SCOMM

101:7

STATE OF ALASKA

DEPARTMENT OF LABOR

ADMINISTRATIVE SERVICES DIVISION

RESEARCH AND ANALYSIS SECTION

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August 3, 1995

Melissa Fouse
Long Range Financial Planning Commission
716 West 4th Room 470
Anchorage, AK 99501

Dear Ms. Fouse:

Enclosed are copies of the graphs used in The Department of Labor employment projections. If they are not sufficient for your needs, please call me at 465-6032 and we will arrange another method of getting satisfactory graphs to you.

Sincerely,

Paul 465 6032

Paul Engelman
Labor Economist

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LONG RANGE FINANCIAL PLANNING COMMISSION REPORT
PROPOSED NEW OUTLINE

AS OF 03 AUGUST 1995

COVER PAGE - **NOTE: WE NEED A TITLE!**

INSIDE COVER: WHAT IS THE LONG RANGE FINANCIAL PLANNING COMMISSION?

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WHY THE LONG RANGE FINANCIAL PLANNING COMMISSION?

The Fiscal Gap is Real

The State of Alaska spends more than it takes in each year.

For the past five years, the legislature, the governor, and state agencies have worked to close the gap by cutting expenditures and holding the line on the growth of expenditures, **reducing spending by 5 per cent per year in inflation adjusted terms.**

Without this steady attention to reducing expenditures, Alaskans may have faced drastic reductions in services and programs, loss of the permanent fund or significant new taxes. **These efforts have not been enough to offset the decline in revenues.**

Alaska has significant oil reserves and a rapidly growing Permanent Fund. We have a Constitutional Budget Reserve fund established to minimize the effect of declining revenues, but that fund and other savings accounts are being spent at a rapid rate. **The CBR and other reserves will be exhausted in five years if we do nothing.**

Without major changes in spending and revenue now, Alaska could face another recession.

WHY DOES THE FISCAL GAP EXIST?

The fiscal gap exists for two reasons. First, Alaska bases its budget on non sustainable revenue sources. We count on oil revenues to fund a budget larger than we can afford in the long term. Second, there is a rapid decline in Prudhoe Bay production. The State of

Alaska depends upon oil & gas revenues for half its income (75% if we exclude Permanent Fund earnings). The decline in production is a decline in state revenues.

At Statehood, Congress endowed Alaska with a substantial land base, including underlying oil and gas resources such as Prudhoe Bay. The state instituted methods by which oil companies could bid on the production of Alaskan oil and that oil began to flow through the Trans-Alaska Pipeline System (TAPS) in 1977.

By 1979, after the OPEC price hikes, Alaska received such large amounts of revenue from royalties and taxes that the state abandoned its more traditional methods of obtaining revenue.

Oil prices peaked in 1980 and began a steady decline, with an abrupt fall in 1986, triggering the 1986-1989 Alaska recession. Even so, Alaskans appear to prefer reliance on the probability of a rebound in oil prices than to address the problem of the state's dependence on a declining revenue source.

The time has come to confront that issue. The members of the Long-Range Financial Planning Commission hope that this preliminary report to the governor, the legislature, and the people of Alaska will provide the basis for vigorous discussion and debate about our state's future.

We were asked to examine the size of the "fiscal gap" — the difference between revenues and expenditures — for a ten-year period, to look for budget reductions and revenue sources, to examine the state budget process, to consider the impacts of changes on local governments, and to hear from the public about the choices Alaskan's face.

In this preliminary report, we describe the size of the fiscal gap, explain the choices available to us, and discuss opportunities for cutting expenditures and raising revenues to fill the gap. We ask you to tell us what you think is a long-term, sustainable state revenue and expenditure strategy.

Declining Oil Production

Alaskans have known all along that oil revenues were finite. North Slope oil production rates started falling in 1991 and will continue to do so until the field is no longer economical to produce.

The chart below shows the current forecast of oil production in Alaska with the following assumptions:

- There is little probability of oil production from ANWR during the next ten years, regardless of how soon ANWR is opened for exploration.

- Some production from currently marginal fields is included. While there may be some additional production from fields not listed, we follow the Department of Natural Resources predictions.

- No production of North Slope natural gas is included; production is currently not expected before 2005.

CHART 1: North Slope Production Forecast

HOW BIG IS THE FISCAL GAP?

The fiscal gap this year is $500 million.

