

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILES 8672

2386 SCOMM 101: LONG RANGE FINANCIAL PLANNING COMMISSION, 1995

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

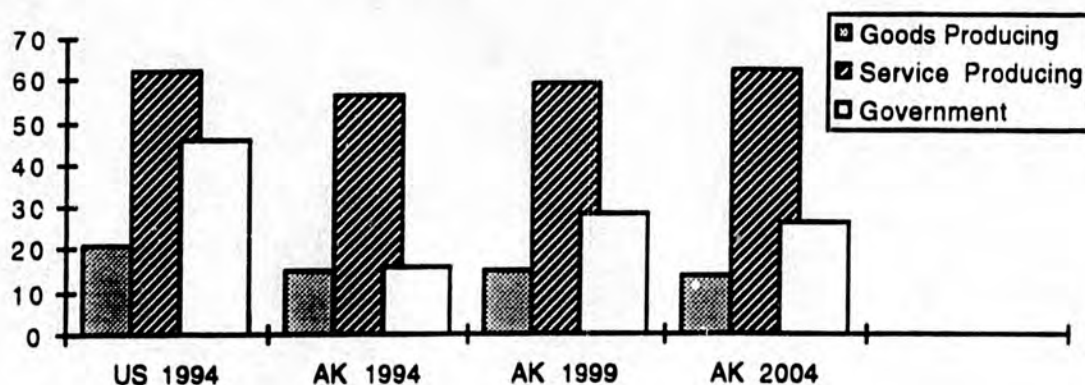
This appendix is a working document containing policy suggestions developed by the Commission and its subcommittees. It contains some of the information that was prepared for the Commission. It is not complete — we expect additional policy choices to come from the public and to be developed by the Commission. 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.

SCOMM

101:20

Closing Alaska's Fiscal Gap

The Long Range Financial Planning Commission's Recommended Plan

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 does the plan do? It:

- Makes the Permanent Fund the cornerstone of Alaska's fiscal future.
- Closes the fiscal gap by the year 2000.
- Ensures growth of the Permanent Fund to offset declining oil and gas revenues.
- Stabilizes and diversifies revenues.
- Controls State general fund spending.
- Maintains a reserve to dampen the effect of oil price swings.
- Decreases our dependence on volatile oil revenues.

This is a plan for ourselves and our grandchildren. It requires all Alaskans to share in the solution. No action to close the fiscal gap is the greatest threat to Alaska's financial future.

The Commission was asked to recommend a plan for three, five and ten years. To be sure that plans for these time frames did not create a reoccurring fiscal gap after that, the Commission also looked at the likely effects of its plan over a fifteen year period.

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 four 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¢ per drink (\$20 million).
- Increase motor fuel tax from the 1961 level of 8¢/gallon to 22¢/gallon and increase marine fuel tax by 3¢/gallon (\$44 million).
- Increase user fees by at least \$3 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 tourists 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% 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% the minimum contribution to the Permanent Fund from certain oil, gas and mineral lease revenues.
- Retain earnings in excess of the 4% annual payout in the fund. Since the historic rate of return to the fund has been 4.79% after inflation, the Fund should retain earnings above inflation-proofing of at least 0.75% 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 CBR 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 ten-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 reappears.

Closing Alaska's Fiscal Gap

The Long Range Financial Planning Commission's Recommended Plan

FINAL REPORT

Alaska's 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, the State will spend \$524 million more from the State general fund than it will take in — this is the fiscal gap. That gap will grow to \$768 million in three years, to \$879 million in 5 years, and \$1,253 billion in 10 years (in today's dollars) if we make no changes to the State's spending and revenue policies. Our interim report contains more details about the growing fiscal gap and options available to close the gap.

The Long Range Financial Planning Commission was appointed jointly by the Legislature and Governor in March 1995 to recommend how to close the gap and put Alaska on firm financial ground. In the past six months, as directed by the resolution creating the Commission, the Commission has:

- Reviewed and evaluated State fiscal policy and strategy recommendations and assumptions from reports and publications from similar efforts in the past made by the executive branch, the legislative branch, the University of Alaska, nonprofit organizations, and private individuals and organizations,
- Identified and evaluated all current State income sources and assets, including recurring revenue, reserves, physical resources, and investments,
- Identified systemic changes to stabilize the State's revenue stream,
- Identified major reductions in State expenditures,
- Evaluated forward funding of the budget,
- Identified new sources of revenue,
- Projected a sustainable long-range financial plan based on a stable revenue stream,
- Evaluated constitutional, statutory, and regulatory language relating to the budget process,
- Reviewed and evaluated forward funding of the State budget,
- Considered the division of responsibility for providing services and raising revenue between the State and local governments and evaluated the effect of the long-range financial plan on local governments,

- Submitted a preliminary report to the Governor and the Legislature, and
- Disseminated information and solicited public comment.

The Commission's deliberations were aided by substantial work and informative presentations by State agency personnel, the Alaska Permanent Fund Corporation staff, Alaska Municipal League and Conference of Mayors, and private citizens who brought additional perspectives to the table.

The Commission's work focused on elements of State spending which affect the fiscal gap. These include:

- General funds, including program receipts
- Permanent fund earnings
- Funds created by appropriations for specific purposes or as "holding accounts"
- Special revenue funds set out in the constitution or statute.

Certain other funds, while included in the overall budget of the state, are not commonly reported in budget presentations, and do not materially affect the fiscal gap. These include:

- Federal funds
- Loan amounts and loan administrative costs
- University receipts
- Internal service funds
- Transfers between agencies for contractual obligations, including interagency receipts

The Commission believes the State budget process should include examination of all spending, regardless of whether the funds affect the fiscal gap. To meet the Commission's charge of closing the fiscal gap, though, we focus on the general fund and Permanent Fund.

The Commission has developed a financial plan for the State of Alaska. It brings Alaska's spending into line with recurring revenues. It balances the needs of current Alaskans with the needs of future generations. It requires that all Alaskans share in the solution.

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 historic earnings rate has been 4.79 percent above inflation, continued good performance by the fund will result in additional retained earnings of 0.79%.

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 fuel 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 CBR will be replenished by its own interest income, and we further recommend any excess revenues from temporary oil price increases be deposited in the CBR.

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

The State cannot continue to spend at the same level it does today. Notwithstanding needs and demands for increased spending and the impending federal transfer of programs to the State, the Commission believes Alaska cannot close the fiscal gap without cutting State spending.

- The plan calls for State general fund spending to be reduced by \$100 million in three years — \$40 million in FY97, \$30 million in FY98, and \$30 million in FY99 — a reduction of \$300 million in today's dollars.
- This decline of State spending reduces per capita State general fund spending from \$4,020 to \$ 3,692 in four years — a reduction to \$3,255 in today's dollars.
- The Commission believes this level of reduction in State spending will be painful, but is a necessary step toward closing the fiscal gap. Recent legislatures have managed to hold spending level, which has resulted in real reductions to some State programs.
- Within these budget targets, the Commission believes the State should give attention to deficits in the State's infrastructure spending, most particularly for maintenance on publicly-owned facilities, roads and highways.
- The Legislature and the Administration may wish to consider voter-approved general obligation bond debt as a way to finance capital projects.
- General recommendations for budget reductions include:

Public salaries and benefits

- Enact a retirement incentive program to reduce personal services expenditures.
- Enact a new Tier III retirement system to reduce retirement benefits for new State and local government employees.
- Revise geographic pay differentials for non-covered State employees.
- Study geographic cost differentials in Alaska for use during collective bargaining negotiations with covered State employees (and for use in other State formula programs).
- Compare salaries and benefits of public employees to appropriate public and private markets in Alaska and the Pacific Northwest. Use that comparison to move Alaska's public pay system for State employees, local government employees, and school districts to market.
- Examine the publicly funded health plans for State, local government, school district, and University employees as well as those who receive Medicaid. Look for opportunities to save substantial costs through pooling or other mechanisms.

Administrative realignment

- Reengineer the delivery of State services to eliminate excessive administration.

- Consolidate state departments and agencies, and realign administrative services.
- Look for opportunities to privatize State programs or to contract out State services. Allow "insourcing" so groups of State employees can offer their own solutions to reduce costs in programs that may otherwise be contracted out.

Target high-cost programs

- If the current litigation against the Alaska Longevity Bonus is successful (ending the current phase-out), eliminate the program.
- Change the Public School Foundation Formula to reduce the growth in education spending. The required local effort should be reexamined, as well as provisions that allow school districts to obtain greater funding for special category students regardless of the programs offered to those students.
- Enact a welfare reform package to reduce dependency on welfare programs and put current welfare recipients to work.
- Revise fee schedules for services such as Pioneers' Homes to reflect cost and ability to pay.
- Examine areas of State spending with disproportionately high costs when compared with other States and determine whether there are legitimate reasons for such programs.

Shift revenues and responsibilities to local governments

- Repeal the State mandate for senior citizens' and veterans' property tax relief by local municipalities, but allow local option to grant or withhold the exemption.
- Transfer a portion of State motor vehicle and motor fuel tax receipts to local governments together with the responsibility for class III local road maintenance.
- Eliminate or shift some inspections to local governments with the ability to collect fees for program support.
- Eliminate State general fund support of troopers for road patrols in communities of more than 2,500, but allow communities to continue retain such services if they are willing to pay for them.

Avoid new costs

- Freeze issuance of certificates of need for new hospitals and reassess need for additional nursing homes

Increase Revenues

The Commission believes Alaska cannot balance its budget responsibly without new revenues. The Commission has chosen a short-term package of taxes on consumption that imposes real service costs on the state,

business taxes, with a longer-term plan of reimposing the State personal income tax.

Increases to existing taxes include:

Tobacco taxes

- Increase tobacco taxes by \$1 per pack on cigarettes and comparable amounts on other tobacco products (raises \$43 million annually, beginning in FY97). This tax increase will dramatically lower teenage smoking and tobacco use, and should somewhat reduce tobacco use by adults, both of which will reduce the State's future expenditures on health care costs. The Commission recommends the taxes increase 25¢ per pack every three years.

Alcohol taxes

- Increase alcohol taxes by an average of 10¢ per drink (raises \$20 million annually, beginning in FY97). Testimony before the Commission indicated that a substantial portion of the criminal justice system's costs — for police, prosecution, public defense, the courts, and the correctional system — are a result of alcohol abuse. This tax increase pays a small portion of the State's costs that result from abuse of alcohol. The Commission recommends also that taxes be equalized among beer, wine, and distilled spirits so that all alcohol users share in the tax burden. We further recommend that alcohol taxes increase every three years.

Over time, certain of Alaska's tax rates have fallen below the national norms, or have not kept pace with inflation. We recommend the following increases:

Motor fuel taxes

- Increase motor fuel tax increases from the 1961 level of 8¢/gallon to the national median of 22¢/gallon (raises \$39 million annually, beginning in FY98). This tax should be indexed to inflation, so it rises as consumer prices rise. The Commission believes these tax receipts should be used to fund road maintenance efforts at the State and local level.

Marine motor fuel taxes

- Increase marine fuel taxes by 3¢/gallon (raises \$5 million annually, beginning in FY98). This tax should be indexed to inflation, so it rises as consumer prices rise. The Commission believes these tax receipts should be used to fund port and harbor maintenance efforts at the State and local level.

Motor vehicle license plates

- Double motor vehicle license fees and eliminate exemptions (raises \$29 million, beginning in FY98). These fees are currently well below the national average.

User fees

- Raise user fees by approximately \$3 million annually and index fees to inflation where practicable.

Fishery and other resource taxes

- Increase taxes on fisheries and other resources by \$30 million.

