

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILES 8672
2424 SCOM 101: LONG RANGE FINANCIAL PLANNING COMMISSION, 1995

Figure 1

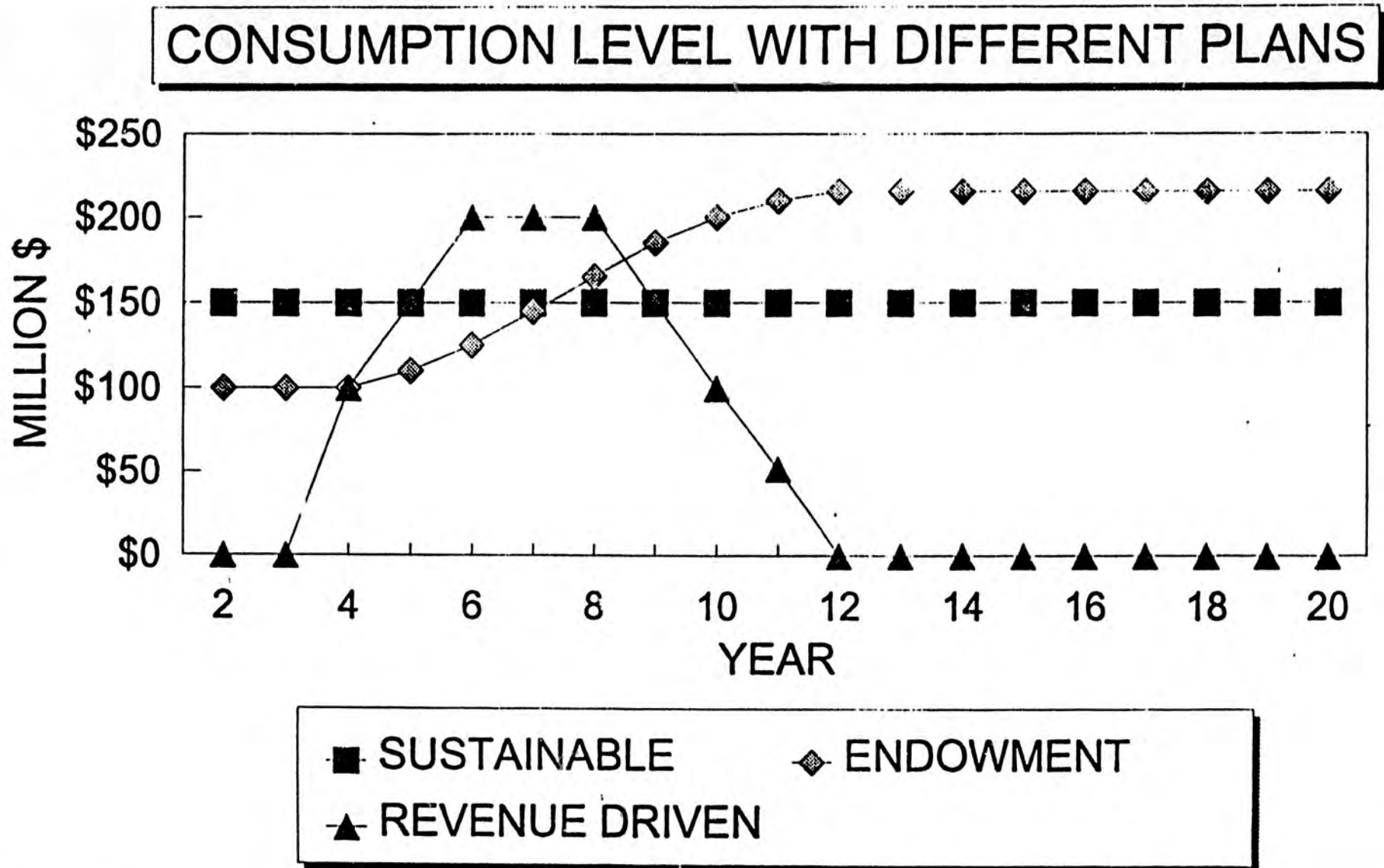
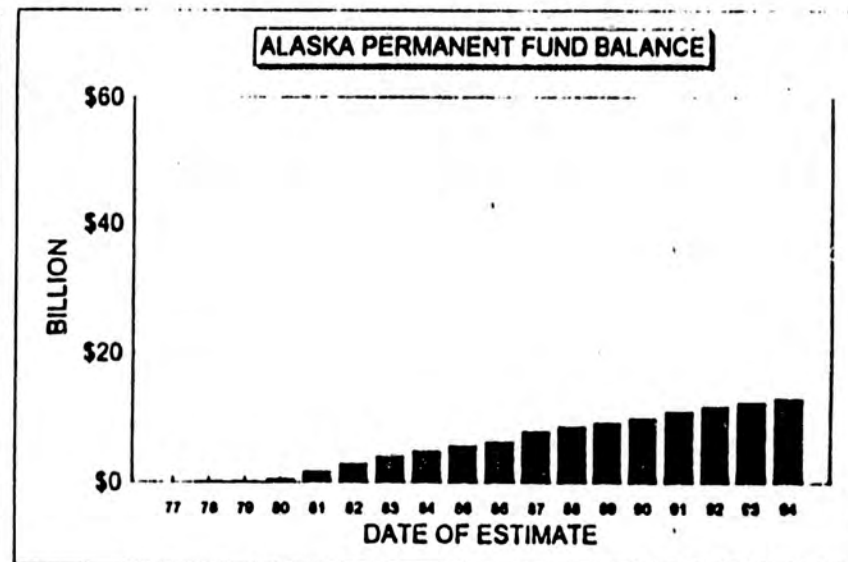
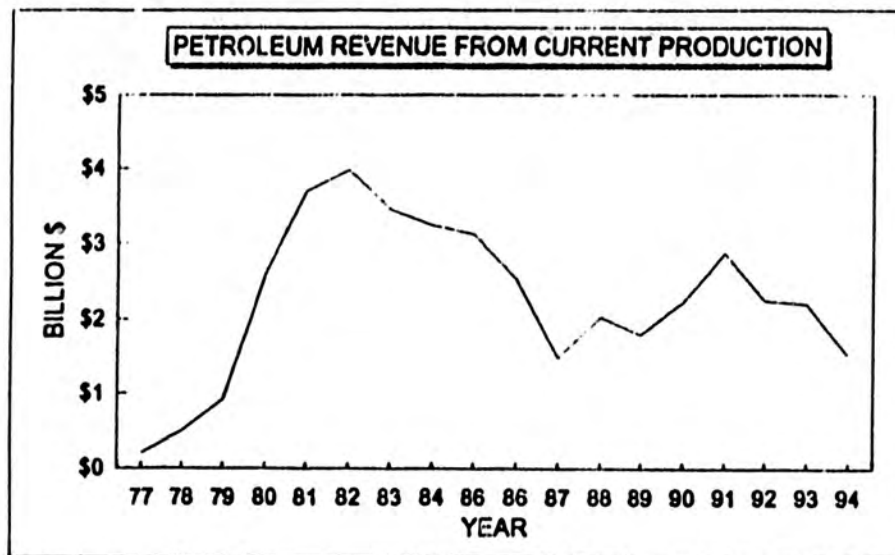


Figure 2



The combined value of oil remaining in the ground and the Permanent Fund have formed the bulk of state assets. Recent year asset valuations for the primary financial assets of the state show that their combined value has varied between \$25 billion and \$44 billion. (Table 3.) The value of oil reserves, simply measured at current reserve and price levels, and the Permanent Fund in each year are shown in Figure 3.

The financial assets of the state include several other accounts which in theory do not complicate the analysis but in practice make it more difficult to calculate the value of state assets from which the sustainable consumption level can be derived.

One complication arises because not all petroleum revenue is collected at the time of production. Disputes between the government and the oil companies over the wellhead value of the oil produced, the base for production taxes and the payment of royalties, have resulted in a large backlog of potential cash settlements. At present the state is claiming approximately \$6 billion from production in prior years. Past experience suggests the state may ultimately collect half of that amount, or \$3 billion. \$3 billion then becomes the estimate of the present value of the windfall associated with these future collections and this amount can be added to the other financial assets of the state for the purpose of calculating sustainable consumption.

The cash reserves of the state are held in several accounts, the largest of which are the General Fund, the Constitutional Budget Reserve, and the Earnings Reserve of the Permanent Fund. This proliferation of accounts creates confusion in the mind of the public as to the total value of state assets since the state does not produce a consolidated statement of state assets for the purpose of estimating sustainable consumption. For example the Earnings Reserve of the Permanent Fund, which has a balance in excess of \$1 billion, is included in the Permanent Fund balance as reported by the Permanent Fund Annual Report, at the same time that it is included in informal legislative reports of funds available for appropriations.

4. UNCERTAINTY IN THE SIZE OF THE WINDFALL

The assumption up to this point has been that the value of the oil windfall is known with certainty. The fact that it can only be estimated further complicates the choice of the time allocation of consumption. Figure 4. shows predictions of the petroleum revenues the state expected to collect in 1994 at various points of time since the state began formally predicting revenues in 1978 and compares those projections to the current estimate of about \$1.5 billion. It shows that the

TABLE 3. STATE OF ALASKA ASSETS
(MILLION 1992 \$)

	GENERAL FUND	CONST BUDGET RESERVE	PF EARNINGS RESERVE	PERM FUND	SETTLE- MENTS	OIL RESERVES:	SUM ALL ASSETS
1988	\$287	\$0	\$573	\$9,859	\$3,783	\$24,762	\$39,264
1989	\$287	\$0	\$688	\$10,547	\$3,898	\$19,833	\$35,251
1990	\$557	\$0	\$668	\$11,019	\$4,007	\$26,156	\$42,405
1991	\$788	\$0	\$630	\$11,445	\$3,780	\$33,810	\$50,453
1992	\$1,000	\$650	\$650	\$11,700	\$3,500	\$23,800	\$41,300
1993	\$1,311	\$680	\$922	\$12,039	\$2,913	\$22,718	\$40,583
1994	\$189	\$1,555	\$94	\$12,254	\$2,828	\$14,987	\$31,907

TABLE 4. SUSTAINABLE CONSUMPTION
GRADUAL RETURN TO EQUILIBRIUM
(ALPHA = 25%)

YR	WINDFALL REVENUES RECEIVED	WINDFALL VALUE	FUND BALANCE START	END	FUND RATE OF WITH- DRAWAL	SUSTAINABLE CONSUMPTIO
1	\$1,000	\$1,500	\$0	\$850	ERR	\$150
2	\$0	\$650	\$850	\$785	18%	\$150
3	\$0	\$715	\$785	\$714	19%	\$150
4	\$100	\$788	\$714	\$585	42%	\$300
5	\$150	\$765	\$585	\$535	44%	\$259
6	\$200	\$691	\$535	\$563	42%	\$225
7	\$200	\$560	\$563	\$623	35%	\$197
8	\$200	\$416	\$623	\$712	28%	\$173
9	\$150	\$258	\$712	\$779	22%	\$154
10	\$100	\$134	\$779	\$818	18%	\$139
11	\$52	\$47	\$818	\$828	15%	\$126
12	\$0	\$0	\$828	\$794	14%	\$115
13	\$0	\$0	\$794	\$768	13%	\$106
14	\$0	\$0	\$768	\$746	13%	\$99
15	\$0	\$0	\$746	\$728	12%	\$93
16	\$0	\$0	\$728	\$713	12%	\$88
17	\$0	\$0	\$713	\$700	12%	\$84
18	\$0	\$0	\$700	\$690	11%	\$80
19	\$0	\$0	\$690	\$682	11%	\$77
20	\$0	\$0	\$682	\$675	11%	\$75

Figure 3

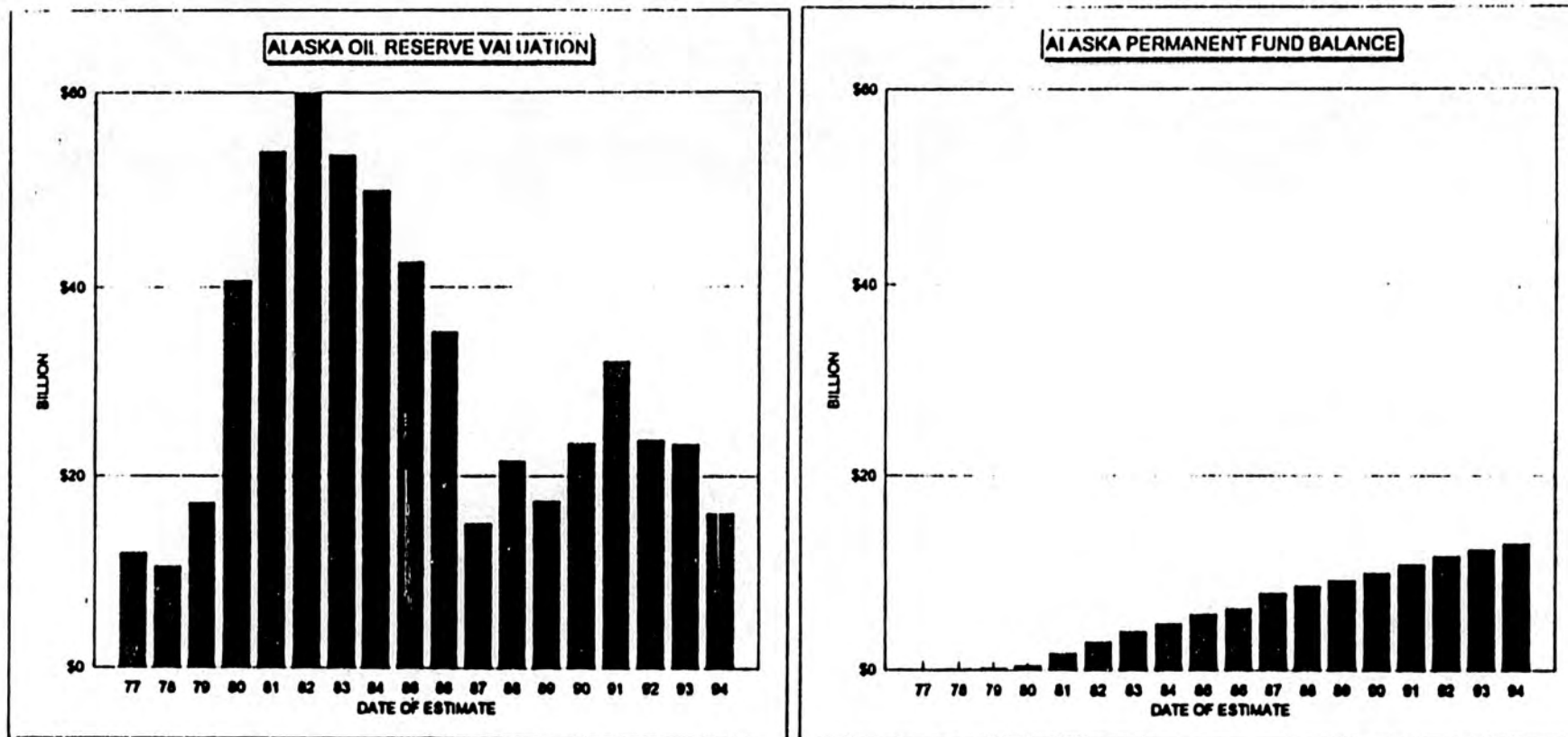
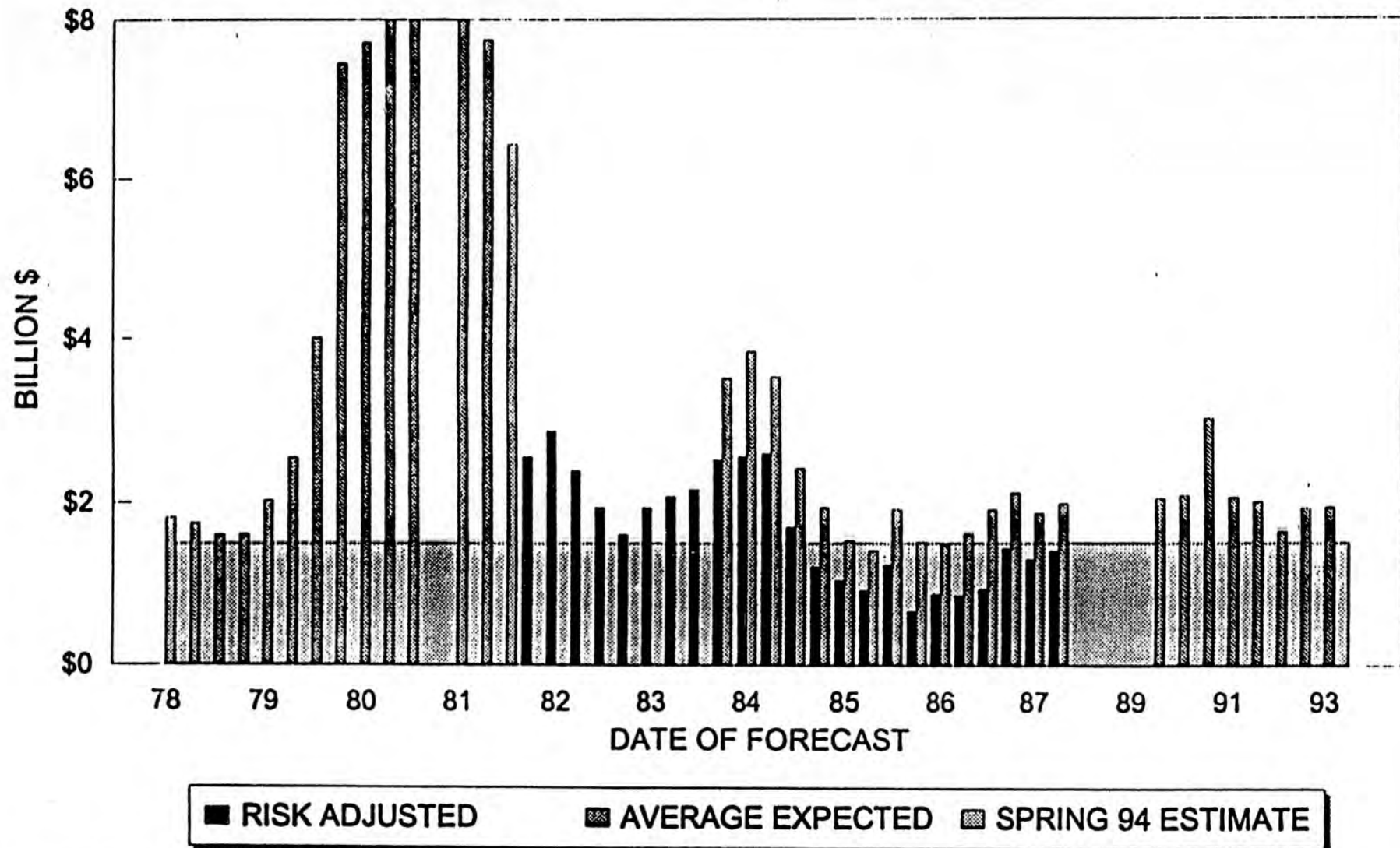