- Equal to all of the salaries and benefits paid to all state employees.
- Almost as much as the whole Permanent Fund dividend program;
- Almost as much as the entire public school funding program.

Without any changes in spending or revenues, the fiscal gap will widen to over $1 billion (current dollars) in the next 10 years.

We designed a "base case" to predict revenue and project spending. For the Commission's work, we chose the following assumptions.

- All projections are in FY96 dollars. In reality, there will be inflation, which affects both revenues (from taxes and investment income) and expenditures.
- Population will grow 1.6% per year (compounded) and so will the state's formula programs.
- State agency expenditures will increase one-half of the rate of population growth.
- Department of Revenue projections are accurate for the purposes of calculating the fiscal gap. New projections of revenues are developed on a regular basis, and may result in changes to the fiscal gap but the scale of the gap is unlikely to change significantly.
- **We used the estimates of Permanent Fund income developed by the Commission staff based on earlier work by the Alaska Permanent Fund Corporation.**

- $50 million is available annually to the state as a dividend from Alaska Housing Finance Corporation income, as provided in the agreement between AHFC and the Governor.
- No new revenues from ANWR and no increased revenues due to repeal of the oil export ban (congressional action is imminent on the oil export ban. Projected revenues from repeal are shown in economic development section.)
- No changes in federal assistance to the State of Alaska. It is likely, however, that current Congressional action will result in substantial cost-shifting from the federal to the state budget.
- All revenues that can be spent are considered available for expenditure or other disposition. Thus, all Permanent Fund earnings are included in the unified budget.
- Program receipts are included if (a) they are significant and can be separately defined, and (b) the receipts are not dependent upon specific state-funded activities to generate the receipts.
- The base case calculates the fiscal gap without use of the Constitutional Budget Reserve (which requires a 3/4 vote of both houses of the legislature), then uses the CBR to fill the gap each year.

The CBR can be used to fill the fiscal gap for four more fiscal years, after which it is depleted and the state faces an $800+ million budget gap.

HOW MUCH DOES THE STATE SPEND?

The State of Alaska will receive $3.2 billion in revenues during the coming fiscal year (FY96).

We will receive $1.5 billion from petroleum revenues, $1.2 billion from permanent fund income, and $480 million from other sources.

The budget calls for spending or placing in reserves $3.7 billion, allocated as follows:

- $1,120 million State agency operations (excluding formula programs*):

$ 195 million	Health & Social Services
167 million	University of Alaska
130 million	Corrections
130 million	Trans & Pub.Fac.
85 million	Public Safety
75 million	Administration
46 million	Courts
43 million	Natural Resources
41 million	Fish & Game
37 million	Comm& Ec.Dev.
31 million	Legislature
31 million	Community & Regional Affairs
31 million	Education
20 million	Law
18 million	Environmental Conservation
15 million	Governor
12 million	Revenue
6 million	Military & Veterans Affairs

* See Glossary for definition of Formula Programs

9 million Labor

- $ 660 million K-12 education
- $ 575 million Permanent Fund dividends
- $ 441 million Permanent Fund inflation-proofing
- $ 414 million Formula programs*
  - $ 145 million Medicaid
  - 72 million Longevity Bonus
  - 60 million Local Government Assistance: Municipal Assistance, Revenue Sharing, Property Tax Exemptions & Renter Rebate
  - 59 million Aid to Families with Dependent Children
  - **78 million Other formulae: what are they?????**
- $ 202 million Transfer to PF Earnings Reserve
- $ 109 million Debt service
- $ 106 million Capital projects
- $ 22 million Loan programs
- $ 20 million Supplemental appropriations for emergencies and court judgments

The difference — $497 million — is the fiscal gap.

Our projections show the following deficits now, in five years, and in ten years (all numbers in millions of dollars):

	FY96	FY00	FY05
Revenues:			
Petroleum	1,473.4	1,474.6	1,200.2
Other sources	301.3	281.4	275.7
Permanent Fund	1,218.0	1,372.7	1,530.8

* See Glossary for definition of Formula Programs

AHFC/adjustments	180.1	79.6	68.0
TOTAL	3,172.8	3,208.3	3,074.9
Expenditures and Transfers:			
Agency operations	1,139.9	1,251.9	1,384.7
Formula programs	413.8	427.2	444.6
K-12 education	660.3	728.8	824.6
Debt service	109.4	44.9	10.9
Capital	106.2	106.2	106.2
Loans	22.2	22.9	23.9
PFDs	575.0	632.0	724.1
Transfers:			
PF Inflation-proofing	441.0	482.6	516.3
PF Earnings reserve	202.0	258.1	310.7
TOTAL	3,669.8	3,954.7	4,325.6
THE GAP	**(497.0)**	**(817.4)**	**(1,322.0)**

HOW HAS STATE SPENDING CHANGED?

