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Alaska's Growing Fiscal Gap

**The Preliminary Report
of the
State of Alaska
Long-Range
Financial Planning Commission**

August 12, 1995

The State of Alaska Long-Range Financial Planning Commission

The State of Alaska Long-Range Financial Planning Commission was established by Alaska's Legislature and Governor in March, 1995, to assess the State's financial condition and to recommend a strategy to balance the state's revenues and expenditures. It consists of 15 Alaskans, five each appointed by the Governor, the Speaker of the house, and the President of the Senate.

We were asked to

- 1) examine the size of the "fiscal gap" - the difference between the State's revenues and expenditures — for a ten-year period,
- 2) to look for budget reductions and revenue increases,
- 3) to examine the budget process,
- 4) to consider the impacts of changes on local governments, and
- 5) to hear from the public about the choices Alaskans face.

In this preliminary report, we will document the size of the fiscal gap, explain the choices available to the state, and discuss the opportunities for cutting expenditures and raising revenues to fill the gap.

We will then ask the Alaska public to let us know what you think is a long-term sustainable state revenue strategy which balances the needs for state services with the limited resources available to Alaska.

After hearing from you, on October 1, 1995 we will make our recommendations to the Legislature, the Governor, and the people of Alaska.

Commission Members

Brian Rogers, Chair
Fairbanks

Judy Brady, Vice Chair
Anchorage

Lee Gorsuch
Anchorage

Sen. Georgianna Lincoln
Rampart

Robert W. Loescher
Juneau

Bruce Ludwig
Juneau

Annalee McConnell
Juneau

Hugh Motley
Cooper Landing

Mike Navarre
Kenai

Mary Nordale
Fairbanks

Mike O'Connor
Anchorage

Rep. Sean Parnell
Anchorage

Pat Pourchot
Anchorage

Sen. Steve Rieger
Anchorage

Marie Westfall
Ketchikan

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State of Alaska Long-Range Financial Planning Commission

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STATE OF ALASKA
LONG RANGE FINANCIAL PLANNING COMMISSION
716 West Fourth Avenue, Anchorage, Alaska 99501
Phone: (907)258-8165, Fax (907)258-9869

July 15, 1995

The Honorable Tony Knowles, Governor of Alaska
The Honorable Drue Pearce, President of the Senate
The Honorable Gail Phillips, Speaker of the House

Dear Governor Knowles, President Pearce and Speaker Phillips:

The Long Range Financial Planning Commission, established by Legislative Resolve 1, was directed to send you a preliminary report by today. Due to the extremely short time allowed to the Commission to complete its work, we have chosen to submit a more complete interim report to you and the people of Alaska in mid-August.

In this preliminary report to you, we summarize the process the commission has used to reach its interim conclusions, report our findings, and describe our plan for the time remaining before the final report is due on October 1, 1995.

The Long Range Financial Planning Commission finds that the fiscal gap is real and growing. Absent changes in the State's financial plan, we project that spending will continue to exceed revenues by a minimum of \$500 million per year, growing to \$1 billion per year over the next 10 years, for a total 10-year deficit in excess of \$6 billion. Our reserves are insufficient to cover a gap of this magnitude. The Commission has found that no one solution responsibly fixes the problem of the fiscal gap; the answer will have a number of elements and may require changes in existing law.

In our interim report to the public to be published in August, we will outline the causes of the fiscal gap, describe the tools to close the gap, give examples of ways in which the gap can be closed, and ask for public comment. After spending the month of August giving the report the widest possible distribution, in September we will hold a series of public hearings with statewide participation. After the public hearings we will give you our recommendations for closing the state's fiscal gap.

The commission has met regularly since its first meeting on April 8, 1995. There are six subcommittees that meet and make recommendations to the full commission. The subcommittees and their areas of responsibility are as follows:

Public Outreach Subcommittee: Identify methods and costs for informing the public and receiving public comment.

Expenditures Subcommittee: Examine budget expenditures and make recommendations as to methods or principles by which to reduce or increase expenditures.

Style and Drafting Subcommittee: Draft interim and final reports.

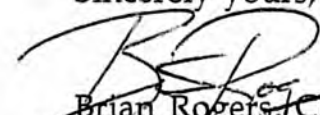
Revenue Sources Subcommittee: Identify potential sources of state revenue, estimate their impacts. Examine earnings of the permanent fund.

Budget Process and Reserves Subcommittee: Examine the method by which state government builds and presents its budget. Examine reserves and their possible uses. Review constitutional budget reserve.

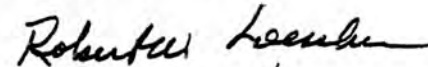
Intergovernmental Subcommittee: Examine impacts from federal and state budget actions. Work with municipalities and school groups.

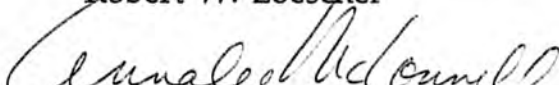
We believe that during the time remaining for the work of the Commission that we will be able to complete our deliberations and produce a responsible long range financial plan for the State of Alaska. Please contact us with any suggestions or concerns. We look forward to continuing to work with you.

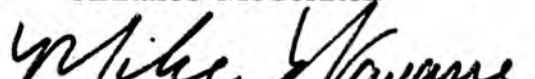
Sincerely yours,

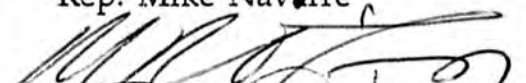

Brian Rogers, Chairman

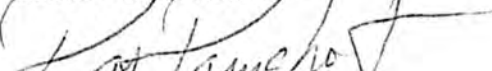

E. Lee Gorsuch


Robert W. Loescher

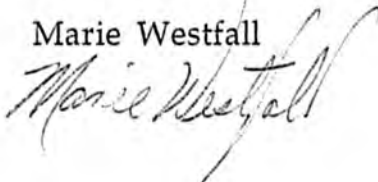

Annalee McConnell

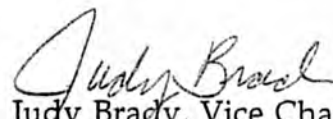

Rep. Mike Navarre

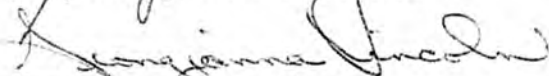

Mike O'Connor


Patrick Pourchot

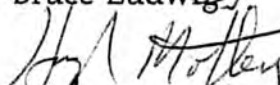
Marie Westfall



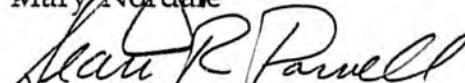

Judy Brady, Vice Chairman

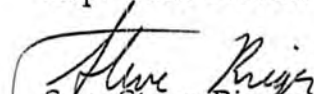

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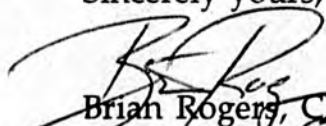
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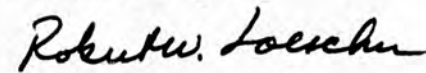
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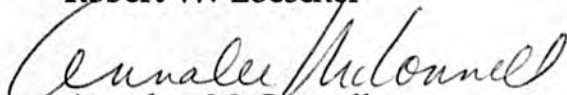
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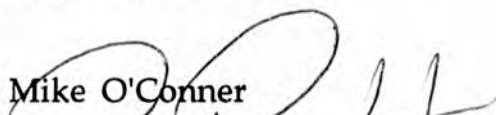

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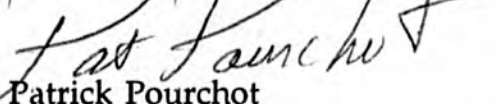

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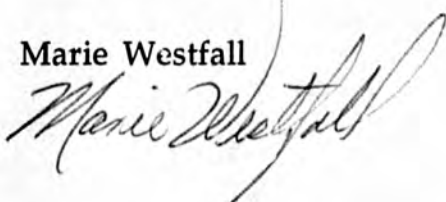

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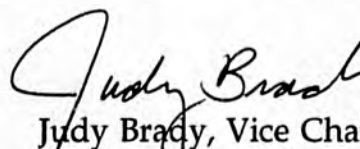
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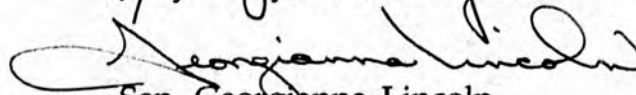

Mike O'Conner

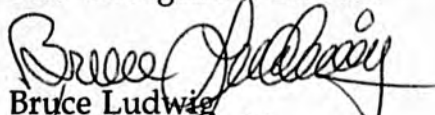

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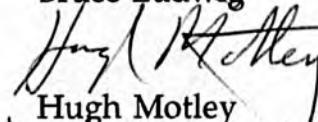
Marie Westfall

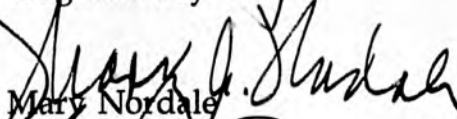



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The fiscal gap is real, and it's growing.

The State of Alaska spends more than it takes in each year, and has done so for six of the past nine years.

This year, we estimate the state will spend \$513 million more than it takes in — this is the fiscal gap. Over the next ten years, this gap will grow. Based on the assumptions adopted by the Commission, we believe it will grow to over \$1.3 billion by 2000 unless the state takes corrective action.

State spending has been reduced by five percent per year for the past five years (in inflation adjusted terms). The legislature, the governor, and state agencies are working to close the gap by cutting expenditures and holding the line on the growth of expenditures. The fiscal gap exists in spite of these efforts.

Efforts to date have not been enough to offset the decline in revenues. However, without this steady attention to reducing expenditures, the gap could soon have forced drastic reductions in services and programs, loss of the permanent fund or significant new taxes.

Alaska has significant oil reserves and a 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 Constitutional Budget Reserve will be exhausted in five years if we do nothing. Other reserves will be depleted shortly thereafter.

Why does the fiscal gap exist?

Alaska depends upon non-sustainable revenue sources and faces declining oil production

There are two primary reasons for the fiscal gap. First, Alaska bases its budget on non-sustainable revenue sources. We count on reserves to fund a budget larger than we can afford in the long term. Second, there is a rapid decline in Prudhoe Bay oil production. The State of Alaska depends upon oil & gas revenues for half its income (80% if we exclude Permanent Fund earnings). The decline in production brings 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 may bid on the production of Alaskan oil and that oil began to flow through the Trans-Alaska Pipeline System (TAPS) in 1977.

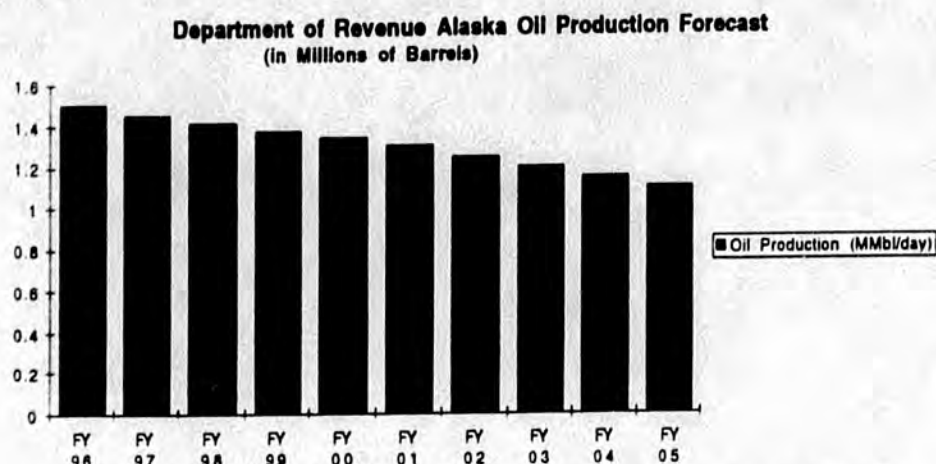
By 1979, after the OPEC price hikes, Alaska received such large amounts of revenue from royalties and taxes that the state abandoned most of its more traditional methods of obtaining revenue.

Oil prices peaked in 1980 and began a steady decline. The abrupt fall in 1986, and the dramatic cut in state and oil industry spending contributed to the 1986-1989 Alaska recession. Even so, Alaskans seemed more determined to rely on the probability of a rebound in oil prices than to address the problem of the state's dependence on a declining revenue source.

Alaskans have known all along that oil revenues were finite. Prudhoe Bay production peaked in 1988. North Slope oil production rates started falling in 1991 and will continue to do so until the fields are no longer economical to produce. Potential new fields are unlikely to replace the loss in production from the North Slope.

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

barrel change in oil prices causes a \$120 million shift in state revenues.



Source: Spring 95 DOR

One could consider the fiscal gap as the distance from the roller coaster to the ground. The fiscal gap looks closer, and more ominous, when the roller coaster is whipsawed downward by falling oil prices. By contrast, it looks farther away and less threatening when the roller coaster shoots up-

- There is little probability of oil production from ANWR during the next ten years, regardless of whether ANWR is opened for exploration or how much of the oil that may be discovered there is commercially recoverable.

- Some production from currently marginal fields is included. While there may be some additional production from fields not listed, we follow the Department of Revenue projections as the best currently available.

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

Fiscal Instability

The volatility of Alaska's revenues complicates the fiscal gap by creating fiscal instability. Fiscal instability is the roller-coaster ride caused by unpredictable oil price fluctuations (from a low of \$8 per barrel to a high of \$32 per barrel in the past 15 years), and the resulting ups and downs in expected state revenue flows. At today's oil production rates, each \$1 per

wards by rising prices.

When the roller coaster heads downhill, people get anxious. Fiscal disaster seems just around the corner, and everyone agrees that there is an urgent need to fix the problems caused by the fiscal gap. When oil prices and the roller coaster swing upwards, however, the fiscal gap suddenly looks farther away, and less threatening; the sense of urgency and the resolve to deal with the problem dissipate. This cycle repeats itself over and over in Alaska, as oil prices and resulting revenue forecasts cycle up and down.

The twin trends of declining revenues due to diminishing production and increasing expenditures due to rapid growth of population combine to increase our fiscal problems each year in the foreseeable future.