New taxes and changes to tax apportionment include:

- Establish new taxes to generate at least \$20 million from tourists. While the Commission was unable to reach consensus on the precise method for gaining additional revenue from tourists or the tourism industry, The Commission believes this part of our economy does not fully pay for the State's cost of providing infrastructure and support to the industry.
- The Commission believes the State's oil and gas production property tax, currently set at 20 mills, should benefit both the State and local governments affected by oil development. State law should be amended to limit the local government share to 10 mills on new oil and gas properties built after 1995, ensuring the State receives at least 50% of this revenue source.

The Commission considered additional taxes on the oil industry. We found that Alaska is currently in the mid-range of oil taxation nationally. We believe that Alaska is already too dependent upon oil revenues, and that higher oil taxes would create a disincentive to attract and retain petroleum development in Alaska. We believe our plan for closing the fiscal gap and providing a stable revenue and spending climate will ultimately result in increased petroleum revenues as the industry responds by further investment in Alaska oil exploration, development and production.

Establish the Permanent Fund as an endowment

When the Permanent Fund was established in 1976, public debate centered on setting aside a portion of today's oil wealth to meet the needs of future generations of Alaskans. Later, the Legislature adopted the dividend plan to heighten public interest in preserving the fund and guarding its investment performance, and to directly distribute some of Alaska's oil wealth to its citizens. The Commission believes it is time to follow the original intent of the fund, preserving current capital wealth for current and future generations of Alaskans. The Commission believes the best

method for doing this is to follow traditional endowment principles. For our Permanent Fund those principles include preservation of the fund, the best possible level of performance of the fund, and the preservation of Alaska's oil wealth for future generations of Alaskans.

Our plan calls for the Permanent Fund to grow as an endowment for the State.

- The plan establishes the Permanent Fund as an endowment that pays up to four percent of the Fund's five-year average market value to the general fund for the dividend program and State services. This use of Permanent Fund earnings will partially replace declining oil revenues. The Commission recommends a four percent payout based on the experience of other endowment funds in the United States, and takes into account the Permanent Fund's earning experience, asset allocation, and need to protect the principal.
- Earnings of the Permanent Fund in excess of this four percent payout rate are retained in the fund. Years with good investment performance will, over the long run, balance years with poor investment performance in order to more than fully inflation-proof the fund.
- The plan calls for an increase to 50 percent of the minimum contribution to the Permanent Fund from certain oil, gas and mineral lease revenues. The plan calls for an amendment to the constitution to achieve that increase.
- The endowment is further built up by a deposit from the Permanent Fund Earnings Reserve and deposits of any funds in excess of \$1.5 billion in the Constitutional Budget Reserve.

Cap the Permanent Fund Dividend pool

The Permanent Fund Dividend program is an important source of protection for the principal of the Permanent Fund and it is important source of income to Alaskans. Without changes to the program, however, dividends will grow to take a major share of State revenues — \$965 million in 2005. The Commission recommends:

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

Clarify the purpose of State's reserves

The State maintains two reserve funds that are important in the effort to close the fiscal gap — the Constitutional Budget Reserve (CBR) and the

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

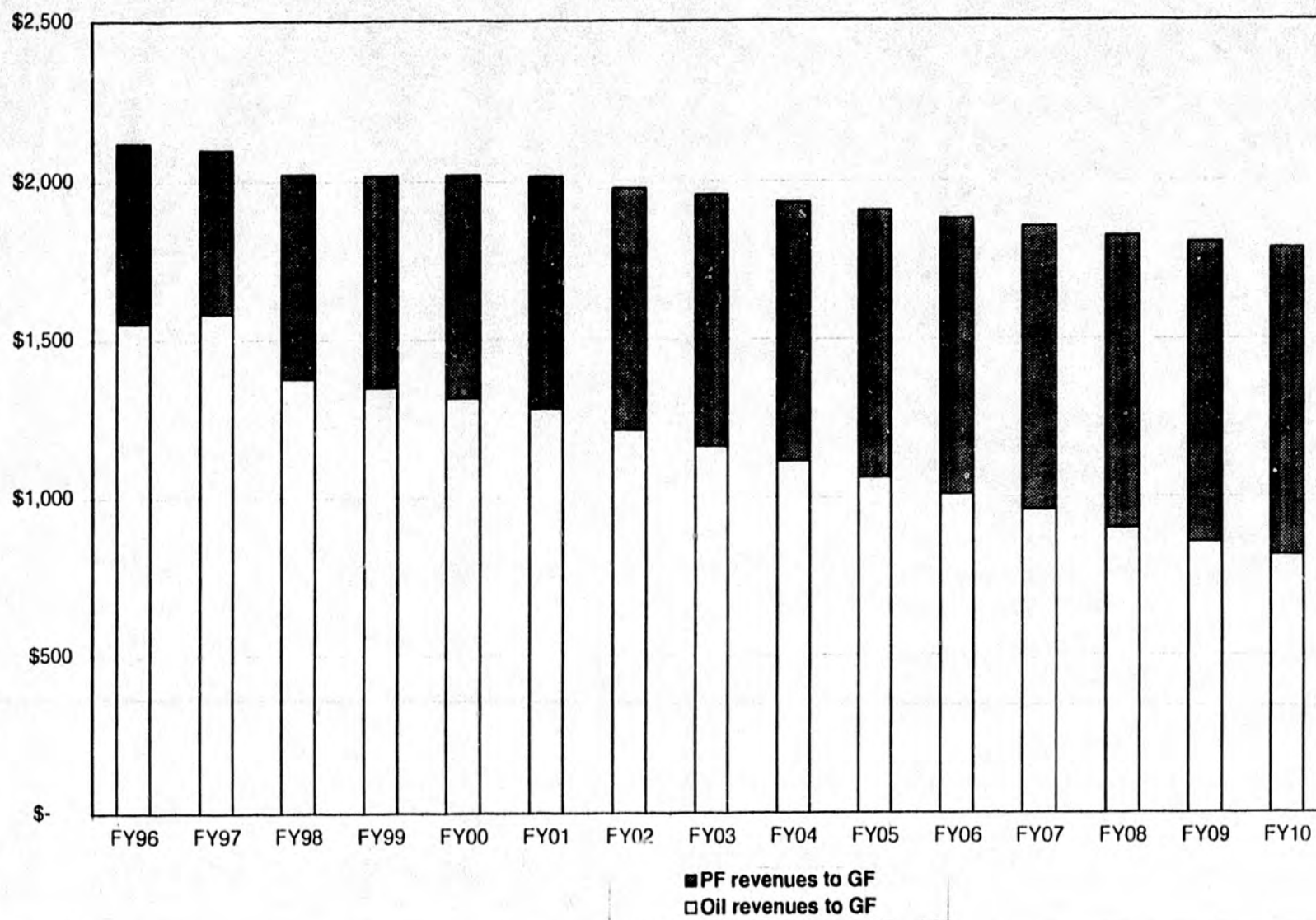
Legislative Action

- 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.

Oil and Permanent Fund Revenues



ENDOWMENT PLAN PROJECTION — OCTOBER 1

PERMANENT FUND EARNINGS AT 4.79% (real)
Endowment payout 4% of 5-year average market value

(Today's Dollars)

	FY 96	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10
AVAILABLE REVENUES (\$ Millions):															
Existing General Fund sources	1,952	1,863	1,880	1,859	1,822	1,784	1,709	1,656	1,600	1,540	1,454	1,374	1,342	1,274	1,209
Less: increase PF deposit to 50%			-230	-236	-232	-226	-217	-208	-201	-193	-182	-173	-174	-164	-154
Lift ANS Export Ban		19	19	18	18	17	17	16	16	15	15	14	14	13	13
Permanent Fund Net Earnings	1,213	1,312	0	0	0	0	0	0	0	0	0	0	0	0	0
Permanent Fund Endowment Earnings	0	0	630	648	677	701	728	762	789	816	844	871	899	925	950
Permanent Fund Inflation-Proofing	-429	-453	0	0	0	0	0	0	0	0	0	0	0	0	0
Transfer to Permanent Fund Earnings Reserve	-219	-358	0	0	0	0	0	0	0	0	0	0	0	0	0
Highway Motor Fuel Tax @ \$.219/gal., indexed	38	39	39	39	40	41	41	42	43	43	44	45	45	46	47
Marine Motor Fuel Tax (\$.08/gal., indexed)	5	5	5	5	5	5	5	5	5	6	6	6	6	6	6
Tobacco Tax (\$1/pkg cigs; 75%/chewing; +25¢ every 3 years)	42	41	42	42	51	51	50	59	58	57	66	65	73	70	69
Motor vehicle license fees (double)		28	28	28	27	27	26	26	26	25	25	25	24	24	23
User fee increases	3	6	8	11	13	12	12	12	12	11	11	11	10	10	10
Fishery and other resource tax increases	0	28	28	28	28	28	28	28	28	28	28	28	28	28	28
Tourism tax increases	0	19	19	19	19	19	19	19	19	19	19	19	19	19	19
Alcohol taxes (increase every 3 years)	19	19	19	19	22	22	22	21	25	25	24	24	24	23	23
Income tax @ \$200 M 1995, adjusted for population growth						0	58	224	227	230	234	238	241	245	249
TOTAL REVENUES	2,517	2,489	2,484	2,477	2,488	2,481	2,499	2,661	2,645	2,622	2,587	2,546	2,551	2,520	2,491
Note: Annual Spending Cuts		39	28	27	0	0	0								
EXPENDITURES (\$ Millions):															
Total GF spending on current programs	2,476	2,365	2,264	2,167	2,119	2,136	2,153	2,170	2,187	2,204	2,222	2,239	2,257	2,275	2,293
PF Dividends (cut \$50 M annually 3 yrs then freeze)	565	500	438	378	367	356	345	334	324	314	304	295	286	277	268
TOTAL EXPENDITURES	3,041	2,865	2,702	2,546	2,486	2,491	2,497	2,504	2,511	2,518	2,526	2,534	2,543	2,552	2,562
PROJECTED ANNUAL FISCAL GAP	-524	-376	-218	-69	2	-10	2	158	135	104	61	12	8	-32	-70
Constitutional Budget Reserve beginning balance	2,006	1,456	1,412	1,368	1,326	1,285	1,245	1,207	1,170	1,134	1,099	1,065	1,032	1,000	970
Interest	125	91	88	86	83	80	78	75	73	71	69	67	65	63	61
Settlements	500	485	141	137	0	0	0	0	0	0	0	0	0	0	0
Drawn for GF spending (deposited from GF surplus)	524	376	219	71	0	12	0	-155	-132	-102	-58	-9	4	35	73
CBR Transfer to Permanent Fund Principal	607	201	11	151	83	68	77	230	205	173	127	76	61	28	0
Constitutional Budget Reserve ending balance	1,500	1,456	1,412	1,368	1,326	1,285	1,245	1,207	1,170	1,134	1,099	1,065	1,032	1,000	957
PF Earnings Reserve beginning balance	703	895	1,215	0	0	0	0	0	0	0	0	0	0	0	0
Net from PF Earnings not used for GF	219	358	0	0	0	0	0	0	0	0	0	0	0	0	0
PF Earnings reserve transfer to PF Principal	0	0	1,215	0	0	0	0	0	0	0	0	0	0	0	0
PF Earnings Reserve ending balance	922	1,253	0	0	0	0	0	0	0	0	0	0	0	0	0
Alaska Permanent Fund beginning balance	14,139	14,945	15,332	17,095	17,896	18,633	19,355	20,074	20,926	21,754	22,547	23,284	23,959	24,629	25,253
Dedicated state revenues - DOR Spring mid-case	217	220	230	236	232	226	217	208	201	193	182	173	174	164	154
FY end principal balance before inflation-proofing & deposits			230	236	232	226	217	208	201	193	182	173	174	164	154
FY end principal balance before inflation-proofing & deposits	14,356	15,166	15,791	17,568	18,361	19,086	19,788	20,490	21,328	22,141	22,912	23,629	24,308	24,957	25,562
Deposits to Principal from CBR	607	201	11	151	83	68	77	230	205	173	127	76	61	28	0
Deposits to Principal PFER	0	0	1,215	0	0	0	0	0	0	0	0	0	0	0	0
Inflation-Proofing	429	453	0	0	0	0	0	0	0	0	0	0	0	0	0
Net income after endowment distribution		0	622	746	782	817	846	870	912	950	986	1,017	1,044	1,071	1,097
FY ending balance Inflation Proofed	15,392	15,820	17,639	18,466	19,226	19,970	20,712	21,591	22,445	23,264	24,024	24,721	25,413	26,056	26,659
Escrow Accounts and Settlements	142	148	155	163	170	178	186	195	204	213	223	234	245	256	268
Net income (Calculated)	1,191	1,312	1,253	1,394	1,458	1,517	1,575	1,632	1,700	1,766	1,829	1,888	1,943	1,996	2,046
Permanent Fund Dividends	565	500	438	378	367	356	345	334	324	314	304	295	286	277	268
Alaska Permanent Fund ending balance	15,392	15,820	17,639	18,466	19,226	19,970	20,712	21,591	22,445	23,264	24,024	24,721	25,413	26,056	26,659
Alaska Permanent Fund ending balance - market	17,766	17,625	19,389	20,161	20,869	21,563	22,256	23,087	23,895	24,669	25,386	26,041	26,692	27,296	27,860