Figure 4

FORECASTS OF 1994 OIL REVENUES

COMPARISON WITH CURRENTLY ANTICIPATED COLLECTIONS



ALASKA DEPT OF REVENUE FORECASTS

1994 revenues were vastly overestimated in the early years and that in general they have been overestimated⁶.

The variation in revenue projections is due to uncertainty in predicting both the remaining reserves and the price of Alaska oil. Estimates of total recoverable reserves have trended upward over time. The initial estimates for the Prudhoe Bay field done in the 1970s were about 9 billion barrels of recoverable oil. Technological advances, cost reductions, and price changes have over the years increased that figure. Today it stands at about 12 billion ultimately recoverable reserves. The ultimate recoverable reserve estimates have also increased over time with the discovery and development of other fields on the North Slope. Although the relationship is inexact, the historical pattern suggests that about 1 barrel of new reserves is added to the inventory of producible oil for every 2 barrels produced. The increase over time in the estimate of ultimately recoverable oil is consistent with the industry practice of not announcing reserve additions until they are relatively certain. This introduces a natural downward bias in the official government statistics which rely on publicly available information from the industry.

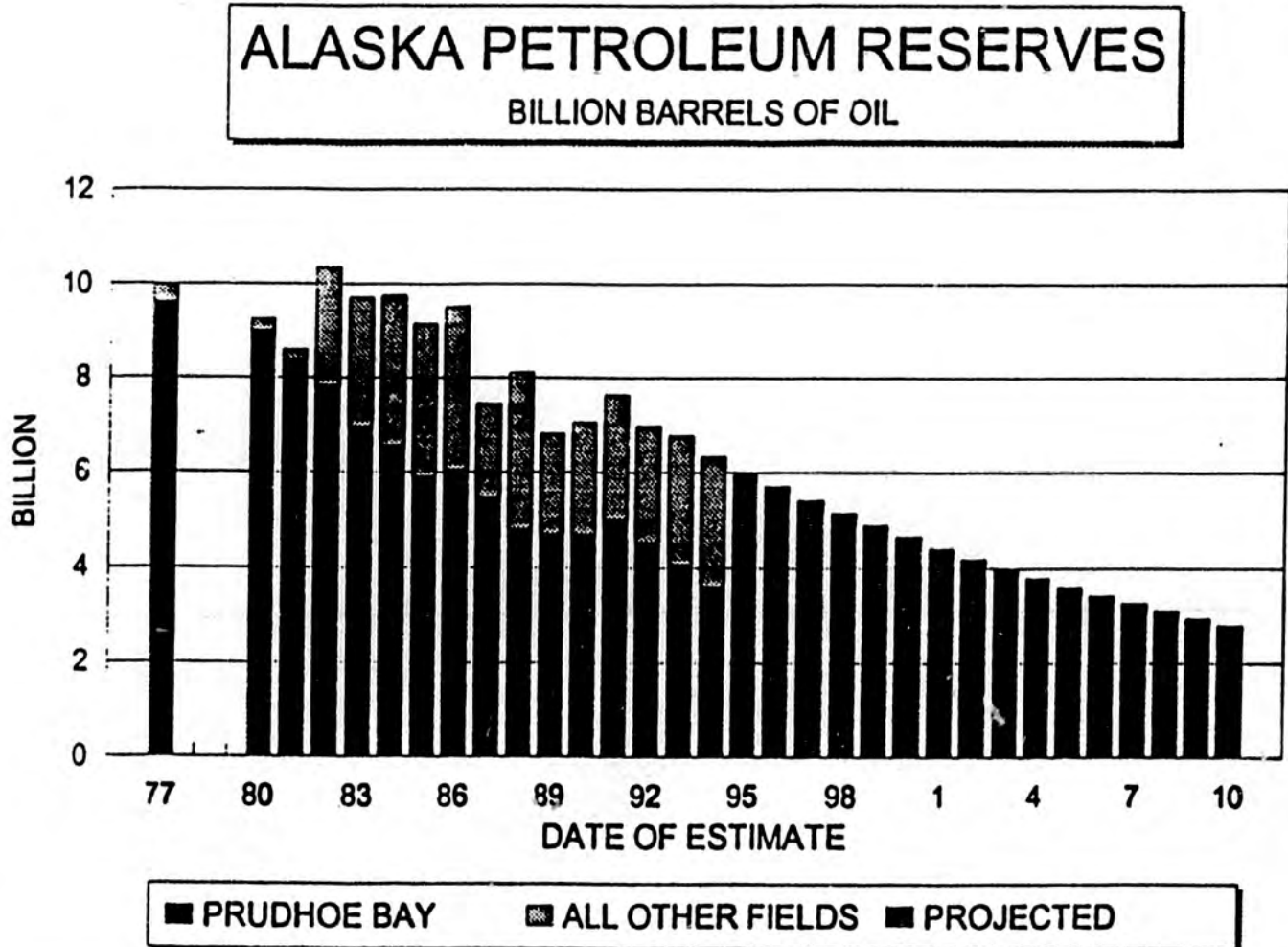
In estimating the size of the windfall, it is possible to predict ultimately recoverable reserves based on the experience of the industry to date in the state. Ultimately recoverable reserves for this purpose would obviously differ from the official estimates of the industry and the state because they would have a different purpose. The official state remaining recoverable reserves estimates shown in Figure 5. can be used together with actual production to develop a historical based estimate of likely reserves taking into account new additions to reserves.

Predictions of price have neither consistently overestimated nor underestimated the price but predictions have fluctuated dramatically with actual and expected market conditions. In the early 1980s the market price was \$35 and expected to grow 1% to 2% faster than inflation for decades. In the mid 1990s the market price is \$15 and projected to grow no faster than the rate of inflation. Since projections of price tend to be heavily influenced by current market conditions, the swings in predicted future price are magnified and this causes the value of oil reserves to fluctuate dramatically as demonstrated in Figure 3.

Predicting the price should recognize that its movements are largely cyclical within a stable range. Estimates of the value of oil reserves could then be made based on the price at different points within that range rather than centered around the most recently observed price which could be anywhere within the range. Although this would result in a broad range of price estimates, they would change

⁶1994 revenues are somewhat lower than prior years due to the recent drop in the price of oil.

Figure 5



slowly over time and the valuation of oil reserves would also change slowly over time.

When the size of the windfall changes, the size of the annual consumption level changes by the same percentage in the sustainable consumption model. So if the estimation of the value of oil in the ground were to increase by a factor of 4 as happened in late 1979 when the market price jumped from \$12 to \$35 per barrel, the calculated annual consumption amount would also increase by a factor of 4.

There was a dramatic increase in Alaska state spending during this time, but the increase in consumption, after netting out investment spending, was not as large as the price jump. The most obvious explanation of this would be that there is a lag effect operating on changes in the level of consumption in response to changes in assets. If so this inertia can reduce some of the fluctuations in consumption due to uncertainty in the estimate of assets.

5. RETURNING TO EQUILIBRIUM: THE TRANSITION TO SUSTAINABILITY

Unanticipated changes in the value of assets, inappropriate policies, and many other factors can knock the state off a sustainable consumption program. If consumption falls below the sustainable level an upward adjustment to the sustainable consumption path can be immediate. If consumption is above the sustainable level the state may choose to return to the sustainable path gradually rather than abruptly. In any case there is a tradeoff between a more rapid movement to a sustainable path and a more gradual movement to a somewhat lower sustainable path.

Complicating the choice of how fast to adjust to the sustainable consumption level is the uncertainty over what that level actually is. The long run sustainable consumption level is a moving target and if it turns out to be higher than currently predicted, a sharp reduction in consumption today may subsequently prove to have been unnecessary. Of course if the sustainable consumption level turns out to be lower than anticipated, then postponing the reduction in consumption means greater reductions in the future.

As shown in the earlier graphs, the range of uncertainty can be quite large and projections of future revenues can change radically in a short period of time. This is primarily the result of changing price predictions but also due to changes in estimates of recoverable reserves.

Over time the uncertainty associated with predicting both price and reserves should fall both because we can use more actual experience over time in making

our predictions and because the value of the reserve declines in importance in the determination of the sustainable consumption level. Nevertheless some method of dealing with the uncertainty of trying to hit a moving target, the long run sustainable consumption level, needs to be identified. A logical policy would be to use an "adaptive expectations" formulation to move incrementally towards the long run sustainable consumption level.

Under such a rule current consumption, C_t , would be reduced from the prior year by a percentage (Alpha) of the difference between actual consumption in the previous year, C_{t-1} , and expected long run sustainable consumption based on current assets, C^* , according to the following formula:

$$\text{Change in Consumption} = -\text{Alpha} * (C_{t-1} - C^*).$$

Equivalently consumption in year t , C_t , would be:

$$C_t = C_{t-1} - \text{Alpha} * (C_{t-1} - C^*).$$

Implementation of this rule requires the continuous calculation of the expected long run sustainable consumption level, C^* , and its comparison with actual consumption. The adjustment parameter, Alpha, should be low if the cost of adjustment is high relative to the loss in long run sustainable consumption from a slow adjustment, and if the level of uncertainty is high. The parameter should be high if the cost of adjustment is low, the difference between actual and long run sustainable consumption is high, and the level of uncertainty is low.

Figure 6. shows the proportion of the difference between initial actual and a constant long run sustainable consumption level closed after each year for several different values for the parameter Alpha. However the long run sustainable consumption level is not constant even in the absence of uncertainty.

Table 4. illustrates this adjustment rule where spending has deviated by 100% from the sustainable consumption level in period 4. An Alpha of 25% returns consumption close to a sustainable level about half as large as before the deviation. Figure 7. shows this case.

A practical difficulty with this strategy of gradually moving into equilibrium is that even with knowledge of the sustainable consumption level and Alpha, during the transition when consumption is falling, a portion of consumption is paid from draws on the balance in the assets account. This means that the asset balance is falling as the falling sustainable level of consumption is approached. Table 4. shows what the draw on assets should be each year as well as what the asset balance is each year, but there is no fixed relationship between the two policy variables--consumption and draw on asset balances.

Figure 6

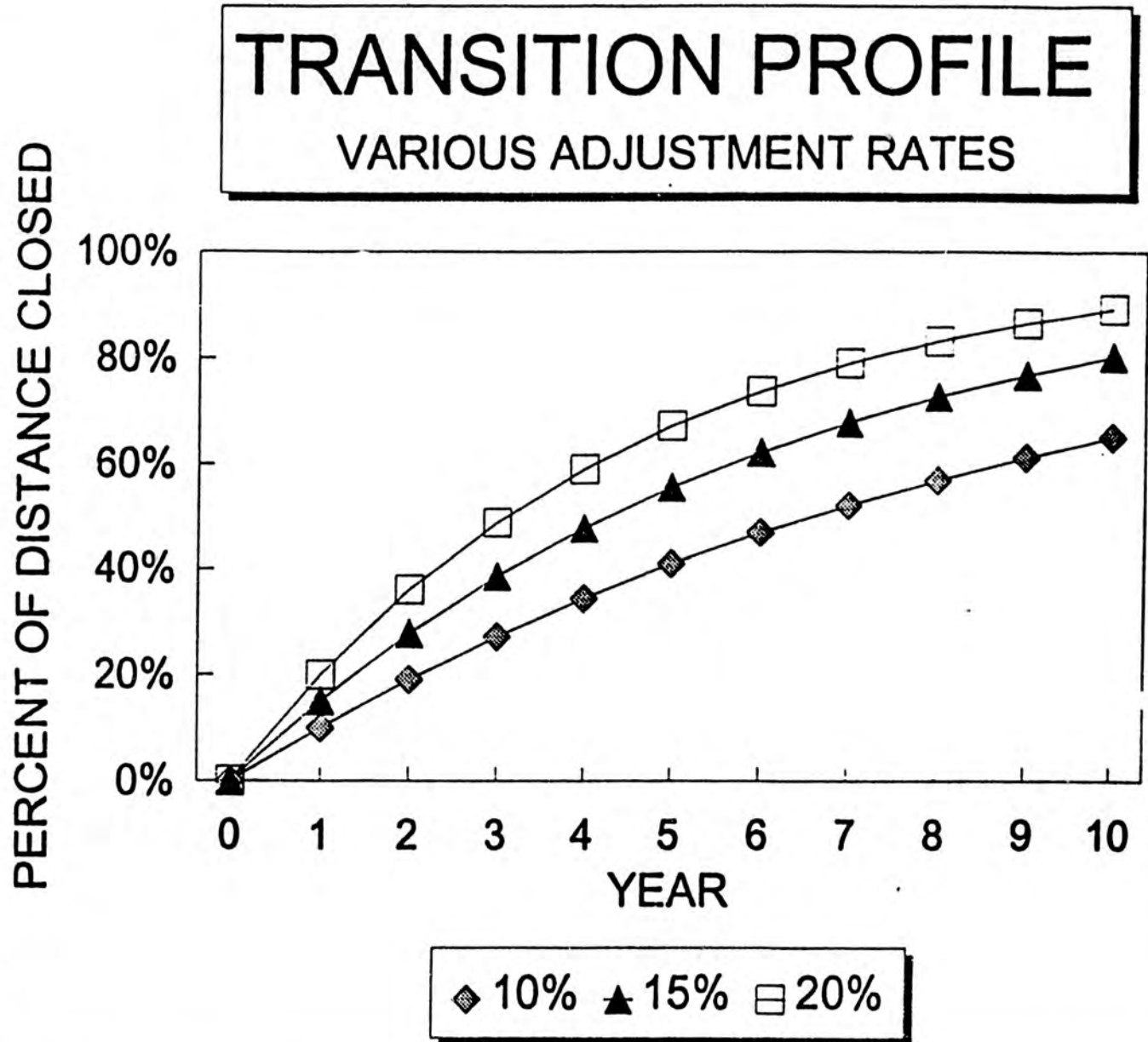
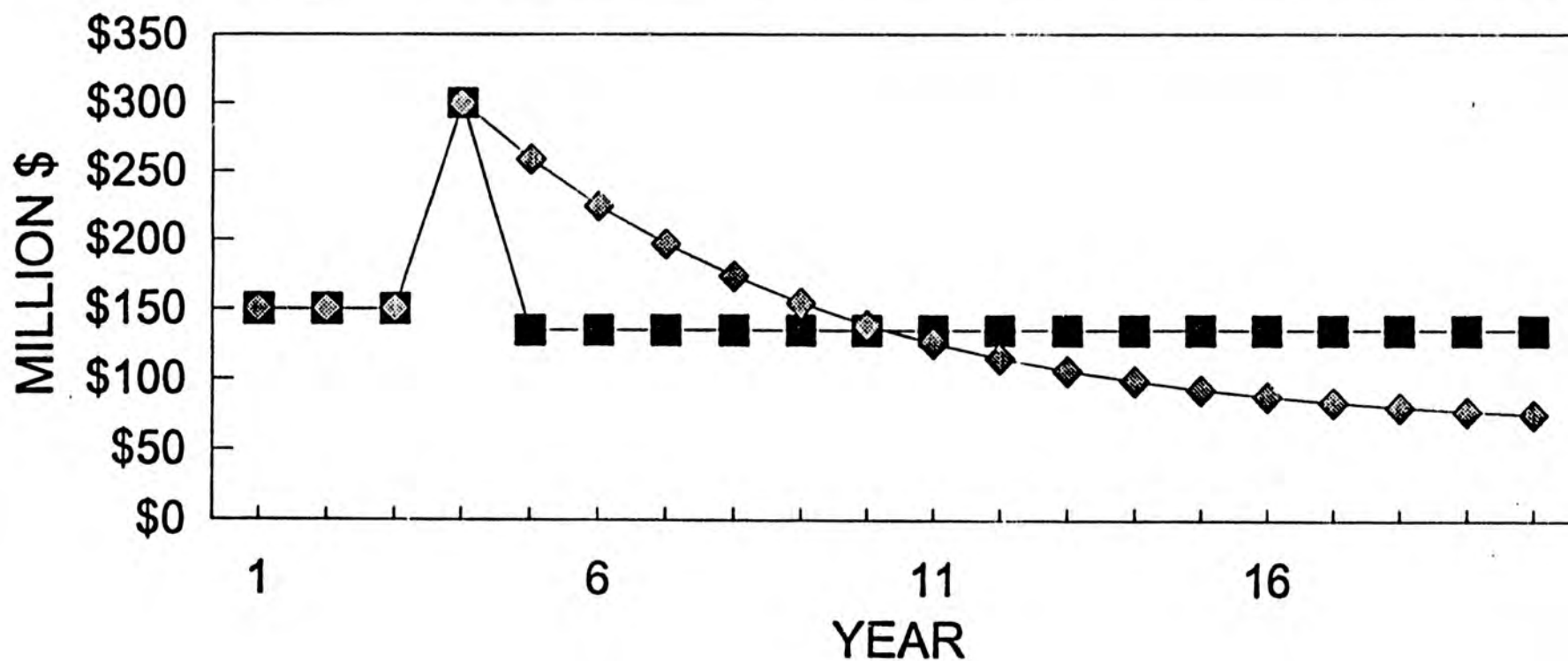