The "moving target" aspect of the fiscal gap problem makes it more difficult to fix, because we don't know how large the gap may actually turn out to be, or how much time we have to fix it.

It's time to get off the roller coaster.

How big is the fiscal gap?

The fiscal gap this year is \$513 million.

Alaska will take in \$3.2 billion this year from petroleum revenues, other taxes and user fees, and permanent fund net income. We will spend or transfer \$3.7 billion for agency operations, formula programs, debt service, Permanent Fund dividends, inflation-proofing, and the earnings reserve.

This fiscal gap is a significant portion of the state budget.

- It is equal to all of the salaries and benefits paid to all state agency employees.

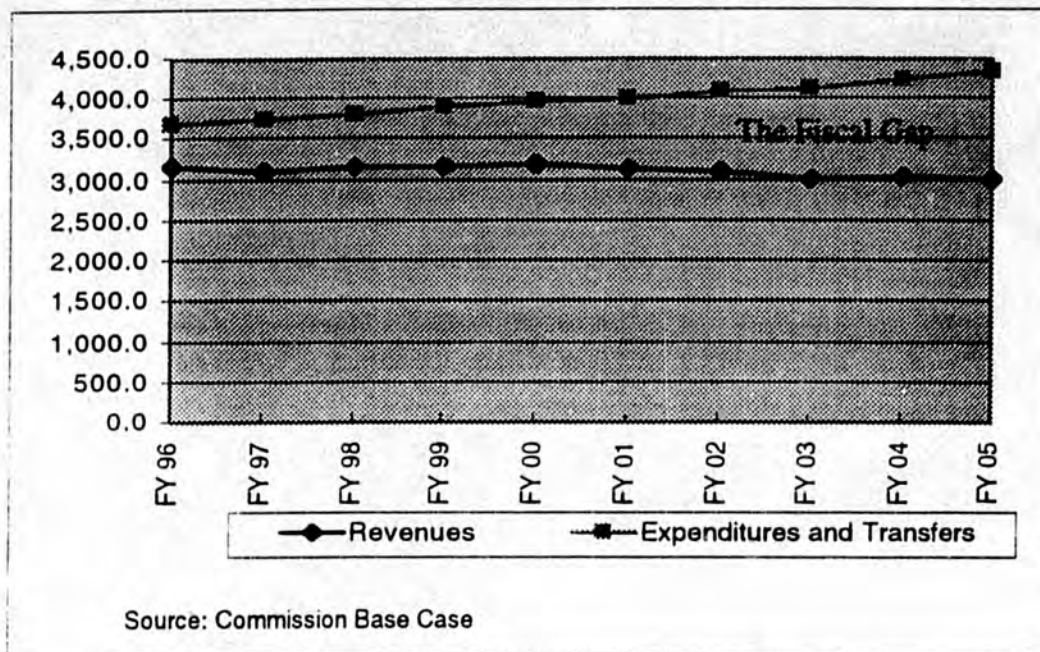
- It is almost as much as the whole Permanent Fund dividend program;

- It equals three-quarters of the entire K-12 public school funding program.

The fiscal gap will widen to over \$1.3 billion (current dollars) in the next 10 years if no changes are made to state spending and revenues. The Commission developed a "base case" to predict revenue and project spending.

The Commission adopted the following assumptions in order to reach this estimate of the fiscal gap.

Alaska's Growing Fiscal Gap (\$ Millions)



- 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) as estimated by the Alaska Department of Labor.

- Absent a change in state policy

- The state's formula programs, except education formula spending, will grow at this rate of population growth.

- Education formula spending will grow at the projected student population growth rate of 2-1/2 %.

- State agency expenditures will increase at one-half of the rate of population growth.

- Department of Revenue projections as of March 1995 are reasonable 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.

- Estimates of Permanent Fund income and dividends developed by Commission staff based on earlier work by the Alaska Permanent Fund Corporation are reasonable for our purposes.

- \$50 million will be available annually to the state as a dividend from Alaska Housing Finance Corporation income, as provided in the agreement between AHFC and the Governor.

- The base case does not include new revenues from ANWR nor 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.)

- These projections assume federal assistance to the State of Alaska will not change. We expect 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, Permanent Fund earnings are included in the unified budget, although changes to use of earnings are not.

- 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 approximately \$567 million in federal and other funds received and expended by the state are not shown, since most cannot be used to close the gap.

These assumptions are debatable. Nonetheless, any reasonable set of assumptions will show there is a significant fiscal gap, and the fiscal gap will grow absent action by the State.

What can be done to close the fiscal gap?

The commission is considering six categories of fiscal choices, some or all of which can be used in combination:

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

For the last five years, the State has used pieces of all six fiscal 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, minerals, fishing, and tourism.

The size of the problem continues to grow due primarily to formula programs driven by population growth and the bydecline in North Slope oil production.

Each of these fiscal 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.

For this initial report, the Commission has compiled a "catalog" of fiscal

choices, which are contained in Appendix Two.

The first part of the appendix contains four scenarios for making budget reductions equivalent to the current fiscal gap. The second analyzes options for raising revenues through new taxes, increases to existing taxes, user fees and excise taxes.

The third discusses use of Permanent Fund income to support government operations and transfers. The fourth reviews state income opportunities from economic development. The final section covers reserves and state assets and opportunities for budget stabilization.

The Commission is not at this time endorsing any specific recommendations, but expects to make its recommendations from among the choices listed in the appendix, supplemented by any ideas which come out in public hearings.

How much does the state spend now?

The FY96 state budget calls for spending or placing in reserves \$3.7 billion in general funds and permanent fund income as follows:

\$1,157,800,000 for state agency GF operations (excluding formula programs):

\$195 million	Health & Social Services
167 million	University of Alaska
130 million	Corrections
130 million	Transportation and Public Facilities
85 million	Public Safety
75 million	Administration
46 million	Courts
43 million	Natural Resources
41 million	Fish & Game

37 million	Commerce and Economic Development
31 million	Legislature
31 million	Community & Regional Affairs
31 million	Education
20 million	Law (plus \$16.8 million from the CBR)
18 million	Environmental Conservation
15 million	Governor
12 million	Revenue
9 million	Labor
6 million	Military & Veterans Affairs

\$1,488,000,000 for GF Formula Programs and other expenditures:

\$660 million	K-12 education
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	Miscellaneous, Leases, Power Cost Equalization
109 million	Debt service (including \$83 million school debt)
116 million	Capital projects
19 million	Loan programs/Transfers
20 million	Supplemental appropriations for emergencies and court judgments

\$1,218,000,000 for Permanent Fund Allocations:

\$575 million	Permanent Fund dividends
441 million	Permanent Fund inflation-proofing
202 million	Transfer to PF Earnings Reserve

In addition the state receives approximately \$567 million in federal and other funds. The receipt and expenditure of these funds has no effect on the fiscal gap.

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

How has state spending changed?

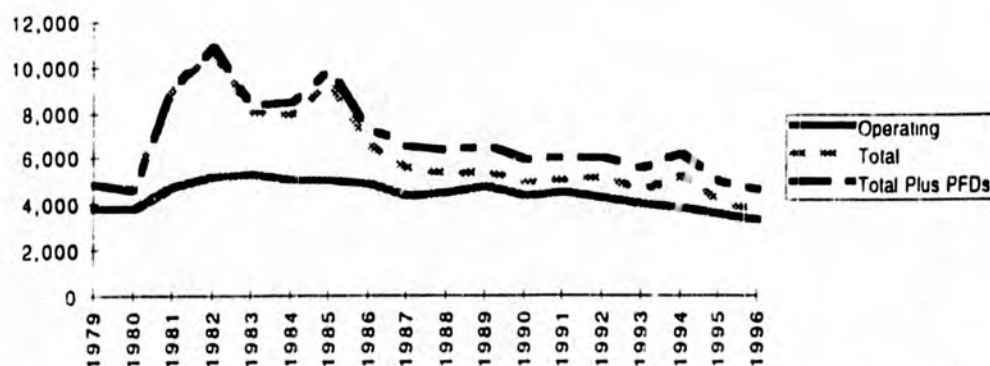
The Commission examined the major growth areas of the state budget. We used FY79 as a starting point, because it was the first full year of petroleum revenues from TAPS and the last state budget prepared before the tripling of state oil

revenues. The bottom chart shows that the largest increases in the 1980s were for capital spending and Permanent Fund Dividends. Operating budgets have been relatively flat.

Alaska's population has grown 52 percent since 1979. Unlike other states, the state's revenues do not grow as population grows. While the overall budget has grown, real

Base Case Summary (millions of \$FY96)			
	FY96	FY00	FY05
Revenues:			
Petroleum	\$ 1,553.4	\$ 1,546.2	\$ 1,253.1
Other sources	221.3	194.7	174.8
Permanent Fund	1,218.0	1,372.7	1,530.2
Other	<u>180.1</u>	<u>79.6</u>	<u>68.0</u>
TOTAL	\$ 3,172.8	\$ 3,208.3	\$ 3,074.9
Expenditures and Transfers:			
Agency operations	\$ 1,157.8	\$ 1,270.4	\$ 1,403.9
K-12 education	660.3	728.8	824.6
Other formula programs	413.8	427.2	444.6
Debt service	109.4	44.9	10.9
Capital	116.1	116.1	116.1
Loans	18.7	22.9	23.9
Permanent Fund dividends	575.0	632.0	724.1
Transfers:			
PF Inflation-proofing	441.0	482.6	516.3
PF Earnings reserve	<u>202.0</u>	<u>258.1</u>	<u>289.8</u>
TOTAL	\$ 3,694.1	\$ 3,954.7	\$ 4,325.6
Required Maintenance	0.0	71.1	71.1
The Fiscal Gap	(513.0)	(861.0)	(1,399.1)

Real Per Capita Spending FY 79 - 96



Source: OMB

LRFPC BASE CASE PROJECTION

(FY 96 Dollars)

		<u>FY 96</u>	<u>FY 97</u>	<u>FY 98</u>	<u>FY 99</u>	<u>FY 00</u>	<u>FY 01</u>	<u>FY 02</u>	<u>FY 03</u>	<u>FY 04</u>	<u>FY 05</u>
1	Average Oil Price (\$/bbl)	16.52	16.14	16.39	16.39	16.48	16.57	16.66	16.75	16.84	16.92
2	Oil Production (MMb/day)	1.503	1.457	1.418	1.375	1.342	1.304	1.246	1.195	1.146	1.103
AVAILABLE REVENUES (\$ Millions):											
3	PETROLEUM (Severance, Royalty, Property & Income Tax)	1,553.4	1,582.9	1,607.6	1,584.9	1,546.2	1,506.3	1,429.8	1,368.9	1,312.9	1,253.1
4	OTHER SOURCES	221.3	205.1	202.6	198.1	194.7	191.3	187.9	182.9	178.8	174.8
5	NONRECURRING SOURCES	188.4	87.4	84.7	82.1	79.6	77.1	74.7	72.4	70.2	68.0
6	PERMANENT FUND NET INCOME	1,218.0	1,251.6	1,284.5	1,319.7	1,372.7	1,395.5	1,387.9	1,400.6	1,493.4	1,530.2
7	TOTAL REVENUES	3,181.1	3,126.9	3,179.4	3,184.9	3,193.2	3,170.2	3,080.2	3,024.8	3,055.3	3,026.1
EXPENDITURES (\$ Millions):											
8	OPERATING - AGENCY	1,157.8	1,186.5	1,214.8	1,242.8	1,270.4	1,297.7	1,324.7	1,351.3	1,377.8	1,403.9
9	FORMULA	413.8	417.1	420.4	423.8	427.2	430.6	434.1	437.5	441.0	444.6
10	K - 12 EDUCATION	660.3	676.8	693.7	711.1	728.8	747.1	765.7	784.9	804.5	824.6
11	DEBT SERVICE	109.4	84.1	76.7	66.4	44.9	28.6	17.0	13.3	11.9	10.9
12	CAPITAL	116.1	116.1	116.1	116.1	116.1	116.1	116.1	116.1	116.1	116.1
13	LOANS/TRANSFERS	18.7	22.4	22.6	22.7	22.9	23.1	23.3	23.5	23.7	23.9
14	PERMANENT FUND INFLATION PROOFING	441.0	428.2	454.5	461.5	482.6	490.0	496.5	503.7	510.1	516.3
15	PERMANENT FUND DIVIDENDS	575.0	581.6	578.7	592.8	632.0	650.2	669.2	688.0	707.4	724.1
16	TRANSFER TO EARNINGS RESERVE	202.0	241.8	211.3	265.4	258.1	255.3	222.2	208.9	276.0	289.8
17	TOTAL EXPENDITURES	3,694.1	3,754.5	3,828.8	3,902.6	3,983.1	4,038.7	4,068.8	4,127.3	4,268.3	4,354.1
18	INFRASTRUCTURE MAINTENANCE		71.1	71.1	71.1	71.1	71.1	71.1	71.1	71.1	71.1
19	PROJECTED ANNUAL FISCAL GAP	-513.0	-698.7	-720.5	-788.8	-861.0	-939.5	-1,059.6	-1,173.6	-1,284.1	-1,399.1
20	CONSTITUTIONAL BUDGET RESERVE BALANCE	1,992.5	1,839.3	1,299.6	700.9	0.0	0.0	0.0	0.0	0.0	0.0
21	DRAW FROM EARNINGS RESERVE					165.4	763.5	1,059.6	301.1	276.0	289.8
22	PF EARNINGS RESERVE BALANCE	844.0	1,040.9	1,260.1	1,486.6	1,517.3	962.3	95.2	0.0	0.0	0.0
23	UNFILLED FISCAL GAP							-872.4	-1,008.1	-1,109.3	
24	CUMULATIVE GAP AFTER CBR AND ERA ARE DRAINED										-2,989.8

Note: Reserve balances and draws may not add exactly due to rounding.
Office of Management and Budget

