is particularly attractive for Alaska because of the exceptional dependence of our state revenues on the price of a single commodity — oil. While the revenues of other states are subject to some volatility — primarily from changes in economic conditions — and numerous states have faced large revenue shortfalls in recent years, no other state has consistently experienced the range of revenue fluctuations which Alaska has since Prudhoe Bay came on line in 1977.

- Adopting cash-based budgeting would not stabilize annual revenues. However, it would enable policy makers to know, with a high degree of certainty, just how much money will be on hand for the coming year's budget.⁴
- Under cash-based budgeting, a sharp drop in oil prices would still result in a sharp decline in state revenues, but no revenue shortfall would occur in the current year budget. The shortfall would need to be addressed in the next year's budget, but mid-year spending cuts would not be necessary, giving the Governor and Legislature more time to address the problem.
- The state now has a window of opportunity to implement cash-based budgeting, in that the combined cash reserves in the Constitutional Budget Reserve and the Permanent Fund Earnings Reserve Account total over \$3 billion — more than enough to adopt cash-based budgeting.
- The advantages of cash-based budgeting are clear. The major factor which argues against the approach is the high cost to implement it — approximately \$2.5 billion would have to be designated and held in reserve to implement the approach. It can be argued that this \$2.5 billion would not have to be "spent" to adopt cash-based budgeting; instead, it would be held in a reserve fund similar to the Constitutional Budget Reserve. However, the money would still be unavailable for other purposes, such as cushioning the state's fiscal gap or inflation-proofing the Permanent Fund.
- Although cash-based budgeting could provide budget stability and certainty for the next year's budget by postponing the effect of revenue shortfalls, it could limit the state's ability to offset these shortfalls and to cushion the fiscal gap, because most of the state's liquid reserves would have to be used to implement cash based budgeting. In this respect, cash-based budgeting could increase, rather than reduce, the impacts of the fiscal gap, and accelerate the need for spending cuts, new taxes, and other measures.

⁴It would still be necessary to project the revenue to be received between the time the Legislature was meeting and the end of the current fiscal year. Such remaining-months projections, however, have generally been within 3% of the amount actually received through June 30.

Use of Fiscal Tools

Every fiscal policy forum of the past several years has concluded that all of the available fiscal tools described in the following sections will have to be employed at some point to deal with the fiscal gap outlined in the Base Case section.

Spending Reductions

In some ways the spending reduction issue may be the hardest for the Commission to grapple with. Previous economic and fiscal summits have agreed that the public must be convinced adequate spending cuts have been made before moving on to the next step in addressing the state's long-term fiscal situation. However, the Finance Committees in the Legislature have been wrestling with the intricacies of cutting state programs for a decade. The past three administrations have made serious efforts at setting public service priorities and improving the efficiency of government operations. The Knowles administration will be conducting a thorough review of executive branch operations during the interim before the 1996 legislative session to identify areas for streamlining and set performance budgeting goals for agencies. In spite of all of this effort, we have yet to work through the "cut government cloud" and on to a path towards sustainability.

Key Considerations

- The size and shape of government is ultimately a political decision that will be decided in the political arena. The Commission may want to focus on what it can do to further that dialogue rather than setting specific targets or suggesting programs that ought to be modified or eliminated.
- Currently state spending supports nearly one third of total jobs in the economy, 25% of private sector jobs and half of local government jobs. The commission may want to address the question of budget reductions from the perspective of the presence of government in the economy.
- During the past decade, state spending has been minutely examined from virtually every conceivable angle to conceptually screen out nonessential programs. (See *The Difficulty of Defining Basic Services* in Appendix I.) Given this level of scrutiny, instead of applying its own screening process the Commission may want to:
 - define principles and guidelines for how to approach budget reductions;
 - set goals for where the state ought to be in 3, 5 or 10 years in terms of per capita spending for certain kinds of services or some other agreed upon measure(s).

Key Questions

- How do we know when the budget has been cut enough?
- Is there an optimal level of government spending or just a continual controversy?