Table 3

FY79 to FY96 GF Budget Comparisons

Alaska's population has grown 52 percent over the past 17 years.

The Commission examined the major growth areas of the state budget. We used FY79 as a starting point, because it was the last state budget prepared before the tripling of state oil revenues.

While the overall budget has grown, services per capita are at the same level as they were in 1979.

The Department of Labor expects the state population to continue to grow at a 1.6 percent compound rate over the next ten years.

Unlike other states, Alaska's revenues do not grow as the population grows.

The twin trends of declining revenues due to diminishing production and increasing expenditures due to increasing population work together to increase our fiscal problems.

Table 3 shows expenditure growth by category. The core of state government, agency spending, grew 93%, compared to 150% growth in the budget as a whole. Major spending drivers were **grants to individuals (443%)** grants to groups (334%), grants to schools (175%) and municipal assistance (165%).

Chart 2 shows that the combination of population growth and inflation would have increased a budget by 155% over that 17-year

period. The fastest-growing state agencies, on a percentage basis, were Corrections (604%), the Legislature (213%), Commerce (206%), and Law (160%). **NOTE: NEED DOLLAR AMOUNTS.**

Projections show that the biggest areas of spending growth will be grants to individuals, groups, schools, and municipal assistance, and the corrections and criminal law budgets.

The recent emphasis during public discussion and in the legislature is on cuts to state spending. Some programs have been eliminated or downsized and other programs serve more people with the same amount of money.

The number of state employees per capita is at a 15-year low.

CHART 4
State Employees per 10,000 population

Chart 5
Alaska's population

The operating budget has been cut over 25% in the past five years on an inflation-adjusted basis

Nonetheless, even excluding Permanent Fund Dividends, Alaska spends more than twice as much per capita as the national average. Part of this is due to Alaska's size and geographic isolation from other states. In part, because of the wealth of the State in the early 1980s, Alaskans came to expect a higher level of services. In addition, there have been significant and substantial program changes in the past 17 years such as heightened federal requirements for assistance and transfer payments, and more stringent environmental regulations .

Comparisons are further made difficult by the fact that Alaska performs many services at the state level that are provided by counties or municipalities elsewhere. Education, criminal prosecution, correctional facilities, and road maintenance are primarily state-provided in Alaska, while these services are local in other jurisdictions. Some expenditures like the Longevity Bonus and Permanent Fund Dividends are unique to Alaska.

Chart 6
Real Per Capita spending FY79-96

HOW MUCH DOES THE STATE COLLECT IN REVENUE?

The major sources of revenue to the state are oil and gas rents, royalties and bonuses, oil and gas property's tax, severance taxes; and corporate income taxes. The state has a number of small sources of revenue, generally excise taxes or charges and fees for services that annually generate approximately $125 million. These revenues are paid into the general fund.

Other revenues, such as interest on the Four-Dam Pool and the Railbelt Energy Fund, which funds the Power Cost Equalization Program, and repayments on mortgages received by the Alaska Housing Finance Corporation are not considered part of general fund revenues.

Revenues to the Alaska Permanent Fund Corporation are not generally treated as available for appropriation in the same sense as tax receipts.

The Commission examined other states' revenues not used by Alaska. Most prominent among these are statewide property taxes, statewide sales taxes, and individual income taxes. Alaska repealed its individual income tax in 1980 and has traditionally allocated to local government use of property and sales taxes.

At the same time however, the state funds certain programs, notably education, that are traditionally considered to be a local

responsibility. Chart 7 compares Alaska's revenue sources with those of a typical state in 1990.

Chart 7

HOW DOES THIS COMPARE WITH OTHER STATES?

Chart 8 compares the total of state and local taxes in Alaska to that in the rest of the United States.

Regardless of income level, Alaskans pay approximately 1/3 of the percentage of family income paid by the average American in state and local taxes.