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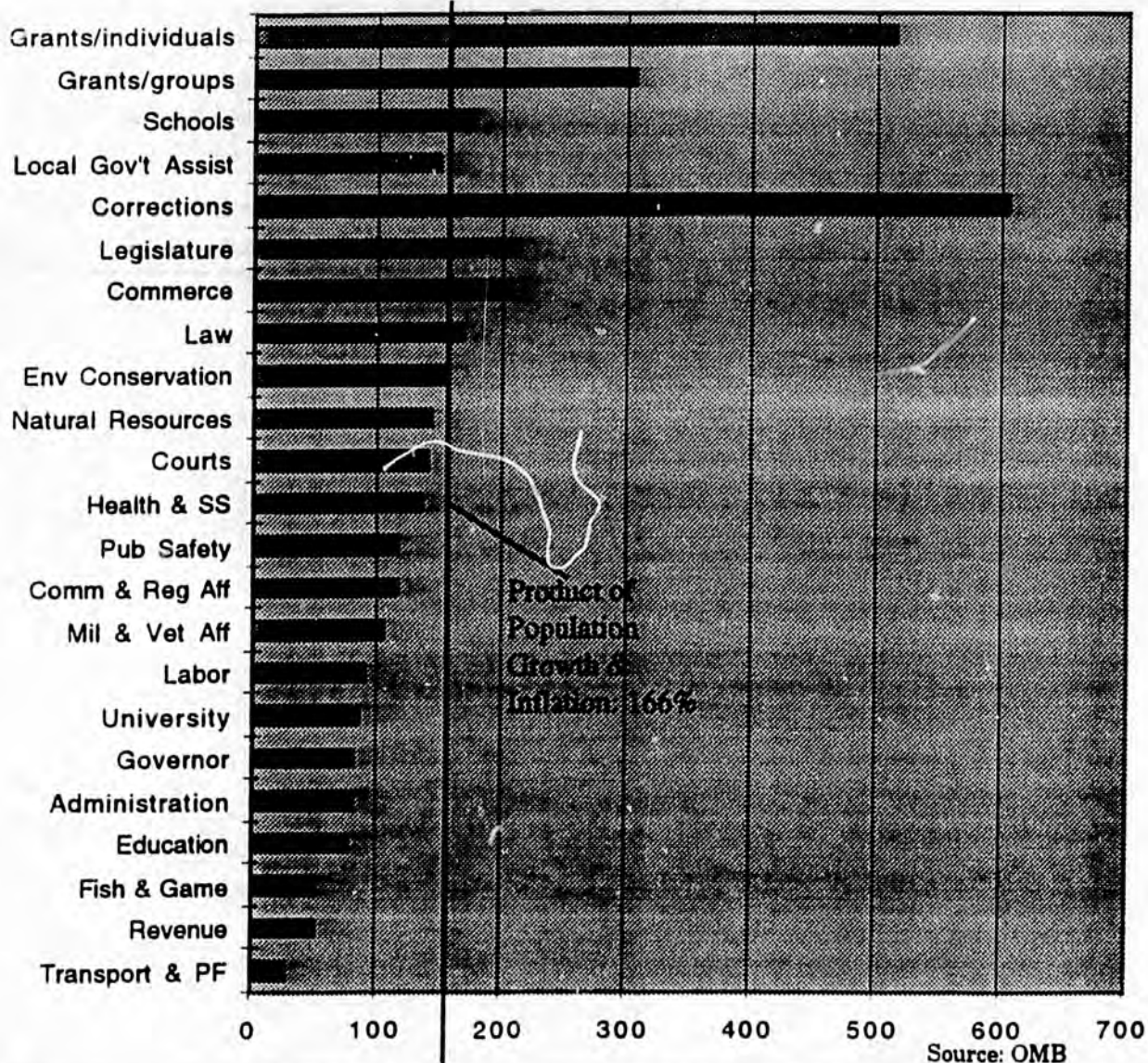
**FY1979 to 96 General Fund
Budget Comparisons
(million \$)**

	1979	1996	% Increase
University	\$89.6	\$167.3	87.2%
Core State Government	\$445.5	\$875.9	97.0%
Local Government Aid	\$37.5	\$92.8	147.0%
Grants to Schools	\$269.3	\$740.6	174.9%
Grants to Groups	\$35.8	\$144.8	305.0%
Grants to Individuals	\$56.9	\$349.4	514.0%
Total	\$935.7	\$2,371.0	153.0%
Consumer Price Index	77.6%	135.8%	75.0%
Population	398,000	606,300	52.3%
CPI * Population	N/A	N/A	166.0%

Source: OMB

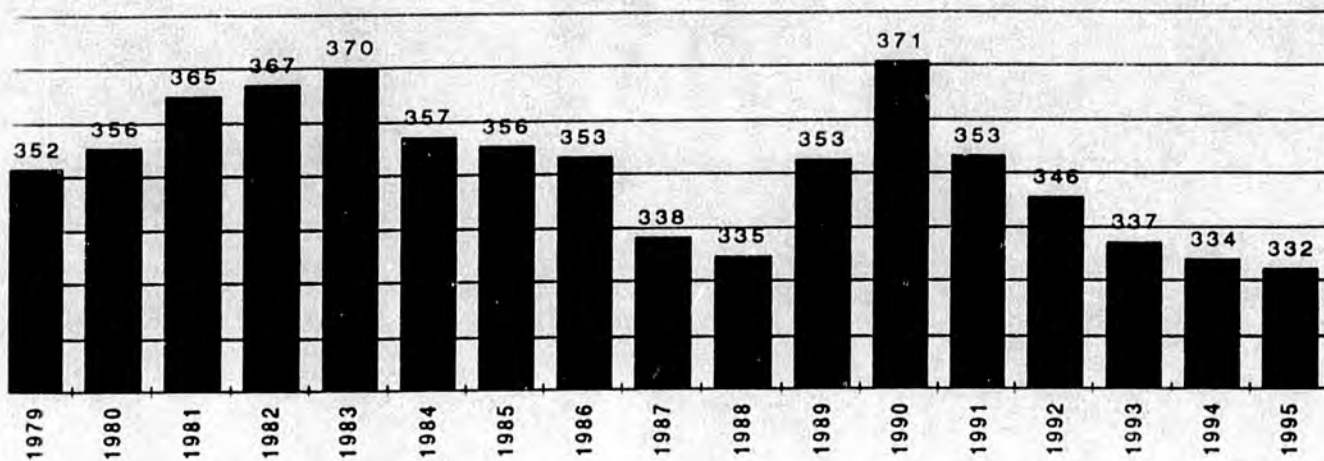
Growth of State Government: FY79 to FY96

Percentage Changes



Source: OMB

State Employees Per 10,000 Population



Source: OMB

per capita spending is at the same level as it was in 1979.

The table at the top of page 8 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%) (not including permanent fund dividends) grants to groups (334%), grants to schools (175%) and local government assistance (165%).

The figure at the bottom of page 8 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%). The largest dollar increases were for the University, Transportation and Public Facilities, Health and Social Services, and Corrections.

Projections for future years show that the biggest areas of spending growth will be formula grants to individuals, groups, and schools, and the corrections and criminal justice budgets.

Emphasis in public discussions and in the legislature has been 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.

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

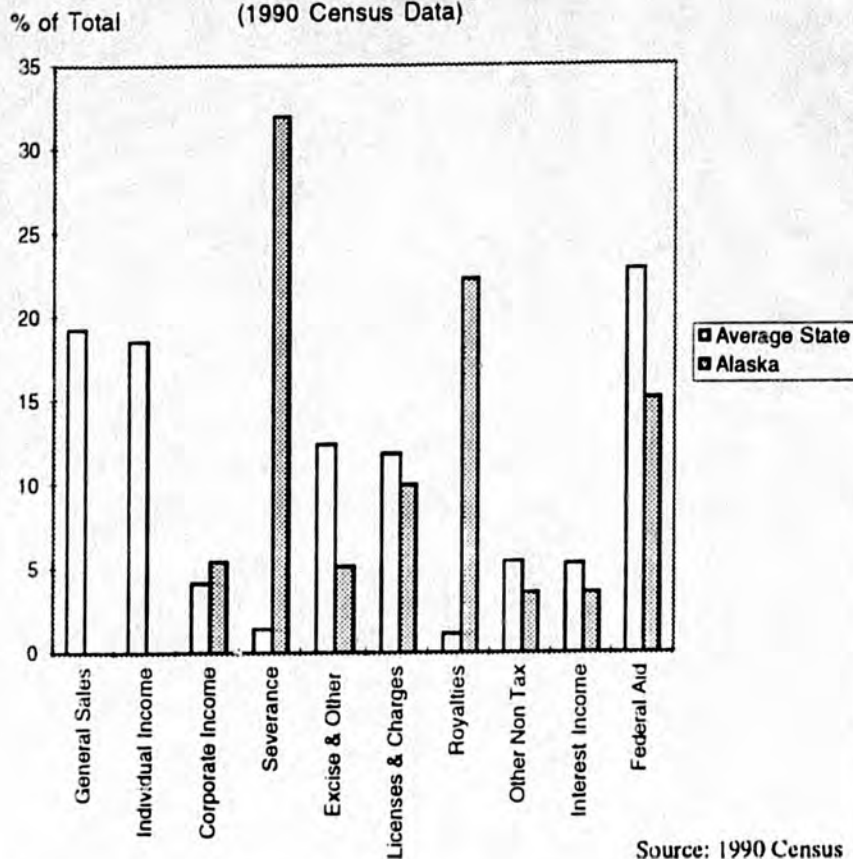
Before the oil years, Alaska spent nearly three times the national average per capita of other states to provide public services. In the 1980s this ratio increased to four times the national average. It has since declined to about the same as in Fiscal Year 1979.

Nonetheless, even excluding Permanent Fund Dividends, Alaska spends more than twice as much per capita as the national average.

Part of this might be 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.

Alaska Revenue Sources vs. U.S. Average

(1990 Census Data)



Source: 1990 Census

We will receive \$1.5 billion from petroleum revenues, \$1.2 billion from permanent fund income (including the \$441 million reserved for inflation-proofing), and \$480 million from other sources. In addition to the \$3.2 billion dollars in general fund and permanent fund revenue, the state also receives and expends federal funds and other funds derived from revenue generating activities.

The major sources of revenue to the state are oil and gas rents, royalties and bonuses, oil and gas properties tax, severance taxes; and corporate income taxes. The state has a number of small sources of revenue, gener-

Comparisons are made more 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.

How much revenue does the State of Alaska receive?

The State of Alaska will receive \$3.2 billion in general fund revenues and permanent fund earnings during FY96.

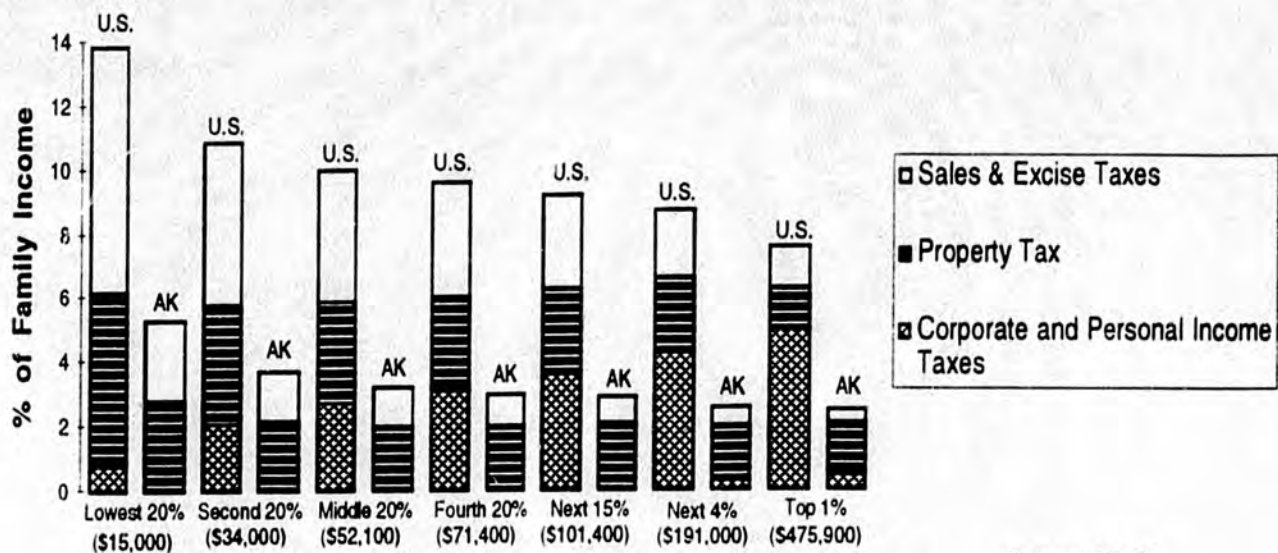
Page 10

ally 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.

The Constitution directs the earnings of the Alaska Permanent Fund to be deposited into the General Fund unless otherwise provided by law. The Legislature has not treated those earnings as available for appropriation in the same sense as tax receipts and the earnings remain in the reserve account until appropriated for dividends or inflation-proofing.

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



Source: OMB

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. This chart compares Alaska's revenue sources with those of an average state in 1990.

How do Alaska's revenues compare with other states?

Alaskans pay approximately a third of the state and local taxes paid by the average American.

The chart at the top of this page compares taxes on the average Alaskan family with those paid by the average American family. It does not take into

account payments to households under the Alaska Permanent Fund dividend program, which more than offsets the combined state and local tax burden for most families.

The two charts on the next page 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 pays significantly less in taxes than a similar family in Seattle WA or Billings MT.

How large are the State's cash reserves?

Alaska is fortunate to have over \$3 billion in cash 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 the use of these reserves can delay for several more years the difficult actions

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	\$2,108
Property Tax	\$ 1,421	\$1,691	\$1,423
Sales Tax	\$ 0	\$ 998	\$ 0
Car Taxes	\$ 93	\$ 538	\$ 493
PermFundDiv.	(\$3,932)	\$ 0	\$ 0
TOTAL	(\$2,418)	\$3,227	\$4,024

Source: Alaska Department of Revenue

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	\$5,418
Property Tax	\$ 2,700	\$ 3,214	\$2,703
Sales Tax	\$ 0	\$ 1,966	\$ 0
Car Taxes	\$ 158	\$ 1,311	\$1,192
PermFund Div	\$ (3,932)	\$ 0	\$ 0
TOTAL	\$ (1,074)	\$ 6,520	\$9,314

Source: Alaska Department of Revenue

\$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 or region of the state, 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 — reimposing personal income taxes, reducing Permanent Fund Dividends, or reducing state spending.