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ENDOWMENT PLAN PROJECTION — OCTOBER 1

PERMANENT FUND EARNINGS AT 7.94% (AVG)
Endowment payout 4% of 5-year average market value

(Nominal Dollars)

	FY 96	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10
AVAILABLE REVENUES (\$ Millions):															
Existing General Fund sources	1,952	1,919	1,997	2,038	2,062	2,083	2,059	2,058	2,052	2,038	1,985	1,936	1,950	1,910	1,870
Less: increase PF deposit to 50%			-244	-259	-263	-264	-261	-259	-258	-256	-249	-243	-253	-246	-239
Lift ANS Export Ban		20	20	20	20	20	20	20	20	20	20	20	20	20	20
Permanent Fund Net Earnings	1,213	1,351													
Permanent Fund Endowment Earnings			670	710	766	818	877	946	1,011	1,079	1,152	1,227	1,306	1,387	1,470
Permanent Fund Inflation-Proofing	-429	-467													
Transfer to Permanent Fund Earnings Reserve	-219	-369													
Highway Motor Fuel Tax @ \$.219/gal., indexed		39	41	43	45	47	50	52	55	57	60	63	66	69	73
Marine Motor Fuel Tax (\$.08/gal., indexed)		5	5	5	6	6	6	7	7	7	8	8	8	9	9
Tobacco Tax (\$1/pkg cigs; 75%/chewing; +25¢ every 3 years)		43	44	44	56	57	58	71	72	73	87	88	90	102	104
Motor vehicle license fees (double)			29	29	30	30	31	31	32	32	33	33	34	35	35
User fee increases		3	6	9	12	15	15	15	15	15	15	15	15	15	15
Fishery and other resource tax increases			30	31	32	33	34	35	36	37	39	40	41	42	44
Tourism tax increases			20	21	21	22	23	23	24	25	26	27	27	28	29
Alcohol taxes (increase every 3 years)		20	20	21	25	26	26	26	32	33	33	34	34	35	35
Income tax @ \$200 M 1995, adjusted for population growth						69	278	291	305	320	335	351	368	385	
TOTAL REVENUES	2,517	2,564	2,639	2,713	2,812	2,893	3,007	3,304	3,389	3,466	3,527	3,582	3,690	3,774	3,850
Note: Annual Spending Cuts		40	30	30											
EXPENDITURES (\$ Millions):															
Total GF spending on current programs	2,476	2,436	2,406	2,376	2,397	2,493	2,593	2,696	2,804	2,916	3,033	3,154	3,280	3,412	3,548
PF Dividends (cut \$50 M annually 3 yrs then freeze)	565	515	465	415	415	415	415	415	415	415	415	415	415	415	415
TOTAL EXPENDITURES	3,041	2,951	2,871	2,791	2,812	2,908	3,008	3,111	3,219	3,331	3,448	3,569	3,695	3,827	3,963
PROJECTED ANNUAL FISCAL GAP	-524	-387	-232	-78	0	-15	-1	193	170	135	79	13	-5	-52	-113
Constitutional Budget Reserve beginning balance	2,006	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Interest	125	94	94	94	94	94	94	94	94	94	94	94	94	94	94
Settlements	500	500	150	150											
Drawn for GF spending (deposited from GF surplus)	524	387	232	78	0	15	1	-193	-170	-135	-79	-13	5	52	113
CBR Transfer to Permanent Fund Principal	607	207	11	166	94	79	93	286	263	229	173	107	89	42	0
Constitutional Budget Reserve ending balance	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,480
PF Earnings Reserve beginning balance	703	922	1,291	0	0	0	0	0	0	0	0	0	0	0	0
Net from PF Earnings not used for GF	219	369	0	0	0	0	0	0	0	0	0	0	0	0	0
PF Earnings reserve transfer to PF Principal			1,291												
PF Earnings Reserve ending balance	922	1,291	0	0	0	0	0	0	0	0	0	0	0	0	0
Alaska Permanent Fund beginning balance	14,139	15,392	16,293	18,744	20,246	21,751	23,311	24,946	26,832	28,780	30,778	32,795	34,820	36,931	39,071
Dedicated state revenues - DOR Spring mid-case	217	227	244	259	263	264	261	259	258	256	249	243	253	246	239
New dedicated state revenues			244	259	263	264	261	259	258	256	249	243	253	246	239
FY end principal balance before inflation-proofing & deposits	14,356	15,619	16,781	19,262	20,772	22,279	23,833	25,464	27,348	29,292	31,276	33,281	35,326	37,423	39,549
Deposits to Principal from CBR	607	207	11	166	94	79	93	286	263	229	173	107	89	42	0
Deposits to Principal from PFER	0	0	1,291	0	0	0	0	0	0	0	0	0	0	0	0
Inflation-Proofing	429	467													
Net income after endowment distribution			661	818	884	953	1,019	1,082	1,169	1,257	1,346	1,432	1,517	1,606	1,697
FY ending balance Inflation Proofed	15,392	16,293	18,744	20,246	21,751	23,311	24,946	26,832	28,780	30,778	32,795	34,820	36,931	39,071	41,246
Escrow Accounts and Settlements	142	153	165	178	192	208	224	242	261	282	305	329	355	384	414
Net income (Calculated)	1,191	1,351	1,331	1,529	1,650	1,771	1,897	2,028	2,180	2,337	2,497	2,659	2,824	2,994	3,166
Permanent Fund Dividends	565	515	465	415	415	415	415	415	415	415	415	415	415	415	415
Alaska Permanent Fund ending balance	15,392	16,293	18,744	20,246	21,751	23,311	24,946	26,832	28,780	30,778	32,795	34,820	36,931	39,071	41,246
Alaska Permanent Fund ending balance-market	17,765	18,152	20,603	22,106	23,610	25,170	26,805	28,691	30,639	32,637	34,654	36,679	38,790	40,930	43,105

Alaska State Senate

SENATOR STEVE RIEGER
District 1

Senate Finance Committee
Chair, Senate Transportation Committee

Legislative Budget and Audit Committee
Administrative Regulation Review Committee
Legislative Council



During Session:
State Capitol, Room 516
Juneau, Alaska 99801
(907) 465-3879

716 West 4th Avenue, Suite 530
Anchorage, Alaska 99501
(907) 258-8188

Minority Report

The Long Range Financial Planning Commission has identified a series of measures which would balance revenues and expenditures over the next ten or more years. However, the final Commission Report goes beyond that task, and recommends additional taxes beyond those which are part of closing the fiscal gap, and which instead serve to place additional money into the corpus of the Permanent Fund. These additional measures are excessive.

The major reason for concern about the fiscal gap was the prospect that, if action was not taken, there would be a crisis reached which would trigger a sudden drop in state spending and threaten the economy and people's jobs, or a major (in the nine figures) new tax such as an income tax or statewide sales tax, or both. These outcomes are all avoided in the Minority Report's plan. However, a major new tax is included in the Commission report.

A set of meaningful but non-precipitous budget cuts, a series of smaller taxes and fees, and use of a portion of the Permanent Fund's earnings after inflation-proofing, closes the gap entirely for about a decade. Under a "Composite Scenario" developed during the Commission's deliberations, (and using the Commission's assumptions), by the year 2010 these measures would also result in a Permanent Fund balance of almost \$30 billion and additional cash reserves of over \$5 billion. In today's dollars these numbers would be over \$19 billion and \$3 billion respectively. The Composite Scenario represents a reasonable course for Alaska.

Where the Commission Report and the Minority Report part company most dramatically is the extent to which they pursue the goal of making the Permanent Fund an "endowment" for future government spending. To pursue this thought, the Commission Report recommends diverting an additional \$250 million of today's royalties away from the general fund and into the Permanent Fund, thereby cutting the present state revenue stream by approximately \$250 million per year and actually increasing the fiscal gap; by dumping most present or forecast cash reserves into the Permanent Fund; reducing the dividend payout more than in the "Composite Scenario" referred to above; imposing an additional \$40 million to \$50 million per year in small taxes over those used in the Composite Scenario; and by imposing a major new personal income tax generating \$385 million per year by the year 2010. These measures, including the smaller reserves, result in a Permanent Fund which is a little over \$40 billion in the year 2010, or the equivalent of \$26 billion in today's dollars.

In the Minority Report's view, these additional measures are not worth the sole accomplishment of a Permanent Fund which is 1/3 larger in size. They do not succeed in creating an endowment for state spending, and impose taxes where they are not needed. The Permanent Fund can be a very substantial source of stability and cash for the future. However, in neither the plan advanced by the Commission nor in the Composite Scenario does it come even close to being the sole source of funding for state government.

The fiscal gap can be closed satisfactorily for the next decade with a much more modest set of measures. These measures would be similar to those shown in the Composite Scenario referred to above. A full version of this Minority Report and the Composite Scenario spreadsheet are available by calling 258-8188--we will mail it to you.