Another approach the Commission might take is to leave the setting of the size and shape of government to our political institutions and instead concentrate on the sequence and timing of the use of the remaining fiscal tools relative to some spending level indicator. For example the Commission might recommend that when reserves fall below a certain amount, that a tax or some other fiscal tool be employed.

Should the commission wish to take a more detailed approach to budget reductions, several observations from previous forums might apply:

- Targets must be realistic.
- Major revamping of state work processes can probably yield further savings but the easy cuts have long since been made.
- Ideas such as regulatory reform and/or restructuring agencies may increase government efficiency over the long term but may not yield substantial spending reductions as long as government is required to perform all of the functions it is currently required by law to do.
- Economic impacts, distributional effects, long-term social consequences and fairness to the groups or individuals who will bear the brunt of cuts must be considered.
- Across the board cuts or "unallocated reductions" should be avoided because they just make all of government less efficient.
- State agency operations have absorbed the lion's share of budget cuts during the past five years – 24% in nominal terms and 32% in inflation adjusted terms. (A few formula programs have taken major cuts, e.g., municipal assistance and revenue sharing have been cut over 55% during the past 10 years.)
- Eliminating programs and/or pruning functions is a better approach than across-the-board percentage reductions.
- Formula programs continue to be the main engine of growth in operations spending and offer the greatest opportunity for controlling long-term costs.
- Adding a means test to entitlement programs with broad eligibility requirements is often cited in fiscal policy forums as a legitimate approach to cost cutting.

- **Nontraditional or unique Alaska programs should be a high priority to review for possible elimination or modification (see following table).**
- **Are there lines of business that the state no longer needs to be in?**
 - **Are there state functions we might pass on to local governments?**
 - **Opportunities for privatization?**
- **In addition to the above, several different screens might be applied to help determine the proper size and shape of government for the future:**
 - **Identify current functions and requirements in terms of broad program areas, e.g., public health, economic development, etc.**
 - **Set priorities within each program area.**
 - **Identify those that are the most expensive and fastest growing.**
 - **Which are required by constitution, state statutes and/or regulations, federal requirements or state policies?**
 - **What are the state's high "value added" functions?**
 - **Another screen to apply would be to compare average per capita spending in other states with Alaska and then look at functions to cut or eliminate where the cost of providing a particular service exceeds the overall ratio.**
- **Another way of determining the proper size and shape of government is to think of it in terms of goals for the future – where the state should be and what government should be doing differently in 2005 or 2020.**
 - **Real world benchmarks (e.g., high school graduation rate, percentage of preschool children receiving inoculations, etc.) provide a means of determining how well government is doing in fulfilling priority functions and achieving goals.**
 - **Performance measures of the effectiveness of programs in achieving benchmarks can help determine the appropriate level of resources needed to realize the state's goals (e.g., dollars spent vs. progress made).**

Table 8

Unique Alaska Programs FY 95 Appropriations

(\$ thousands)

School Debt Reimbursement	103,300
Longevity Bonus Program	73,410
Municipal Assistance	33,925
Pioneer's Homes	30,039
UA Outreach Colleges	18,429
PF Dividend Hold Harmless	21,955
Power Cost Equalization	18,635
Permanent Fund Corporation	27,458
Tourism Marketing Council	4,993
PF Dividend Administration	4,467
Mt. Edgecumbe Boarding School	2,212
Contract Jails	4,445
Longevity Bonus Hold Harmless	66
Subsistence Division	1,692
RATNET	1,190
 General Fund Subtotal	 \$346,216
 Permanent Fund Dividends	 \$585,000
 Grand Total	 \$931,216

•Note these are programs that are either only found in Alaska or are funded by state general funds to an extraordinary degree when compared to other states.