The study compared some special effects from these three choices, including the "federal tax offset" and "tax exporting."

The federal tax offset recognizes that any action that affects personal incomes

necessary to close the fiscal gap, with the potential for suddenly magnifying the state's fiscal and economic problems when the reserves are finally exhausted.

Economic Impacts of Fiscal Choices

Any fiscal choice made will have an adverse impact on Alaska's economy. Failure to make fiscal choices will have a worse impact on Alaska's economy when reserves run out.

For each \$100 million per year removed from Alaska's economy, the gross economic effect is similar whether it's

of Alaskans changes the federal tax liability for Alaskans. The federal tax offset is largest for reimposition of the personal impact tax; approximately 20% of the increase in state taxes becomes a decrease in federal taxes. Approximately 15% of a decrease in permanent fund dividend payments would be offset by a decrease in federal taxes paid by Alaskans. Cutting state spending has some federal tax offset, since a portion of state employees' salaries are paid in federal income taxes, but it is difficult to estimate that tax offset.

"Tax exporting" refers to that 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 Alaska residents). 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.

The effects of these options can also be differentiated by income level. Reimposing a state income tax hits upper income residents higher than lower income residents; reductions to the permanent fund dividends are proportionally greater on lower income residents.

What do you think should be done to close the fiscal gap?

Alaskans have the opportunity to respond to the issues raised in this report.

The Commission is interested in public comment upon the issues raised in this report.

You can contact the Commission by mail at:

**State of Alaska
Long-Range
Financial Planning Commission
716 West Fourth Avenue
Anchorage, AK 99501**

or by electronic mail at:

LRFPC%legis@state.ak.us

The Commission will hear public comment during the following hearings:

Sept. 11	7:00 p.m.	Interior/North
Sept. 12	7:00 p.m.	Southcentral
Sept. 13	7:00 p.m.	Anchorage
Sept. 14	7:00 p.m.	Southeast

Each hearing will be held at the Legislative Information Office Conference Room at 716 West Fourth Avenue, Anchorage and teleconferenced to other LIO sites. If you live in a community which is not served by a Legislative Information Office, to get information on participation in the process please contact the Commission staff at (907) 258-8165.

The Commission will also hear from the public during its regular meetings at the Anchorage LIO on the following dates:

Aug. 26	11:00 a.m.
Sept. 16	11:00 a.m.
Sept. 30	11:00 a.m.

The Commission is particularly interested in hearing about fiscal choices which are not listed in the appendices — other spending cuts, new revenues, uses of Permanent Fund income, uses of reserves, or other economic development strategies.

We want to know which fiscal choices are preferable to others, and why. We believe that in order to close the fiscal gap, Alaska will have to use portions of several choices, and we want to know if Alaskans have suggestions on timing of these fiscal choices — what should come first, and why?

Appendix One

Catalog of policy choices to close the fiscal gap

Part One: Spending Cuts

This appendix is a working document containing policy suggestions developed by the Commission and its subcommittees. It contains some of the information that was prepared for the Commission. It is not complete — we expect additional policy choices to come from the public and to be developed by the Commission. Individual members of the Commission may disagree or agree with any policy listed herein. Readers should feel free to add new policy choices to this catalog.

The Legislature directed the Commission to develop a list of spending cuts that equal the current fiscal gap. This means identifying how to cut more than \$500 million, or 15 percent, from state spending.

Budget cutting is a painful, divisive undertaking.

It does, however, provide us who live in Alaska the opportunity to re-think our expectations of government. It helps us consider what we believe government should provide and how it can 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.

It requires Alaskans to redefine the State's responsibility.

The following scenarios of more than \$500 million in spending cuts are in response to the charge by the Legislature. The subcommittee does not recommend that the fiscal gap could or should be filled only by budget cuts to government operations.

The following represents considerations used in developing reduction scenarios:

1. **Many Alaskans will not take the fiscal gap seriously or be willing to accept the individual sacrifices to resolve the gap until they believe state government is spending responsibly.**
2. **Spending cuts are an important and necessary tool to solve the fiscal gap.**
3. **The State has been accomplishing actual budget cuts by holding the budget flat (which means that the agency or recipient has been absorbing additional costs due to inflation).**

effectiveness of service delivery, who should be providing these services, and who should be paying for them.

The important point is that fiscal policy goals are critically important to the kind of reductions contemplated under any scenario.

Considerations in Making Spending Cuts

Spending cuts require careful attention to both the immediate impact of the cut (loss of federal funds or state jobs, less aid to local governments, smaller grants to individuals and organizations, etc.) and the long term effects (condition of state facilities, impacts on citizens' health and safety, results for economic development, etc.).

In some cases, cuts at the state level might only shift problems to local communities, just as federal cuts will shift burdens to the State.

In other cases, cuts may not result in loss of services to the public. For instance, continued state efforts to streamline programs, and improve technology can produce further cost savings.

Reduction scenarios could incorporate a number of cost-saving ideas, such as:

Grants and Services to Individuals

- In the face of community need for basic services, non-needs based grants to individuals are eliminated.

Grants to Organizations and Local Governments

- Reduce administrative and other costs by consolidation of grantee organizations, local governments and school districts to stretch funds for direct services.
- State directed mandates to local governments could be fully funded or made optional.
- Tie grants to local governments to provide specific services rather than general block grants for local services.

Note: If state and local governments charge for services and at a rate similar to that in other states, these increased fees would help offset reduced state funding.

Salaries and Benefits

Significant savings would be realized from reforms to the public employee compensation system. These reforms apply not only to state

4. **Additional budget cuts, over and above a flat budget, probably will be necessary to solve the fiscal gap.**
5. **Spending cuts should be governed by announced fiscal policy goals.**
6. **Increases in formula programs are only partly explained by population increases; all formula programs must be re-examined or they will overwhelm and defeat all attempts to resolve the fiscal gap problem.**
7. **All state expenditures, including Permanent Fund earnings and dividends, should be included for review in determining fiscal policy goals for spending cuts.**

Note: It should be pointed out that individual Commission members would choose different percentages or even different programs for cutting, if such drastic reductions were required. The following scenarios of spending cuts are to demonstrate that each option has its own set of consequences.

Rules of the Road

- Spending cuts were made only to programs supported by the state general fund. This means potential reductions in programs funded from other sources (such as Power Cost Equalization, student loans, etc.) were not identified as potential reductions. An option is to reduce such programs and have the savings go into the general fund to help bridge the gap.
- For purposes of discussion, the Commission agreed to bring appropriations of Permanent Fund earnings "on budget" since they are an expenditure of state funds. The question of the future of the earnings is central to Alaska's long range fiscal policy.
- The spending cuts discussed here underestimate the impact on local and state economies and services because they do not reflect the anticipated reductions to federal funds.

The Important of State Fiscal Policy Priorities

The state budget reflects what the Governor and Legislature believe to be public policy priorities in terms of needs and services. It also reflects what decision makers believe about who should provide the services and who should share in Alaska's revenues.

As revenues decline, we simply can't pay for all of the things we have been doing in the past nor can we continue to share revenues in exactly the same way. Alaskans are going to have to re-think our fiscal priorities, the

employees, but also to those employed by local governments and school districts. Such cost-saving reforms could include:

- A different health benefit package for all employees and different retirement package for new hires to reduce current benefit costs and future retirement costs for new hires.
- A retirement incentive program to reduce the number of current high-cost employees, cut the overall number of employees in conjunction with a lower cost for all new employees.
- Changes to the current compensation system to better reward individual performance and limit increases in personal services expenses.

Service Delivery Options

State government services could be delivered in different ways. Options include:

- Contract with non-profit and private sector organizations to provide services.
- Privatize the service by selling an asset to a private entity to operate.
- Provide eligible individuals with a voucher so they can purchase services from a private sector vendor.

Four Scenarios to Cut Over \$500 Million—or 15% of the Budget

To accomplish the assigned task of cutting over \$500 million, these considerations were incorporated into four scenarios. They are for illustration and the Commission will not necessarily be recommending any of these.

Scenario 1: *If the decision were made that services provided by the State should be maintained, in so far as possible given the size of the reductions, the following kinds of cuts could be considered. Local governments would then have to decide what services--formerly funded by the State--they are willing to provide and pay for.*

- **Transfer and increase services and fiscal responsibilities to local governments.**
- **The Permanent Fund Dividend would continue to be paid while other non-needs based payments to individuals would be eliminated.**
- **Consolidate and privatize programs at the state level.**

	Estimated Savings by FY 2000	Amount Remaining
Grants that Benefit Individuals: -\$100,002.0		
Longevity Bonus	-72,152.6	0.0
Permanent Fund Dividend	0.0	556,000.0
Public Assistance Programs	-10,163.1	91,468.0
Medical Assistance Programs	-15,035.6	135,320.2
Alaska National Guard Benefits	-226.6	906.3
Day Care Assistance	-1,017.3	10,193.8
Other Programs	-1,406.8	1781.9
Grants to Local Governments: -\$228,072.4		
K-12 Funding	-66,030.9	594,278.5
Human Services Matching Grants	-1769.6	0.0
Senior Citizens Property Tax Relief	-1,500.0	0.0
Revenue Sharing	-26,271.1	0.0
Municipal Assistance	-31,959.0	0.0
Community Jails	-218.7	4,156.0
Capital Matching Grants	-20,000.0	0.0
School Debt Reimbursement	-80,322.4	0.0
Employee Salary/Benefit Reforms and Streamlining Programs: -\$96,150.8		
State Agency Programs	-74,037.9	1,166,246.3
Court System	-2,292.1	43,550.3
Legislature	-3,084.6	27,761.0
University	-16,736.2	150,625.5
Privatization: -\$54,217.4		
Pioneer Homes	-29,842.3	0.0
RATNET	-794.8	0.0
Alaska Council on the Arts	-564.0	0.0
Vocational Technical Schools	-5,106.3	0.0
Harborview	-4,550.0	0.0
Alaska Tourism Marketing Council	-5,365.3	0.0
Alaska Seafood Marketing Council	-7,994.7	0.0
Competitive Contracting Opportunities: -\$11,799.7		
Park Management	-1,672.1	3,941.0
Motor Vehicles Division	-2,062.5	6,187.3
Road and Vehicle Maintenance	-5,050.1	1115,161.9
Other Programs	-47.0	141.2
Consolidate/Eliminate Programs: -\$19,296.8		
Alcohol Beverage Control Board	-479.5	159.8
Alaska Public Offices Commission	-475.4	158.4
Cultural Program Grants	-88.4	0.0
Agricultural Development	-1,034.2	0.0
Rural Development Grants	-1,119.4	0.0
General Obligation Debt (debt obligations fulfilled)	-16,100.0	0.0
Grants to Organizations who Provide Services: -\$11,837.7		
Senior Programs	-954.1	6678.5
Alaska Public Broadcasting Grants	-1,109.1	3,327.5

Regional Non-Profit Corporations	-1,068.7	9,618.1
Health Grants	-698.7	6,288.0
Alcohol and Drug Abuse Grants	-1,435.9	13,823.2
Community Mental Health Grants	-2,583.8	23,254.0
Community Developmentally Disabled Grants	-2,056.2	18,596.2
Council on Domestic Violence Grants	-224.4	4,262.7
Child Care Grants	-269.1	2,553.7
Other Programs	-1,437.7	25,644.6

TOTAL **-\$521,376.9**

Scenario 2: *If the decision were made that, even though massive reductions in state services will occur with \$500 million in cuts, the State should continue to fund services through local governments, the following kinds of cuts could be considered. In this scenario, individuals would share in the responsibility of closing the fiscal gap by foregoing half of their Permanent Fund Dividend.*

- **Major consolidation and privatization of programs at the State level.**
- **Eliminate all but needs-based payments to individuals.**
- **Cap Permanent Fund Dividend payments at 50% and distribute the funds to local governments for community needs (\$278 million based on 1994 dividend amount).**

	Estimated Savings by FY 2000	Amount Remaining
Grants that Benefit Individuals: -\$320,002.0		
Longevity Bonus (needs-based)	-14,152.6	58,000.0
Permanent Fund Dividend	-278,000.0	278,000.0
Public Assistance Programs	-10,163.1	91,468.0
Medical Assistance Programs	-15,035.6	135,320.2
Alaska National Guard Benefits	-226.6	906.3
Day Care Assistance	-1,017.3	10,193.8
Other Programs	-1,406.8	1781.9
Grants to Local Governments: No Reductions		
K-12 Funding	0.0	660,309.4
Human Services Matching Grants	0.0	1769.6
Senior Citizens Property Tax Relief	0.0	1,500.0
Revenue Sharing	0.0	26,271.1
Municipal Assistance	0.0	31,959.0
Community Jails	0.0	4,384.4
Capital Matching Grants	0.0	20,000.0
School Debt Reimbursement	0.0	80,322.4
Employee Salary/Benefit Reforms and Streamlining Programs: -\$96,150.8		
State Agency Programs	-74,037.9	1,166,246.3
Court System	-2,292.1	43,550.3
Legislature	-3,084.6	27,761.0
University	-16,736.2	150,625.5

Privatization: -\$54,217.4

Pioneer Homes	-29,842.3	0.0
RATNET	-794.8	0.0
Alaska Council on the Arts	-564.0	0.0
Vocational Technical Schools	-5,106.3	0.0
Harborview	-4,550.0	0.0
Alaska Tourism Marketing Council	-5,365.3	0.0
Alaska Seafood Marketing Council	-7,994.7	0.0

Competitive Contracting Opportunities: -\$11,799.7

Park Management	-1,672.1	3,941.0
Motor Vehicles Division	-2,062.5	6,187.3
Road and Vehicle Maintenance	-5,050.1	1115,161.9
Other Programs	-47.0	141.2

Consolidate/Eliminate Programs: -\$19,296.8

Alcohol Beverage Control Board	-479.5	159.8
Alaska Public Offices Commission	-475.4	158.4
Cultural Program Grants	-88.4	0.0
Agricultural Development	-1,034.2	0.0
Rural Development Grants	-1,119.4	0.0
General Obligation Debt (debt obligations fulfilled)	-16,100.0	0.0

Grants to Organizations who Provide Services: -\$11,837.7

Senior Programs	-954.1	6678.5
Alaska Public Broadcasting Grants	-1,109.1	3,327.5
Regional Non-Profit Corporations	-1,068.7	9,618.1
Health Grants	-698.7	6,288.0
Alcohol and Drug Abuse Grants	-1,435.9	13,823.2
Community Mental Health Grants	-2,583.8	23,254.0
Community Developmentally Disabled Grants	-2,056.2	18,596.2
Council on Domestic Violence Grants	-224.4	4,262.7
Child Care Grants	-269.1	2,553.7
Other Programs	-1,437.7	25,644.6

TOTAL**-\$513,304.6**

Scenario 3: *If the decision were made that the level and kind of services provided to Alaskans by state and local governments are essential to the economy and well-being of the State, the following reduction could be considered.*

- **No reduction in services at state or local government levels.**
- **No reduction in funds to state or local governments**
- **Permanent Fund dividend eliminated.**

	Estimated Savings by FY 2000	Amount Remaining
Grants that Benefit Individuals: -\$556,000.0		
Permanent Fund Dividend	-556,000.0	0.0

Scenario 4: *If the decision were made only to fund services that meet basic life, safety, education and health needs, the following reductions could be considered.*

- **Only programs known to be constitutionally mandated, necessary for basic departmental functions or required by federal law would be retained.**
- **All functions that could be privatized would be eliminated.**
- **Permanent Fund Dividend would be retained.**

Program effects of these potential reductions are summarized by broad service areas:

Education: \$-64,508,000

- K-12 foundation funding and court mandated-educational services are retained as well as state supported school debt. Instructional, nutritional, and facilities support is eliminated.
- Anchorage and Fairbanks campuses of the University of Alaska are retained. State support to other university campuses and programs are eliminated.
- Eliminate general fund support to the Post secondary Education Commission.
- Eliminate nearly all vocational education programs.
- Eliminate RATNET, public broadcasting, state museums, library, archives, and cultural programs.