RIEGER COMPOSITE SCENARIO PROJECTION — SEPTEMBER 30

PERMANENT FUND EARNINGS AT 4.79% (real)

(FY 98 Dollars)

	FY 98	FY 97	FY 96	FY 95	FY 94	FY 93	FY 92	FY 91	FY 90	FY 89	FY 88	FY 87	FY 86	FY 85	FY 84
AVAILABLE REVENUES (\$ Millions):															
Existing General Fund sources	1,952	1,863	1,880	1,859	1,822	1,784	1,709	1,656	1,600	1,540	1,454	1,374	1,342	1,274	1,209
Lift ANS Export Ban		19	19	18	18	17	17	16	16	15	15	14	14	13	13
New oil production															
Permanent Fund Net Earnings	1,213	1,351	1,365	1,381	1,398	1,414	1,430	1,445	1,460	1,474	1,488	1,501	1,514	1,526	1,538
Permanent Fund Inflation-Proofing	-429	-479	-509	-516	-523	-530	-537	-544	-550	-557	-563	-568	-574	-579	-584
Transfer to Permanent Fund Earnings Reserve	-219	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Highway Motor Fuel Tax @ \$.219/gal., indexed		38	39	39	40	41	41	42	43	43	44	45	45	46	47
Marine Motor Fuel Tax (\$.08/gal., per HB 122, indexed)		5	5	5	5	5	5	5	5	6	6	6	6	6	6
Tobacco Tax (\$1/pkg cigs, 75%/chewing, +25% triennially)		42	41	42	51	51	50	50	58	57	66	65	73	72	70
Motor vehicle license fees (double)			28	28	27	27	26	26	26	25	25	25	24	24	23
User fee increases		3	6	8	11	13	12	12	12	11	11	11	10	10	10
Alcohol taxes (increase similar to HB 96)			19	19	18	18	18	18	17	17	17	17	16	16	16
TOTAL REVENUES	2,517	2,841	2,892	2,883	2,888	2,840	2,772	2,735	2,686	2,662	2,636	2,589	2,539	2,475	2,412
Note: PF earnings used for GF programs	0	340	371	428	450	529	537	550	556	559	561	562	501	504	507
Note: Cumulative Spending Cuts total		39	66	91	0	0	0								
EXPENDITURES (\$ Millions):															
Total GF spending on current programs	2,476	2,365	2,264	2,167	2,184	2,202	2,219	2,237	2,255	2,273	2,291	2,309	2,327	2,346	2,364
Permanent Fund Dividends	565	558	518	479	464	405	416	419	423	427	431	435	439	443	446
TOTAL EXPENDITURES	3,041	2,924	2,782	2,646	2,648	2,607	2,636	2,655	2,678	2,700	2,722	2,744	2,766	2,788	2,811
PROJECTED ANNUAL FISCAL GAP	-524	-82	-110	-237	-219	-233	-136	80	8	-48	-86	-185	-227	-314	-398
DRAW FROM CBR	524	82	-109	-235											
Constitutional Budget Reserve beginning balance	2,008	1075	1498	1785	2199	2474	2771	2983	3147	3248	3285	3305	3221	3094	2879
Interest	125	87	94	112	137	155	173	186	197	203	206	207	201	193	180
Settlements	600	485	141	137	0	0	0	0	0	0	0	0	0	0	0
Drawn for GF spending	524	82	-109	-235	-217	-230	-134	77	4	51	89	188	230	317	401
CBR Transfer to Permanent Fund Principal	1009	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Constitutional Budget Reserve ending balance	1,107	1,545	1,842	2,289	2553	2859	3078	3247	3349	3398	3410	3323	3192	2971	2658
PF Earnings Reserve beginning balance	703	878	851	824	799	774	751	727	706	683	662	642	622	603	584
Net from PF Earnings not used for GF	219	0	0	0	0	0	0	0	0	0	0	0	0	0	0
PF Earnings reserve transfer to PF Principal	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
PF Earnings Reserve ending balance	904	878	851	824	799	774	751	727	706	683	662	642	622	603	584
Alaska Permanent Fund beginning balance	14,138	15,812	16,003	16,226	16,455	16,680	16,899	17,109	17,311	17,508	17,694	17,870	18,038	18,206	18,385
Dedicated state revenues - DOR Spring mid-case	217	220	230	236	232	226	217	208	201	193	182	173	174	164	154
FY end principal balance before inflation-proofing & deposits	14,356	16,033	16,233	16,462	16,687	16,906	17,116	17,318	17,512	17,710	17,876	18,043	18,212	18,370	18,520
Deposits to Principal from CBR	1,000	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Deposits to Principal PFER	500	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Inflation-Proofing	429	479	509	516	523	530	537	544	550	557	563	568	574	579	584
FY ending balance Inflation Proofed	16,285	16,512	16,742	16,978	17,210	17,436	17,653	17,862	18,063	18,256	18,439	18,611	18,785	18,949	19,104
Escrow Accounts and Settlements	142	148	155	163	170	178	186	195	204	213	223	234	245	256	268
Net Income (Calculated)	1,190	1,351	1,365	1,381	1,398	1,414	1,430	1,445	1,460	1,474	1,488	1,501	1,514	1,526	1,538
Real Return	761	871	856	865	875	884	893	901	910	918	925	933	940	947	954
Permanent Fund Dividends	582	558	518	479	464	405	416	419	423	427	431	435	439	443	446
Income transferred to (from) General Fund	-40	340	371	428	450	529	537	550	556	559	561	562	501	504	507
Alaska Permanent Fund ending balance	16,285	16,512	16,742	16,978	17,210	17,436	17,653	17,862	18,063	18,256	18,439	18,611	18,785	18,949	19,104

10/2/95 # 33

Executive Summary

I. The Commission's Plan Failed to Recognize and Address Alaska's Fundamental Problem: Unstable, Unpredictable Revenues

- Alaska depends upon volatile natural resource revenues for state spending.
- Alaska spends those resources, under the current system, at an unsustainable rate.
- A sustainable level of government spending cannot be defined until Alaska has a *stable* source of revenue.
- The Commission spent the majority of its time grappling with how to close the present fiscal gap rather than focusing on how to stabilize Alaska's revenue stream.
- Alaska's revenue stream must be stabilized and made sustainable for a healthy future: long range planning is impossible without a predictable revenue stream.

II. The Commission's Plan Is Unacceptable to the General Public

- The plan assumes the current level of government spending is acceptable and sustainable.
- The public does not accept this premise and will not accept the plan's recommendations for new taxes, cuts in permanent fund dividends, and expending permanent fund earnings to increase state government unless more meaningful reductions are made.
- The Commission's plan recommends creating a partial endowment using the permanent fund to increase spending.
- The Commission's partial endowment fails to stabilize revenues and fails to define a sustainable level of spending.
- The Commission's plan relies on "faith in the Legislature" rather than building fiscal restraint into the legislative budget process.

III. The Benefits of a True Endowment System

- The true endowment establishes a stable and sustainable level of revenues for state funding.
- The true endowment constitutionally forces fiscal restraint upon the Legislature and Governor.
- The true endowment strengthens and protects the permanent fund.
- The true endowment constitutionally protects future windfalls (ANWR taxes and royalties, for example) by depositing them in their entirety to the corpus of the permanent fund.

IV. Principles to Use for Closing the Present Fiscal Gap

- Once resource revenues have been stabilized through a *system*, a long range financial plan can be developed.
- A fiscal plan should prioritize meaningful budget reductions before taxes.
- State agencies should be consolidated to operate more efficiently.
- Voters, not the Legislature, must approve an income tax.

Opinion
Senator Georgianna Lincoln

While I believe the Long Range Financial Planning Commission did an admirable job identifying the options for closing Alaska's ever-widening fiscal gap, I have concerns that lead to this opinion. I did vote to advance the final document to the Governor and the Legislature, as did the majority of the Long Range Financial Planning Commission. However, I do not believe any commission member considered this to be an endorsement of **everything** within the report. It must be pointed out the commission was given a huge task to accomplish within a very short time and with an extremely small budget.

I applaud the commission for giving the public the opportunity to participate in its work, with serious attention paid to the comments throughout our deliberations. One subject which received, in my opinion, strong public support has not been incorporated into the commission's recommendations and that is reinstitution of the state income tax **now**. During my years in the legislature, I have wrestled with the wisdom of such an action. Since 1990, Alaska has grown by approximately 100,000 residents with as much as 25 percent of our work force being non-resident; non-residents contribute little to our economy but take much from it. The current plan recommends immediate introduction of a number of smaller taxes based on use with the state income tax implemented *after the year 2000*. I believe a state income tax, which taxes everyone (**resident and non-resident**) equitably, would result in a reduction to the state's fiscal gap, but would not result in such a huge, immediate reduction in state government programs as proposed by the commission. Recommended cuts to these programs would devastate those who can least afford them -- our youth, our elders, and the disadvantaged. *Again*, it was my sense in listening and talking to citizens across the state that folks are willing to reinstate the state income tax **now** and not later as the commission report recommends.

We **do not know** specifically what Washington D. C. will do within the next year in terms of revisions and/or reductions to programs such as welfare reform, Medicaid, and the transfer of federal responsibility for services such as transportation and education to the State. We **do know** many of these decisions will have a major negative fiscal impact on our Alaska citizens.

Further, I believe economic opportunity is another key to closing the fiscal gap. Jobs, jobs, jobs!!! This plan does not go far enough in providing incentives for entrepreneurship or enhancing economic opportunity throughout our state. In failing to do so, the plan does not propose solutions to diversify the economy, create jobs, and end the vicious cycle of welfare. We must analyze, in the proper perspective, the impacts of closing the fiscal gap in a rational manner. Without question, the state must cut spending to close the fiscal gap. Although I support many of the commission's current recommendations, I caution those responsible for implementing a final plan to ensure cuts are spread equitably and economic and job development reaches the smallest of communities throughout our great state.

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20 Sept 95
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Long Range Financial Planning Commission

Dissenting Opinion

October 11, 1995

By
Representative Sean Parnell
and
Hugh Motley

Introduction

The Long Range Financial Planning Commission was created by House Joint Resolution 1 to develop a plan addressing Alaska's current fiscal situation and future. The Commission spent many months formulating its plan which was issued on October 1.

The Commission's recommendations ultimately included substantial new taxes, reductions in permanent fund dividends, and spending a portion of the permanent fund to support government services, with only minimal reductions in government spending. The plan imposes no fiscal restraints upon the Legislature; it relies simply upon faith in the Legislature. The plan does not adequately stabilize Alaska's volatile revenue stream and therefore fails in its portrayal of "sustainable" spending.

In short, the underlying, unspoken assumption of the plan is that state government spending is at an acceptable and sustainable level, and that it must be maintained. We disagree, and respectfully dissent from the Commission's plan.

Executive Summary

I. The Commission's Plan Failed to Recognize and Address Alaska's Fundamental Problem: Unstable, Unpredictable Revenues

- Alaska depends upon volatile natural resource revenues for state spending.
- Alaska spends those resources, under the current system, at an unsustainable rate.
- A sustainable level of government spending cannot be defined until Alaska has a *stable* source of revenue.
- The Commission spent the majority of its time grappling with how to close the present fiscal gap rather than focusing on how to stabilize Alaska's revenue stream.
- Alaska's revenue stream must be stabilized and made sustainable for a healthy future: long range planning is impossible without a predictable revenue stream.

II. The Commission's Plan Is Unacceptable to the General Public

- The plan assumes the current level of government spending is acceptable and sustainable.
- The public does not accept this premise and will not accept the plan's recommendations for new taxes, cuts in permanent fund dividends, and expending permanent fund earnings to increase state government unless more meaningful reductions are made.
- The Commission's plan recommends creating a partial endowment using the permanent fund to increase spending.
- The Commission's partial endowment fails to stabilize revenues and fails to define a sustainable level of spending.
- The Commission's plan relies on "faith in the Legislature" rather than building fiscal restraint into the legislative budget process.

III. The Benefits of a True Endowment System

- The true endowment establishes a stable and sustainable level of revenues for state funding.
- The true endowment constitutionally forces fiscal restraint upon the Legislature and Governor.
- The true endowment strengthens and protects the permanent fund.
- The true endowment constitutionally protects future windfalls (ANWR taxes and royalties, for example) by depositing them in their entirety to the corpus of the permanent fund.

IV. Principles to Use for Closing the Present Fiscal Gap

- Once resource revenues have been stabilized through a *system*, a long range financial plan can be developed.
- A fiscal plan should prioritize meaningful budget reductions before taxes.
- State agencies should be consolidated to operate more efficiently.
- Voters, not the Legislature, must approve an income tax.

The Commission's Plan Failed to Recognize and Address Alaska's Fundamental Problem: Unstable, Unpredictable Revenues

- Alaska depends upon volatile natural resource revenues for state spending.
- Alaska spends those resources, under the current system, at an unsustainable rate.
- A sustainable level of government spending cannot be defined until Alaska has a *stable* source of revenue.
- The Commission spent the majority of its time grappling with how to close the present fiscal gap rather than focusing on how to stabilize Alaska's revenue stream.
- Alaska's revenue stream must be stabilized and made sustainable for a healthy future: long range planning is impossible without a predictable revenue stream.