Potential New Taxes

The Department of Revenue is conducting a comprehensive review of current and potential taxes which will be completed by late June and will be presented to the Commission at the August 26 meeting. (A schedule of current taxes and their yields along with a summary list of potential taxes was provided to members in the Hickel summit workbook.) For purposes of the initial work session, a brief update of information on general tax measures affecting individuals and households is provided. The intent is to provide some guidance for thinking about particular tax instruments.

General Tax Measures Key Issues

Alaska is one of 7 states with no personal income tax and one of 5 with no sales tax. It is the only state with neither. With fiscal projections indicating a large and increasing structural deficit, with limited expectations of future lump sum oil tax and royalty settlements, policy makers are going to have to consider additional revenue sources.

Considerations for evaluating general tax measures include:

- equity of application (does it apply to everyone?);
- fairness in terms of ability to pay;
- incidence of taxation (who actually pays), particularly the ability to tax nonresident visitors and workers;
- social and economic impacts;
- and, ease of administration and potential for realizing administrative efficiencies by piggy-backing state and local taxes.

Personal Income Tax \$75 million first year; \$250 – \$400 million/yr. thereafter

- Forty-three states have personal income taxes; rates vary from 0.4% to 11% of taxable income, with two states applying it as a percentage of federal tax liability.
- Among the various states, the personal income tax is employed second only to the general sales tax as a revenue source, accounting for about 30% of total state revenues.
- The amount generated depends on the rate at which it is applied and the number of adjustments and credits allowed.
- Prior to repeal in 1980, Alaska's personal income tax was based on the adjusted gross income (AGI) computed on each individual's federal tax form. A person's AGI was taxed on a sliding scale ranging from 3 – 14.5%.

- Our ability to accurately project personal income tax revenues has atrophied since repeal. DOR is examining the cost of developing a model to provide reasonable estimates of varying personal income tax proposals.
- As a taxing instrument, the personal income tax has four basic advantages:
 - It is the only major state tax that is progressive, i.e., is applied according to ability to pay.
 - It is deductible from each individual's federal income tax, thus placing part of the burden on the federal government.
 - Its revenue tends to rise faster than the growth of the economy.
 - It would capture a portion of the earnings of nonresidents working in Alaska.
- The personal income tax has four main disadvantages:
 - Its revenue stream tends to be relatively volatile.
 - It is less popular among voters than a sales tax.
 - It taxes earnings rather than consumption, thus providing no incentive for savings.
 - Because of the number of total returns, it is relatively more expensive to administer than a sales tax.⁵

Statewide Sales Tax

1% = \$50 million; 6% = \$216 million/yr.⁶

- Forty-five states have sales taxes with rates ranging from 3.5% to 8%; the median tax rate is 5%.
- State sales taxes provide nearly one third of general revenues raised by state governments.
- A comprehensive sales tax is more regressive than an income tax because it applies equally to consumption by people at all income levels, i.e., poor people spend a larger share of their income on purchases of goods and services and therefore pay a greater proportion of their income in tax.

⁵For example Montana spends about 1.2% of revenues to administer an income tax – revenues total about \$350 million per year with an administrative budget of \$4.2 million and 100 employees.

⁶The 6% rate is used instead of the median national rate because ISER had an already developed estimate of the tax yield. There is some elasticity to sales tax receipts, i.e., as the percentage rate increases revenues increase at a slower rate.

- To reduce the regressive nature of the sales tax, 28 states exempt food purchases; 43 states exempt prescription drugs; 32 states exempt at least some natural gas, heating fuel and/or electric utility payments; five states exempt clothing purchases; and four states allow sales taxes to be credited against state income taxes. Only three states have comprehensive sales taxes on all personal and professional services.
- Sales taxes have traditionally been supported by the higher income proportion of the population when the alternative is increased income or property tax. In fact, the sales tax is the most popular of the general taxes on the population, probably because it is paid a little at a time and is less noticeable than income or property taxes.
- The sales tax has several advantages:
 - It is not particularly costly or difficult to administer with many fewer returns to deal with than an income tax.⁷
 - Many states with both state and local general sales taxes gain administrative efficiency by piggybacking local tax collection onto the state tax system.
 - Piggybacking may provide some incentive for communities to develop their own tax bases or to incorporate.
 - It can be designed so that revenue grows in direct proportion to the economy.
 - It is relatively popular with voters.
 - It captures revenues from nonresidents (but not very efficiently).
 - It taxes consumption and does not affect savings.
- The sales tax also has a few disadvantages:
 - It is regressive in terms of taxing citizens according to their ability to pay.
 - Depending on the number of exemptions – if applied too narrowly, the sales tax is relatively volatile, with revenues falling sharply in recessions.
 - The sales tax is not deductible from federal income tax.