This chart does not take into effect the Alaska Permanent Fund dividend program, under which many families receive more than they pay in state and local taxes.

Chart 8:

1991 State and Local Taxes: US Average vs. Alaska as Shares of Income of a Family of Four

Charts 9a and 9b show the annual tax burdens of Alaskan families with two sample incomes. They show that the net effect of the dividend is that the average Alaskan family making $50,000 pays $4,000 to $5,000 less in taxes than a similar family in Seattle WA or Billings MT; a family making $100,000 pays $7,000 to $10,000 less than similar counterparts.

What is the annual tax burden for a family of four with a gross income of $50,000 and a typical house for that income?

	Anchorage	Seattle	Billings
Pers. Inc. Tax	$ 0	$ 0	$2108
Property Tax	$1421	$1691	$1423
Sales Tax	$ 0	$ 998	$ 0
Car Taxes	$ 93	$ 538	$ 493
PermFundDiv.	($3932)	$ 0	$ 0
TOTAL	($2418)	$3227	$4024

Chart 9a

What is the annual Tax Burden for a family of four with a gross income of $100,000 and a typical house for this income?

	Anchorage	Seattle	Billings
Pers. Inc. Tax	$ 0	$ 0	$5418
Property Tax	$ 2700	$3214	$2703
Sales Tax	$ 0	$1966	$ 0
Car Taxes	$ 158	$1311	$1192
PermFund Div	$(3932)	$6520	$9314
TOTAL	$(1074)	$6520	$9314

Chart 9b

HOW BIG ARE OUR RESERVES?

Alaska is fortunate to have over $3 billion in liquid reserve funds

These substantial reserves constitute one of the primary fiscal tools 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.

What role should these reserve funds play to create a stable fiscal future for the state?

Potential uses of reserve funds include:

- Use reserves to offset current budget shortfalls, postponing the impacts of the fiscal gap and buying time to develop and implement fiscal solutions;
- Minimize the current use of reserves, in order to maintain substantial reserves for offsetting even larger budget shortfalls that may occur in the future, and to cushion the state's adjustment to lower petroleum revenues;
- Deposit all or some reserves into the Permanent Fund to increase sustainable long-term revenues;
- Use reserves to establish forward funding for the state budget; and,
- 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:

- In what priority should reserve funds be used, relative to other fiscal tools such as spending reductions, tax increases, and permanent fund earnings?

- 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?

- 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?

- 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).

WHAT CAN BE DONE TO FILL THE FISCAL GAP?

There are six choices, some or all of which can be used in combination:

- **Cut spending**
- **Use reserves**
- **Raise revenues through economic development**
- **Raise taxes and user fees**
- **Use Permanent Fund income**
- **Increase oil production from new fields**

Each of these choices has an effect on Alaska's economy and on the lives of the people of Alaska. The effects can vary, by region of the state, by income level of Alaskans, by the kind of business in which a person works.

To some extent, the choices made will all have an adverse impact on Alaska's economy — for each $100 million per year removed from Alaska's economy, the gross effect is the same whether it's $100 million less in state spending, $100 million less in Permanent Fund Dividends distributed to Alaskans, or $100 million more

collected in taxes and user fees from Alaskans. For any one family, however, the choice could make a big difference.

There are some differences in the economic impact of various choices. A 1987 study for the State Legislature compared the effects of three options — imposing personal income taxes, reducing Permanent Fund Dividends, or reducing state spending. That study indicated the following effects:

Imposing the Personal Income Tax

- A personal income tax reduces Alaskans' disposable personal income by about $340 million, or 2 percent of Alaskans' overall purchasing power.
- This reduction in Alaskans' purchasing power reduces business activity and cost the state's private support industries about 2,000 jobs annually — about 1 percent of the average annual employment.
- The drop in employment reduces disposable personal income in Alaska by an additional $110 million, or 1 percent of overall purchasing power.

Reducing Permanent Fund Dividends

- Reducing Permanent Fund Dividends by a comparable amount costs the state $400 million in disposable personal income.
- This results in a job loss of 2,700 private industry jobs annually.
- Which further reduces personal income by another $140 million.

Cutting State Spending

- If the state cuts spending by reducing costs for all the expenditures represented in current state spending — a mixture of salaries, capital projects, transfers, and others — about 3,000 public and 1,500 private jobs, and about $320 million in disposable personal income are lost.