Figure 7

SUSTAINABLE CONSUMPTION LEVEL INSTANT VS. GRADUAL TRANSITION



■ INSTANT

◆ 25% OF VARIANCE

With multiple accounts it is more difficult to sort through the financial picture to extract the essence of what is happening to asset values and sustainable consumption over time. Table 5. shows an abbreviated consolidated income statement for Alaska including the most important financial accounts. Most attention concentrates on the state General Fund as the source of funding for most state government operations. In 1994 expenditures exceeded revenues by about \$1.4 billion. Some of those revenues representing a draw on oil reserves are not sustainable. However the oil reserve was partially replenished by additions to reserves. Some of the shortfall in the General Fund was made up by revenues exceeding expenditures in the Permanent Fund. In addition considerable transfers among funds further blurred the distinction between what was a revenue and what was a draw on assets.

Alaska is in the situation of spending above the sustainable level. Income generating assets have a value of \$34 billion, which can generate between \$1 billion and \$1.7 billion in earnings each year at a real rate of return of between 3% and 5%. Other sources of state revenue currently add \$400 million for a total sustainable revenue flow of from \$1.4 and \$2.1 billion. In contrast annual expenditures are more than \$3 billion (including the Permanent Fund Dividend). If a personal income tax were reintroduced at an annual level of collections of \$300 million, the state could sustain a \$2.4 billion budget if earning assets generated a real return of 5%. Sustainable spending could be reached if there were an immediate drop in spending of \$600 million. Table 6. shows this calculation.

Implementation of a policy of this type may be further complicated if the fiscal structure is not flexible in the sense of revenue sources being available when needed to fund the targeted level of spending. The fiscal structure in Alaska may allow for that flexibility but it is not assured. The three major components of fiscal policy related to asset management are the Permanent Fund, the Constitutional Budget Reserve, and oil revenues. Use of the principal of the Permanent Fund is constitutionally prohibited. The purpose of the Constitutional Budget Reserve is to cover budgetary shortfalls when petroleum revenues alone are insufficient. If this fund is large enough and is maintained long enough it can serve that purpose until the earnings of the Permanent Fund alone are sufficient to fund spending. However there is no guarantee that the Constitutional Budget Reserve will be large enough to continue to serve that purpose. If it were to become prematurely depleted the transition would need to be partially funded by the Permanent Fund balance. This would require a constitutional amendment.

TABLE 5. STATE OF ALASKA CONSOLIDATED BALANCE SHEET FOR FISCAL YEAR 1994
(MILLION \$)

	GENERAL FUND	CONST BUDGET RESERVE	PF EARNINGS RESERVE	PERM FUND	SETTLE- MENTS	OIL RESERVES:	SUM ALL ASSETS
BALANCE 6/30/93	\$1,350	\$700	\$950	\$12,400	\$3,000	\$23,400	\$41,800
RESOURCES PROVIDED-FY94							
Revenues-Non Oil	\$400						\$400
Investment Earnings	\$50	\$50		\$1,050	\$200		\$1,350
RESOURCES USED	(\$3,200)			(\$550)			(\$3,750)
CURRENT ACCOUNT SHORTFALL							
ASSETS TRANSFERRED INTO GF							
From Oil	\$1,350					(\$1,350)	\$0
From Settlements	\$200				(\$200)		\$0
From ER	\$950		(\$950)				\$0
TRANSFERS OUT OF GF							
To CBR	(\$900)	\$900					\$0
TRANSFERS IN/OUT PF							
In from Oil				\$200		(\$200)	\$0
Out to ER			\$100	(\$100)			\$0
NET CHANGE	(\$1,150)	\$950	(\$850)	\$600	\$0	(\$1,550)	(\$2,000)
BALANCE BEFORE CHANGE	\$200	\$1,650	\$100	\$13,000	\$3,000	\$21,850	\$39,800
IN VALUE OF INVENTORY							
Additions to Inventory						\$1,050	\$1,050
Inventory Valuation Adjustment						(\$7,000)	(\$7,000)
BALANCE 6/30/94	\$200	\$1,650	\$100	\$13,000	\$3,000	\$15,900	\$33,850

Notes

Permanent fund figures from PFCorp Monthly Report Oct 1993
Settlements balance for 6/30/93 based on OMB presentation to Commonwealth North
October 1993 (\$4.3 billion), with adjustment by author to reflect fact
that only a portion (50%) of disputed revenues are actually received,
and subsequent disclosure in Feb. 94 that \$6 billion remains outstanding.
Constitutional Budget Reserve and Earnings Reserve balances for 6/30/93 based on
OMB presentation to Commonwealth North, October 1993
General Fund Balance includes Statutory Budget Reserve, Railbelt Energy Fund,
and Investment Loss Trust
OMB presentation to Commonwealth North, October 1993
Value of Oil Reserves based on reserves and current revenues per barrel produced
Additions to Inventory based on 10 year historical average change in reserves
Inventory Valuation Adjustment based on change in DOR fall oil price forecast
Estimates for FY94 assume
DOR Fall 93 projection adjusted by Revenews estimate for Feb. 94
Deposit of \$924 million into Constitutional Budget Reserve occurs
Budget for FY94 is \$3.2 billion

Assumptions	Pop	Inflation
1988	531	1
1989	534	1.03
1990	554	1.06
1991	570	1.05
1992	586	1.03
1993	600	1.03
1994	612	1.03

TABLE 6. TRANSITION CALCULATION
ALASKA 1994
 (BILLION \$)

STATE ASSETS	\$34
REAL RATE OF RETURN ON ASSETS	5%
SUSTAINABLE INCOME FROM ASSETS	\$1.700
OTHER RECURRING REVENUES	\$0.400
TOTAL RECURRING REVENUES FROM CURRENT SOURCES	\$2.100
POTENTIAL REVENUES FROM PERSONAL INCOME TAX	\$0.300
TOTAL RECURRING REVENUES INCLUDING INCOME TAX	\$2.400
STATE SPENDING	\$3.000
ACTUAL MINUS SUSTAINABLE SPENDING	
WITHOUT INCOME TAX	\$0.900
WITH INCOME TAX	\$0.600

7. IMPLICATIONS FOR FISCAL POLICY FOR THE NEXT CENTURY

As oil in the ground is converted into financial and other assets the nature of the state fiscal structure and uncertainty evolves. Petroleum revenues decline and an increasing share of revenues come from other sources such as financial investments. Evidence of this structural change is the fact that in 1994 Alaska petroleum revenues will be \$1.5 billion while investment earnings will be over \$1 billion.

In this environment portfolio management becomes centrally important to the fiscal strength of the state. The difference between a 3% and 5% real return on the \$13 billion Permanent Fund is \$260 million, about the amount which a state personal income tax would generate. Since higher returns are always associated with greater variability in earnings, care much be given to cushioning state finances from those fluctuations as well as maximizing the return on investment.

A simple way to do this would be to draw off the fund earnings each year based on the expected long run average return on investment independent of the actual return in the most recent year. This rate can be reasonably estimated based on the historical experience of investments with characteristics similar to those in the portfolio. The flow of consumption would be stabilized and adjustments to the draw rate could be made incrementally based on actual performance.

Finally in this environment sustainability obviously depends on maintenance of the value of the corpus of the fund. This is accomplished by investing only in income earning assets and drawing no more than the real earnings of the fund for current consumption.

SCOMM

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RESEARCH SUMMARY

R.S. No. 56

March 1995

WHO PAYS FOR ALASKA'S SCHOOLS?

Alaska's public schools cost \$1.2 billion in the 1992-93 school year. That included both operating and capital spending and amounted to about \$10,000 for each of the state's 119,000 elementary and secondary students.

This *Research Summary* looks at where Alaska's public schools got their money and how they spent it in 1992-93. We don't yet have complete figures for the 1993-94 year. The information is based on work by Matthew Berman, an associate professor of economics at ISER, and Teresa Hull, an ISER research associate.

- About one quarter of the state government's general fund budget went to schools in 1992-93. The \$775 million in state money covered 64 percent of school costs (Figure 1).

- About 30 percent of all taxes raised by cities and boroughs went to schools in 1992-93. The \$217 million in local taxes covered 18 percent of school costs. Residents of the rural school districts known as Regional Education Attendance Areas (REAA's) pay no local taxes.

- School districts—including REAA's—raised an additional \$54 million from fees and other local sources, to cover about 4 percent of school costs. Taxes and other local sources together covered 22 percent of school costs.

- The federal government paid \$173 million (14 percent) of school costs.

- The School Foundation Program alone paid for half of all the costs of Alaska schools in 1992-93 (Figure 1). Of the \$614 million distributed through the foundation program, \$572 million was state money and \$42 million was federal.

The program is intended to equalize money available to all districts, richer or poorer. But the size and the equity (to both students and taxpayers) of the foundation program are coming under scrutiny in the Alaska Legislature, which is looking for ways to close a large projected budget deficit.*

- Per student costs in 1992-93 varied from \$1,600 for correspondence students to around \$15,000 for students in REAA's and at Mt. Edgecumbe, a boarding high school in Sitka. In city and borough districts, where 85 percent of students are enrolled, costs averaged about \$9,600 per student (Figure 2).

*In 1991, Matthew Berman and Eric Larson of ISER assessed the equity of the foundation program in *Education Equity and Taxpayer Equity: A Review of the Alaska Public School Foundation Funding Program*. A summary is available at no charge and the full report for \$15.00.

Figure 1. School Revenues by Source

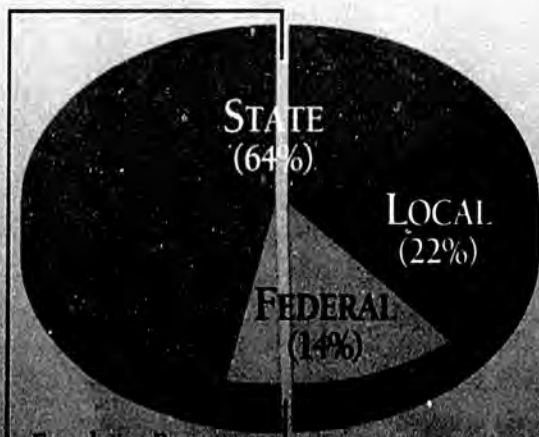
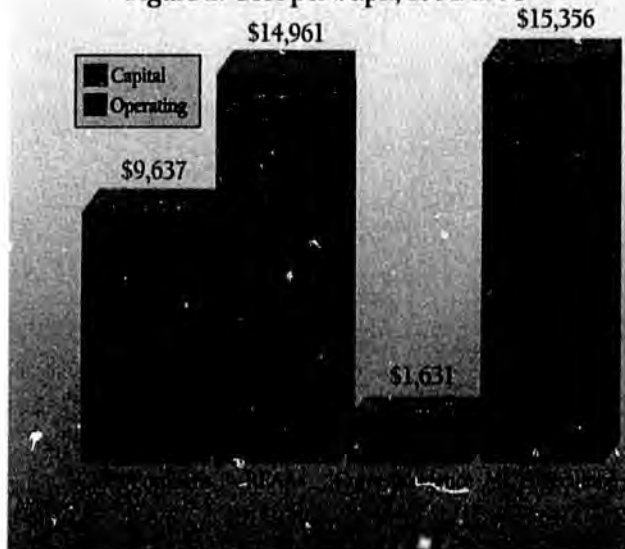


Figure 2. Cost per Pupil, 1992-1993



SOURCES OF MONEY

State Revenues

• Schools received close to \$572 million in state money through the School Foundation Program in 1992-93 (Figure 3). That was almost three quarters of all the state money schools got. Under the program, the legislature decides how much it will pay for each classroom. Then, state officials use a complex formula to determine how much each district receives, based on how many regular and special classrooms it has and how much local and federal money it receives.

• The second largest state source of state money for schools in 1992-93 was \$127 million for debt service. Since 1970, the state government has reimbursed cities and

boroughs for a big share of debt service they pay on school construction bonds. The share has varied over the years. Right now the state pays 70 percent of debt service on new school bonds. The state government also paid more than \$22 million in cash for new school construction.



Figure 3. Education Revenues
1992-93 School Year
(In Millions of Dollars)

• Other state money schools received in 1992-93 included nearly \$29 million for transporting students to and from school and to athletic and other events, and close to \$16 million in grants to help pay for community schools, a boarding home program, and other expenses.

• The state also contributed more than \$7 million for schooling outside school districts. The state operates Mt. Edgecumbe High School in Sitka, a boarding school for about 270 rural students; until 1985 it was operated by the Bureau of Indian Affairs. Students who don't want to attend village high schools have the option of attending Mt. Edgecumbe. The state also offers correspondence courses to about 2,200 students living in remote places.

Local Revenues

• Local contributions to schools in 1992-93 were mostly taxes. Cities and boroughs contributed \$217 million in tax money to schools that year. The rest of the local contributions (\$54 million) came from miscellaneous sources, the largest of which were fees city and borough districts and REAAs collected for use of school facilities (Figure 3).

Federal Revenues

• The biggest source of federal money for Alaska schools—\$104 million in 1992-93—is a federal law that pays state and local jurisdictions because they can't tax federal land. The federal government owns about 60 percent of the land in Alaska.

Most money under that law, known as Public Law 81-874, goes directly to school districts, but the state also receives some—which it adds to the foundation program. The PL 81-874 payments to Alaska were especially large in fiscal year 1993, because of a change in federal accounting methods. That change meant the state received two years of PL 81-874 funding in a single fiscal year—which amounted to \$42 million—or \$21 million extra in federal money. Because of the double federal payment in fiscal 1993, the legislature reduced the state appropriation for the school foundation program by about \$21 million.

• Program grants of \$69 million made up most of the rest of the federal money for schools in 1992-93. These included both direct grants to school districts and grants the state passed on to districts.

^a Includes state tuition \$2.4; cigarette tax \$2.7; direct construction \$22.2; school district grants \$15.8; state schools \$7.1

^b Includes interest on investment—\$4.6, user fees—\$32.9, in kind services—\$9.2, and miscellaneous—\$7.1

^c Includes program grants passed through the state—\$48.8, and direct local program grants—\$11.6

TYPES OF SPENDING

- Operating expenses made up about 82 percent of school costs in 1992-93 and capital expenses 18 percent. State school expenses (Figure 4) are for Mt. Edgecumbe boarding high school and correspondence courses.