⁷Montana recently introduced a 4% sales tax in its Legislature that was expected to generate \$275 – \$290 million with monthly collections amounting to 800,000 returns and an administrative cost of 1.8% of collections. Quarterly collections would require less paperwork.

Employment Tax

\$100 per job = \$40 – \$50 million per year

- The employment tax could be applied all persons age 19 and older holding a job, whether employed by others or self-employed, similar to the old "school tax" which was repealed in 1980.
- About 25% of the total tax collections would come from nonresidents working in Alaska (estimate by DOL for Hickel proposal).
- Collection of the employment tax could be streamlined by linking the collection of the tax for employees with other payroll taxes collected by the state.
- Self-employed persons could be billed through their business or commercial fishing license application file.
- The main drawback to the employment tax is that it is regressive. However, because of the modest amount of the tax, a person working at a \$5 per hour job would pay less than one percent of their annual income in employment tax.
- The regressive nature of the tax could be offset by spreading the collection of the tax over more than one paycheck.

Statewide Property Tax

One mill = about \$28 million per year

- Projected oil and gas property tax collections for FY 95 total \$319 million, of which, all but \$64 million was passed through to municipalities.
- The full and true value of petroleum facilities statewide is estimated at \$16 billion, while all property within organized municipalities is estimated at \$28 billion (petroleum facilities excluded).
- Property values within organized municipalities are well known but estimates for communities within the unorganized borough are highly speculative.
- The disparity in property wealth among communities in the state ranges from \$4,395 per capita in Point Hope to \$1.4 million in the North Slope Borough.
- Except for oil and gas property, much of the property in the unorganized borough is exempt from taxation because it is comprised of Native allotments under ANCSA – there is very little cash economy in the bush to support a property tax.
- Administration of property taxes is a very labor intensive business and the amount of effort that would be needed to equitably administer a statewide property tax would be considerable.
- Very few states have comprehensive statewide property taxes though several have centralized assessment and collection of taxes on certain types of property, similar to our oil and gas property tax. Several municipalities have approached

the state assessor's office about the possibility of centralized assessment and collection of property tax on airplanes and boats.

Economic Development as a Revenue Generating Tool

All of the previous fiscal policy summits have recognized that economic development will play some undefined role in generating additional future state revenues. Work for the Hickel summits (updated in table below) demonstrated that at current rates, revenue generated from direct taxation of non-petroleum businesses could play a significant role in balancing revenues with expenditures during the next 10 years. However, all previous fiscal policy forums have concluded that it is not possible for the state to simply grow out of the current fiscal gap.

Key Issues from Other Forums

- The official Department of Revenue position is that while lifting the export ban is a very real near term possibility, the TAGS project and development of ANWR are unlikely to occur within the commission's ten year time horizon. (Potential revenues from the Gasline, ANWR and lifting the export ban are dealt with specifically in Appendix II.)
- More information on the potential uses of North Slope natural gas will become available in early June, when the major producers are due to release the findings of a cooperative study of gas alternatives.
- Other fiscal policy forums have acknowledged that the state has chosen to take its return on the development of public resources (other than oil) in the form of private sector jobs and profits rather than public revenues.
- Several forums have noted that it often costs more to support, manage and regulate our natural resource industries than they return to the state in the form of general fund revenues.
- Virtually every other fiscal policy forum has concluded that indirect taxation of income, payroll and/or consumption are more appropriate means of collecting state revenues from most kinds of economic development than additional direct taxes on businesses.