Social Services: -\$161,694,000

- Eliminate virtually all special senior programs including state support of pioneer homes, the longevity bonus, senior support, and tax exemption programs.
- Eliminate most family and children's services currently provided by non-profits. Retain centralized services.
- Retain basic welfare programs such as AFDC required by federal law.
- Eliminate special Alaska welfare options such as waivers for additional benefits and longevity bonus.
- Eliminate all programs for disabled, developmentally disabled, and veterans.

Health: -\$26,002,000

- Retain basic state health services such as lab, nursing, epidemiology and the medical examiner.
- Retain mental health services included under terms of the Mental Health Trust settlement.

- Eliminate state support for prevention services such as mental health, child abuse, and public health.
- Eliminate most outpatient and institutional services provided by private non-profits.
- Eliminate all health care administrative services not required by federal law.

**Natural Resources Management and
Environmental Conservation: -\$66,687,000**

- Retain most restoration and protection functions.
- Eliminate nearly all general funded resource management functions with the exception of the boards of fish and game.

Public Protection: -\$28,763,000

- Retain essential licensing functions.
- Retain sanitation and health inspections.
- Retain basic state safety functions, eliminate all outreach programs.
- Eliminate all civil rights functions.
- Eliminate special state national guard retirement benefits.
- Eliminate regulatory functions with the exception of alcohol and public utilities.

Administration of Justice: -\$28,437,000

- Retain state troopers, fish and wildlife protection and village public safety officer programs.
- Retain probation and child support enforcement.
- Eliminate domestic violence and sexual assault program.
- Retain prosecution, courts, and incarceration with minimal cuts.
- Eliminate contract jails.

Development: -\$25,875,000

- Eliminate all promotional assistance, financing, and rural economic development aid programs.
- Eliminate all but minimal maintenance from statewide facilities and transportation services.

General Government: -\$111,034.0

- Retain revenue collection, elections, and debt service.
- Eliminate all but minimal general administrative and support services.
- Eliminate all general fund support of local governments.
- Decrease capital spending to fill remainder of the gap.

TOTAL -\$513.0 million

Appendix One

Catalog of policy choices to close the fiscal gap

Part Two: New Revenues

This appendix is a working document containing policy suggestions developed by the Commission and its subcommittees. It contains some of the information that was prepared for the Commission. It is not complete — we expect additional policy choices to come from the public and to be developed by the Commission. Individual members of the Commission may disagree or agree with any policy listed herein. Readers should feel free to add new policy choices to this catalog.

Taxes are potential sources of revenue to close part of the fiscal gap.

The Commission recognizes that taxes impose costs on both individuals and businesses. Economic burdens on individuals and businesses can impair economic development, although it is widely known that most accept the necessity of paying taxes and ask only that the burdens be imposed fairly and for important services.

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

At the same time, the state funds certain programs, notably education, that are traditionally considered a local responsibility. The Commission notes that many states use a statewide real property tax as the primary source of revenue to fund statewide education support.

Four major new taxes can be parts of a solution to the fiscal gap.

- statewide real property tax
- statewide sales tax
- individual income tax
- employment tax (similar to the old "school tax")

Statewide Real Property Tax = \$28 million per mill

The state can expect to receive approximately \$28 million annually for each one mill of real property tax in addition to the amount the state receives now from the oil and gas property tax.

There are difficulties in collecting property taxes in the unorganized borough and costs of tax administration may exceed collections.

Statewide Sales Tax = \$58.0 million each 1 percent

The Department of Revenue estimates that each one percent of statewide sales tax that exempts food, health and social services, would generate \$58.9 million annually, excluding sales taxes that could be imposed on mail order sales.

Sales taxes are easy to collect because the seller, in effect, is the tax collector and it spreads the tax burden widely to all purchases of goods and services. In addition, it captures some revenues from non-residents visiting Alaska.

Sales taxes are a preferred form of taxation in other states as well as among Alaska's local governments. Some local governments, e.g. Anchorage, have steadfastly resisted the imposition of a sales tax. Fairbanks had a sales tax until the state increased revenue sharing and municipal assistance in the early 1980s. Juneau imposes a four percent sales tax. In contrast, the State of Washington imposes a sales tax of approximately 8 percent.

An argument against sales and use taxes is the tax creates the largest proportional burden for those who have lower incomes. In recognition of this, many jurisdictions exempt food and other categories of essential goods and services. Notwithstanding, sales taxes are increasingly supported by all income groups, including those upon whom the burden of a sales tax falls most heavily.

Another option is to establish a statewide sales tax that supersedes local sales taxes and apportions the receipts between the state and the local government in which the sales taxes are collected. Either as a part of this tax, or as a separate tax, the legislature can act as the borough assembly of the Unorganized Borough and enact a sales tax to support a portion of rural services.

Individual Income Tax = \$74.5 million @ 1 percent

The Department of Revenue estimates that each 1% tax on Alaskans' federal taxable incomes would raise \$67 million, with non-residents adding another \$7.5 million. The amount which would result from graduated taxes is estimated in the following table:

Estimated Individual Income Tax (on Alaska residents)

Income Class	# of Returns	Adjusted Gross Income (Federal) (\$000)	Exemptions & Deductions (\$000)	Alaska Taxable Income (\$000)
\$0— \$29,999	233,370	\$1,805,391	\$1,133,050	\$672,341
\$30,000— \$49,999	52,100	2,051,278	675,210	1,376,068
\$50,000— \$74,999	37,460	2,388,194	615,690	1,672,504
over \$75,000	29,809	3,602,086	650,515	2,951,571
Total	352,739	\$9,746,949	\$3,074,465	\$6,672,484

Employment tax @\$100 each employee = \$40 million

The Territory and later the State levied a tax of \$10 per employed person. The proceeds of the tax were used to fund education. Reinstitution of this tax at a level of \$100 would yield approximately \$40 million, based on current labor force estimates, with approximately 8% of that amount paid by nonresident workers. This tax creates a heavier proportional burden for low wage earners than for persons in high income brackets.

There is no structure in place for collection of these taxes and there can be significant costs incurred for tax collection. The Commission believes that if new taxes are necessary to close a portion of the fiscal gap, the taxes should generate more revenue than costs.

Existing other taxes can be increased as parts of a solution to the fiscal gap

- corporate net income tax
- highway motor fuel tax
- marine motor fuel tax
- aviation motor fuel tax
- fisheries business tax
- fishery resource landing tax
- tobacco tax
- alcoholic beverages tax

For each of these existing taxes, there is a structure in place to collect the tax, and small cost to begin the collections.

Possible changes in the taxes would yield the following additional revenues.

Raise highway motor fuel tax to U.S. median = \$58.7 million

Highway motor fuel tax: an increase from 8¢ per gallon to the US. median tax rate of 21.9¢ per gallon would yield \$58.7 million (if the off-highway exemption stays at 6¢) or \$39.3 million (if the off-highway tax remains at 2¢). Repeal of the exemption for gasohol would raise \$4 million.

Raise marine motor fuel tax to U.S. median = \$28.1 million

Marine motor fuel tax: an increase from the current 5¢ per gallon tax to the highway rate of 8¢ per gallon would raise \$5 million; an increase to the average US. median tax of 21.9¢ per gallon would raise \$28.1 million.

Repeal aviation motor fuel tax foreign exemption = \$10 million

Aviation motor fuel tax: A repeal of the current exemption for foreign flights would raise \$10 million.

Fisheries business tax: eliminate differential = \$2.5 million

Alaska levies a raw fish tax, a portion of which is shared with communities. Established fisheries bear a larger portion of the tax than "emerging" fisheries. All of the fisheries should be examined to determine if it is reasonable to continue to distinguish between established and emerging fisheries. Whatever that decision may be, the raw fish tax could be doubled without additional administrative expense, leaving the local share the same. The Department of Revenue estimates if all exemptions were eliminated and all fisheries were taxed at the rate of 4 percent, the additional revenue would be \$2.5 million.

Increase fishery resource landing tax: .7% = \$1 million

Fishery Resource Landing Tax: An increase from 3.3% to 4% would raise \$1 million.

Increase tobacco tax \$1.00 per pack = \$57 million

Tobacco Tax: Alaska has the fifth highest rate of smoking nationally and the highest rate of chewing tobacco use. Experience in Canada has shown that total revenue from tobacco taxes have continued to rise even though total consumption dropped when the tax was increased to \$3.00 per pack. After factoring in expected decreases in cigarette consumption, an increase of \$1 per pack in Alaska would bring in an additional \$42 million annually. An increase in the tax on chewing tobacco to 55¢ would bring in \$370,000 annually.

Increase alcohol tax rate = \$19 million

Alcohol Tax: A raise in the tax on alcoholic beverages from 3-4 cents a drink to 10 cents a drink would raise an additional \$19 million.

Resource taxes and royalties

Alaska taxes natural resources. The Commission notes that any proposal to create or increase resource taxes requires serious consideration of the interplay between levels of taxation and resource development. There are diverse views as to what impact taxes have on new resource development or the continuation of existing resource-based industries.

Minerals Industry Taxes

The state presently collects approximately \$343,000 from the mining license tax. This is a tax levied on the net value of resources, primarily gold and coal. Because many of Alaska's mineral resources, other than oil and gas, are now in an early state of development of both mines and markets, the Commission notes that a thorough examination of the economic impact of taxes or royalties on the minerals industries is needed.

Timber

The Commission did not undertake an analysis of the tax and royalty the state's timber resources could support. Such an amount is not likely, however, to be significant in closing the fiscal gap.

Oil and Gas

No discussion of potential revenues would be complete without considering a increased taxes or royalties on the state's oil and gas resources. Alaska's revenue shortfall is the result of a major decline in oil production. This means that the oil and gas industry is also suffering from the same decline in revenues and, at the same time experiencing increasing production costs.

Without consideration of Permanent Fund earnings, the oil and gas industry in Alaska presently generates 80 percent of Alaska's income through royalties, severance taxes, real property taxes and corporate income taxes. Inclusion of Permanent Fund earnings reduces that percentage to about 50 percent.

Royalties are set by contract and in 1995 new legislation gave the Commissioner of Natural Resources the ability to negotiate varying royalty rates for different oil fields.

A few years ago, a measure changing the reduction in severance taxes scaled to the economics of production from a mature or maturing oil field was enacted. Real property tax revenue is a function of the value of the property assessed. With

respect to oil and gas property, economic or useful life and, thus, value, is closely tied to the life of the field or fields served.

Fish royalty tax @ oil and gas rate = \$60 million

This is not an existing tax, but is modeled after the existing royalties on non-renewable resources. A four percent royalty on fish would recover approximately \$19 million annually, and would provide the state a return on valuable limited entry permits. Establishing royalty rates on fish comparable to those on oil and gas would raise \$60 million annually from commercial fishermen.

New revenue sources — non-tax

Service and User Fees

At the present time, the state imposes service and user fees in approximately 170 different categories. Some fees are mandated by federal programs, some are fixed to cover regulatory costs and others are designed to fund services, such as occupational licensing.

Programs which are fully supported by fees and other charges seldom receive adequate scrutiny by both the legislature and the administering agencies to determine if the service can be less expensive or if the service can or should be fully supported by fees and charges. The Commission has requested information showing a comparison of fees and costs.

Table 2, attached, shows those user fees which (a) were collected in 1991, (b) brought in at least \$100,000 in 1991, and (c) for which rates were not primarily market-driven. These amounts will be updated in the next version of this report and certain items may be moved to the tax list (e.g. insurance taxes are here, not on the list of taxes).

Statewide lottery = \$10 to \$20 million

Charitable gaming represents a potential new source of income to the state. The state receives a small percentage of gaming receipts to cover the cost of licensing and audits. The balance of the receipts are shared by operators and the charities the operators serve. From time to time, this activity has been examined to determine if a fair share of proceeds reach the hands of the charities, but no examination has been made with the goal to determine if the state receives a fair share.

Periodically proposals for a statewide lottery emerge. At this time, the evidence indicates that after prizes and expenses of administration and regulation are deducted, a statewide lottery probably yields about \$10-20 million.