- Nearly \$982 million went into operating Alaska schools in 1992-93. The biggest expense is classroom instruction. Most operating expenses are salaries—for teachers, administrators, teachers' aides, librarians, bus drivers, custodians, and others. Some expenses are for heating school buildings, repairing computers, and doing other types of maintenance.

Most operating expenses are paid by the state's foundation program. Table 1 shows estimates of how much the foundation formula calculated for general instruction and how much extra it provided for vocational, special, and bilingual instruction in 1992-93.

The state doesn't track whether school districts actually spend this money for general or special instruction—so these numbers don't necessarily represent how much the districts spent for each but rather how much they were entitled to, under the formula. Also, the foundation program is not the only source of money for special education; the federal government also provides program grants for special types of instruction.

Table 1. Foundation Money for General and Special Instruction, 1992-93
(In Millions of Dollars)

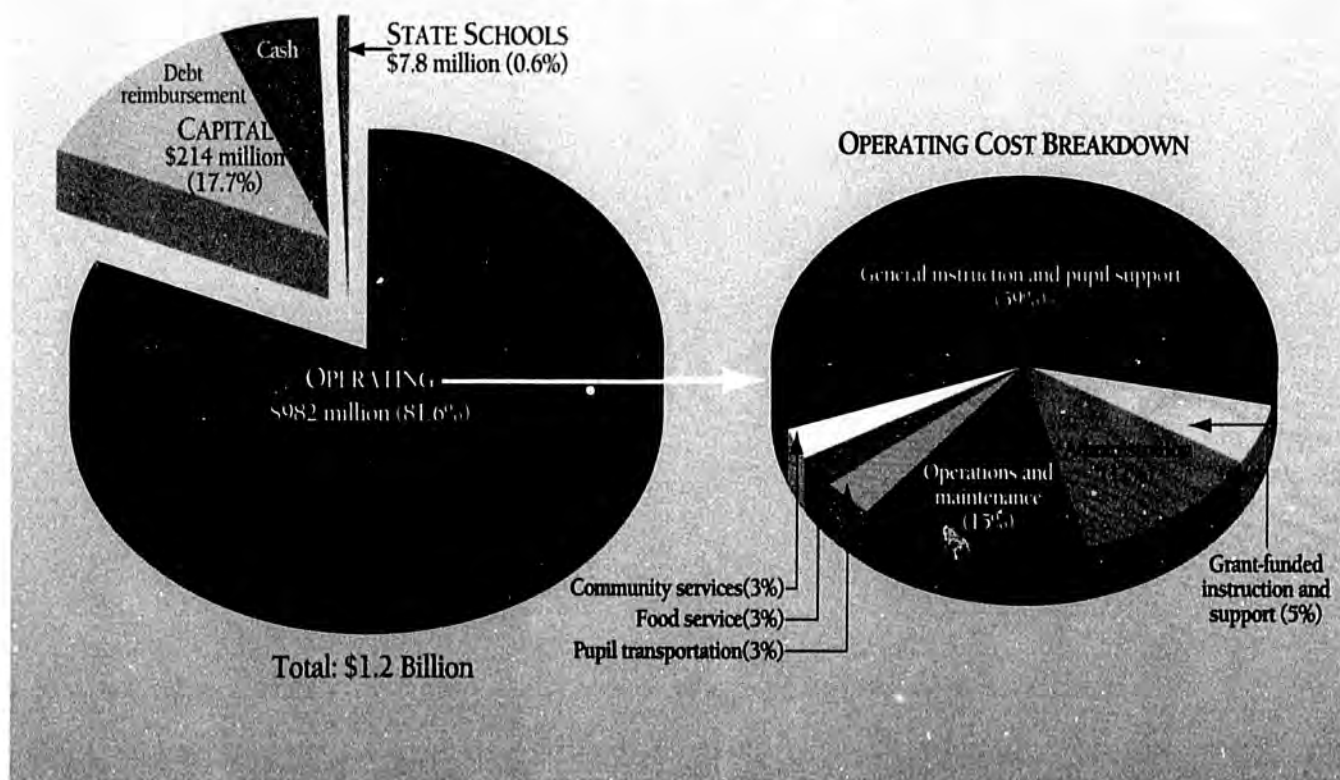
General instruction	\$508.4
Vocational instruction	7.4
Bilingual instruction	14.7
Special education*	83.5
Total Foundation	\$613.7

*Includes instruction for students with a wide range of needs, from those with learning disabilities to those who are gifted.

- Two-thirds of the \$214 million in school capital spending in 1992-93 was for debt service on existing bonds and one-third for new bonds and construction projects. The state paid most capital costs, but school districts also contributed some.

Cities and boroughs typically sell bonds to finance school construction and are liable for paying off those bonds. But the state government reimburses them for a large share (between 70 and 90 percent, depending on when the bonds were sold) of their debt service on bonds. REAAs have no organized local governments and can't sell school bonds to finance construction. The state government generally pays outright for schools in REAAs.

Figure 4. Total School Spending



CHANGE IN SPENDING, 1990-1993

- Spending for schools increased from \$1.03 billion to \$1.2 billion between fiscal 1990 and 1993, while the number of elementary and secondary students increased from 104,000 to 119,000. By fiscal 1994, the number of students had increased to 125,000. Figure 5 shows growth in the numbers of Alaska elementary and secondary students from 1981 to 1994.

- Growth in spending just about matched growth in the number of students in the early 1990s—which means per student spending, with no adjustment for inflation, increased just slightly, as the top bars in Figure 6 show. But real spending—spending adjusted for inflation—dropped about 7 percent between 1990 and 1993, as the bottom bars show.

- Several states in the Northeastern U.S. spent just about as much per student as Alaska did in the 1992-93 school year, according to the National Education Association. Alaska's per student spending was about 50 percent above the national average that year. The NEA's figures are not, however, adjusted for differences in living costs among the states—and some of Alaska's higher spending is due

to the state's higher living costs. The association's figures also omit some school costs (and are therefore lower than ISER's figures) but they at least provide a general picture of comparative spending among the states.*

*National Education Association, Research Division, Rankings of the States 1994. For information on getting copies, call 1-800-229-4200.

**Figure 5. Growth in Numbers of Students
FY 1981-1994**

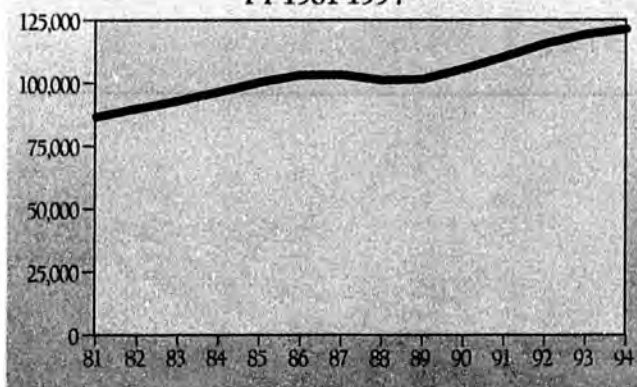
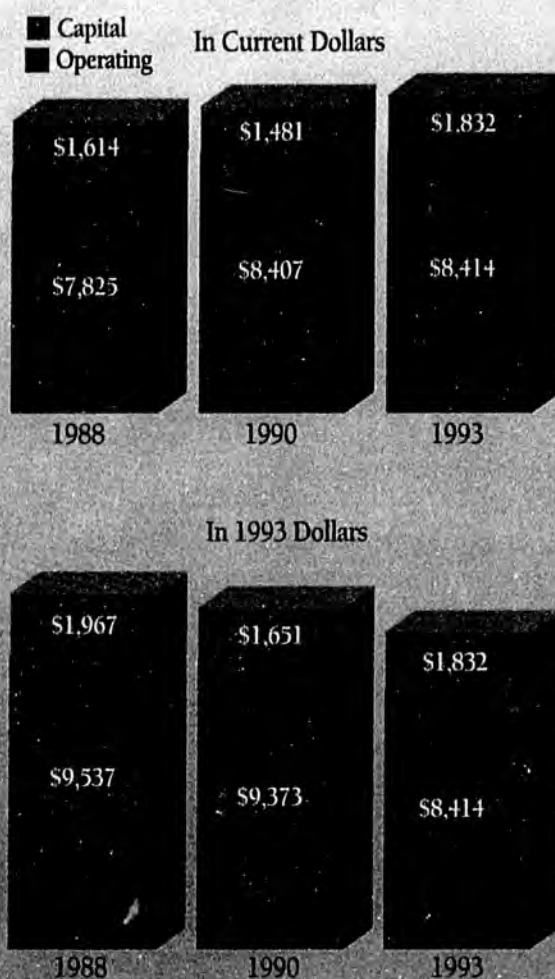


Figure 6. Per Student Spending, FY 1988-1993



RESEARCH SUMMARY (No. 56)

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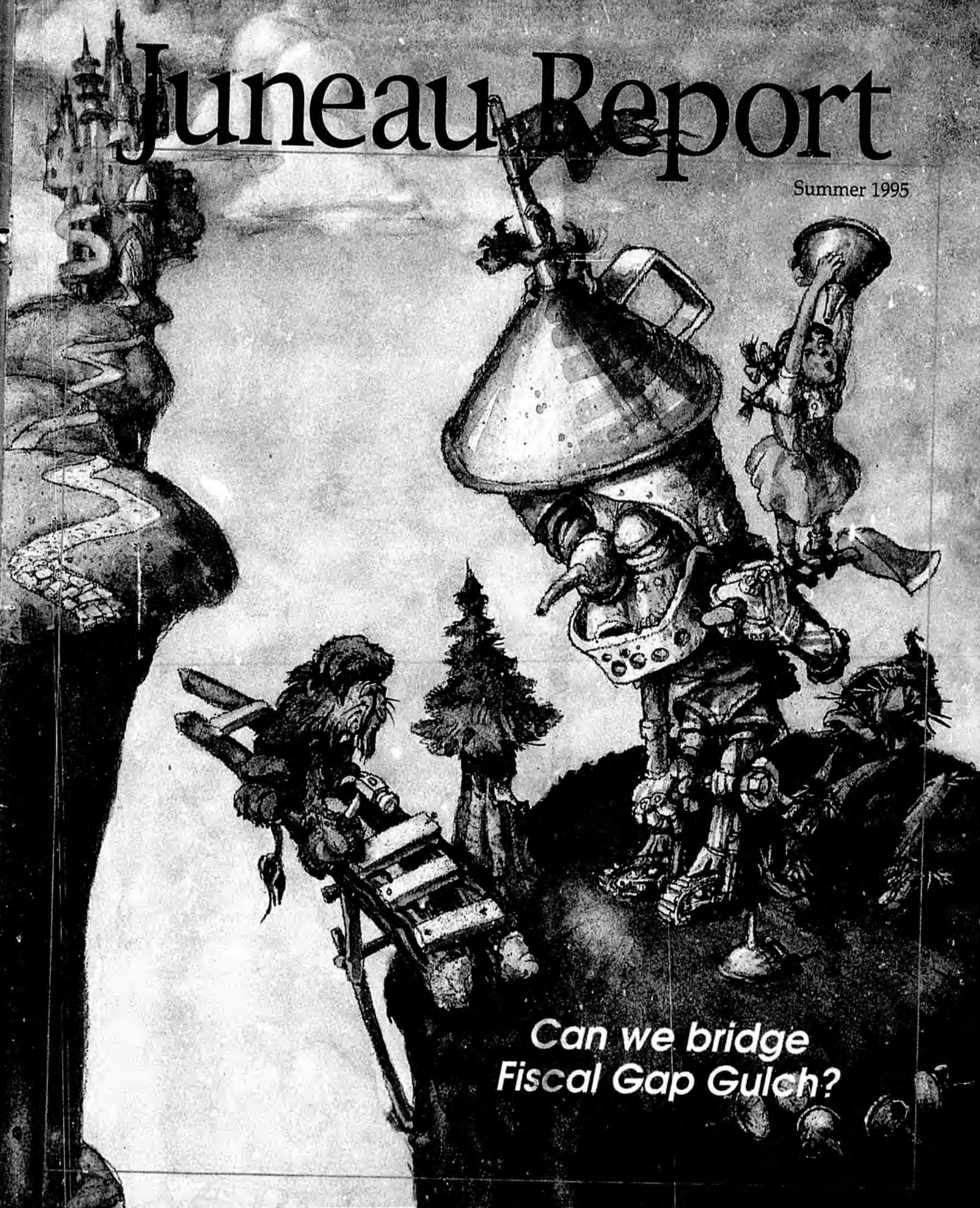
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Juneau Report

Summer 1995



*Can we bridge
Fiscal Gap Gulch?*



BADAMI WELLS COMPLETED—Nabors Rig 18-E drilled one of two appraisal wells this past winter at BP's Badami prospect, on the Arctic coast about 30 miles east of Prudhoe Bay. The other Badami well was drilled by Doyon's Rig 9. Badami is one of several economically marginal prospects being considered by BP and its partners.

COVER ART: created by Dee Boyles

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Dear Alaskan:

With this issue, we premier a new format and design for *Juneau Report*, the quarterly public policy magazine published by BP Exploration for its employees, business associates and others. *Juneau Report* articles are written by writers outside BP, to focus attention on important public policy problems facing Alaska. The articles do not represent the opinions of BP's management or its employees, but are intended to foster dialogue, debate and, hopefully, resolution of public policy issues.

In this issue we discuss the state's fiscal gap, and options for its resolution. This is of interest to BP, the state's major taxpayer. But it also has major consequences for all Alaskans.

We welcome your comments.

Jim Palmer
Director, External Affairs
BP Exploration (Alaska) Inc.

The *Juneau Report* is published by the BP Exploration External Affairs Department to provide an overview of issues and legislation as they relate to the petroleum industry. Opinions of authors expressed here do not necessarily reflect the opinions of the company. Inquires should be directed to BP External Affairs: 564-5504 or 564-5489.



Building the Bridge

Tools are available to span the fiscal gap..

If Alaska delays implementing a plan to deal with the fiscal gap, state government will run out of money in five years, according to projections by the University of Alaska. The resulting spending cuts and taxes could severely damage Alaska's economy. The \$15 billion Permanent Fund may be at risk.

But there are options and tools to bridge the gap. They include intelligent spending cuts and new

revenues. With the state's fiscal house in order, one big impediment to new investment will be removed. If we do this right, the future is bright.

Think of it as bridge construction. The chasm to be spanned is "Fiscal Gap Gulch." If Alaska totters into the gulch, bad things happen: the state's economy turns sour (one in three Alaska jobs now depends on its oil-fueled state budget), municipal taxes soar to make up for lost shared revenues, and the quality of public services (particularly schools) sinks.

To paint the picture even darker: At some point, things might get so bad the \$15 billion Permanent Fund may be in jeopardy, as well as its dividends. And then, Alaskans may wind up paying high state taxes anyway.

But things don't have to be like this. Alaska has potential for a very bright future. With the diversity of its resources and the natural beauty of its landscape, there's no reason

ducers can't develop new fields fast enough to replace the declining production. State revenues (85 percent dependent on oil) are dropping. The State of Alaska is now half a billion dollars a year in the red. In a few years, it will be a billion dollars a year in the red.

State leaders have sustained spending by drawing down various state cash reserves and assets. In FY 1995 they took \$518 million. In FY 1996 they will take about \$575 million. At that rate, according to projections by the University of Alaska, the account will be empty in five years, except for, of course, the \$15 billion Permanent Fund. That's why it's vulnerable — if nothing is done about the fiscal gap.

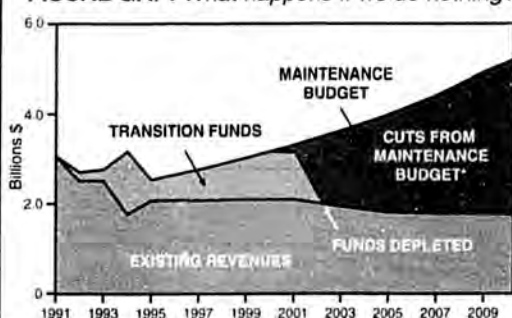
The solutions are only a bit more complex: State leaders have to cut spending. That's already starting to happen. Alaskans then have to think seriously about what they really want government to do, and then cut out the frills, the luxuries, to get to the basics. Alaskans need to "re-invent" government, too, reorganizing many programs to make them function more efficiently.

But cuts alone won't cover the gap without severe damage to Alaska's economy and public services. Cuts alone are not an option.

But an intelligent plan for cutting, combined with an intelligent plan for new revenues, will do the job. In fact, it's really our only option. One way or another, Fiscal Gap Gulch will be bridged.