There are differing other effects from these three choices. Two of note are the "federal tax offset" and "tax exporting."

The federal tax offset recognizes that any action that affects personal incomes of Alaskans changes the federal tax liability for Alaskans. Two of these choices have tax offsets which are relatively easy to calculate.

- First, personal income taxes paid at the state level are deductible from federal income taxes. A state personal income tax that raised $300 million reduces Alaskans' federal tax liability by approximately 20%, or about $60 million.

- Second, permanent fund dividends are taxable income to Alaskans. A reduction to Permanent Fund dividends would reduce Alaskans' federal tax liability by approximately 15%, or $45 million.

Cutting state spending has some federal tax offset, since a portion of state employees' salaries are paid in federal income taxes, but it is not easy to calculate or estimate the tax offset for this option.

"Tax exporting" refers to the portion of taxes paid by non-residents. Approximately 8 percent of the income earned in Alaska is earned by non-residents (not including part-year residents, who count as Alaskan residents). This is a conservative (low) estimate; somewhere between $25 and $40 million of a $300 million personal income tax would be paid by non-resident workers.

A sales tax has a similar tax exporting provision — a portion of sales taxes are paid by non-resident workers and by visitors to Alaska.

For the last five years, the State has used pieces of all six choices. In particular, spending has been reduced, reserves used, and user fees increased. The State has attempted to create economic incentives to increase development of oil and gas, timber, and mineral resources. But the size of the problem has continued to grow, primarily due to population growth-driven formula spending and the decline in Prudhoe Bay production.

TABLE 2a

Growth of State Agencies: %

TABLE 2b

Growth of State Agencies: $

TABLE 2c:

Growth of Formula Programs: %

TABLE 2d

Growth of Formula Programs: $

Budget cutting is a painful, divisive undertaking. It does, however, provide all of us who live in Alaska the opportunity to re-think what we want government to do. It helps us decide what services we believe government should provide and how they could be provided at less cost. It forces us to decide what services we are willing to do without and what services we are willing to pay for. Finally, and perhaps most importantly, it requires us to re-define the common good—what is each of us is willing to give up or pay for—in the best interest of all of the people of Alaska.

The Commission agrees to the following conclusions:

- Spending cuts are an important and necessary tool to solve the fiscal gap.
- The State has been accomplishing actual budget cuts by holding the budget flat.
- Additional budget cuts, over and above a flat budget, will be necessary to solve the fiscal gap.
- It would be devastating to the economy and poor public policy to attempt to solve the fiscal gap by budget cuts to government operations alone.
- Any significant reduction plan should be phased to the year 2000.

- Spending cuts should be governed by announced fiscal policy goals.

The Key: Fiscal Stability

Much of the public discussion about Alaska's finances focuses on Alaska's fiscal gap. This is as it should be because the fiscal gap represents the fact that our need for services and our ability to pay for them have fallen out of alignment.

The fiscal gap is hard to define. Shifting oil prices and fluctuating revenue projections make the fiscal gap shrink or grow which changes our perception about the urgency of filling in the gap. Revenue instability contributes to making the gap harder to define.

As long as Alaska's revenue situation remains unpredictable we will make hasty policy choices as the gap changes. When it appears there is more revenue (and a smaller gap) we often increase state spending. When it appears there is less revenue (and the gap is larger) we may make unnecessary program eliminations or cutbacks.

Fiscal stability is the key to developing predictable financial policies. By defining and ensuring a consistent revenue stream and by ratcheting down operating and capital spending we can begin to assess our needs and our resources to meet those needs. Stable state spending will contribute mightily to Alaska's overall economic stability.

The Commission is considering methods by which we can bring fiscal stability to state spending. Among them are

- Development of a Reserves Policy. Approaches for employing reserve funds as budget stabilizers in addition to being shock absorbers. A steady year-to-year level of expenditures will enhance program planning and economic development.

- Application of Permanent Fund Earnings. Approaches for using portions of the Funds earnings to augment ordinary revenue.

- Economic Development Initiatives. Approaches to further development of North Slope oil and gas resources, oil and gas exports.

- Petroleum Hedging. Investment banking approaches for reducing risk and maximizing income through the use of security and commodity futures, and options.

- Oil & Gas Settlements. Approaches for striking a balance between current use and deferred use of oil litigation settlement funds.

WHAT DO YOU THINK WE SHOULD DO?