AGENCY	DIVISION	NATURE OF FEES	1991 COLLECTIONS	SOURCE OF FEES
DOT/PF	Admin Svcs	Airport Fees, etc	\$24,148,724	Other
Public Safety	Motor Vehicles	Vehicle Registration	\$17,572,608	Statutory
ADF&G	Administration	License & Tag Fees	\$11,474,010	Statutory
ADF&G	Comm Fish Entry C.	Entry Permit Fees	\$5,912,800	Regulation
Public Safety	Motor Vehicles	Drivers Licenses	\$3,611,473	Statutory
Commerce	Occ. Licensure	All Occupations	\$2,540,490	Regulation
Commerce	Insurance	Insurer Fees	\$2,022,700	Regulation
Court System	All Courts	Filing Fees	\$1,828,800	Other
Commerce	Occ. Licensure	Business Licenses	\$1,536,000	Statutory
Commerce	Occ. Licensure	Gaming Licenses	\$1,526,000	Statutory
Revenue	ABC Board	Liquor Licenses	\$1,482,700	Statutory
Commerce	Banking, Sec & Corps	Security Registration	\$707,438	Regulation
		Oversize Overweight		
Commerce	Measurement Stds.	Vehicle Registration	\$681,900	Regulation
DHSS	Public Health	Vital Statistics	\$612,029	Other
Env.Cons.	Spill Prevention	UST Fees	\$500,000	Statutory
Commerce	Insurance	Agents, Licenses	\$467,800	Regulation
Public Safety	Fire Protection	Plan Review	\$388,400	Regulation
ADF&G	Wildlife Conservation	Permit Hunt App	\$380,395	Statutory
Commerce	Banking, Sec., & Corps	Broker Dealers	\$310,790	Regulation
DOT/PF	Admin Services	Utility Permits	\$272,199	Regulation
Education	Educational Finance	Teacher Certification	\$224,625	Regulation
Commerce	Banking Sec. & Corps	Incorporations	\$223,650	Regulation
Labor	Labor Stds & Safety	Certs. of Fitness	\$216,000	Statutory
Commerce	Investments	Late Fees	\$208,500	Regulation
Labor	Labor Stds & Safety	Boiler Fees	\$208,000	Regulation
Revenue	ABC Board	License Application	\$201,400	Regulation
Education	Vocational Rehab	Vendor Fees	\$200,000	Other
Commerce	Banking, Sec. & Corps	Agents & Invest.Advs.	\$186,030	Regulation
Public Safety	Criminal Records	Fingerprinting	\$110,480	Regulation
Governor	Lt. Governor	Notaries Public	\$109,137	Statutory
Other	Statutory Fees	Not listed above	\$2,318,058	Statutory
Other	Fees set in Regulation	Not listed above	\$4,966,345	Regulation
Other	Fees not statutory or regulatory	Not listed above	\$10,488,692	Other

Permanent Fund Earnings Reserve Account (PFER). The CBR consists of funds received in settlements of administrative proceedings or litigation regarding mineral lease bonuses, rentals, royalties, royalty proceeds and taxes. The PFER is a holding account into which is deposited all investment income until the transfers to principal for inflation proofing and to the dividend fund are made. Excess funds in the PFER are held and invested in the same manner as the principal of the Permanent Fund. The Commission determined that under our plan the state needs only one significant reserve.

- The CBR should be maintained at a level of \$1.5 billion to provide stability in the event of a rapid decline in oil prices or production or in the event of a natural disaster. That amount is approximately one year's oil revenues. Funds in excess of that amount should be deposited into the principal of the Permanent Fund. Earnings from CBR investment should continue to flow into the CBR.
- Funds in the CBR should be invested in accordance with the prudent investor rule based upon the purposes of the reserve. The commission recommends that the general fund be allowed to borrow against the CBR to even out the flow of funds required to meet monthly cash flow needs.
- The sweep provisions in the current CBR should be eliminated (Article X, Section 17 (d) of the Constitution). Sufficient controls on the use and withdrawal of funds from the CBR are achieved by limiting withdrawals from the fund to make up for projected annual revenue declines rather than availability of funds.
- Once the constitutional amendment establishing the Permanent Fund as an endowment is in place in FY98, all funds in the Permanent Fund Earnings Reserve should be deposited into the principal of the Permanent Fund. As an endowment, the Permanent Fund will be effectively inflation-proofed. The dividends will be payable out of the automatic annual withdrawal.

Reform the budget process

The Commission found the budget process does not yield adequate information concerning the State's finances, nor does it describe what we get for what we spend. It discourages appropriate scrutiny of overall State spending. Although the fiscal gap relates to State general fund spending, special funds set aside or collected affect services delivered by the State and require oversight and control.

- The budget process should include review of all State spending, not just State general funds. The executive and legislative branches should establish procedures to provide appropriate scrutiny and disclosure.
- A report to the public should be prepared annually on progress toward closing the fiscal gap. The Commission suggests the spreadsheet format it has used to show the existence or absence of a fiscal gap for the current and succeeding 10 years.
- The legislature should review each program funded or operated by the State, including loans and special appropriations to determine whether or not it meets its intended purpose and whether the program is needed in the 21st century. State programs should also be reviewed to determine if the service is better delivered at the local level.
- Capital improvement funding should be based on a six-year plan to achieve greater efficiencies in funding, planning, construction and maintenance.

The Commission was asked to examine the division of responsibility for providing services and raising revenues between the State and local governments. This area deserves intensive examination, substantially more than the Commission had time to give it. The Commission believes that the State and local governments must continue to work on the issue the division of State and local responsibilities.

The five- and ten-year plan

In 1999, Alaska comes to a fork in the road. To prevent the fiscal gap from reappearing, we can cut the budget further, reinstitute the State personal income tax, increase other taxes, and/or further reduce dividends. The Commission recommends that a follow-up review be done in late 1998 and early 1999 to adjust the overall plan as needed for the succeeding five to ten years. By that time the budget should balance and we will know more about several things that are now uncertain such ANWR, the gas line and federal budget changes. As a result, decisions for the first decade of the next century will be less dependent on speculation.

This Commission recommends reimposition of the State personal income tax once the deficit reappears. Under the Commission's plan, after cutting spending and raising revenues, the fiscal gap reappears in about the year 2002. A personal income tax act will require enactment in the year 2000 in order for it to take effect in 2002.

First Session Progress Report on the Financial Plan

Legislation

1. Resolution approving financial plan.
2. Permanent fund endowment constitutional amendment goes to the voters.
3. Constitutional budget reserve constitutional amendment goes to the voters.
4. Retirement incentive program.
5. Tier III to reduce retirement costs for new hires.
6. Geographic pay differential for non-covered employees.
7. Road/harbor transfers to local government and fuel tax increases.
8. Senior/veterans tax exemption becomes local option.
9. New oil & gas property tax has 50/50 split before debt
10. Tobacco tax increase.
11. Alcohol tax increase.
12. User Fee increases of at least \$3 million

Budget Action

1. Meet fiscal gap target (about \$390 million); \$40 million cut from FY96.
2. Show all funds in State spending plan.
3. Deposit from CBR into Permanent Fund as in plan.
4. Administrative consolidations.
5. Six year capital plan approved.
6. Show Permanent Fund earnings and dividends as part of budget.
7. Do maintenance and deferred maintenance within budget target.
8. Start performance based budgeting.
9. Reduce growth rate of Medicaid and AFDC.

Second Session Progress Report

Legislative Action

1. Fisheries and other resource tax.
2. Tourism tax or self-support of industry promotion.
3. Deposit from CBR to Permanent Fund as in plan.
4. Additional \$3 million in fee increases/indexing.

Budget Action

1. Meet fiscal gap target of about \$220 million; \$70 million cut from FY96.

Third Session Progress Report

Legislative Action

- 1. Resolution creating financial planning Commission to review progress and make new recommendations.

Budget Action

1. Meet fiscal gap target of about \$60 million; \$100 million cut from FY96.

*For
Greathand
mailers*

THE STATE LONG RANGE FINANCIAL PLANNING COMMISSION REPORT

An Endowment For Alaska's Future The State Long Range Financial Planning Commission Report

EXECUTIVE SUMMARY

Alaska's fiscal gap is real and growing

The State is spending \$524 million more than it will take in during the current fiscal year. That gap will grow to \$1.3 billion per year in today's dollars by 2005 if we make no changes to the State's spending and revenue policies.

The Long Range Financial Planning Commission was appointed jointly by the Legislature and Governor in March 1995 to recommend ways to close the gap and put Alaska on firm financial ground. This report details our plan and our recommendations.

What the plan does:

Makes the Permanent Fund the cornerstone of Alaska's fiscal future

The plan calls for a constitutional amendment establishing the Permanent Fund as an endowment fund with an annual payout to the general fund based on a rolling five year average. The Permanent Fund will continue to grow with additional deposits, and retain some of its earnings in the next few years so that its income replaces declining oil revenues in the future.

Closes the fiscal gap by the year 2000

The combination of spending cuts, revenue increases, and uses of Permanent Fund income closes the fiscal gap in four years. With imposition of a State personal income tax in about 2002, the budget balances for another five years.

Ensures growth of the Permanent Fund to offset declining oil and gas revenues

The constitutional dedication of mineral lease revenues, royalties and bonuses to the Permanent Fund increases to 50 percent. The annual payout rate from Permanent Fund earnings is capped at a rate of up to four percent of the five-year average market value of the fund, which will allow additional retained earnings to build up the fund. Earnings in excess of the four percent payout rate will, over the long term, fully inflation-proof the fund, and preserve its earning power. Since the projected earnings rate is 4.79 percent above inflation, continued good performance by the fund will result in additional retained earnings of 0.79 percent.

Stabilizes and diversifies revenues

A reliable payout from Permanent Fund earnings will stabilize Alaska's income during periods of oil price volatility and substitute for declining oil revenues. New consumption taxes and business taxes will provide a portion of the State's revenues. These revenues will grow as the State's population grows, providing some links between State revenues and its service needs. The State personal income tax, once imposed in about 2002, will be related to State population growth, and will bring in revenues from non-resident workers.

Controls State general fund spending

The "bottom line" for general fund spending will shrink by five percent per year in today's dollars for the next four years. Depositing of reserve fund balances and a higher level of oil revenues into the Permanent Fund limits the money available to fund State spending growth.

Maintain a reserve to dampen the effect of oil price swings

The Constitutional Budget Reserve will be available to cushion oil

price decreases, and be used to absorb revenues from oil price increases. The second state reserve, the Permanent Fund Earnings Reserve, will be closed and deposited into the Permanent Fund. The Commission recommends maintaining a level of \$1.5 billion in the Constitutional Budget Reserve fund. That amount is approximately one year's oil revenues. Amounts in excess of the \$1.5 billion level should be deposited in the Permanent Fund. The CER will be replenished by its own interest income, and we further recommend any excess revenues from temporary oil price increases be deposited in the CER.

Decreases our dependence on volatile oil revenues

The combination of Permanent Fund income, increased and new taxes and user fees, and the reimposed State income tax, will offset oil revenues as the primary source of funding for State government operations.

The plan closes the fiscal gap with the following steps:

- Cuts spending,
- Increases revenues, and
- Establishes the Permanent Fund as an endowment,
- Caps the Permanent Fund dividend pool.

The first three years

The key elements of the three-year plan are to:

Cut spending

- Cut current State general fund spending by \$100 million — \$40 million in 1996, \$30 million in 1997, and \$30 million in 1998 — a reduction of \$300 million in today's dollars.
- Reduce per capita State general fund spending from \$4,020 to \$3,692 in five years — a reduction to \$3,255 in today's dollars.

Increase Revenues

- Increase tobacco taxes by \$1 per pack (\$43 million).
- Increase alcohol taxes by 10 cents per drink (\$30 million).
- Increase motor fuel tax from the 1961 level of 8 cents/gallon to 22 cents/gallon and increase marine fuel tax by 3 cents/gallon (\$44 million).
- Increase user fees by at least \$5 million per year, double motor vehicle license fees, and eliminating motor vehicle license fee exemptions (\$32 million).
- Establish a new tax to generate at least \$20 million from sources and increase taxes on fisheries and other resources by \$30 million.

Use the Permanent Fund as an endowment

- Establish the Permanent Fund as an endowment to partially replace declining oil revenues.
- The endowment will pay up to 4 percent of the Fund's five-year average market value to the general fund for dividends and State services.
- Constitutionally protect Permanent Fund principal by building long-term inflation-proofing into the endowment plan.
- The endowment payout and increased Permanent Fund contribution require voter approval of a constitutional amendment in 1996.

Boost the earning power of the Permanent Fund

- Build Permanent Fund principal by
 - (a) making additional special deposits to fund principal;
 - (b) increasing the minimum annual deposit to the Permanent Fund;
 - and (c) retaining additional earnings in the Permanent Fund.
- Deposit \$600 million from the Constitutional Budget Reserve into the Permanent Fund this year.
- Close out the Permanent Fund Earnings Reserve once the endowment is in place, by depositing it into the Permanent Fund (approximately \$1.2 billion).
- Increase to 50 percent the minimum contribution to the Permanent Fund from certain oil, gas and mineral lease revenues.
- Retain earnings in excess of the 4 percent annual payout in the fund. Since the projected rate of return to the fund is 4.79 percent after inflation, the Fund should retain earnings above inflation-proofing of at least 0.75 percent annually.

Cap the Permanent Fund Dividend pool

- Reduce the total amount spent for the dividend program from \$565 million this year by \$50 million a year for each of the next three years.
- Individual dividends will be about \$900 next year, \$800 in 1997, and \$700 in 1998.

Clarify the purpose of the State's reserves

- Maintain the CER at \$1.5 billion to cushion against oil revenue volatility. Clarify its use and repayment in a constitutional amendment.