Alaska's fundamental problem, and also its greatest opportunity, lies in the nature of its wealth.

Most states derive their general fund revenues from private sources, by taxing citizens and their property. The amount of revenue collected in this manner is more or less directly linked to a state's population. It is predictable and relatively stable. If the population increases, revenues tend to increase. If the population decreases, revenues generally decrease.

Alaska is different. Its wealth is *public*, not *private*. Alaska derives nearly all its revenues from natural resources. The Constitution provides for these resources to be utilized in the best interests of the owners, the people of Alaska (Article 8, Section 1). State services are paid for with these "public" dollars; individuals pay negligible amounts in state taxes.

Alaska's most obvious natural resource is oil. The revenue derived from oil is highly volatile, depending upon the market price, size of field, and level of production. Each one dollar fluctuation in the price of oil results in over a \$100 million corresponding fluctuation in state revenues. Oil prices are also unpredictable. *Because Alaska's revenues are natural resource based, they are neither predictable nor stable.*

Alaska spends its revenues, under the current system, at an unsustainable rate. As oil production continues to decline, Alaska's fiscal problems will worsen.

Furthermore, it will remain impossible to define a sustainable level of government spending until Alaska has a stable source of revenue.

The Commission spent the majority of its time grappling with how to close the present fiscal gap rather than focusing on how to stabilize Alaska's revenue stream. Months were spent pouring over volumes of information and numbers. While they did formulate a plan to close the gap, *the Commission failed to adequately recognize and address Alaska's fundamental problem; unstable and unpredictable revenues.* Consequently, the Commission's plan is, at best, a short term fix because oil revenue volatility can rapidly open another gap, or dump windfalls on the state which will surely be spent.

Alaska's revenue stream must be stabilized and made sustainable for a healthy future: long range planning is impossible without a predictable revenue stream. **THAT is the problem.**

The Commission's Plan Is Unacceptable to the General Public

- The plan assumes the current level of government spending is acceptable and sustainable.
- The public does not accept this premise and will not accept the plan's recommendations for new taxes, cuts in permanent fund dividends, and expending permanent fund earnings to increase state government unless more meaningful reductions are made.
- The Commission's plan recommends creating a partial endowment using the permanent fund to increase spending.
- The Commission's partial endowment fails to stabilize revenues and fails to define a sustainable level of spending.
- The Commission's plan relies on "faith in the Legislature" rather than building fiscal restraint into the legislative budget process.

The majority of the Commission concluded that government spending is close to where it should be; their plan reflects this philosophy. The Commission's recommendations ultimately included a plethora of taxes, minimal budget cuts, reducing dividends, and spending from the permanent fund.

In the first three years of its plan, the Commission recommended only \$100 million in budget reductions while recommending over \$500 million in increased taxes and user fees during the same three year period. In addition, the dividend payout is

capped in FY99 and an income tax is to begin in the year 2002. To raise additional revenues for spending, the Commission also recommended a fixed 4% withdrawal from a "partial endowment" comprised of the permanent fund, earnings reserve, moneys in excess of \$1.5 billion from the Constitutional Budget Reserve (CBR), and fifty percent of all future dedicated royalties and bonuses.

We believe the majority of the public will not accept recommendations for new taxes, cuts in permanent fund dividends, and expending permanent fund earnings to increase state government unless more meaningful reductions are made first.

The partial endowment created in the Commission's plan was intended to provide an increasing flow of revenue to the general fund through appreciation in the permanent fund and by capping the dividend. The Commission appears to have misunderstood the fundamental goal of a true endowment--to achieve a stable and sustainable revenue stream.

The Commission's partial endowment fails to stabilize revenues and define a sustainable level of spending. By maintaining the current system of depositing a majority of natural resource revenues to the general fund, a significant portion of the state's budget will remain volatile. If oil prices drop significantly, another gap will open. If oil prices skyrocket, the Legislature will have access to most of the resulting "windfall," meaning it could all be spent in one year (imagine ANWR revenues). Because revenues remain unstable, a sustainable level of spending cannot be defined under this plan.

The partial endowment fails to build fiscal restraint into the legislative budget process. Under the Commission's plan, the Legislature retains free access to spend as much of incoming general fund revenues as it deems appropriate. In the Commission's plan, a minimum of \$1.5 billion in the Constitutional Budget Reserve is left on the table for the Legislature to access if it chooses. Few, if any, Commission members expressed faith that the Legislature would actually let the surplus sit in the CBR without spending it.

The Commission's adopted plan is a continuation of the current system by which Alaska derives its revenues. It takes a faltering step toward changing that system; however, it fails by falling short of a complete systemic change. *Alaska does not need, and cannot effectively use, a plan until it undergoes a systemic change to eliminate reliance upon a volatile and unpredictable revenue source.* We must fundamentally change the method of deriving revenues to create a stable, and

sustainable level of state income; otherwise, long range planning will be little more than a guess.

The Benefits of a True Endowment System

- The true endowment establishes a stable and sustainable level of revenues for state funding.
- The true endowment constitutionally forces fiscal restraint upon the Legislature and Governor.
- The true endowment strengthens and protects the permanent fund.
- The true endowment constitutionally protects future windfalls (ANWR taxes and royalties, for example) by depositing them in their entirety to the corpus of the permanent fund.

The Commission briefly considered another type of endowment, what we characterize as a "true endowment," which would substantially alter the system by which the state calculates its general fund revenues available for appropriation.

Under the present system, approximately 25% of natural resource bonuses and royalties (and no severance taxes) are deposited into the permanent fund with the remainder going to the general fund (the Commission's plan changes the percentage of bonuses and royalties to 50%). A true endowment would place *all* current reserves and *all* recurring natural resource revenues (including severance taxes) into the permanent fund. Thus, the endowment would consist of the existing permanent fund, the earnings reserve account, the CBR, and all future natural resource revenues.

The true endowment would establish a sustainable, stable revenue source upon which to build a fiscal plan. It should be used as a model; the specifics of it are subjective, to a certain extent. The Commission discussed a conservative range of values that could be applied to a true endowment model. These variables pertained to the true endowment's estimated total return, a sustainable rate of withdrawal from it, and the appropriate length of a "transition period." *It is important to remember that the true endowment is not magic, but mathematical; it will not end the need for tough decisions.*

Although most endowments probably have a total return of 10% or more, a rate of 9% total return has been suggested as a conservative estimate for the investment performance of the true endowment. A fixed percentage of money would be

withdrawn from the true endowment each year to fund state government. This withdrawal, plus non-resource revenues, would be the amount of general fund revenues available for appropriation by the Legislature for the upcoming fiscal year.

The percentage rate of withdrawal from the true endowment would be set in the constitution; it would need to be high enough to fund government spending at the greatest sustainable level, yet low enough to avoid eroding the principal of the fund. Rates of withdrawal varying from 4-6% have been suggested.

If a system such as the one described were started next year, the income derived from a 4-6% withdrawal would be significantly less than what government currently spends in a fiscal year. That is because that amount represents the only sustainable level. *Using more resource revenue, on top of this withdrawal amount, as is currently done and as the Commission recommended in its plan, is not sustainable in the long term.*

As earlier discussed, Alaska spends significantly more than what is sustainable under the current system. Because of this, a transition period is necessary to avoid shocking the economy before the state can successfully subsist on an annual 4-6% fixed withdrawal rate of the fund. A higher rate of withdrawal from the fund would initially be used and gradually reduced each year until the goal of a fixed, lower percentage rate was reached. This would make larger sums of general fund dollars available for the Legislature to work with in the early years of the endowment. The length of such a transition period is also subjective; 10-15 years has been suggested as an appropriate length.

There are several advantages to a true endowment.

First, a true endowment sets a stable and sustainable level of revenues available for state funding by eliminating the state's dependence on volatile oil revenues. The Legislature and Governor would have the advantage of knowing exactly how much revenue is available to fund state government as they prepare the next fiscal year's budget. Boom and bust cycles resulting from wild fluctuations in oil prices would no longer be an issue. The struggle would be over allocation of available funds rather than allocation *plus* the vagaries of an unstable revenue stream.

A true endowment constitutionally forces fiscal restraint upon the Legislature. All general fund expenditures, including the permanent fund dividend program, of government that the Legislature chooses to fund would be appropriated from a

single, constitutionally mandated withdrawal amount plus non-resource based revenues earned outside of the endowment. This spending limit would force the Legislature to make some difficult decisions in terms of what programs the state should pay for and what programs should cease to exist as a function of state government, or what non-resource revenues must be raised to augment endowment withdrawals. This method forces the Legislature to stick to a constitutionally mandated "allowance."

The true endowment system would strengthen and protect the permanent fund. The role of the permanent fund, as the financial backbone of our state, would be preserved, protected, and strengthened. Under the guidelines used in the true endowment scenarios reviewed by the Commission, the permanent fund will be significantly larger in twenty years than under the partial endowment adopted by the Commission. The immediate one-time deposit of all other reserves currently not in the permanent fund, plus future deposits of 100% of natural resource revenues, plus all investment income, despite the withdrawals (which are limited to the growth of investment), will result in a larger and stronger fund.

Finally, a true endowment will constitutionally protect future windfalls from being spent by the Legislature by depositing them in their entirety to the corpus of the permanent fund. The Commission's partial endowment leaves most of the revenue from large booms (for example, ANWR moneys) vulnerable to appropriation by the Legislature. The Commission's partial endowment relies on faith in the Legislature to exercise fiscal restraint; the true endowment forces budget discipline.

Once a systemic change like the true endowment is in place and Alaska has a predictable, sustainable stream of revenue for government spending, it can plan how to responsibly spend those revenues.

Principles To Use For Closing the Present Fiscal Gap

- Once resource revenues have been stabilized through a *system*, a long range financial plan can be developed.
- A fiscal plan should prioritize meaningful budget reductions before taxes.
- State agencies should be consolidated to operate more efficiently.
- Voters, not the Legislature, must approve an income tax.

Again, the true endowment itself is not a plan; it is a systemic change upon which to build a fiscal plan.

As previously stated, the Commission heavily favored spending and revenue increases in its report while recommending only minimal budget reductions. We do not believe the public will or should accept the Commission's approach. *The Commission received hours of public testimony calling for substantial budget reductions.* The majority of the public perceives government as too expensive and intrusive. The electorate wants to see government downsize before giving up permanent fund dividends or income to pay taxes.

Alaska provides a level of services and benefits few other states are capable of matching. This is a direct result of the oil wealth we enjoy. For example, Alaska spends \$8,374 per pupil compared to the national average of \$4,960. Alaska spends \$844 per person on highways, compared to the national average of \$178.* Alaska spends \$923 for a family of three on welfare; the next highest state pays \$735.** Other examples of higher cost or unique programs abound, including the permanent fund dividend program, the longevity bonus, and the pioneer homes.

A fiscal plan should prioritize meaningful budget reductions. Part of this can be accomplished by re-examining the scope of services the state should be expected to provide for its citizens. Formula programs must be carefully considered in this evaluation.

During the first half of the legislative session for the Nineteenth Alaska State Legislature, the House Majority announced a plan to reduce spending by \$250 million over a five year period. The goal was to cut \$70 million in FY96, followed by \$60 million, \$50, \$40, and \$30 million in each subsequent year. We support reductions of this magnitude (\$250 million over five years) rather than the \$100 million limit adopted by the Commission.

Three categories of spending comprise approximately three-quarters of Alaska's general fund budget: education, health and social services, and state employee salaries and benefits. These budget categories will continue to grow as Alaska's population increases.

In previous years, education and state salaries and benefits have been held harmless from budget reductions. The remaining one-quarter of the state budget has borne the brunt of reductions. Obviously, this pattern cannot continue. While further

* Source: The Book of the States, Volume 30, 1994-95 Edition, The Council of State Governments

** Source: U.S. Department of Health and Human Services

reductions may be possible in this 25% of the budget, the Legislature must address spending growth in education, health and social services, and state employee salaries and benefits, if any meaningful progress is to be made toward filling the gap.