Potential Policy Issues

- What weight should be given to potential economic development revenues in the state's long-term fiscal strategy?
- From a fiscal policy perspective, what is state government's role in promoting economic development? Possibilities might include:
 - expanding and diversifying the tax base;

- providing a positive business climate;
 - allowing tax credits and exemptions;
 - offering subsidies to certain industries or businesses;
 - generic promotion, e.g., ASMI, Tourism Marketing Council, etc.;
 - disseminating information and/or providing market research for business;
 - providing or facilitating financing;
 - other?
- What role, if any, should future state and local revenue generation play in forming the state's economic development policy?

Table 9

**Potential Additional Economic Development Revenues
(in millions of FY 95 \$)**

	FY 96	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05
Speculative										
Lift Export Ban	80.0	40.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Optimistic										
Mining	1.0	7.6	9.8	12.0	13.1	14.4	15.8	17.4	19.2	21.1
Timber	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Seafood	1.9	1.9	2.0	2.1	2.2	2.3	2.4	2.5	2.6	2.7
Tourism	2.6	2.7	2.9	3.1	3.2	3.4	3.6	3.9	4.1	4.3
Other	26.6	30.9	33.4	36.1	38.9	42.1	45.4	49.1	53.0	57.2
Total	114.1	83.2	68.1	73.3	77.5	82.2	87.3	92.8	98.8	105.3

Assumptions: Export ban lifted in FY 96 with later revenues corresponding to forecast of West Coast crude surplus.
Mining—all projects currently in the development stage go into production by 2000, with revenue from additional projects increasing at a real rate of 10% per year thereafter.
Timber—FY 95 revenues of \$400,000 projected to grow at the 10 yr. real industry average of 6%.
Seafood—FY 95 revenues (net of pass thrus) = \$44 million. Growth occurs at 10 yr. real average of 4%.
Tourism—FY 95 revenues estimated at \$40.4 million with visitor growth increasing at 6% per yr.
Other—FY 95 nonpetroleum revenues=\$331.3 million projected to increase at 10 yr. real rate of nonpetroleum GSP growth (8%).

Reserve Funds

Key Policy Issues

Alaska is fortunate to have over \$3 billion in liquid reserve funds and additional less liquid reserves and assets. These substantial reserves constitute one of the primary fiscal tools which the state can, and has used, to temporarily fill the fiscal gap. However, these large reserve balances also have a negative side, in that these reserves can delay the difficult actions necessary to close the fiscal gap for several more years, with the potential for suddenly magnifying the state's fiscal and economic problems when the reserves are finally exhausted.

One of the major policy issues facing the Commission is what role these reserve funds should play over the next several years in creating a stable fiscal future for the state.

Potential roles and uses of reserve funds include:

1. Use reserves to offset current budget shortfalls, thereby postponing the impacts of the fiscal gap and buying time to develop and implement fiscal solutions;
2. Minimize the current use of reserves, in order to maintain substantial reserves for offsetting even larger budget shortfalls which may occur in the future, and to cushion the state's adjustment to lower petroleum revenues;
3. Deposit all or some reserves into the Permanent Fund to increase sustainable long-term revenues;
4. Use reserves to establish forward funding for the state budget; and,
5. Maintain a minimum level of reserves as insurance against oil price volatility, and to meet cash flow requirements.

Additional policy questions regarding the use of reserve funds include:

1. In what priority should reserve funds be used, relative to other fiscal tools such as spending reductions, tax increases, and permanent fund earnings?
2. Should the state use only its liquid reserves in dealing with the fiscal gap, or should the state consider using some of the assets of state corporations such as the Alaska Housing Finance Corporation, the Alaska Industrial Development and Export Authority, and the Alaska Energy Authority?
3. If it is desirable for the state to maintain a minimum level of reserves to guard against sharp declines in oil prices, what is the appropriate level of reserves for this purpose?
4. Can major reductions in state services or increases in revenues be justified to the public while the state still has substantial liquid reserves?