Reform the budget process

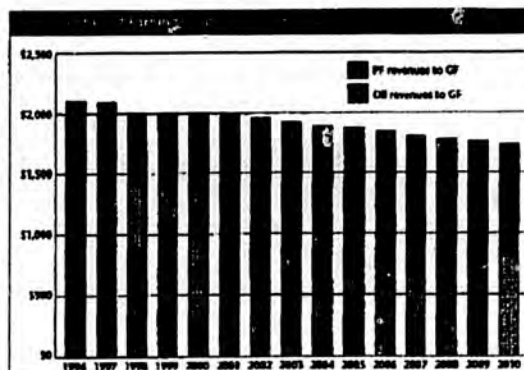
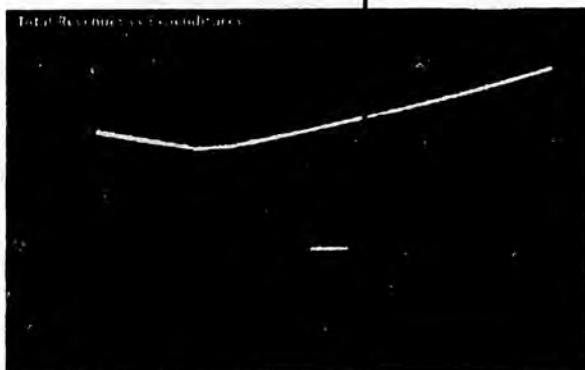
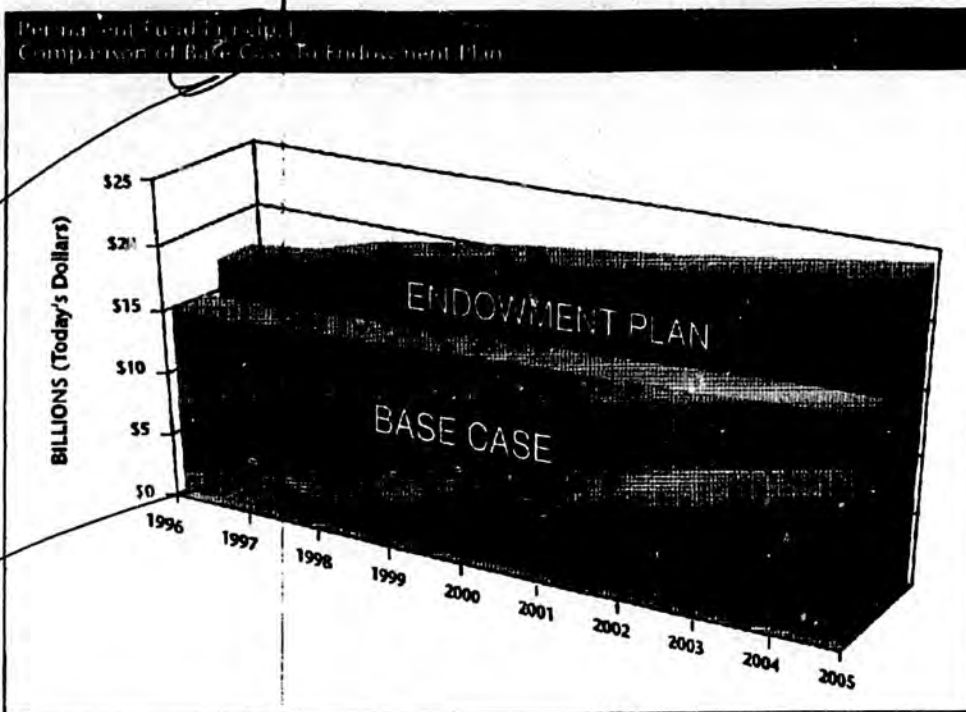
- Scrutinize all State spending, not just State general funds.
- Report annually to the public on progress toward closing the fiscal gap.
- Focus on whether programs are needed, cost-effective and achieve their intended results.

The five- and 10-year plan

In 1999, Alaska comes to a fork in the road. By that time the budget is balanced under the Commission's plan. To prevent the fiscal gap from reappearing, we can cut the budget further, institute a personal income tax, increase other taxes, and/or further reduce dividends. The Commission recommends that a follow-up review be done in late 1998 and early 1999 to adjust the overall plan as needed for the succeeding five to ten years. By that time the budget is balanced and we will know more about ANWR, the gas line and federal budget changes. As a result, decisions for first decade of the next century will be less dependent on speculation. Under our plan, after budget cuts, tax increases, the Permanent Fund endowment and dividend reductions have been made, this Commission recommends the State adopt a personal income tax in 2000 to begin in 2002, once the deficit disappears.

B. 164530

THE STATE LONG RANGE FINANCIAL PLANNING COMMISSION REPORT



Special Acknowledgements

The members of the Long Range Financial Planning Commission are: [List of names]

Thanks go to the [List of names]

In addition, the members of the Commission acknowledge the contribution of the [List of names]

Appendix One

Catalog of policy choices to close the fiscal gap

Part Three: The Alaska Permanent Fund

This appendix is a working document containing policy suggestions developed by the Commission and its subcommittees. It contains some of the information that was prepared for the Commission. It is not complete — we expect additional policy choices to come from the public and to be developed by the Commission. Individual members of the Commission may disagree or agree with any policy listed herein. Readers should feel free to add new policy choices to this catalog.

The Principal

A Constitutional Amendment adopted by the voters of Alaska established the Alaska Permanent Fund in 1976. It is a savings account designed to capture a portion of the revenue received by the state from state and federal mineral rents, royalties and bonuses.

The Alaska Permanent Fund receives special appropriations as well. Special appropriations made by the Legislature into the fund total \$4.5 billion dollars.

The principal of the Permanent Fund totals \$14.1 billion

The Income

The income of the Permanent Fund is currently used for two purposes. The first purpose is to preserve the principal of the fund against inflation (inflation-proofing). The second purpose is to pay each Alaskan an equal share in the fund's earnings (dividends).

Net income of the Permanent Fund since 1977 is over \$12 billion

The Dividend

Since 1980, the Permanent Fund Dividend has become imbedded in the culture and economy of the state. The amount of the annual dividend has risen from approximately \$300 per applicant to approximately \$950 per applicant.

Since the dividend program started, approximately \$5 billion in dividends has entered the Alaska economy.

Allocation of the Permanent Fund

The Permanent Fund is the subject of much commentary. There are questions about its purpose, about the use of its income, and what role it should play in the fiscal management of Alaska. Nearly every witness appearing before the Commission included the Permanent Fund as a portion of his or her recommendations.

A number of specific plans were presented and the purpose of this document is to compare the various proposals. Before doing so, however, it is important to understand certain ideas about the Fund.

Income: Article IX, Sec. 15, refers to "all income" as being required to be deposited in the General Fund. The constitution does not distinguish between ordinary income such as dividends and interest and capital gains that accrue by reason of the increase of value over the purchase price of an investment.

Sums used to pay dividends and to provide inflation proofing include both ordinary income and capital gains.

Income of the Permanent Fund

Statutory definitions of net income:

- Income of the earnings reserve account.
- Computed as of the last day of the fiscal year.
- Excludes unrealized gains and losses.
- May not exceed net income for the fiscal year just ended plus the balance in the earnings reserve account.
- Net income available for distribution equals 21 percent of the net income over the last five years. (AS 37.13.140)

Net Income Distribution:

- Fifty percent (50%) of the income available for distribution is transferred to the dividend account.
- Balance available to inflation-proof Permanent Fund.
- Any remainder is held in the earnings reserve account. (AS 37.13.145)

At the end of FY 1995 (June 30, 1995), the sum to be allocated to dividends was estimated to be \$556 million and the amount required for inflation proofing was estimated at \$344 million.

Inflation proofing: AS 37.13.145 requires that the inflation rate determined as directed by the statute be applied "to the value of the principal of the fund on the last day of the fiscal year just ended." The term, "value," is not otherwise defined and the practice of the Alaska Permanent Fund Corporation has been to value the principal of the fund at cost. The investments of the principal are inflation proofed annually at the original purchase price of the investments.

Some of the issues raised by the statutory definitions or treatment of income are:

- Should capital gains be segregated from ordinary income and only ordinary income be used for the purpose of dividend distribution?
- Should capital gains be treated as appreciation of the value of the principal rather than as income available for dividends and inflation proofing?
- Should the principal of the Fund be calculated at cost (book value) or at market value to determine the total income amount necessary to inflation proof the Fund and the net earnings available for dividends and other uses?

The Commission is also examining management policies of the Alaska Permanent Fund Corporation with particular focus on the Fund's asset allocation.

Permanent Fund scenarios

The Commission asked the Alaska Permanent Fund Corporation to prepare charts and graphs based on possible changes in allocations and classifications of income.

The Commission appreciates the cooperation of APFC in helping to clarify the significance of a number of ways to manage the Fund and use the Permanent Fund's income for the purpose of closing the fiscal gap. The Permanent Fund Corporation endorses none of these scenarios. These proposals are only to explore the potential of the Fund.

Most of the scenarios propose that the dividend fund be capped at \$500 million. Capping the dividend fund means that a dividend of nearly the same amount would be distributed annually, slightly diminished each year because of population growth.

All of the scenarios use the Commission's base case in analyzing expenditures and revenues. The APFC uses a different model for estimating revenues, inflation and earnings. Copies of the APFC runs are available from the Commission. Although the Commission's base case was revised, it is unlikely that adjustment will significantly alter the results. The amounts shown as available to the general fund are stated in nominal dollars.

Scenario No. 1

- Transfers surplus earnings directly to General Fund.
- Available to General Fund:
 - 1998 \$268 million
 - 2000 \$255 million
 - 2005 \$660 million
- Increases principal to \$22.3 billion in 2005.

Scenario No. 2

- Caps Dividend Fund at \$500 Million.
- Transfers all earnings in excess of inflation proofing & dividend into General Fund
- Available to General Fund:
1998 \$376 million
2000 \$453 million
2005 \$670 million.
- Increases principal to \$22.3 billion in 2005.

Scenario No. 3

- Deposits all royalty & rental income into the Permanent Fund.
- All realized gains added to principal of Permanent Fund, and amount deducted from amount to inflation proof Fund.
- Unrealized gains excluded from inflation proofing requirement.
- Dividend fund capped at \$500 million.
- Available to General Fund:
1998 \$310 million
2000 \$446 million
2005 \$830 million.
- Increases principal to \$31.2 billion in 2005
- Increases the fiscal gap by \$700 million

Scenario No. 4

- Deposits existing royalty & rental income into the Permanent Fund.
- All realized gains added to principal of Permanent Fund, and amount deducted from amount to inflation proof Fund.
- Unrealized gains excluded from inflation proofing requirement.
- Dividend fund capped at \$500 million.
- Available to General Fund:
1998 \$275 million
2000 \$339 million
2005 \$519 million.
- Increases principal to \$22.3 billion in 2005.

Scenario No. 5

- Deposits all royalty & rental income into the Permanent Fund.
- All earnings from investments considered part of principal of Permanent Fund.
- Four percent of total fund available for dividends and transfer to General Fund.
- Unrealized gains excluded from inflation proofing requirement.
- Dividend fund capped at \$500 million.

- Available to General Fund:
1998 \$305 million
2000 \$459 million
2005 \$900 million
- Increases principal to nearly \$34 billion in 2005

Scenario No. 6

- Deposits current statutory royalty & rental income into the Permanent Fund.
- All earnings from investments considered part of principal of Permanent Fund.
- Four percent of total fund available for dividends and transfer to General Fund.
- Unrealized gains excluded from inflation proofing requirement.
- Dividend fund capped at \$500 million.
- Available to General Fund:
1998 \$215 million
2000 \$296 million
2005 \$ 527 million
- Increases principal to nearly \$25 billion in FY 2005

Other Plans affecting the Permanent Fund

Rieger Plan: Senate Bill 51

- Uses real earnings rather than nominal earnings as basis of payout calculation. Real earnings are the amount by which returns exceed inflation.
- Inflation-proofing is automatic; it is treated as a return of capital to the fund.
- Approximately half of real earnings paid as dividends, remainder of real earnings available for other uses. Payout based on five year average.
- Reduces need for earnings reserve except to insure five year average payout commitment is met.
- Available to the General Fund:
1998 \$358 million
2000 \$481 million
2005 \$598 million

The Roger Cremo Plan

- Requires constitutional amendment.
- All natural resource revenues, including income earned on the Permanent Fund and reserves be placed in a single fund.
- The fund is then invested to reap a total nominal return of about 10 percent.
- The constitutional amendment sets an annual distribution rate from the Fund, with the transition period at a higher rate
- Transition period required to accomplish changeover to full funding from endowment.

The 40-30-30 Plan (changed in 1989 to 50-30-20 plan)

- Requires constitutional amendment.
- Establishes constitutional appropriations limit.
- Creates a budget reserve fund.
- Allocates 50% Permanent Fund income to dividends.
- Allocates 30% to inflation proofing of the Permanent Fund.
- Allocates 20% to budget reserve fund.

The Alaska Permanent Fund Corporation is assisting the Commission by creating models of the Rieger, Cremo and 40-30-30 plans. The Commission will compare these plans and the scenarios already prepared by the Permanent Fund Corporation using the same revenue, inflation and growth assumptions.

The Alaska Permanent Fund must be considered in any long-range financial plan. If the Commission recommends that the Alaska Permanent Fund contribute to closing the gap, legislative or constitutional changes will be required to create a revenue stream to make the Fund's contribution meaningful.

Appendix One

Catalog of policy choices to close the fiscal gap

Part Four: Economic Development

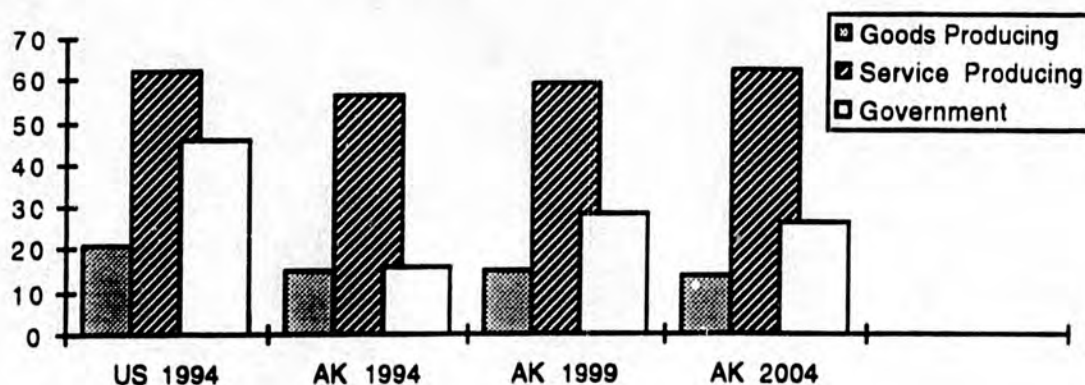
This appendix is a working document containing policy suggestions developed by the Commission and its subcommittees. It contains some of the information that was prepared for the Commission. It is not complete — we expect additional policy choices to come from the public and to be developed by the Commission. Individual members of the Commission may disagree or agree with any policy listed herein. Readers should feel free to add new policy choices to this catalog.