Next, state agencies and their functions should be consolidated. Some departments perform similar or overlapping services. Some of them could operate more efficiently under one administrative roof. The Department of Commerce and Economic Development and the Department of Community and Regional Affairs are examples of agencies that could combine and restructure to serve the public more efficiently.

The Commission dedicated a significant portion of its time discussing the implementation of a myriad of taxes as a way to increase state revenues, at the expense of debate on reductions and efficiencies. Income taxes, sales taxes, and excise taxes, among others, were discussed.

In our view, taxes should not be implemented until the public is satisfied that government spending has been substantially reduced. Moreover, implementation of a state income tax should not occur without voter approval.

Finally, it is unrealistic to believe the Legislature would use income tax revenues to close the fiscal gap; those revenues would be used to increase spending. Given the nature of politics and the Legislature's penchant for spending what is on the table, it is unlikely that revenues raised through taxes would be used to close the gap. Revenue raised from taxes will instead be used to increase state spending, and we do not concur with this.

Conclusion

We believe the Commission built a fiscal plan upon a system that is unsustainable, unpredictable, and unstable.

If Alaska chooses the road of an endowment, it should choose one that leads to fiscal stability and fiscal restraint. Only the "true endowment" meets these objectives.

Alaska State Legislature

REPRESENTATIVE
SEAN R. PARNELL



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While in Juneau
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JUNEAU, ALASKA 99801-1182
(907) 465-2995

HOUSE OF REPRESENTATIVES

MEMORANDUM

DATE: June 2, 1995

TO: Melissa Fouse, Staff Coordinator
Long Range Financial Planning Commission

FROM: Representative Sean Parnell

RE: Meetings of May 19 & 20

Due to travel, I was unable to attend last month's Long Range Financial Planning Commission meetings. Please provide a summary of what took place at the meetings.

I appreciate your assistance in this matter.

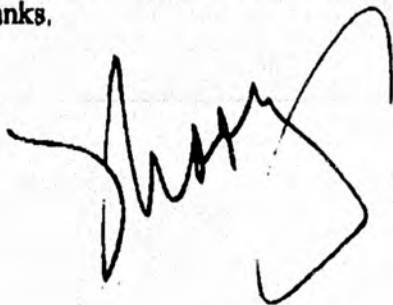
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TRANSMITTAL

to: Melissa Aber Fouse
fax #: 907-258-9869
re: Minority report
date: October 12, 1995
pages: 1, including cover sheet.

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MESSAGE:

Melissa: Please make d--n sure that the Rieger minority report and the Parnell minority report are identified only to the authors and that I, as another member of the minority, am not associated with either of them. Thanks.



From the desk of...

Mary A. Nordale
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TRANSMITTAL

to: Melissa Aber Fouse
fax #: 907-258-9869
re: Kim Elton - ASMI
date: September 21, 1995
pages: 3, including cover sheet.

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MESSAGE:

Melissa: Transmitted is my response to Kim Elton's letter. Don't fax it around the rest of the commission, but you can make copies for distribution on the 28th. Thanks.



From the desk of...

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September 21, 1995

Hon. Kim Elton
House of Representatives
Alaska State Legislature
State Capitol
Juneau, Alaska 99801-1182

Dear Kim:

Thank you for your thoughtful and informative letter regarding the LRFC's preliminary report. Would that we receive more of the same from other commenters!

While I cannot speak for the commission, I can report that I believe that what we are striving for is an overall reduction of state government, including even programs such as ASMI that are almost entirely industry supported. The Alaska fishing industry should be mature enough now that the state no longer needs to mediate the varying positions of industry components. Moreover, I do not think the state needs to be encumbered with the retirement and medical care coverage expense for what is essentially a private sector organization.

What to do about fishing, tourism and other industry promotional efforts is a bit of a conundrum, if a conundrum can ever be small. I see a significant role to be played by the state in promoting its assets, but I am not convinced that industry-government partnerships or associations must be state funded and operated. As both federal and state budgets force a shift to user fees and taxes, I think that industries that generate profits should not be more protected than John Q. Public from the costs of economic activity.

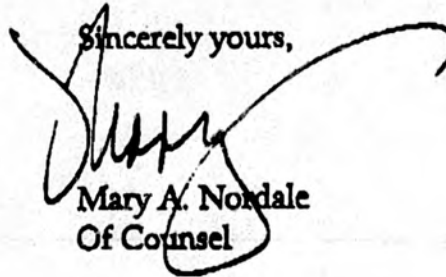
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Hon. Kim Elton
Page 2
September 21, 1995

I do not see the federal government continuing its export promotion efforts. It seems to me that we should be prudent and set up a structure for ASMI that is wholly operated and funded by those who derive the direct economic benefit from its promotional efforts.

Cutting budgets and programs is not fun. Neither is recommending such cuts much fun. However, the LRFPC has a much easier task that you and the other legislators and you have my best wishes for your fortitude and success.

Sincerely yours,



Mary A. Nordale
Of Counsel

cc: Commission members

Side by Side Scenario Comparisons

First year impacts

total new taxes/fees
budget level
PF dividend

Second year impacts

total new/increased taxes/fees
budget level
PF dividend

Permanent Fund

principal in 98, 00, 05, 10
risk of decrease in principal

Income/Sales tax

when decision needed
amount needed

Coping with volatility

low oil revenues
low PF earnings

high oil revenues
high PF earnings

Impacts - other

who pays

max. aggregate impact on economy in 1 yr.

coping with federal reductions

susceptibility to giving tax breaks

coping with state economic downturn

coping with increased population/service needs
effect on local govt.

Brian: Here's my bit. I think we have to have this much on the subject because Gail Phillips is a strong believer in forward funding and will be mightily upset if we simply say it's a bad idea and won't work.



FORWARD FUNDING

Legislative Resolve No. 6 (?) requested an evaluation of forward funding of the budget. The concept of forward funding has been advanced for a number of years. It is based on the idea that appropriations should be made only from funds already received and on hand.

To put forward funding into effect the equivalent of a surplus of not less than 18 months of unappropriated revenues would be required. This is because, under current practice, appropriations for a fiscal year rely on revenues that are received during that fiscal year. In order to make the leap to forward funding, assured funding for two fiscal years would have to be in place--reasonable estimates of revenues to be received for the first fiscal year and funds actually on hand to fund the second fiscal year. This would enable the state treasury to accumulate revenues during the second fiscal year to fund the third fiscal year.

Proponents of forward funding have expressed the belief that forward funding would bring discipline to the appropriation and expenditure processes, limiting the growth of the budget and eliminating the fiscal gap. While that could be true, the probability is that legislatures would be asked to adjust funding for agencies and constituencies that find appropriation levels too restrictive. The adjustments would have to be made from the revenues accumulated in advance for the succeeding fiscal year. Such adjustments would require stringent reductions in the next fiscal year, increasing uncertainties with respect to levels and quality of services.

The Commission found that the state does not have sufficient reserves, even if both the Constitutional Budget Reserve and the Earnings Reserve Account of the Permanent Fund were to be used, to inaugurate forward funding as well as to fund the fiscal gap. Moreover, without adequate reserves, the state would not be able to meet the costs of emergencies or to respond to population growth spurts and shifts or substantial upward swings in inflation.

MEMORANDUM**State of Alaska****Office of the Governor**
Office of Management and Budget**TO:** Long Range Financial Planning
Commission Members**DATE:** September 14, 1995**FROM:** Jack Kreinheder
Brad Pierce **PHONE:** 465-4676**SUBJECT:** Constitutional Budget Reserve Options **FAX:** 465-3008

You requested that we present options for addressing the concerns which have been expressed by legislators and others about the implementation and impacts of the Constitutional Budget Reserve Fund (CBR). Please note that we do not believe it is appropriate for us to comment on the merit or validity of the concerns listed below, or to recommend particular solutions.

Instead, we will present options for dealing with these concerns, to the extent that the Commission members believe these concerns are justified and warrant corrective action. These options are not discussed in any depth in this memo, but are intended to serve as a starting point for further discussion by the Commission. If you would like further analysis of any of these options, please let us know.

We have discussed the CBR concerns and potential solutions with attorneys from both the Department of Law and the legislative Division of Legal Services.

The primary concerns which have been expressed about the CBR are:

- Some individuals believe that the requirement for a three-fourths vote of the legislature to appropriate money from the CBR has led to increased spending, not lower spending. A related concern is that the provision of the CBR which allows majority vote appropriations to offset revenue shortfalls has not operated as intended, because of the Alaska Supreme Court ruling that the Permanent Fund Earnings Reserve Account must be considered as money available for appropriation.
- The phrase "amount available for appropriation" is not clearly defined in the CBR amendment.
- The repayment provision of the CBR amendment has no implementation guidelines.
- The Supreme Court rulings on the CBR have not given sufficient guidance to identify specific funds included under the provisions governing both appropriations from the CBR, and repayments to the CBR.

Long Range Financial Planning Commission Members
September 14, 1995
Page 2

- The Department of Revenue and Department of Administration have stated concerns regarding the current CBR repayment provisions. The general fund is likely to owe a large balance — potentially billions of dollars — to the CBR essentially forever. This indebtedness is not a positive feature in documenting the state's financial health and credit rating.

The range of options for addressing these concerns include the following:

- Place a constitutional amendment on the ballot to repeal the CBR in its entirety.
- Consolidate the state's major reserve funds — the CBR and the Permanent Fund Earnings Reserve Account — into a single fund.
- Put an amendment on the ballot which would retain the CBR, but would modify or repeal the elements of the current CBR provisions which have not worked as intended or have had undesirable effects.
- Address the three-fourths vote issue by transferring the balance of the Permanent Fund Earnings Reserve Account into either the PF principal, or into the CBR.
- "Zero out" the CBR by transferring the fund balance to the principal of the Permanent Fund or another reserve fund established by statute.
- Enact legislation to clarify and implement certain provisions of the CBR, such as the repayment requirements.

21 SEPT:
SENT MSG TO
BRAD RE: did
this memo get
distributed?

Office of Management and Budget
September 14, 1995

Reserve Fund Issues: How Much is Enough

There are at least four major roles which reserve funds could play in Alaska's fiscal future:

- Providing a source of funds to allow a more gradual implementation of the fiscal measures necessary to close the fiscal gap, thus reducing some of the negative impacts which a sudden "fiscal crisis" would create. This is a temporary role or objective, while the following roles are more permanent.
- Enabling the adoption of a "payout rule" or "real earnings" approach to the use of Permanent Fund earnings, by serving as a buffer during years of lower than average Fund earnings.
- Providing insurance against annual fluctuations in petroleum prices and revenues.
- Serving as a source of funds to allow a prompt and effective response to major natural disasters.

How much money in reserves would be necessary to meet these objectives? No precise amount can be calculated, but the following observations may help to establish an approximate range for consideration:

- The amount of reserve funds necessary to meet the first objective — a gradual closing of the fiscal gap — is tough to estimate, and clearly depends on what strategies and timing are used to close the gap. If we can close the gap in two years, much less in reserves would be needed than if the gap is closed over four or five years, or longer.

What we do know is that the state is likely to need at least \$500 million per year in reserves to balance the budget for the next several years, less the amount of spending cuts or revenue increases that are implemented.

- The reserves needed for the second objective — enabling the adoption of a "payout rule" or "real earnings" approach to the use of Permanent Fund

earnings— depends on the specifics of the approach, but could range roughly from \$1 billion to \$1.6 billion.

- The reserves necessary for the third objective — providing insurance against annual fluctuations in petroleum prices and revenues — will depend on how large of a drop in prices and the duration of low prices we want to insure against.