Current and Past Use of Reserve Funds

In the current fiscal year — FY 95 — the state will spend about \$240 million in reserves to balance the budget. For FY 96, the state is projected to spend about \$573 million in reserves. The predominant use of reserve funds during the last several years has been to offset current-year budget shortfalls. However, it would not be accurate to say that spending reserve funds has been the state's only response to the fiscal gap. For example, since FY 90, state agency budgets have been cut by 24 percent in nominal dollars and 32 percent in real dollars (adjusted for inflation).

During the past ten years, the State of Alaska has used reserve funds in four of the five roles outlined above (forward funding is the exception).

The option of depositing reserves in the principal of the Permanent Fund is under consideration by the legislature as this is being written. SB 84, which was passed by the Senate in March, would transfer about \$900 million from the Permanent Fund earnings reserve account to the principal of the fund. This action would have the effect of increasing the long-term real earnings of the Fund by about \$45-55 million per year (in comparison to spending this \$900 million for another purpose).

Table 10
State of Alaska Fund Balances

(millions of dollars)

Fund	Amount	Notes
Constitutional Budget Reserve Fund	1,965.3	Projected balance as of June 30, 1995. This projected balance includes fund receipts through 5/1/95. Additional deposits of \$350 million will be made to the fund in both FY 96 and FY 97 under the 1994 BP settlement. Purpose of the fund is to save "windfall" revenues, and to offset annual revenue fluctuations and cushion longer term declines in revenues. Impact of spending from the fund is to reduce the state's ability to offset future revenue shortfalls.
Permanent Fund Earnings Reserve Account	1,148.0	Projected balance as of June 30, 1995 from the March 31 financial statements of the Alaska Permanent Fund Corporation. Purpose of the ERA is to offset potential future shortfalls in funds available for inflation-proofing the Permanent Fund. Impact of spending from the ERA is to potentially create a shortfall in inflation-proofing funds. However, this will depend on future earnings of the Permanent Fund and the impact is uncertain.
Science and Technology Endowment Fund	101.0	Purpose of the Science and Technology endowment is to finance development and commercialization of new technologies. Impact of spending part of all of the endowment would be to reduce or eliminate the scope of the program.
Alaska Housing Finance Corporation (AHFC)	445.0	This figure is an estimate by the Division of Legislative Audit of the amount that could be transferred from AHFC to the state's general fund as bond issues are paid off. The Division estimated that \$295 million could be transferred in FY 96, and an additional \$150 million could be transferred in FY 97. The purpose of AHFC's assets is to reduce the cost of home mortgages and to finance low-income housing. Spending these funds may reduce AHFC's ability to perform these functions.
Alaska Industrial Development and Export Authority (AIDEA)	17.0	AIDEA's estimate of its unrestricted assets. The purpose of AIDEA's assets is to finance industrial and commercial development. Spending these funds may reduce AIDEA's ability to finance new projects.

Permanent Fund Policy Issues

Key Issues

- What role should the Permanent Fund play in closing the fiscal gap?
- When should it be used, relative to other fiscal tools?
- What options for use of fund earnings should be considered?
- How much can the Permanent Fund contribute to closing the fiscal gap?

Possible Roles Of The Permanent Fund

- Treat the Fund as an integral part of the State's operative fiscal strategy.
- Treat the Fund separately from fiscal policy; e.g., as an ultimate insurance policy to protect against fiscal calamity, etc.
- Allow the Fund to grow until it is large enough to help finance state government at an "acceptable" or "sustainable" level.
- Other roles, or combination of roles.

Purpose?

- To pay out dividends to Alaskans.
- To save money for a "rainy day".
- To help pay for state government programs and services.
- To help develop Alaska's economy.
- To help "wean" state government from its dependence on volatile petroleum revenues; e.g., as Kuwait did.
- Other purposes, or combinations of purposes.