New revenues" includes new state taxes of some sort, hopefully modest. It should also include some changes to Permanent Fund income management, so that the \$15 billion fund, which earns about a billion dollars a year, can make some meaningful contribution to public services.

FISCAL GAP: What happens if we do nothing?



* Maintenance budget assumes increase for inflation, 1% annual population growth
Source: University of Alaska Institute of Social and Economic Research

Alaska can't have a diversified, prosperous economy, continuing petroleum production, high-quality public services, and be a nice place to live as well. But the fiscal gap threatens all that.

There is a solution, a bridge over the chasm, so to speak. The tools to build the bridge are available now. They're widely recognized by knowledgeable political and community leaders. But the will to use them is weak. The public is confused.

The problem is fairly simple. Alaska's big North Slope oil fields are running down and oil pro-

Fiscal Gap

Safe landing strategy

What's the impact of \$1 billion state budget cut?

If Alaska fails to adopt a long-range fiscal plan, the state will keep spending until it runs out of money. The sudden, large cut of about \$1 billion in the state budget forced then will have drastic economic effects. The last time Alaska saw \$1 billion suddenly cut from the budget was in 1986, which triggered a sharp economic recession in Alaska. Here were some of those effects:

- State job loss: 22,000 (10 percent)
- Anchorage population loss: 29,000 (9 percent)
- Decline in Anchorage assessed property value: \$7.2 billion (46 percent)
- Residential properties foreclosed on, January 1985-March 1988: 10,429 (7 percent of total)

Source: University of Alaska Institute of Social and Economic Research

This was, after all, what Alaskans had in mind when they created the fund in 1976. The idea was to save part of the oil earnings to help sustain public services, and avoid ruinous taxes, when oil money winds down. The idea of the Permanent Fund dividend came later, in 1980.

But now, dividends and the required "inflation-proofing" of the Permanent Fund consume almost all the fund's income. The way the formulas are constructed in state law, there really won't be any money left to support public services.

So, why not just change the formula so all three goals, dividends, "inflation-proofing" and money for the treasury, are met? It's possible. But politicians are cautious in doing anything that might depress — or even appear to depress — the growth of dividends.

The alternate of devising an intelligent plan — postponing and doing nothing — only makes the pain worse

in five years when the ready cash reserves are gone and Alaskans arrive at the chasm. They had a sample, in 1986, of what happens when a billion dollars a year is suddenly taken out of the state's economy. It could be a portent of things to come.

Developing blueprints for the bridge over Fiscal Gap Gulch is the job of the new state Long Range Financial Planning Commission created this spring by the legislature and Gov. Tony Knowles. The panel is composed of veteran legislators, administration officials and several citizens who have had some experience with business, politics and public sector fiscal management.

The real purpose of the panel, of course, is to provide political "top cover" for the governor and legislators, something like what the Base Closings Commission does for Congress.

When the time comes for the tough decisions, Alaska's leaders feel they will need some support, from at least the citizen members of the commission. They'll need that, and more.



The University of Alaska's Institute of Social and Economic Research, after a lengthy study of the state's pending fiscal gap, developed a "safe landing strategy." It is a plan to cover the gap by gradually reducing spending, raising revenues and using several billion dollars from various reserve accounts to cushion the transition to a sustainable state budget.

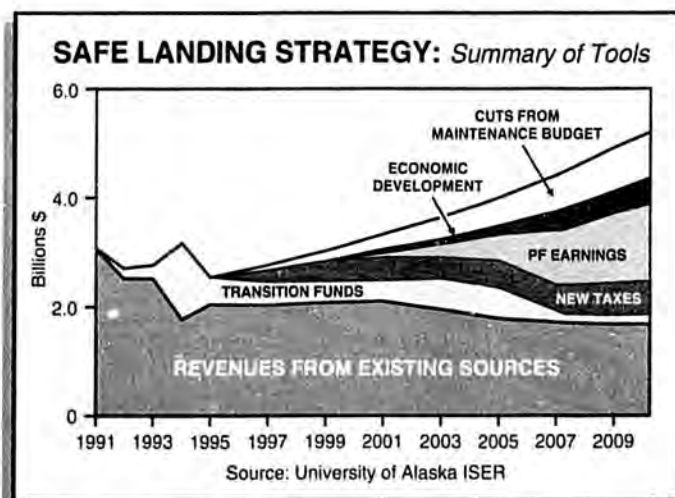
Key elements in ISER's plan:

- Freeze budget growth and constrain increases at less than inflation, effectively shrinking real (inflation-adjusted) state spending by 20 percent by 2000.

- Phase out Permanent Fund dividends. Retained earnings would increase the fund by over \$2.5 billion. After 2002, use a portion of the earnings to pay for government.

- Reinstate an income tax immediately; it would bring in approximately \$250 million

annually, after a two year startup. If local governments choose to increase taxes to national averages, they could offset \$150 million in reduced state revenue-sharing.



Can we cut the budget?

Why is it so hard to cut state spending? Institutional factors partly explain it: There's no incentive for agencies to save and send unspent money back to the treasury, for example.

But more important: constituent groups are quick to organize lobbying for spending, but not for cutting. For elected officials, it's difficult to say "no" with constituents at the door.

Why can't we just cut our \$2.5 billion state budget to live within our means? Alaska spends much more (per capita) than any other state. Surely there's a lot of bureaucratic "fat" to be trimmed.

Easy to say that, from the outside looking in. From the inside, not surprisingly, things look different.

Constituent groups who support particular programs, or projects, are quick to mobilize and lobby their elected officials. But there's no organized lobby for budget cuts. Faced with constituents at the door, it's difficult for a legislator to say no.

Actually cutting the budget raises other problems: Almost half of the operating budget consists of the big formula programs in which state statutes link spending to external factors, like school enrollment growth, inflation, welfare or Medicaid caseloads, or municipal population growth.

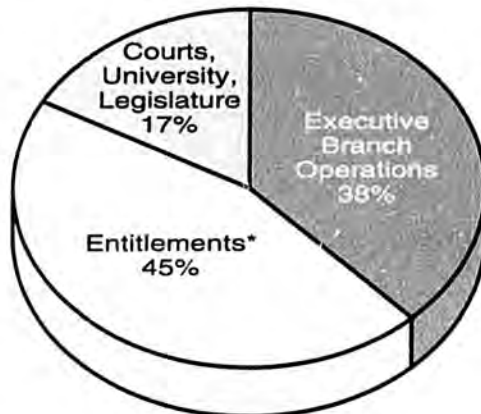
Cuts in the school foundation program, or state money shared with municipalities, result in local service cuts, local tax hikes, or both. Other formula programs, such as welfare and Medicaid, are tied to federal programs. Cuts are possible, but it's a painful, controversial and complex process.

Operating state agencies consume slightly over half the operating budget. Over the last few years, spending for these units—ranging from executive branch agencies to the University of Alaska and the courts—has been reduced. But increases in formula programs, driven mainly by population growth, have eaten up the savings.

State personnel costs also increase continuously. The big public employee unions have been able to bargain for increases when labor contracts come up for renewal, although recently most of these have been less than the rate of inflation.

But there are still perks in the system: Most state employees routinely get "merit" increases, to the point they're now considered almost an entitlement.

Fiscal Year 1995 State Operating Budget Breakdown (general funds only)



* Entitlements are in funds transferred to others, mostly in education, welfare, medicaid and senior longevity bonuses.

FY 95 Spending by Service Area (\$ Millions)



* Gen. Government includes: transportation, development, admin. of justice, public protection and natural resource mgt.

** Health & Social Services includes: welfare, medicaid

*** Education includes: state funding to local schools, university

Source: Cheryl Frasca, Fiscal Notes



Where does the money go?



Rep. Mark Hanley, of Anchorage.

Photo Paul Helmar

Public employees, and teachers, also have generous medical benefits and retirement plans.

Why is all this so hard to change? If there's political gridlock in attacking the budget, it is largely institutional, resulting mainly from the way government bureaucracies and elected officials interact with each other. (The problems are familiar in other states and in Congress.)

Unlike private business, performance in government is usually judged by how much budget an agency administrator can garner. There's no incentive to turn back unspent money. Even if there's a desire among top appointed or elected officials, agency managers know that commissioners, governors and legislators come and go. The technical knowledge of how things really work is in the agency staff. No

matter how dedicated a commissioner might be, his or her tenure is usually too short to bring about substantial change. An example is that during Gov. Hickel's four years in office, there were three commissioners at the helm of the Dept. of Transportation and Public Facilities, the largest and, arguably the most unwieldy state agency.

Except in very crude ways, it's difficult for legislators to make cuts by themselves, because operating agencies have the technical knowledge of how programs work.

Without access to that information, it's hard for lawmakers to make significant program

reductions.

If state employees have ideas for cost savings, they are usually reluctant to share them with the legislature or even with the governor's Office of Management and Budget, the executive branch unit responsible for the fiscal big picture.

One way legislators can force cuts on agencies is through crude across-the-board "unallocated" percentage cuts, which apply to every agency, large and small. Lawmakers have ordered several of these across-the-board cuts on agencies in recent years.

The problem is that these kind of cuts affect agencies in different ways. Small agencies have little flexibility in shifting costs; large ones can spread the pain among several programs. Vital services, like state troopers, are affected along with less traditional programs, such as state subsidies for

(continued on page 8)

Where does all that money go?

The state now spends about \$2.45 billion in general funds yearly. Another \$1.3 billion in other revenues — federal funds and "user fees" — are also spent. Where does all that money go?

- Operating budget: \$2.2 billion this year, to fund state services and programs, employee salaries, building leases, and including grants to organizations, from domestic violence programs to tourism promotion.

- Capital budget: \$109 million this year, mostly for construction projects, including state "matches" for federal highway, airport and harbor funds; repairs to state buildings, and rural water/sewer systems.

- Debt service: \$109 million this year, of which \$80.3 million reimburses school districts for school construction and major repairs. The remaining pays lease costs for state buildings and for voter-approved debt.

About 48 percent of the state budget is in direct grants to others (school districts, municipalities, welfare, senior citizens). Some 30 percent is in employee salary and benefits; 14.2 percent is in contractual services.

Why does Alaska spend so much? Partly because of higher costs, distances and a population scattered in small communities, which defeat any economies of scale.

But mainly it is because of Alaska's "special" programs, the perks remaining from the days of high oil revenues. Until most of these are gone, citizens are unlikely to take the fiscal gap seriously.

(continued from page 7)

rural entertainment TV. Several years of across-the-board cuts have left some state programs approaching non-functional status.

Why does Alaska spend so much in the first place? It's partly because almost all costs are higher, on average, than other states, and partly because a large part of the state's population is scattered across a wide area, clustered in small communities where services can achieve no economies of scale. This has been Alaska's problem since statehood, and is largely the reason why Congress gave Alaska a large endowment of public lands. (The rationale was natural resource income, i.e. Prudhoe Bay, could help offset the lack of a large tax-paying population.)

But mainly, spending is high because Alaska does things no other state does, beginning with annual Permanent Fund dividends paid to every citizen.

There's also the Longevity Bonus Program, which pays senior citizens a \$250 monthly stipend, regardless of assets. There are the state-subsidized Pioneer's Homes, which have evolved from simple retirement homes for seniors to costly nursing facilities.

Suggestions that some of these benefits be available only on a need basis (so that upper-income seniors don't get them or pay their own way) have been fiercely resisted by seniors' groups.

There are other special programs: Multimillion dollar subsidies for high-cost electrical generation are paid to rural utilities; public radio and TV programming is supported; a fleet of state ferry vessels is subsidized.

Legislators did finally crack the Longevity Bonus program. It is now on a gradual phaseout. Next year, for the first time, it will require about \$800,000 less (the current year budget is \$73.4 million). Rural electric subsidies are on a kind of phaseout: Two years ago the legislature set aside a fund sufficient to finance the subsidy, (which takes about \$17 million a year) for five years. That at least defers the political obstacle of terminating the program now and gives rural utilities time to plan for a possible cutoff.

Alaskans also have some perks that no longer require subsidies: Alaska Housing Finance Corp., given a generous \$1.5 billion endowment in the early 1980s, builds rural, low-income and seniors' housing and underwrites many middle-class home mortgages. AHFC is not only self-sufficient, it makes a profit.

In similar good shape is the Alaska Industrial Development and Export Authority, which helps finance private commercial and industrial development in partnerships with banks and private companies. The

In inflation-adjusted dollars, state's operating budget has dropped

State Operating Budgets FY 84-95 in Real FY 95 Dollars (Total General Funds)



Source: State Office of Management and Budget



It's tough to get real cuts



Rep. Gary Davis, of Soldotna. Photo Paul Helmar

state-owned Alaska Railroad Corp. operates freight and passenger trains and makes a profit, although that is because of its revenues from leased lands.

But just stripping state government of its "perk" programs doesn't really save a lot of money — unless the Permanent Fund dividend is included. Ending state ferry subsidies gains about \$35 million; eliminating the Pioneers' Homes gains about \$25 million; cutting rural broadcast subsidies saves about \$1 million; cutting support to public broadcasting would save about \$5 million.

Permanent Fund dividends — at \$550 million per year — are the big-ticket exception to this. But dividends are so popular they will be impossible to get rid of. (They could, however, be "capped" in some manner, so that their annual growth slows or stops.)

The real savings, most who have studied the problem agree, lie in slowing or stopping the growth in the big formula programs. But that means, in the case of school and municipal funding, passing more of the buck back to local governments, which may mean more taxes at that level.

In the case of welfare and Medicaid,

it means reducing the long-established social safety net that is being challenged today in Congress and many other states.

This year, the leadership of the State House pushed a plan to cut money for welfare, and state employees. Many legislators also wanted to hold education funding at current levels. The formula would require \$18 million more next year, to compensate for increasing enrollment.

Education, welfare, Medicaid and state employee costs consume 75 percent of the operating budget. House leaders argue those programs must share in cuts because no significant savings can be gained from the remaining 25 percent of the budget.

This year, the House Finance Committee proposed \$70 million in cuts from current year spending. Gov. Knowles wanted a more gradual approach. He was unenthusiastic about wholesale cuts to education, or welfare, this year. Much of welfare, he points out, is in the Aid to Families with Dependent Children program.

The solution to welfare is not cutting money but helping people find jobs, the governor argues.



Reps. Mike Navarre, Jerry Mackie and Gene Kubina. Photo Paul Helmar

The legislature achieved an estimated \$46.8 million spending cut in Fiscal Year 1996, the budget year beginning July 1, according to figures from the House Finance Committee. Republican leaders in the 1995 session wanted to cut more.

The state operating budget was about \$5 million higher. Within the operating budget, cuts by legislators of \$21 million in state agency budgets were offset by \$26 million in growth by "formula" programs, such as aid to schools and welfare.

Most of the overall reduction came through lower state debt payments resulting from school and general obligation bonds being paid down, and the fact that a large one-time appropriation to a new state Mental Health Trust in the 1994 legislature was not repeated in 1995.

Three areas Republican legislative leaders wanted to cut were in welfare benefits, state employee salaries and in holding education spending flat, not allowing an increase.

Three quarters of the \$2.4 billion state budget is spent in those areas. To significantly reduce the state budget, cuts will be needed, Republicans argued.

But Democrats disagreed. To secure their required agreement to take \$498 million from the state's Constitutional Budget Reserve to balance the FY 1996 budget, Republicans had to agree to an increase in school spending and not to cut welfare and employee pay.

Education: Rising enrollment hikes cost

Alaskans have always been generous in their support of schools. Education support consumes a third of the state budget, including money for elementary and secondary schools, and the state university system.

As school enrollments rise and state revenues fall,

Alaskans face some tough choices: How can they not only maintain the current system, but improve it?

But the real crisis in Alaska education may be rural schools, which have no alternative to state funding.

As state revenues decline and budgets tighten, the battle over education spending will become fierce. The skirmishing is beginning even now, as the state legislature examines the school foundation formula and whether it "tilts" toward rural schools at the expense of urban schools.



Photo Chris Arend

Despite the fall of state revenue, state population and school enrollments continue to increase. School enrollments were up 4.5 percent and 4.8 percent in 1991-92 and 1992-93, although growth has slowed to 3.1 percent in 1992-93 and 1.8 percent in 1993-94.

Classes are getting larger, which requires more classrooms and teachers. As budgets tighten, some fear a decline in quality of education as the pupil-teacher ratio rises.

Even now, Anchorage schools would be near the bottom of the heap in terms of class size, among U.S. school districts of similar size, were it not for hard-hit California school districts, which are being hammered by recession and Proposition 13 local tax caps.

Despite the criticism of "perks" in Alaska's state budget, Alaskans have always given education a clear priority. A lot of state spending goes to support schools. Even in the lean years before North Slope oil, the legislature voted much of Alaska's more meager public resources to education.