What about Economic Development?

The Department of Labor forecasts that the overall state economy will grow by approximately 11 % over the next ten years (short of the projected 16% growth in population). This is a slower rate of growth than we have experienced since the completion of the pipeline.

The primary reason for slower growth will be reduced expenditures by both the state and federal governments. Examples of reduced federal expenditures include the recent closure of Adak Naval Station and Fort Greely. Those reductions will be reflected in direct employment and reduced growth in the construction and service industries. The average wage earned in Alaska is expected to decline as jobs are shifted from higher paying government and goods producing positions to lower paying service industries.

Share of Wage & Salary Employment by Major Sector



A review of the most recent data available shows the number of nonresident workers has begun to decline for the first time since 1986 as the state's rate of economic growth has slowed. Still non-residents comprise 23% of the labor force. Earnings of nonresidents in 1993 totaled \$883 million.

- Population growth is expected to average 1.6 % per year during the next decade, down from 2-3% rates experienced since the mid-80s recession. School enrollment is projected to increase 2.5% each year. Increases due to more births than deaths will account for 86-88% of population growth, with net migration accounting for the rest.
- The number of persons over 65 is expected to almost double during the next 10 years primarily due to the aging of the resident population. The proportion of elderly residents is expected to rise from 4.5% to 6% and will be concentrated in urban areas.

The pressure for jobs will be strongest among younger state residents. To the degree that job growth lags behind population increases, there may be an increase in the out-migration of young adults or a failure of young adults to return to Alaska following college or military service. There is also likely to be a continued migration of rural and bush residents to urban areas in search of jobs.

Changing job composition is also likely to change the social character of Alaskan communities. Decline in the growth of higher paying, higher skilled federal and state government employment opportunities in favor of lower paying service jobs leads to a decline in the average educational level among younger adults migrating to or remaining in communities.

In- and out-migration to Alaska is most affected by employment opportunities within the state relative to opportunities in Alaska's key feeder states. They are Washington, California, Oregon, and to a lesser degree, the Mountain states. One third of the migration to and from Alaska originates in these three key feeder states and half of our migration originates in the West. Alaska has the highest population turnover of any state except the District of Columbia and Nevada.

Military personnel and their dependents currently comprise about 10% of Alaska's population and contribute to the transient nature of Alaska's population. By 2005 the military and dependent proportion of the population is expected to shrink to 6.5% or less. The population of rural Alaska is expected to grow more slowly than the urban or bush populations partly due to migration to urban areas. Of projected population growth between 1995-2005, 84% is in urban Alaska, 12% in the bush and 4% in rural regions.

Potential Economic Development Revenues

Policy makers recognize that economic development will play some role in generating additional future state revenues. Conclusions reached in earlier fiscal policy summits (see table below) demonstrate that at current tax rates,

even a very optimistic projection of non-petroleum economic development yields revenues that play only a marginal role in balancing revenues with expenditures in the next 10 years.

Presently, revenues from non petroleum economic growth can be expected to provide an increment of perhaps \$30 - \$70 million per year.

Lifting of the oil export ban may be of much greater significance, at least in the short term. US Department of Energy projections are much higher than those of the Alaska Department of Revenue.

Potential Additional Economic Development Revenues FY 96-2005 (in millions of FY 96 \$)

Speculative

	FY 96	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05
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	0.4	0.4	0.5	0.5	0.6	0.7	0.9	1.1	1.3	1.5
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
Total	84.9	45.0	25.4	25.7	26.0	26.4	26.9	27.5	28.1	28.6

Source: OMB/BP 4/28/95

Assumptions:

- Export ban lifted in FY 96 with late revenues corresponding to forecast of West Coast crude surplus
- Mining: All projects currently in development 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 year industry average of 6%.
- Seafood: FY 95 revenues (net of pass-throughs) equal \$44 million. Growth occurs at 10 year real average of 4%.
- Tourism: FY 95 revenues estimated at \$40.4 million with visitor growth increasing at 6% per year.

To date, the fiscal policy forums have concluded that while economic development will play a significant role in our fiscal future, it is not possible for is alone to close the fiscal gap.

Other key economic development issues

- The official Department of Revenue position is that the Trans-Alaska Gas System project and development of Arctic National Wildlife Refuge are unlikely to occur within the commission's ten year horizon. (In fact, the three main North Slope gas owners have recently stated that gas sales are not projected to become economically feasible before 2005, although Yukon Pacific Corporation states that gas sales could occur one to three years earlier)
- To date, the state has chosen to take its return on the development of public resources other than oil in the form of private sector jobs, personal income, and corporate profits rather than taking its return in public revenues. This distinction between benefits to individuals or businesses and the impacts on the state treasury is important to keep in mind as economic development is pursued.
- It often costs more to support, manage, and regulate our natural resources industries than they return to the state in the form of general fund revenues. Only petroleum pays for itself in terms of state revenues versus expenditures. Currently, mining, tourism, timber, and fisheries do not provide net revenue return to the state, although these industries are important revenue producers at the local level. (Fishing and tourism come closest to paying for themselves. Depending upon accounting methods, some analyses have shown that fishing and tourism contribute a small amount of net revenues.)
- Local governments capture some return from economic development through property and other taxation methods.
- Since state and local governments provide far more in terms of the cost of public services than are paid for directly by citizens, economic development efforts have a perverse effect on the fiscal gap. More jobs created and resident benefits increased in-migration of families and also means a greater drain on the state treasury. Additional spending schools, infrastructure, social services, transfer payments, public protection costs, etc., mean a larger fiscal gap.
- Past fiscal policy forums have concluded the state gets the most bang for its economic development buck promoting high paying resource development related jobs, specifically petroleum industry employment.

Appendix One

Catalog of policy choices to close the fiscal gap

Part Five: Dealing with fiscal instability and revenues

This appendix is a working document containing policy suggestions developed by the Commission and its subcommittees. It contains some of the information that was prepared for the Commission. It is not complete — we expect additional policy choices to come from the public and to be developed by the Commission. Individual members of the Commission may disagree or agree with any policy listed herein. Readers should feel free to add new policy choices to this catalog.

Much of the public discussion about Alaska's finances focuses on Alaska's fiscal gap. The fiscal gap demonstrates that our services and our ability to pay for them have fallen out of alignment.

Addressing the fiscal gap requires developing a strategy to reduce uncertainty about state revenues and state spending.

The fiscal gap is difficult to measure. The fiscal gap shrinks or grows as oil prices fluctuate, which changes our perception about the urgency of closing the gap. As long as Alaska's revenue stream remains unpredictable hasty policy choices may be made as the gap widens. A stable, predictable revenue stream and spending level would contribute significantly to Alaska's overall economic stability and long-term government program planning.

The Commission is considering methods we can use to develop long-term fiscal stability. Among them are:

- An endowment to fund services over the long term.
- A policy to guide the use of reserve funds as budget stabilizers and "shock absorbers".
- Forward funding or cash based budgeting.
- Formulas tied to Permanent Fund earnings.
- The Cremo plan.
- Hedging oil revenues.

Alaska has over \$3 billion in cash reserve funds

There are two cash reserve funds: the Constitutional Budget Reserve (CBR) and the Permanent Fund Earnings Reserve (PFER). These substantial reserves constitute one of the primary fiscal tools the state can use to temporarily reduce the fiscal gap. The CBR has been used for this purpose in recent years; the PFER has not.

However, large reserve balances also have a negative side: using them can delay for several more years the difficult actions necessary to close the fiscal gap. This has the potential for suddenly magnifying the state's fiscal and economic problems when the reserves are finally exhausted.

Last fiscal year (FY 95) the state spent approximately \$240 million in reserves to balance the budget. For FY 96, the state is projected to spend over \$500 million in reserves. The predominant use of reserve funds during the last several years has been to offset current-year budget shortfalls. This has not been the state's only response to the fiscal gap. For example, since FY 91, state agency budgets have been cut by 13 percent in nominal dollars and 25 percent in real dollars (adjusted for inflation).

What role should reserve funds have in creating a stable fiscal future ?

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 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 Science & Technology Foundation?
- What is the appropriate minimum level of reserves to guard against sharp declines in oil prices?
- Can major reductions in state services or increases in revenues be justified to the public while the state still has substantial liquid reserves?

Appendix One

Catalog of policy choices to close the fiscal gap

Part Six: Other state assets

This appendix is a working document containing policy suggestions developed by the Commission and its subcommittees. It contains some of the information that was prepared for the Commission. It is not complete — we expect additional policy choices to come from the public and to be developed by the Commission. Individual members of the Commission may disagree or agree with any policy listed herein. Readers should feel free to add new policy choices to this catalog.

Enterprise Funds

The state has established several corporations, foundations, funds and programs that can be deemed "enterprise funds." The term "enterprise funds" is usually applied to funds or corporations that perform services or produce goods that yield profits or are operating on business rather than government principles. The Commission has categorized these various funds into corporations and foundations, loan programs, pension funds and service agencies. Each entity receives funding in whole or in part from private or non-state sources. Some are expected to operate without state support, but it appears that all began because of initial capitalization by the state. We have not determined whether all of the initial capital has been returned.

Corporations and Foundations

Alaska Housing Finance Corporation, Alaska Industrial Development and Export Authority, Alaska Aerospace Development Corporation, the Alaska Railroad, and the Science and Technology Foundation were established to provide important services which were not otherwise available to Alaskans at the time the entities were created. No consistent policies have been established that govern the repayment of capital or the payment of dividends or a portion of earnings.

The base case adopted by the Commission includes \$50 million per year to be paid from surplus of the Alaska Housing Finance Corporation, based on the current agreement between the AHFC Board and the Governor's Office. The Commission has not been able to determine if this amount is appropriate and whether or not the other corporations and foundations can or should pay some portion of their earnings to the state. The financial structures of each of the corporations and foundations should be examined to determine whether or not they perform a service not otherwise obtainable at a reasonable cost and whether or not they can contribute from earnings a reasonable dividend on an annual basis. Although the Commission believes that dividends should be paid

by enterprise funds, the amount of such dividends in the aggregate cannot be estimated.

Loan Programs

The agricultural revolving loan program, the student loan program and business and veterans loan programs were established to provide capital to businesses and individuals who had difficulty in obtaining credit on a reasonable basis. The veterans loan program was established to allow veterans to acquire capital at reduced interest rates in recognition of their service to the country and to Alaska. The student loan program has in recent years been operated through funding provided by revenue bonds. The funding sources for the agricultural revolving loan program and the business development loan programs were general fund moneys at the inception of the programs.

Each loan program should be scrutinized to determine if the borrowers could obtain loans from other sources at equal or nearly equal costs and whether, if the programs were terminated, all of the capital contributed by the state can be returned.

If the programs are continuing to provide loans that are not available from other sources, the programs should be reviewed to determine if the programs should be allowed to grow through the retention of all earnings or a portion of the earnings can be paid to the general fund on an ongoing basis.

Miscellaneous

In addition to the categories listed above, there remain a few entities or programs for which no suitable classification exists. One such entity is the Alaska Municipal Bond Bank Authority. This agency serves as a coordinator for local governments in the sale of municipal bonds, both general obligation and revenue bonds. The fees charged by the bond bank support it. Additionally, it may receive income from the bond trustees. The income and expense of the AMBBA should be reported so it can be determined if AMBBA possesses capital that should be returned to the general fund.

Appendix Two

Budget Process Improvements

The resolution creating the Commission asked that we examine changes to the state budget process. We believe the public, the executive branch and the legislature will be better served in the budget process if changes are made to improve the quality of budget and accountability. Improvements under consideration by the commission are noted below:

- Present the annual budget in the context of an annually updated three to five year financial plan and 10-year projection. This plan should describe the state's economic outlook, population estimates, projections of state revenues and expenditures, anticipated changes in federal/state funding and programs, and other relevant factors. It should also bring attention to problems that may require more than one year to address adequately such as facility maintenance, replacement of computer equipment or phased changes in the delivery of state services.
- Report all spending, including Permanent Fund Dividends and other disbursements in a comprehensive budget.
- Develop a budget format and summary that is more understandable to the public and provides a more rational basis for executive and legislative branch decision-making.
- Establish and track progress on performance measures that relate to the effectiveness of all state services and assets.
- Use a high degree of scrutiny for all expenditures (including loan programs) regardless of funding source, i.e., whether a particular program contributes to the general fund fiscal gap or not.
- Make it easier to see the budget implications of all funds requiring legislative appropriation for the coming year (e.g. Permanent Fund revenues, reappropriations, power cost equalization, AHFC).
- Require accurate estimates of the current and long-term financial impacts of proposed programs and legislation.
- Partial funding of regular annual expenditures with the expectation that remaining funds will be provided later as supplemental appropriations should only be done in extraordinary circumstances.
- Establish a consistent system for showing annual revenues and expenditures so that accurate year-to-year comparisons can be made.

- Present an annually updated six year capital (as required by statute). Include reasonable estimates of future operations and maintenance costs.
- Annually incorporate ongoing maintenance and routine facility renewal and replacement costs into the state's operating budgets to prevent the accumulation of deferred maintenance backlogs which deteriorate the state's assets and require higher costs in later years. Replacement of computers and communications equipment should also be an integral part of the operating budget.
- Develop chargeback fees for state facilities to ensure efficient use of building space.
- Upgrade the state budget and accounting system to provide easily accessible management data.
- Require the Office of Management and Budget to monitor overall expenditures at least quarterly to ensure that spending levels remain within departmental appropriations.
- Ensure that the budget review process identifies investments in prevention that can reduce future costs.
- Provide incentives for management efforts to control costs and improve service delivery. Current impediments include the inability on the part of agencies to save one year's operating dollars to fund technology improvements in the following fiscal year, and the relatively small categories of appropriations that restrict managers in some departments from funding needed improvements in one area with savings achieved in another.
- Pay particular attention to areas of the budget in which expenditure growth exceeds the population and inflation index.
- Provide an annual report card on how the state is doing to meet the fiscal plan.