Insuring against a drop in oil prices from the mid-case forecast price to the lowest annual average oil prices over the last 15 years would require about \$275 million per year, or about \$550 million to cover two years of low oil prices.

In the attached memo, Commissioner of Revenue Wilson Condon argues that the state should be prepared for two years of \$10 oil prices, which would require \$1.6 billion in reserves.

- Responding to a natural disaster on the scale of the 1964 Alaska earthquake could require major state expenditures. However, if a substantial level of reserves are maintained for one or more of the purposes discussed above, these reserves could also be made available if necessary to respond to major natural disasters.

A case can be made that the state should retain \$2 billion or more in reserves to meet these objectives. However, the use of reserves to gradually close the fiscal gap would reduce the level of reserves available for the other, more permanent objectives. Another important consideration is that it could be difficult to convince the Alaska public that increased taxes and reduced services are necessary if the state still has billions of dollars in reserve funds.

Memorandum
Department of Revenue
Office of the Commissioner

TO: Annalee McConnell
Director, Office of Management and Budget

FROM: Wilson Condon *W. Condon*
Commissioner

DATE: September 15, 1995

RE: Reserve Needs

You have asked our views on the reserve needs of the State in relation to the dependence of the State on oil and gas revenue.

The State confronts two major risks calling for some kind of a reserve strategy in relation to its current dependence on oil revenue. These risks are:

- (1) the possibility of a disaster of some sort causing catastrophic failure of the Trans Alaska Pipeline System; and
- (2) very low oil prices.

One can certainly imagine a disaster which might interrupt the flow of oil for at least a year. We assume that in a disaster of this magnitude, all the annual income of the Permanent Fund would be available to meet the public needs of the State. A complete shut-down of TAPS for two years would leave a \$3.2 billion hole in the State budget. The Permanent Fund at its current size would likely earn \$2.5 billion over a two year period. A \$700 million reserve in addition to Permanent Fund earnings plus whatever else was needed to close the then current budget gap would certainly be adequate to cover this speculative shortfall.

In planning to meet the reserve needs occasioned by the possibility of low oil prices, one certainly might evaluate that risk by analyzing the last ten years' crude oil price volatility. I believe that the highest and the lowest oil prices experienced during the last ten years were due to normal market fluctuations. During this time period, we did not witness a sustained price war (to depress prices) or sustained production controls (to increase prices). In addition, as shown in the table below, an analysis based on ten-year oil price fluctuations shows the lowest as having occurred in Calendar Year 1986 at \$13.89 per barrel or in Fiscal Year 1994 at \$14.22 per barrel depending on whether your measuring periods are calendar or fiscal years.

Year	Destination Value - Calendar Year	Destination Value - Fiscal Year
1986	\$13.89	\$22.03
1987	\$17.73	\$14.98
1988	\$13.75	\$16.45
1989	\$17.29	\$14.80
1990	\$21.59	\$17.34
1991	\$17.46	\$21.72
1992	\$17.57	\$16.88
1993	\$15.60	\$17.93
1994	\$15.31	\$14.22
1995	\$17.54	\$16.83

Further, we know that the oil companies doing business in Alaska today base their project planning on an ANS price in destination markets of \$16.00-\$17.00 per barrel (the Department of Revenue's mid-case forecast). Alaskan oil producers screen out projects which are unprofitable at ANS crude destination market oil prices below \$14.00/bbl (for all practical purposes, the Department of Revenue's low-case forecast). One can infer, then, from this information, that oil producers view \$14.00/bbl oil as the lowest likely price level during "normal" market fluctuations.

I strongly believe that for reserve purposes, we should use a different analysis. I believe we should base our reserves policy on the possibility of a sustained market collapse.

What price level would we see if OPEC members decided to aggressively move to increase their market share and we witnessed a one to two year oil price war? Would we see \$10.00/bbl oil prices? \$12.00/bbl? \$8.00/bbl? I believe that a sustained price war might depress oil prices in destination markets to \$10.00/bbl. As oil prices fall, energy use begins to switch away from other sources back to oil. We witnessed just the opposite in the 1970's when oil prices increased dramatically under OPEC production controls. If oil prices fall far enough, we will see a dramatic change in energy use patterns, returning to high dependence on oil. With this switch comes an increase in demand for oil. I believe that such a demand increase would prevent oil prices from dropping below \$10.00/bbl.

If we experienced \$10.00/bbl (\$5.00/bbl at the wellhead) oil prices for two years, State oil revenues would be at half their current level, or \$1.6 billion over a two year period. The budget gap would be \$1.6 billion above the current projection over the two year period.

Available reserve resources and the considerations pertinent to them follow:

Reserve	Amount Available Over Next 5 Years	Amount Available in 2005	Considerations Pertaining to This "Reserve"
Constitutional Budget Reserve	approximately \$2.0 billion	Depends on fiscal plan	* Needed to bridge gap until gap reduced or resolved. * Currently invested in fixed income short to medium term. Amount unlikely needed for short term cash needs would likely earn a greater return if it could be invested more aggressively * If transferred to Permanent Fund, earnings would enhance size of dividend stream. As currently invested, all earnings used to support government operations.
Earnings Reserve Account	approximately \$1.0 billion	Depends on fiscal plan, including whether (1) it is used for purposes other than inflation proofing and dividends and (2) whether amounts continue to be appropriated back to principal of fund.	* Some amount necessary to accommodate fluctuations based on income and distribution formula (whether you use correct formula or newly proposed Rieger formula) * Earnings Reserve Account is not inflation proofed under current formulas or Rieger proposal. Amounts transferred to principal are.
Permanent Fund Earnings Used for Dividends and Inflation Proofing	approximately \$1.0 billion per year	Depends on fiscal plan	* Is it politically possible to use these as reserves? For a natural catastrophe? For an oil price crash?

Closing Alaska's Fiscal Gap

The Long Range Financial Planning Commission's Recommended Plan

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 does the plan do? It:

- Makes the Permanent Fund the cornerstone of Alaska's fiscal future.
- Closes the fiscal gap by the year 2000.
- Ensures growth of the Permanent Fund to offset declining oil and gas revenues.
- Stabilizes and diversifies revenues.
- Controls State general fund spending.
- Maintains a reserve to dampen the effect of oil price swings.
- Decreases our dependence on volatile oil revenues.

This is a plan for ourselves and our grandchildren. It requires all Alaskans to share in the solution. No action to close the fiscal gap is the greatest threat to Alaska's financial future.

The Commission was asked to recommend a plan for three, five and ten years. To be sure that plans for these time frames did not create a reoccurring fiscal gap after that, the Commission also looked at the likely effects of its plan over a fifteen year period.

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 four 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¢ per drink (\$20 million).
- Increase motor fuel tax from the 1961 level of 8¢/gallon to 22¢/gallon and increase marine fuel tax by 3¢/gallon (\$44 million).
- Increase user fees by at least \$3 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 tourists 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% 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% the minimum contribution to the Permanent Fund from certain oil, gas and mineral lease revenues.
- Retain earnings in excess of the 4% annual payout in the fund. Since the historic rate of return to the fund has been 4.79% after inflation, the Fund should retain earnings above inflation-proofing of at least 0.75% 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 CBR 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 ten-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 reappears.

Closing Alaska's Fiscal Gap

The Long Range Financial Planning Commission's Recommended Plan

FINAL REPORT

Alaska's 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, the State will spend \$524 million more from the State general fund than it will take in — this is the fiscal gap. That gap will grow to \$768 million in three years, to \$879 million in 5 years, and \$1,253 billion in 10 years (in today's dollars) if we make no changes to the State's spending and revenue policies. Our interim report contains more details about the growing fiscal gap and options available to close the gap.

The Long Range Financial Planning Commission was appointed jointly by the Legislature and Governor in March 1995 to recommend how to close the gap and put Alaska on firm financial ground. In the past six months, as directed by the resolution creating the Commission, the Commission has:

- Reviewed and evaluated State fiscal policy and strategy recommendations and assumptions from reports and publications from similar efforts in the past made by the executive branch, the legislative branch, the University of Alaska, nonprofit organizations, and private individuals and organizations,
- Identified and evaluated all current State income sources and assets, including recurring revenue, reserves, physical resources, and investments,
- Identified systemic changes to stabilize the State's revenue stream,
- Identified major reductions in State expenditures,
- Evaluated forward funding of the budget,
- Identified new sources of revenue,
- Projected a sustainable long-range financial plan based on a stable revenue stream,
- Evaluated constitutional, statutory, and regulatory language relating to the budget process,
- Reviewed and evaluated forward funding of the State budget,
- Considered the division of responsibility for providing services and raising revenue between the State and local governments and evaluated the effect of the long-range financial plan on local governments,

- Submitted a preliminary report to the Governor and the Legislature, and
- Disseminated information and solicited public comment.

The Commission's deliberations were aided by substantial work and informative presentations by State agency personnel, the Alaska Permanent Fund Corporation staff, Alaska Municipal League and Conference of Mayors, and private citizens who brought additional perspectives to the table.

The Commission's work focused on elements of State spending which affect the fiscal gap. These include:

- General funds, including program receipts
- Permanent fund earnings
- Funds created by appropriations for specific purposes or as "holding accounts"
- Special revenue funds set out in the constitution or statute.

Certain other funds, while included in the overall budget of the state, are not commonly reported in budget presentations, and do not materially affect the fiscal gap. These include:

- Federal funds
- Loan amounts and loan administrative costs
- University receipts
- Internal service funds
- Transfers between agencies for contractual obligations, including interagency receipts

The Commission believes the State budget process should include examination of all spending, regardless of whether the funds affect the fiscal gap. To meet the Commission's charge of closing the fiscal gap, though, we focus on the general fund and Permanent Fund.

The Commission has developed a financial plan for the State of Alaska. It brings Alaska's spending into line with recurring revenues. It balances the needs of current Alaskans with the needs of future generations. It requires that all Alaskans share in the solution.

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 historic earnings rate has been 4.79 percent above inflation, continued good performance by the fund will result in additional retained earnings of 0.79%.

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 fuel 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 CBR will be replenished by its own interest income, and we further recommend any excess revenues from temporary oil price increases be deposited in the CBR.

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

The State cannot continue to spend at the same level it does today. Notwithstanding needs and demands for increased spending and the impending federal transfer of programs to the State, the Commission believes Alaska cannot close the fiscal gap without cutting State spending.

- The plan calls for State general fund spending to be reduced by \$100 million in three years — \$40 million in FY97, \$30 million in FY98, and \$30 million in FY99 — a reduction of \$300 million in today's dollars.
- This decline of State spending reduces per capita State general fund spending from \$4,020 to \$ 3,692 in four years — a reduction to \$3,255 in today's dollars.
- The Commission believes this level of reduction in State spending will be painful, but is a necessary step toward closing the fiscal gap. Recent legislatures have managed to hold spending level, which has resulted in real reductions to some State programs.
- Within these budget targets, the Commission believes the State should give attention to deficits in the State's infrastructure spending, most particularly for maintenance on publicly-owned facilities, roads and highways.
- The Legislature and the Administration may wish to consider voter-approved general obligation bond debt as a way to finance capital projects.
- General recommendations for budget reductions include:

Public salaries and benefits

- Enact a retirement incentive program to reduce personal services expenditures.
- Enact a new Tier III retirement system to reduce retirement benefits for new State and local government employees.
- Revise geographic pay differentials for non-covered State employees.
- Study geographic cost differentials in Alaska for use during collective bargaining negotiations with covered State employees (and for use in other State formula programs).
- Compare salaries and benefits of public employees to appropriate public and private markets in Alaska and the Pacific Northwest. Use that comparison to move Alaska's public pay system for State employees, local government employees, and school districts to market.
- Examine the publicly funded health plans for State, local government, school district, and University employees as well as those who receive Medicaid. Look for opportunities to save substantial costs through pooling or other mechanisms.