Timing Of Use

- Start using it now to help close the fiscal gap.
- Use it only under a defined set of circumstances; e.g., as part of a fiscal contingency plan, etc.
- Do not use it until absolutely necessary, whenever that is; i.e., as a "pot of last resort".

- "Schedule" its use as an integral part of a short-term/long-term fiscal plan.
- Use it only after FY 2000; i.e., when the fiscal gap is the greatest.
- Use it only after certain other fiscal steps have been taken; e.g., only after budget reductions have been made and/or a personal income tax has been adopted, etc.
- Other timing considerations or approaches, or combinations of them.

Fiscal Options For Using The Fund

- Use the Earnings Reserve Account balance to help support the budget.
- Re-invest the Earnings Reserve Account balance into the Fund, in order to stimulate the Fund's long-term growth.
- Limit the amount paid out as dividends to the real earnings of the Fund; i.e., the amount of earnings in excess of the rate of inflation.
- Make inflation-proofing the first priority use of the Fund's income, instead of dividends; i.e., to ensure the long-term value and earnings potential of the Fund.
- Reduce, cap or eliminate dividends and use the revenue generated to help support the budget.
- Reduce, cap or eliminate dividends and re-invest the generated revenue in the Fund for "X" years, in order to stimulate the Fund's long-term growth.
- Reduce, cap or eliminate inflation-proofing. (Or, conversely, provide for cumulative inflation-proofing, to make up for years when inflation-proofing deposits have been insufficient.)
- Decrease (or increase) the current stream of revenues dedicated to the Fund.
- Use a portion of the Fund's income for economic development projects; e.g., via the Alaska Industrial Development and Export Authority (AIDEA).
- Channel all state government revenue (dedicated and non-dedicated) through the Fund, and annually finance state government via a percentage of the Fund's overall market value (the "Cremo plan").
- Other fiscal options for using the Fund, or combination of options.

Permanent Fund Questions and Issues

USES AND EFFECTS At least from one perspective, the Permanent Fund consists of four potential "pots" or sources of funds:

- "Earnings Reserve Account balance"
- "Dividend Funds"
- "Inflation-Proofing Funds"
- "Principal"

What are the trade-offs (e.g., on Fund growth, on Fund value, on dividend amounts, on amounts available for general fund purposes, etc.) in taking money from one "pot" versus another, or any given combination of them?

RISK/ PREDICTABILITY

Managing investments more aggressively, in order to increase the Fund's rate of return, will entail accepting higher levels of risk than at present. While the expected higher return may be achieved over a given period, the effect of the greater risk may be to cause significant year-to-year fluctuations in income. This could have important implications for a fiscal plan. For example, the fluctuations might make it harder to achieve annual income targets for budget purposes. On the other hand, such fluctuations might not be so much of a problem if the income from the Fund were to be employed as part of a reserves strategy, or for dealing with contingencies, etc.

DIVIDENDS

If one purpose at least of the dividend program is to ensure a public which is interested in the Fund's use and preservation, how large does an annual dividend check have to be to ensure that?

INFLATION- PROOFING

Especially if more of the Fund's assets are to be invested in equities (e.g., stocks), instead of in fixed-income securities (e.g., bonds), do we need to inflation-proof the Fund as much as is done at present?

EQUITY

In considering the potential role of the Fund as a "tool" for closing the fiscal gap, how should we distinguish the rights of current Alaskans from those of future generations?

TAXATION

Which would be preferable -- to (e.g.) reduce dividends and use the money generated to support state government programs and services, or (e.g.) to leave dividends as they are but treat them as personal income for purposes of a statewide personal income tax? Why?

OVERALL

Looking at all of these (and other) options, how might we best begin the process of evaluating the potential future role(s) of the Permanent Fund? What areas of agreement or disagreement exist? What are the impediments of consensus? How can we get past those impediments, to get to the question of what we want the Permanent Fund to do for us?