Today about one quarter of the \$2.5 billion state budget goes directly to local school districts for elementary through high school programs. When the University of Alaska is included, education spending reaches about a third of spending.

According to studies by the University of Alaska's Institute of Social and Economic Research, Alaska local governments spend, on average, about a third of their tax revenues to support local school districts.

Schools in organized municipalities vary in their dependence on state funds, but the School Foundation Program (which distributes most state money to local schools) pays about half of all school costs in the state. Anchorage taxpayers, for example, are expected to contribute about \$86.9 million to the municipality's \$352.9 million school budget next year. The rest will be state or federal funds.

Rural schools outside organized municipalities are completely dependent on state, and to a lesser extent, federal funds.

Despite higher Alaskan costs, spending among the state's urban school districts does not seem out of line compared with other parts of the nation. Per-student spending for operations in Anchorage, for example, compares favorably with many school districts of similar size in the higher-cost regions of the U.S. Northwest and



Anchorage school costs about on par

Anchorage's education spending of \$5,965 per student (operating funds only; no capital money) in 1991-92, although well above the national average for similar-sized school districts, was about on par with many northern-state school systems. In that same year, a cluster of school districts in Washington state had expenditures in the same range, from \$6,049 per student in Seattle to \$5,553 in Tacoma, \$4,633 in Kent, \$5,023 in Edmonds.

Schools in Minneapolis spent \$6,886 per student in 1992; nearby St. Paul spent \$6,262. Many southern school districts spent less, like \$3,619 per student in Jackson, Miss., and \$3,561 in Birmingham, Ala. There were exceptions, however: Orleans Parish, La. spent \$7,652; Atlanta spent \$6,161.

Class size statistics, however, paint a different picture: Anchorage's pupil-teacher ratio in 1992 was 22.3, compared with 19.5 in Seattle; 18.1 in Tacoma; 20.7 in Kent; and 21.5 in Edmonds. Even in less affluent schools like Alabama's, pupil-teacher ratios ranged from 17.1 in Birmingham and Huntsville schools to 19.4 in Mobile County.

Source: U.S. Department of Education.

Northeast, according to U.S. Department of Education data.

Several states in the northeastern U.S. spend as much per student statewide (about \$10,000) as does Alaska, although the nationwide average, with the poorer southern states included, is about half what Alaska spends.

As the budget crunch tightens, the public debate will reflect diverse feelings among the public on education policy.

Some critics, for example, propose ending kindergarten — "subsidized" day-care — and suggest elimination of innovative, but costly, educational options, like Anchorage's popular language-immersion programs.

Since 87 percent of Anchorage school costs are in labor, there's also criticism of teachers' salaries and benefits, and unions.

But urban school districts at least have a financial alternative to state funding — the local taxpayer. Rural schools, in small villages with no local tax base, have no alternatives.

Alaska's "bush" schools are expensive because of their remoteness, and small enrollments that create high overheads. There's no hope for the economies of scale enjoyed in urban areas.

Per-student costs in the state-funded Rural Education Attendance Areas averaged about \$15,000 in 1992-93, according to the ISER study, compared with an average of \$9,600 per year in urban schools. In

Anchorage, it is \$7,290 yearly. The figures include operating and capital costs.

Regional boarding schools are an alternative, but they won't save money. The state's one rural boarding school, Mt. Edgecumbe in Sitka, is highly-regarded, but it cost an average of \$15,356 per student in 1992-93, according to the ISER study.

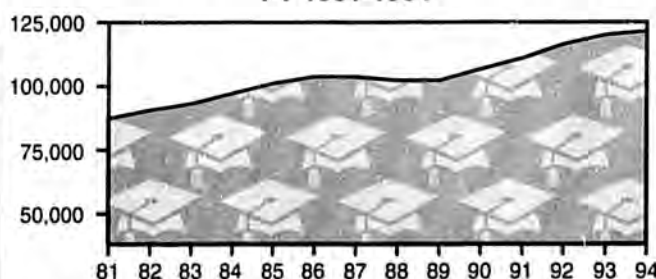
Today many rural students get a poor education because, among other reasons, a variety of teaching specialties are not available in small village schools.

The real crisis in Alaska education is likely to be over rural schools, however, as urban legislators increasingly fight to preserve state education money for their own regions.

That means, whatever else happens, schools will continue to take a big chunk of Alaska's state budget. Unlike most states, where school funding is mainly a local concern, Alaska's constitution makes education in Alaska a state responsibility.

The fight will be over how shares of a dwindling budget "pie" will be divided, and whether the system that remains is relevant to Alaska's unique needs in the emerging global economy.

**Alaska school enrollments are growing
FY 1981-1994**



The rising cost of welfare

Alaska's welfare costs are rising fast. This year state legislators and Gov. Tony Knowles were determined to do something about it.

The legislature wanted to cut benefits but Knowles opposed that because much welfare spending affects children and the disabled.

But Knowles and legislators agreed on getting able-bodied people off welfare and into training and jobs.



Photo Chris Arend

Alaska's welfare costs are growing at alarming rates. The state's benefits are the most generous in the nation. But it's tough for politicians to tackle the problem without striking directly at those society is supposed to care about when they need help: children, the disabled, the blind and the elderly.

This year, Alaska legislators appear ready to take on welfare costs. State House members propose reductions that would lower many benefits to federal minimums. What's unclear is whether the State Senate has the appetite for a cut of that magnitude. Gov. Knowles flatly opposes it, preferring his own plan to get people off the dole and into jobs.

There is some good news, however, in that Alaska has been able to slow welfare cost increases. And a federally-supported program to help get welfare people into jobs is having some success.

Still, the increases are numbing. Between 1990 and 1994, Aid to Families with Dependent Children (AFDC), the largest welfare program, grew 72 percent, from 7,549 families in Fiscal Year 1990 to 12,941 in FY 1994. State contributions (which match the federal contributions) jumped from \$62.4 million in FY 1990 to \$136.1

million in FY 1995. AFDC's cost is projected to decline to \$130.2 million in FY 1996, due largely to cuts in the

program ordered by legislators.

About half of these increases are due to federal mandates requiring two-parent families be included (before, only single-parent families could get AFDC aid). Caseload growth is now slowing, however.

A second major welfare program, Adult Public Assistance (APA), totally funded with state dollars, saw a caseload growth from 6,918 in FY 1990 to 11,176 projected for FY 1996. Expenditures increased from \$24.9 million in FY 1990 to an estimated \$45.4 million in FY 1996. Unlike AFDC, caseloads in the APA program are still growing.

The legislature has shown it can cut welfare. After years of paying generous benefits (Alaska was the last state paying automatic cost-of-living increases) the legislature voted in 1993 to end those automatic increases and roll benefits back to 1992 levels.

Those actions saved \$6.09 million in FY 1994 and \$11.1 million in FY 1995 in the AFDC program. State officials point to another \$4.1 million in savings due to better control of eligibility, fraud control and "enhanced self-sufficiency" (helping people to get jobs).

In Adult Public Assistance, the reductions saved \$3.2 million in the current budget year; next year they will result in a \$4.6 million savings. But APA costs will still grow \$4.2 million because of increased caseloads.

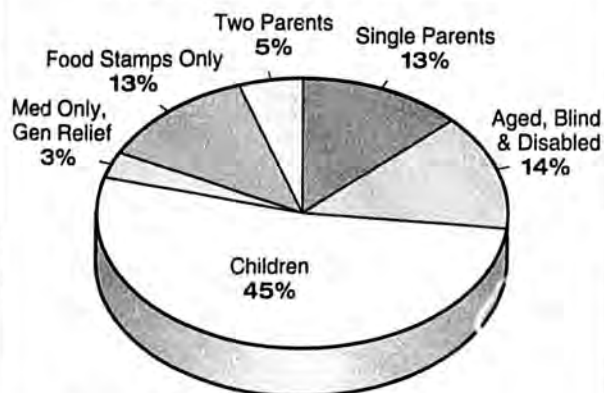
Reducing growth in the APA program will be tough. Unlike AFDC welfare recipients, many of whom are young people needing temporary help and are good candidates for jobs programs, most Adult Public Assistance clients are the disabled or elderly. Employment is not an option, because of physical or mental disability,



Welfare reform

Where does welfare go?

October 1994 payments in Alaska



Alaska Dept. of Health & Social Services

1,100 families applying for AFDC in October 1993, 19 percent had moved to Alaska within the past year.

The hope is that for an increasing number of recipients the experience will be short-lived. The state's Job Opportunities and Basic Skills Program, or JOBS, is one federal mandate (Family Support Act of 1988) that appears to be working. It steers young AFDC parents who lack skills or basic education into training and educational programs.

Since the program started in 1990, 3,700 AFDC parents have gone through the JOBS program, and 2,000 have gone off welfare, subsequently earning \$4.2 million in wages. The savings to the AFDC program have been \$3.2 million. Total savings, including Medicaid and food stamps, is very likely much more.

State lawmakers and Gov. Knowles pushed through big changes in Alaska's welfare programs in the 1995 legislative session. The governor is unhappy, however, with a new five year maximum time period for dependents in the Aid to Dependent Families (AFDC) program that legislators placed in House 78. He may veto the measure.

As it passed, the bill would also establish pilot programs to test the effectiveness of a "workfare" program that would require dependents to work in community service if they can't find jobs; a new 24-month limit for benefits to dependents in training or education courses; liberalization of asset and income limits for dependents who want to start small businesses; and a program for temporary emergency assistance as an alternative to long-term dependency.

Gov. Knowles and Democrats in the legislature successfully fought an effort by Republican legislative leaders to reduce welfare benefits in some categories to federal minimums. Alaska's entitlements are the highest in the nation.

House Bill 78 was sponsored by Rep. Mark Hanley, but as it passed the bill contained elements of Gov. Knowles' proposals for welfare reform as well as proposals by Sen. Lyda Green.

or age.

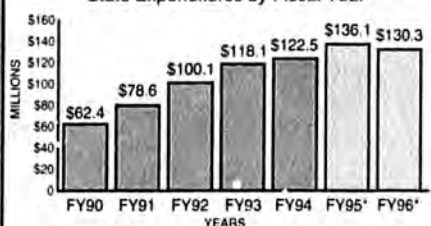
The fastest-growing component of APA is aid to the disabled, which is increasing at an average annual rate of 10 percent. Interestingly, old age assistance, another part of the program, is increasing at a slower rate of 5.3 percent yearly, less than the national average. In fact, the percentage of Alaska's seniors on old age welfare assistance has dropped from 19.3 percent in FY 1980 to 14.2 percent in FY 1994.

For the disabled or seniors needing assistance, the state currently provides a \$362 supplement to a \$458 Federal Supplemental Security Income (SSI) payment.

The rapid increase in Alaska's welfare caseloads during good economic times, and at much higher rates than the increase in the general population, raises the inevitable suspicion that Alaska's generous benefits are actually causing immigration.

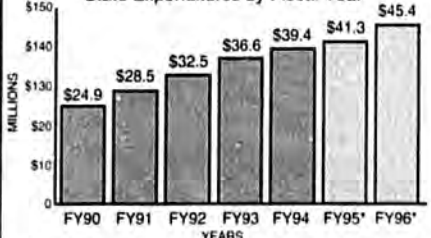
The evidence only hints at this, however. One study did show that of

Aid to Families with Dependent Children
State Expenditures by Fiscal Year



* FY 95 Authorized and FY 96 Projected. Source: Dept. Health & Social Services

Adult Public Assistance
State Expenditures by Fiscal Year



* FY 95 Authorized and FY 96 Projected. Source: Dept. Health & Social Services

Is Medicaid Out of Control?

Alaska's Medicaid costs are soaring, seemingly out of control. Costs are rising faster than health care inflation and population growth.

Medicaid serves those on welfare but its recipients today largely include children, the elderly and disabled.

Medicaid also now finances a major part of Alaska's health care industry. This means efforts at change raises concerns among influential constituent groups.

Among reasons for rising costs:

Congress has liberalized Medicaid for certain groups like the elderly and disabled, and children and pregnant women, while Alaska has added extra services.

Alaska's spending for Medicaid seems out of control. This government-paid health care program was once mainly for low-income people. But it is now expanding into coverage for many middle-income families.

Costs in Alaska have been increasing more than 10 percent yearly for several years, driven by rising health care costs and changes in federal requirements that expand coverage to new groups. The state pays 50 percent of Medicaid costs.

Proposed state Medicaid spending in Gov. Knowles' Fiscal Year 1996 budget is \$154.9 million, up from \$133.8 million in FY 1995. With the federal government's match to Alaska's general fund expenditure, total Medicaid spending in Alaska will be more than \$350 million next year. This makes Medicaid a

key source of income for the health-care industry.

As in welfare, the legislature has made efforts to cut Medicaid's costs. Last year a number of "optional" services were cut, resulting in some savings. (The federal government requires certain core services be provided, but allows states to add options). This year the legislature may refuse to fund all of the program's projected expansion. Administrators will then have to figure out where to make cuts.

The problem in controlling Medicaid costs is partly that it is so large a part of the health-care industry in Alaska. Any attempted change brings influential lobby and constituent groups down on the legislature and the Department of Health and Social Services, which administers Medicaid.

In FY 1994, Medicaid paid 14 percent of total revenues for urban hospitals and physicians. But in smaller communities, where hospitals are often combined with nursing homes, Medicaid paid 70 percent of revenues. One sixth of Alaskans received some sort of help from Medicaid in 1994. Medicaid paid out one eighth of total spending on health care in Alaska that year.

Change is also difficult because any innovation, an idea that either saves money or improves health care,

Photo Chris Arend



Medicaid has grown since 1965 start

Medicaid became part of federal law in 1965, under amendments to the Social Security Act. Every state and U.S. possession participates in Medicaid except Arizona, which is participating in a federally-funded demonstration project that has received waivers from Medicaid requirements. Alaska entered the program in 1972.

The federal government pays 50 percent of Medicaid costs in Alaska, the minimum. Many states receive more than 50 percent.

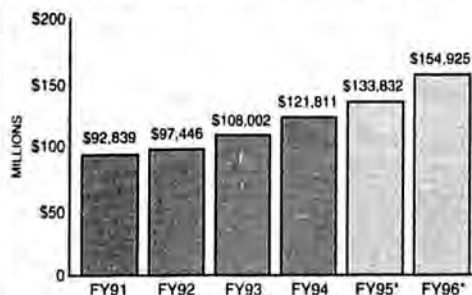
Medicaid began in 1965 as a program to provide health coverage for families or individuals on welfare, or supplementary Social Security disability assistance. Over the years, Congress broadened Medicaid's required coverage and allowed states to add optional services or eligible groups.

In 1984 the federal government expanded coverage for pregnant women and children who met welfare requirements but were not on welfare. In 1986 and 1987 Congress gave states the option of covering pregnant women and children with more liberal income guidelines. Most states took advantage of the change.

In 1993, Alaska exercised another option to pay home-based care for disabled children without regard to parents' income.

Congress also expanded Medicaid coverage for the aged and disabled, a major reason why both federal and state Medicaid expenses are rising.

Medical Assistance / Medicaid



requires a waiver from the federal government. Some critics feel the department hasn't been aggressive enough in pursuing waivers.

After a lengthy process, Alaska did get one waiver that allows Medicaid support for home care of the elderly disabled, a more humane (and cheaper) alternative to nursing homes. But other states have many waivers.

More fundamentally, people are sensitive to change because 35 percent of Medicaid spending goes for services to children, and 20 percent to disabled adults. In fact, nursing homes receive 19 percent of Alaska Medicaid payments. (Hospitals receive 30 percent of all Medicaid payments; physicians receive 18 percent.)

All states are experiencing similar problems, and Medicaid is also a major concern in the federal budget. To a large extent, its growth reflects broad changes in social policy. An example is the decision by Congress to allow children and pregnant women to qualify for Medicaid at higher income and no asset limits. That created access to better care for children and pregnant women, but it also raised costs.

Society is also changing. The population is aging. The cost of long-term elder care is skyrocketing beyond the means of many middle-income

families. The result is major growth of Medicaid coverage in nursing homes.

Some felt Alaska was too quick to add optional services, like chiropractic care, in the days when oil revenues were high, and has been slow to remove them as revenues fell. Since the services covered are set in statute, what's put on or taken off the list gets highly political (chiropractic care was taken off last year).

Another criticism is that Medicaid has been allowed to become an indirect subsidy for small hospitals in outlying communities. Many of these have added long-term care beds largely supported by Medicaid. (The Division of Medical Assistance recently warned legislators that a number of Alaska health care facilities are planning new additions of long-term care capacity, which are estimated to cause state Medicaid expenditures to increase another \$10 million.)