Administrative realignment

- Reengineer the delivery of State services to eliminate excessive administration.

- Consolidate state departments and agencies, and realign administrative services.
- Look for opportunities to privatize State programs or to contract out State services. Allow "insourcing" so groups of State employees can offer their own solutions to reduce costs in programs that may otherwise be contracted out.

Target high-cost programs

- If the current litigation against the Alaska Longevity Bonus is successful (ending the current phase-out), eliminate the program.
- Change the Public School Foundation Formula to reduce the growth in education spending. The required local effort should be reexamined, as well as provisions that allow school districts to obtain greater funding for special category students regardless of the programs offered to those students.
- Enact a welfare reform package to reduce dependency on welfare programs and put current welfare recipients to work.
- Revise fee schedules for services such as Pioneers' Homes to reflect cost and ability to pay.
- Examine areas of State spending with disproportionately high costs when compared with other States and determine whether there are legitimate reasons for such programs.

Shift revenues and responsibilities to local governments

- Repeal the State mandate for senior citizens' and veterans' property tax relief by local municipalities, but allow local option to grant or withhold the exemption.
- Transfer a portion of State motor vehicle and motor fuel tax receipts to local governments together with the responsibility for class III local road maintenance.
- Eliminate or shift some inspections to local governments with the ability to collect fees for program support.
- Eliminate State general fund support of troopers for road patrols in communities of more than 2,500, but allow communities to continue retain such services if they are willing to pay for them.

Avoid new costs

- Freeze issuance of certificates of need for new hospitals and reassess need for additional nursing homes

Increase Revenues

The Commission believes Alaska cannot balance its budget responsibly without new revenues. The Commission has chosen a short-term package of taxes on consumption that imposes real service costs on the state,

business taxes, with a longer-term plan of reimposing the State personal income tax.

Increases to existing taxes include:

Tobacco taxes

- Increase tobacco taxes by \$1 per pack on cigarettes and comparable amounts on other tobacco products (raises \$43 million annually, beginning in FY97). This tax increase will dramatically lower teenage smoking and tobacco use, and should somewhat reduce tobacco use by adults, both of which will reduce the State's future expenditures on health care costs. The Commission recommends the taxes increase 25¢ per pack every three years.

Alcohol taxes

- Increase alcohol taxes by an average of 10¢ per drink (raises \$20 million annually, beginning in FY97). Testimony before the Commission indicated that a substantial portion of the criminal justice system's costs — for police, prosecution, public defense, the courts, and the correctional system — are a result of alcohol abuse. This tax increase pays a small portion of the State's costs that result from abuse of alcohol. The Commission recommends also that taxes be equalized among beer, wine, and distilled spirits so that all alcohol users share in the tax burden. We further recommend that alcohol taxes increase every three years.

Over time, certain of Alaska's tax rates have fallen below the national norms, or have not kept pace with inflation. We recommend the following increases:

Motor fuel taxes

- Increase motor fuel tax increases from the 1961 level of 8¢/gallon to the national median of 22¢/gallon (raises \$39 million annually, beginning in FY98). This tax should be indexed to inflation, so it rises as consumer prices rise. The Commission believes these tax receipts should be used to fund road maintenance efforts at the State and local level.

Marine motor fuel taxes

- Increase marine fuel taxes by 3¢/gallon (raises \$5 million annually, beginning in FY98). This tax should be indexed to inflation, so it rises as consumer prices rise. The Commission believes these tax receipts should be used to fund port and harbor maintenance efforts at the State and local level.

Motor vehicle license plates

- Double motor vehicle license fees and eliminate exemptions (raises \$29 million, beginning in FY98). These fees are currently well below the national average.

User fees

- Raise user fees by approximately \$3 million annually and index fees to inflation where practicable.

Fishery and other resource taxes

- Increase taxes on fisheries and other resources by \$30 million.

New taxes and changes to tax apportionment include:

- Establish new taxes to generate at least \$20 million from tourists. While the Commission was unable to reach consensus on the precise method for gaining additional revenue from tourists or the tourism industry, The Commission believes this part of our economy does not fully pay for the State's cost of providing infrastructure and support to the industry.
- The Commission believes the State's oil and gas production property tax, currently set at 20 mills, should benefit both the State and local governments affected by oil development. State law should be amended to limit the local government share to 10 mills on new oil and gas properties built after 1995, ensuring the State receives at least 50% of this revenue source.

The Commission considered additional taxes on the oil industry. We found that Alaska is currently in the mid-range of oil taxation nationally. We believe that Alaska is already too dependent upon oil revenues, and that higher oil taxes would create a disincentive to attract and retain petroleum development in Alaska. We believe our plan for closing the fiscal gap and providing a stable revenue and spending climate will ultimately result in increased petroleum revenues as the industry responds by further investment in Alaska oil exploration, development and production.

Establish the Permanent Fund as an endowment

When the Permanent Fund was established in 1976, public debate centered on setting aside a portion of today's oil wealth to meet the needs of future generations of Alaskans. Later, the Legislature adopted the dividend plan to heighten public interest in preserving the fund and guarding its investment performance, and to directly distribute some of Alaska's oil wealth to its citizens. The Commission believes it is time to follow the original intent of the fund, preserving current capital wealth for current and future generations of Alaskans. The Commission believes the best

method for doing this is to follow traditional endowment principles. For our Permanent Fund those principles include preservation of the fund, the best possible level of performance of the fund, and the preservation of Alaska's oil wealth for future generations of Alaskans.

Our plan calls for the Permanent Fund to grow as an endowment for the State.

- The plan establishes the Permanent Fund as an endowment that pays up to four percent of the Fund's five-year average market value to the general fund for the dividend program and State services. This use of Permanent Fund earnings will partially replace declining oil revenues. The Commission recommends a four percent payout based on the experience of other endowment funds in the United States, and takes into account the Permanent Fund's earning experience, asset allocation, and need to protect the principal.
- Earnings of the Permanent Fund in excess of this four percent payout rate are retained in the fund. Years with good investment performance will, over the long run, balance years with poor investment performance in order to more than fully inflation-proof the fund.
- The plan calls for an increase to 50 percent of the minimum contribution to the Permanent Fund from certain oil, gas and mineral lease revenues. The plan calls for an amendment to the constitution to achieve that increase.
- The endowment is further built up by a deposit from the Permanent Fund Earnings Reserve and deposits of any funds in excess of \$1.5 billion in the Constitutional Budget Reserve.

Cap the Permanent Fund Dividend pool

The Permanent Fund Dividend program is an important source of protection for the principal of the Permanent Fund and it is important source of income to Alaskans. Without changes to the program, however, dividends will grow to take a major share of State revenues — \$965 million in 2005. The Commission recommends:

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

Clarify the purpose of State's reserves

The State maintains two reserve funds that are important in the effort to close the fiscal gap — the Constitutional Budget Reserve (CBR) and the

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
Greatholder
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 links 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 CBR will be replenished by its own interest income, and we further recommend any excess revenues from temporary oil price increases be deposited in the CBR.

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 \$3,693 in four years — a reduction to \$3,255 in today's dollars.

Increase Revenues

- Increase tobacco taxes by \$1 per pack (\$45 million).
- Increase alcohol taxes by 10 cents per drink (\$20 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 \$3 million per year, double motor vehicle license fees, and eliminating motor vehicle license fee exemptions (\$32 million).
- Reestablish a new tax to generate at least \$20 million from tourists 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 CBR at \$1.5 billion to cushion against oil revenue volatility. Clarify its use and repayment in a constitutional amendment.

Reform the budget process

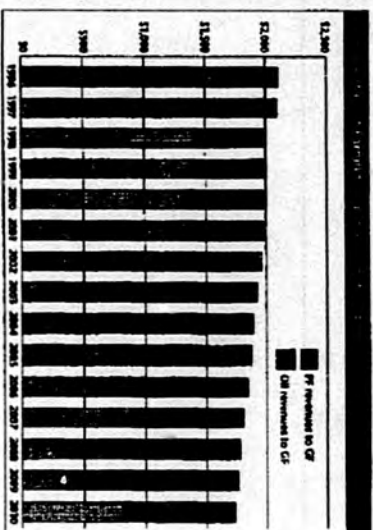
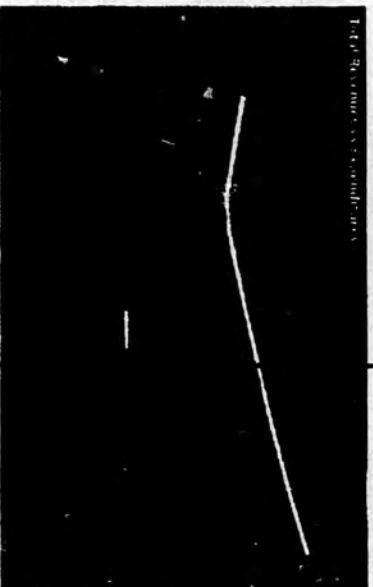
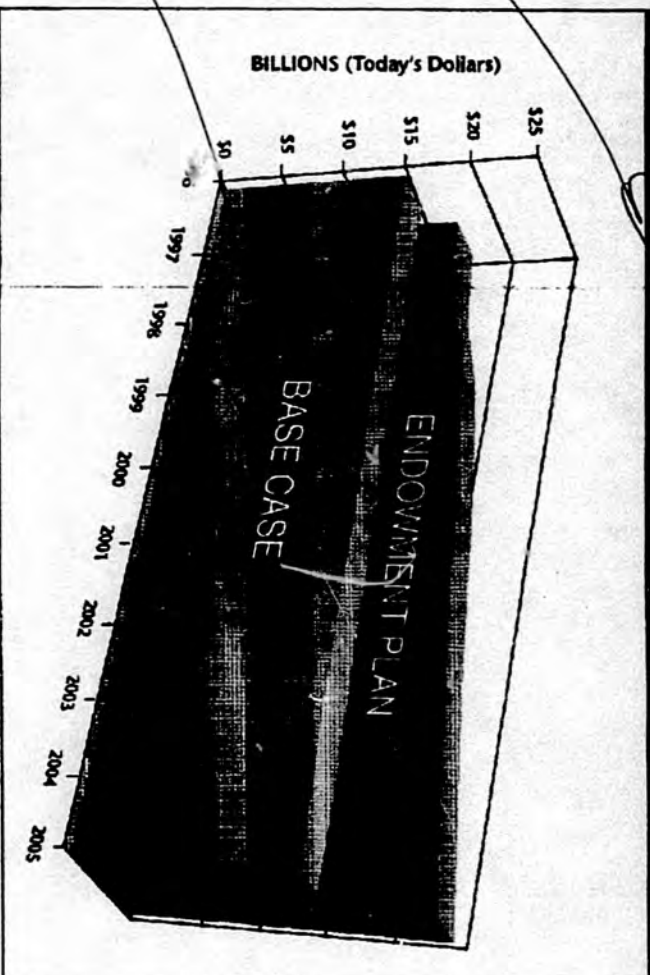
- Scrutinize all State spending, not just State general funds.
- Report annually to the public on progress toward closing the fiscal gap.
- Focus on whether programs are needed, cost-effective and achieve their intended results.

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 reappears.

THE STATE LONG RANGE FINANCIAL PLANNING COMMISSION REPORT

For our first forecast report
Comparison of Base Case To Endowment Plan



Special Acknowledgements

The members of the Long Range Financial Planning Commission, including the following, are thanked for their contributions to this report:

Thanks are due also to those persons who have, by their own efforts, contributed to the success of the Commission, including the following:

In addition, the members of the Commission acknowledge the contributions of the Alaska Journal of Commerce and Northwest Statewide in producing this report.