Since the Department of Health and Social Services must issue Certificates of Need for new health facilities, some feel the department's certification authority should be strengthened so it can influence the growth or duplication of health care facilities that impact the budget.

Another option, for Alaska, is to get the federal government to pick up more than 50 percent of the tab, as it does in many states. If federal law is changed so that Alaska's higher costs are factored into the Medicaid formula, the federal share would jump to 62 percent instead of 50 percent, a savings of \$55.3 million to the state budget. But the cost is then just passed on the federal budget.

New Revenues

Alaska has options, but taxes will be a tough sell

Many Alaskan leaders realize new revenue measures — taxes, or reduced Permanent Fund dividends — may lie in our future. The challenge is how to sell this to the public.

People will demand, quite reasonably, that what they consider excessive public spending, particularly "giveaway" programs, be cut before they pay new taxes or agree to lower dividends.

The political problem of enacting a personal income tax and changing (but most likely never ending) the dividend program is a huge challenge, mainly in which comes first.

Meanwhile, people are often willing to pay taxes when they see where the money goes and recognize a benefit. They do not want to pay taxes into a bureaucratic black-hole.

But how far will spending have to be cut until people agree there is a "need"?

Politicians are deathly afraid of the "T-word" — taxes — on citizens at least. And with good reason: In local elections voters in some communities have rejected sales taxes and pushed "caps" on property taxes. Several Alaskan leaders in recent years have been willing to discuss such unpopular subjects. They include former governors Bill Sheffield and Steve Cowper, former legislator Fran Ulmer (now lieutenant governor) who actually introduced legislation to reinstate the personal income tax, and Mike Navarre, a current legislator, who proposed raising state motor fuel taxes, now the lowest in the nation. Former Gov. Walter Hickel also proposed a higher fuel tax, as well as a "royalty" on salmon harvests and a modest increase in "sin" taxes (tobacco and alcohol). None of these proposals were enacted into law.

University of Alaska studies show Alaskans not only pay the lowest taxes in the nation, they actually get more cash directly from government than they pay. The average Alaska family (2.6 people) pays \$2,000 in taxes (mostly local) and receives \$2,600 in cash, mainly the Permanent Fund dividend, according to studies by the university's Institute of Social and Economic Research. Thanks to oil, the amount of public services the average family receives (\$19,600 per year, not including the

dividend) is almost 10 times the taxes they pay, the ISER calculates.

Many political and community leaders believe Alaska will need additional sources of revenue, from somewhere, as oil production and revenues decline. They also say that the link between taxes and government — that citizens will better watch government and demand accountability when they pay part of the tab — must be reestablished in Alaska.

In a detailed study of the fiscal problem, the ISER finds that except for oil and gas, development of industry and natural resources will create jobs but relatively little state revenue. With some changes, the Permanent Fund's \$1 billion-plus annual income can make a substantial contribution to the gap, ISER says. But in the end, they point out, Alaskan citizens may have to start paying taxes again.

For the state's political leaders, the challenge is



Photo Chris Arend



how to sell this to the public.

It has often been demonstrated that people are willing to pay taxes as long as they perceive they are getting their money's worth, and that government isn't blowing the money.

The problem in Alaska is that too many still see government blowing money in perceived "giveaway" programs. It's reasonable for an average taxpayer to question the government's need for an income tax when Permanent Fund dividend checks are still being mailed out.

"Waste" in public spending is also a matter of perception. The public's perception is that politicians give in too easily in granting pay and benefits increases to public employee unions. For their part, public employees feel they shouldn't be asked to sacrifice when legislators fund "wasteful" (in their eyes) capital projects.

Taxpayers are quite willing to pay for services they can see, and depend on. For example, while some Alaska communities repealed sales taxes when oil revenues flooded the state treasury in the early 1980s, most municipalities maintained them.

Voters in some communities even supported temporary sales tax increases tied to specific projects, such as a new community swimming pool or recreational ski project.

Last year Alaskan air carriers accepted an increase in state aviation fuel taxes as an alternative to higher landing fees to help maintain state airports. Two years ago, commercial fishermen did not strenuously object to a new state tax on salmon because the legislation

contained a provision that the money would go to support fisheries marketing (the law is not legally binding, however).

There are other examples: Trucking companies have voiced support for an increase in the motor fuel tax if the added revenues could be dedicated to improved road maintenance. Tour operators say they are willing to pay special tourism taxes if part of the money could be tied to tourism marketing.

Alaska's constitution now prohibits such "dedicated" funds, except for the Permanent Fund. But there have been several recent proposals for constitutional amendments allowing tax revenues to be dedicated for specific projects. These were proposed to get support from influential constituencies.

Early in his administration, Gov. Hickel supported a fund for highway and airport maintenance, to which fuel taxes would be dedicated. Gov. Cowper proposed a dedicated fund for schools, with revenues from a restructured Permanent Fund dividend program.

But a series of dedicated funds in the constitution could be a heavy price to pay to get citizen support for selected revenue measures because they could also lock Alaska's state government into a rigid funding structure that would see politically-popular programs funded well but others (welfare, environmental protection) starved for resources. This has been indeed the experience of other states with dedicated funds.

The need for new revenues can be "sold" to the public, but it will take, somehow, a restoration of voter confidence that the money is really needed, and that it will be used well. That's the real challenge facing Alaska's leaders.

Commonwealth North's plan

Several Alaskan citizen groups have reviewed the problem of the state's fiscal gap, including an "economic summit" of the state's business and community leaders called together by former Gov. Hickel in 1992; Alaska Commonwealth Ground, a citizen public policy group, in 1993; and Commonwealth North, the Anchorage-based group that often tackles policy issues, also in 1993, and others.

After extensive discussions, all of these groups suggested variations of the "safe landing strategy" developed by the university's Institute of Social and Economic Research, involving spending cuts, changes to the Permanent Fund dividend and new taxes.

Key elements of Commonwealth North's plan:

- Freeze the operating budget below current levels
- Cut capital spending
- Cap Permanent Fund dividends, then reduce expenditures for dividends \$50 million yearly
- Increase some taxes such as alcohol, tobacco, motor fuel, fisheries
- Create an income tax commission to analyze taxes, and submit a proposal to the legislature
- Create a financial planning commission to develop a long-term finance plan

Commonwealth North's recommendations laid the foundation for creation of the Long Range Financial Planning Commission created by the legislature in the 1995 session.

Will the Permanent Fund help cover the gap?

Alaska's Permanent Fund, the big bank account of saved oil revenues, is viewed by some as Alaska's salvation in bridging the looming fiscal gap. The \$15 billion fund now earns about a billion dollars a year, enough to pay 40 percent of state spending. But changes would have to be made in how the fund's income is used. About half of it now goes to pay for annual dividends to the state's citizens. What's left goes to "inflation-proof" the fund, offsetting the effect of inflation for the year.

Changes in earnings management of the fund, to make money available for public services, will be highly controversial because they are likely to reduce the citizen dividends.

It's ironic, but Alaska's \$15 billion Permanent Fund, which earns a billion dollars plus each year, won't do much to help the state bridge its looming fiscal gap. At least not the way the fund's income is now used.

When Alaska voters approved the constitutional amendment creating the Permanent Fund in 1976, the understanding was that it was to be a way of saving a portion of the state's "non-renewable" oil revenue for the day oil revenues ran down, to support

help finance Alaska development projects?

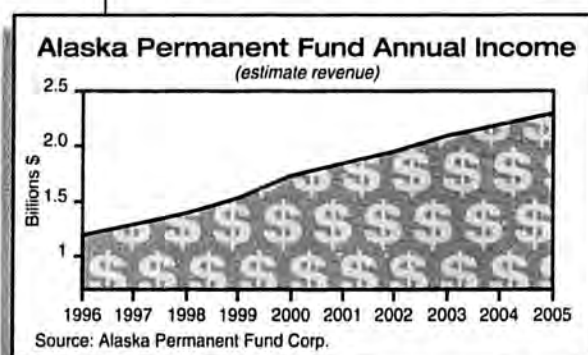
Legislators looked at Alberta's Heritage Fund, a similar oil revenue savings account, which had been depleted by investment in politically-popular but money-losing projects within the province. The trust concept finally won out in Alaska, and became the guiding principle for the Permanent Fund investment policy.

The citizen dividend program, virtually unique in the world, became law in 1980. Since it is created in state law, it can be changed by the legislature.

Two ideas were behind the dividend: First, at the time Alaska was rolling in surplus oil revenue (oil price hikes had far exceeded expectations) So, legislators felt, why not share a bit of the wealth directly with citizens? Most analysts at the time believed prices would remain high. Alaskans believed they were permanently wealthy.

Secondly, Jay Hammond, then governor, felt giving citizens a direct stake in the performance of the fund would create a powerful watchdog constituency for the fund, encouraging good management and discouraging legislators from devising any scheme to "raid" the fund. (Even with constitutional protection, there are ways the fund's value can be depleted, such as soft "loans" to the state or to uneconomic development projects.)

At first, the dividend program was tied to length of residence in Alaska, so that a lifelong Alaskan, for example, would receive a larger dividend than a new arrival. That was successfully challenged in court, however. Now the dividend is paid equally to all Alaskans, regardless of length of residency.



basic public services without imposing ruinous taxes on Alaska's citizens. (In the days before North Slope oil, Alaska local and state taxes were very high.)

In 1976, no one was thinking of the Permanent Fund dividend. The constitutional amendment provided only that a portion of oil royalties and bonuses be saved. What to do with the income, and how the fund should be managed, were decisions left to the legislature.

In 1979 and 1980, fierce debates raged in the legislature over the basic investment policy of the fund. Should it be a "trust" type fund, invested in very safe, conservative investments, which almost by definition meant mostly outside Alaska? Or should it be at least partly a "development" fund that could, among other investments,



Senator Rieger's plan for fund

In 1980, the legislature also provided for special "inflation-proofing" payments to be made from earnings to the protected body of the fund, to offset the effects of inflation.

Another decision the legislature made that year was to have the dividend payment made first, and inflation-proofing second, from the earnings. If the earnings fall short, dividends have priority over inflation-proofing. Between these two claims on the earnings — dividends and inflation-proofing — there isn't much left for the general treasury.

There have been small surpluses in recent years, however, and these have accumulated in the present \$1.2 billion Earnings Reserve Account (a part of the general fund, not the fund itself).

But with the size of the fund increasing, two things happen: The amount needed to inflation-proof grows larger each year, and dividends are also likely to grow. The Permanent Fund Corp. anticipates that in a few years the fund's earnings won't be sufficient to cover both. Then inflation-proofing will begin to suffer, at the expense of increasing dividends.

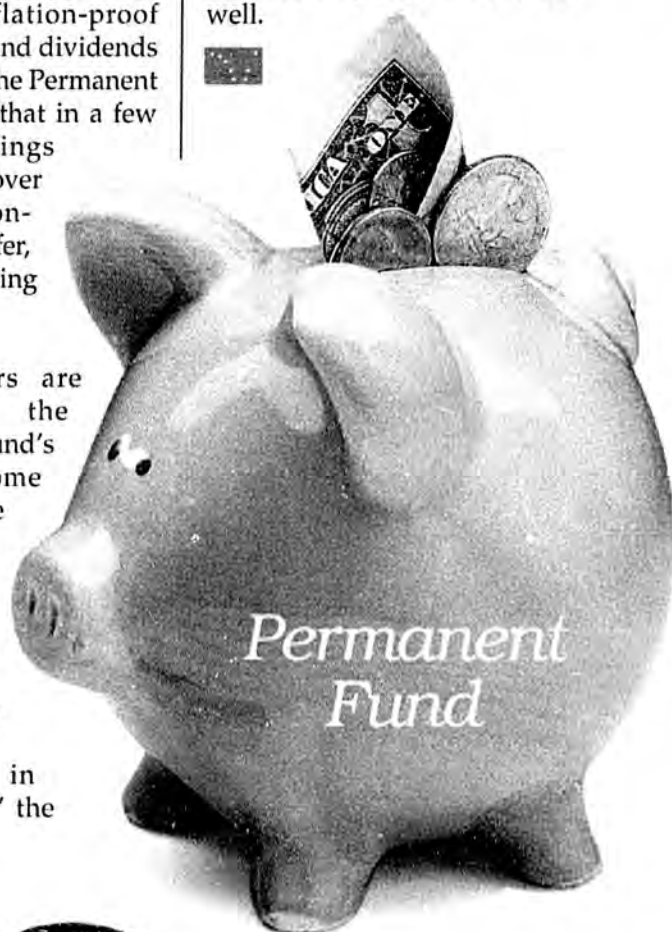
Many legislators are aware of the intricacies of how the fund's earnings are split. Some privately agree with the University of Alaska's Institute of Social and Economic Research that Permanent Fund earnings should be a central part of a plan to span the fiscal gap.

One idea discussed in recent years is to "cap" the

dividend at some level, halting its growth. One suggestion is at \$1,000; another is a "rollback" to \$500. Over time, this would create increasing "wedge" of earnings available to the general treasury.

In its "safe-landing strategy" plan to bridge the fiscal gap, the university's ISER recommended a gradual phaseout of the dividend. The savings would accrue at first to the corpus of the fund, so that it would grow faster and increase its earnings. The income would then be available to support public services.

The problem for state leaders is how to somehow change the distribution of the earnings without angering a public that has come to view the dividend as an entitlement. Gov. Hammond's strategy of creating a constituency for the fund may have worked too well.



If the Permanent Fund is to be an important part of Alaskans' strategy to bridge the fiscal gap, the first task should be to more fully protect the principal of the Fund against erosion by inflation. State Sen. Steve Rieger proposes to do this in Senate Bill 51.

Basically, the bill would reverse the current practice of paying dividends from the Fund's annual earnings before the required inflation-proofing payment is made. Current law requires that part of the yearly earnings be deposited into the body of the Fund, to offset inflation for the year.

Current law also provides that dividends be paid first. But as the Fund grows, the time will come when there won't be enough earnings to do both. At that time, inflation-proofing will be shorted to sustain a larger dividend payout.

That's unwise policy, Rieger argues, because it will lead to a gradual, long-term erosion of the Fund. A better policy is to inflation-proof first and pay dividends second. Senate Bill 51 would do that.

The legislation would lead to a temporary dip in the dividends, but Rieger feels that would be acceptable to give the Fund long-term protection against inflation.



Can Development Raise New Revenues?

Alaska has great potential for development of its natural resources. Despite its cycles, fisheries is an enduring industry with potential for growth. New mines are opening up. Demand is hot for Alaskan timber products, although timber is increasingly inaccessible. Tourism is steadily increasing. There is potential for new oil development, most likely small to medium-sized deposits.

But these cannot cover cover the fiscal gap. In fact, the gap threatens their potential. All of them, including tourism, work on thin margins in highly competitive markets. New taxes could easily price them out of the market.

Some think a solution to the fiscal gap is to simply "grow" our way out of the problem, to either find a new Prudhoe Bay (very unlikely) or to stimulate development of Alaska's other natural resources.

Those resources are indeed rich and varied. Off Alaska's coasts is one of the world's great fisheries. Its minerals potential is huge. There is vast acreage of virgin forests. Tourism increases at a steady clip. This mix could bring a diversified, prosperous private economy to Alaska. But it won't cover the fiscal gap. Not by itself.

Fisheries, tourism and, to lesser extent, mining and timber, are significant employers. But they also operate on razor-thin margins in highly competitive world markets.

Some can afford to pay more taxes. In fact, fisheries now pays more than it

did just a few years ago. But it's peanuts compared to petroleum: Fisheries paid \$75 million into the state treasury in Fiscal Year 1992, compared with \$2.5 billion paid by oil and gas production.

Most natural resource industries can't afford the kind of taxes that oil and gas pays.

Any significant tax risks pricing these other products, even tourism (Alaska's natural beauty is a kind of commodity) out of the market.

A look at the numbers is revealing: Mining is a high-wage industry that creates good jobs, and the prospects are good for new mines. But in FY 1992 the state received only \$3.48 million in all types of revenues from mining, according to data collected by the House Research Agency, an arm of the legislature.

Today mines are more important as taxpayers to municipalities than state government. Red Dog Mine, for example, is the primary taxpayer to the Northwest Arctic Borough. The AJ Mine, if it reopens, will provide about 10 percent of the City and Borough of Juneau's budget.

Fisheries comes closer than any industry other than petroleum in paying for itself. According to state Dept. of Fish and Game data, the industry now pays slightly more than it costs the state to manage. Like mining, fisheries pays good wages, and is an important source of taxes to coastal communities.

Timber, also a high wage-paying industry, ought to be a booming industry for Alaska, given the state's vast forest resources and the looming shortage in wood supply (and rising prices) in Pacific markets. But sadly, it appears to be a shrinking industry, mainly because of land-use conflicts with environmental groups. In FY 1992, timber generated \$1.6 million in revenues to the state treasury, mostly receipts from state timber sales, according to the House Research Agency.

Tourism is a steady-growth industry, every year notching up 3 to 6 percent growth. While highly seasonal and somewhat lower paying, the industry's economic benefits are spread widely around the state. Interestingly, the industry acknowledges tourists can



Photo Chris Arend



The tools are there; can we really do it?

afford to pay more tax, but tour operators would like the tax structured in a way that fairly taxes all segments of the industry — cruise lines, airlines, lodge operators — fairly. One way to do this is a seasonal sales tax which kicks in during summer when the tourists come north, although Alaskans would also pay a share. But the overall revenue gain is modest.

The only new economic development likely to bring major new state revenue is the old

enough for commercial gas sales to be economically viable) but a gas pipeline system will pay the state oil and gas property tax and other taxes. Potential revenues were estimated by former Gov. Hickel, an ardent supporter of the project, to be in the range of \$300 million to \$400 million yearly. That's significant, but not enough to cover the gap.

As for finding another Prudhoe — it's not a possibility a prudent person would plan on, even in the Arctic National Wildlife Refuge. Alaskans

The University of Alaska's Institute of Social and Economic Research, Commonwealth North and others have laid out the array of tools available, and needed, to bridge the fiscal gap: spending cuts, economic development, new sources of revenue.

The question now is whether Alaskans can carry out a plan to span the gap, because parts of that plan will be unpopular.

There are also proposals, however, to help force the issue:

- Anchorage attorney Roger Cremo proposes a constitutional amendment to convert the Permanent Fund, and other state reserves, into an endowment-type fund, with forced spending reductions. Earnings from the fund could then support many state government's expenses.

- House Speaker Gail Phillips proposes "forward funding" the state budget with existing cash reserves to stabilize funding for state programs. It doesn't address the fiscal gap directly, but forward funding could force decisions sooner by taking reserve funds "off the table."

The new state Long-Range Financial Planning Commission is now wrestling with these issues. Its report is due in October.

Potential Additional Economic Development Revenues

(An "optimistic" case, annual revenues in millions)

	FY 96	FY 97	FY 98	FY 99	FY 00	FY 01
Optimistic						
Mining	5.0	7.0	9.0	11.0	12.0	13.2
Timber	0.8	0.9	1.1	1.2	1.5	1.7
Seafood	3.6	3.9	4.1	4.4	4.7	5.1
Tourism	1.1	1.1	1.1	1.2	1.2	1.2
Other	30.6	32.8	35.1	37.6	40.3	43.2
Total	41.0	45.6	50.4	55.4	59.7	64.4

Source: State OMB; prepared for Gov. Hickel's 1992 "Economic Summit"

standby, petroleum. There are good prospects, but the kind of new oil and gas fields likely to be developed, ones Alaskans can reasonably be able to count on, are medium-sized to small discoveries. They can contribute a modest amount of "new oil" and will play a vital role in sustaining the economic viability of the Trans-Alaska Pipeline. But they won't replace Prudhoe Bay.

There is, most likely, an Alaska natural gas pipeline in the future — someday. Gas will not duplicate what oil pays to the treasury (it is difficult

have seen too many expectations fizzle (the Mukluk and Kuvlum wells on the North Slope, to name two).

Alaska undoubtedly has a bright future. But, as former state Commerce and Economic Development Commissioner Paul Fuhs has pointed out, the looming fiscal gap, and the uncertainty of how the state will deal with it, now serves to actually chill new resource investment.

When resources companies see the state's fiscal house is in order, they will see Alaska as a stable and inviting place to invest.

Update - Alaska state legislature 1995 session

Oil and gas development incentives

State legislators approved a proposal by Gov. Tony Knowles to give the Commissioner of Natural Resources authority to modify state oil and gas royalty on marginally economic undeveloped oil and gas deposits.

The bill is important because it gives the state a new tool to encourage companies to develop marginal oil discoveries. House Bill 207 is the first step in making Alaska more competitive in the world energy arena.

For many years state law has given the commissioner the ability to modify royalty on producing oil and gas fields and even, under certain circumstances, undeveloped discoveries. HB 207, which passed in the final hours of the 1995 legislature, clarifies that authority.

The bill came under close scrutiny in both the State House and Senate. Legislators were mainly concerned with the delegation of authority to the commissioner to reduce royalty on undeveloped fields without some mechanism for oversight by elected officials other than the governor.

Proposals for outright legislative approval were rejected, but the final version of HB 207 gives the legislature's Budget and Audit Committee the authority to review the agreements.

As it finally passed, the bill includes a provision to "sunset," or automatically terminate, after 10 years unless extended by the legislature. That is intended to allow lawmakers to review effectiveness of the program.

In 1996, the legislature may consider other oil and gas incentive



House Speaker Gail Phillips and Rep. Al Vezey.

Photo Bob Tkacz

proposals intended to broaden the tools the state has to attract new industry investment.

These include Senate Bill 114, which grants special tax and royalty credits for continued production of very high-cost wells or wells drilled in heavy oil deposits; and SB 112, which reenacts a five percent "discovery" royalty as an incentive for exploration (the state's royalty on most oil and gas leases is 12.5 percent).

The Senate Resources Committee, chaired by Sen. Loren Leman will hold work sessions on those proposals in the interim between legislative sessions. The House Oil and Gas Committee, under chairman Rep. Norm Rokeberg, and the House Resources Committee, chaired by Rep. Joe Green, will consider other proposals. In addition, Gov. Knowles' Oil and Gas Policy Council will review other recommendations toward improving Alaska's competitive position.



House Minority Leader Jerry Mackie.

Photo Paul Helmar

Minerals exploration incentive

The legislature also approved a new minerals exploration incentive program, which allows mining companies to credit certain "up front" costs in exploring or evaluating a new discovery against present or future state mining taxes or royalties.

House Bill 197 passed both the House and Senate by wide margins.

The Department of Revenue has certain problems with the bill; HB 197 is now under review by Gov. Tony Knowles.

Permanent Fund deposit

State lawmakers also voted to deposit about \$1 billion of accumulated surplus Permanent Fund earnings into the corpus of the Fund, which now has about \$15 billion (before the deposit). Once in the Fund the money cannot be appropriated for state operations.

Some lawmakers argue the action takes state cash reserves "off the table," and forces the fiscal gap to be dealt with sooner. If the \$1 billion in Permanent Fund earnings is deposited (Gov. Knowles may veto it or reduce the amount) the state will have \$2.2 billion left in the Constitutional Budget Reserve, or due to be paid in, by the end of FY 1996. At current spending rates, those reserves will be exhausted by 2000.

New business legislation

A number of business-related bills passed the 1995 legislature. One important bill making major changes in Alaska's "tort," or liability, laws, passed the State House and will be reviewed by the Senate in the 1996 legislature.

Business legislation approved included House Bill 115, giving judges flexibility in awarding punitive damages in lawsuits brought on overtime wage claims.

Also passed was HB 237, making changes in workers' compensation laws and granting immunity from

liability for insurance companies and industry trade associations who participate in workplace safety inspections.



JUNEAU REPORT



Top: Rep. Joe Green.
Photo Paul Helmar

Middle: Sen. Mike Miller.
Photo Heidi Bradner

Bottom: Rep. Brian Porter.
Photo Heidi Bradner

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March 22, 1991

Members of the Legislative Budget
and Audit Committee:

In accordance with a Legislative Budget and Audit Committee request and the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

COST OF PREPARING ALASKA'S ANNUAL BUDGET AND THE ADVANTAGES AND DISADVANTAGES OF BIENNIAL BUDGETING

March 22, 1991

Audit Control Number

01-4375-91

The objective of this audit was to evaluate the amount of agency staff time, by department, consumed during the annual budget development, documentation, and presentation process. Also, we attempted an assessment of the potential savings that could result from establishing a biennial budget process and identified both positive and negative aspects of biennial budgeting.

The audit was conducted in accordance with generally accepted governmental performance auditing standards. Audit scope and methodology are discussed in the Report Objectives, Scope, Methodology, and Assumptions section of this report. Audit results can be found in the Issues Analysis and Conclusion.

A handwritten signature in cursive script, reading "Randy S. Welker".

Randy S. Welker, CPA
Legislative Auditor

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REPORT OBJECTIVES, SCOPE, METHODOLOGY, AND ASSUMPTIONS

In accordance with a Legislative Budget and Audit Committee request and Title 24 of the Alaska Statutes, we evaluated budget preparation costs for the State of Alaska and considered both advantages and disadvantages of a biennial budget cycle.

Objectives

The objectives of our review were to:

1. Evaluate the amount of agency staff time, by department, consumed during the annual budget development, documentation, and presentation process and the evaluation of agency-estimated non-personal services costs.
2. Attempt an assessment of potential savings that could result from establishment of a biennial budget process.
3. Document both positive and negative aspects of a biennial budget process.

Scope and Methodology

Because of restrictions in the Alaska Constitution regarding appropriations, we have defined biennial budgeting as a "mixed budget cycle" consisting of biennial budget preparation and annual appropriation.

Our scope focuses on the cycle utilized by the executive, judicial, and legislative agencies in the annual operating and capital budget preparation process. We examined the procedures followed in the preparation of agencies budgets from development through presentation to, and approval by, the Legislature.

Pertinent sections of the Alaska Constitution and Alaska Statutes were reviewed in consideration of partial or complete implementation of a biennial budget process (see "Legal Issues" section of report).

We reviewed reports, articles, and other publications addressing budgetary issues. Information was received from the National Association of State Legislatures and the Council of State Governments. We also received reports and publications prepared by the United States General Accounting Office, other governmental research agencies, state budget personnel in other states, and by educational institutions.

We analyzed the sources of the state revenues and identified areas of forecast uncertainty. Further, we analyzed the feasibility of long-term projections considering the volatile price of oil.

We prepared and distributed a questionnaire to all other state budget offices. We asked for opinions as to potential costs savings, advantages, and disadvantages of biennial budgeting based upon their experiences. And, for biennial budget states, we inquired as to methods used to adjust budgets in the off-budget year.

We solicited from the various executive, judicial, and legislative agencies the estimated number of hours spent in the development, documentation, and presentation of their respective operating and capital budgets. We calculated the total personal services cost by multiplying the number of hours by the hourly salary, considering bargaining unit and the location. We also calculated the average benefit rate for each respective department and included that within the total personal services cost. Agencies also estimated their non-personal services costs.

Finally, we received estimates of the percentage of time legislative staff spent in review and analysis of the annual operating and capital budgets during the FY 90 legislative session. If possible, legislative staff were also asked to estimate non-personal services costs.

Assumptions

Assumptions were made to better evaluate the agencies' role in preparation of the agency budgets and to assess potential cost savings that could result from changing to a biennial budget cycle.

Our first assumption was that subsequent legislative, executive, and judicial involvement would be receptive to the priorities and level of services budgeted for under a biennial process for the current biennium.

We also assumed that actual revenues would not fall significantly below that budgeted for either year in the biennium. A material shortfall would necessitate a reevaluation of budget policy by the legislative, executive, and judicial branches, thereby reducing potential savings achieved during the preparation of the biennial budget.

A third assumption was that annual appropriation would occur as required by the Alaska Constitution (see "Legal Issues" section of this report).

Finally, our evaluation assumed that biennial budgets would have two years presented in one set of budget documents, not two complete sets of budget documents. Some information will continue to be fiscal year specific such as personal services and increment/decrement explanations.

ORGANIZATION AND FUNCTION

The FY 92 Budget Cycle is shown below. The cycle begins each July when the Division of Budget Review (DBR) in the Governor's Office of Management and Budget, develops budget instructions and guidelines. DBR is involved in training, instruction, compiling data, and working with various agencies, the Legislature, and the Governor and his staff throughout the entire budget process. The timing of the October submission requirements may vary by as much as three weeks from year to year.

FY 92 BUDGET CYCLE

CALENDAR YEAR 1990

JULY	AUGUST	SEPTEMBER	OCTOBER	NOVEMBER	DECEMBER
July 1 OMB Develop Budget Instructions and Guidelines	Early August Budget Forms and Instructions Available Aug. 24, 25, & 26 Cabinet Meeting Agency-Adjusted Base Determination	Agency Budget Preparation Sept. 14 Completed CI Form Due to OMB	Oct. 5 Agency Operating Budget & Agency Issues Memo (A-4) Due to OMB Oct. 18 Agency Capital and Loans Budgets Due to OMB OMB Review	Nov. 1 Preliminary Supplemental Requests Due to OMB Nov. 30 Last day to submit Revised Detail Budget Pages to OMB OMB Review	Early December Governor's Budget Decisions Dec. 15 Draft Appropriation Bill to Legislature and Public
	TRAINING (AS NECESSARY)		Revenue Forecast		

CALENDAR YEAR 1991

JANUARY	FEBRUARY	MARCH	APRIL	MAY	JUNE
Jan. 21 1991 Legislative Session Convenes Jan. 24 Governor's Budget Speech	Feb. 6 Submission of Supplemental Requests to OMB Feb. 19 Submission of Supplemental Requests to Legislature	Mar. 6 Deadline for Submission of Budget Amendment Request to OMB Mar. 21 Submission of Budget Amendment Request to the Legislature	OMB Review of Agency Supplemental Requests Based on Year-to-Date Expenditures	May 26 End of Legislative Session Appropriation Review Begins	Governor's Review, Veto and Signing of Operating, Capital and Reappropriations Legislation
		Legislature Adjustments, Governor's Review and Adjustments			
		Conference Committee Budget Preparation			

Some agencies begin development of their budget more than twelve months prior to the beginning of the budget year. The majority of the agencies wait for receipt of the budget instructions which include, but are not limited to, policy guidelines, deviations from past practices, general technical instructions, employee benefits, overhead, and other costing factors.

Agencies develop goals and objectives congruent with the Governor's goals. Budget request units within the various agencies then develop more specific goals, objectives, and performance measures (the operational plan) to carry out the agency goals. Executive agencies present their budgets in October to DBR for technical review which includes reviewing the agency requests for accuracy, clearness, and proper format. The Governor's Draft Budget Development Group holds a series of budget workshops towards finalization of the Governor's budget.

The Governor submits a draft appropriation bill to the legislature, and makes copies available to the public, by December 15th of each year. Additionally, an advance copy of the Governor's budget workbook is provided to the Division of Legislative Finance by the first Monday of January (second Monday in January following a gubernatorial election year).

Upon receipt of the Governor's budget, the Legislative Finance staff begins its review and analysis. Analysts prepare computerized worksheets (short form budgets) for the legislative committees, which include budget data from the prior year, current year, and request year. In addition to the fiscal information, each component also contains information on new positions, legislative intent, audit recommendations made by the Division of Legislative Audit, and other information helpful in understanding the request.

The House and Senate Finance Committees perform detailed review of the budget information through use of subcommittees each assigned to analyze and review specific agency budgets. Committees hold public hearings, with testimony provided by state agency officials, executive budget staff, legislators, representatives of private organizations, and the general public.

The House and Senate Finance Committees may submit "committee substitutes" for the Governor's general appropriation bill. The final version is negotiated in the Conference Committee on the budget. The Conference Committee version, after passage by the legislature and approval/veto by the Governor, becomes the general operating and capital budget for the upcoming fiscal year.

Supplemental budget requests are submitted by agencies that anticipate a shortfall in the current budget year authorization in contrast to the upcoming fiscal year annual budget cycle presented above. Alaska Statute 37.07.070 requires supplemental appropriations to be submitted for introduction by the Rules Committee up through the 30th legislative day. Normally, preliminary supplemental information is submitted to DBR during the beginning of November and is finalized, and resubmitted to DBR, during early February.

DBR reviews preliminary supplemental request information and asks that agencies identify any existing department resources which can be reallocated or reappropriated to cover all or part of the shortfall. Agencies are asked to provide both accounting and analysis information, including explanation of legal obligations or legislative intent, and a discussion of how the supplemental impacts personal services and positions.

Revised programs (RPs) constitute a revision to a program's authorized budget and positions. The agency's authorized budget and position information is given in the appropriation act and the Conference Committee report issued by the Division of Legislative Finance. Authorized positions are determined by DBR and are shown in the Position Authorization and Control System.

The executive branch has the flexibility to revise programs through several means. Transferring funds between line items and allocations is made possible through statute. Transferring funds between allocations is possible only when the appropriation bills designate lines in the bill as allocations rather than appropriations.

Agencies are, at this time, allowed to process some RPs without DBR approval such as those that transfer funds between specific non-personal services allocations such as travel, supplies, and equipment. Others RPs, such as those affecting changes in authorized positions and movement into and out of personal services, grants, and miscellaneous line items, must be approved by DBR. Other RPs (RPLs), such as those that increase authorization to spend based on unbudgeted federal or other program receipts, must be submitted for review by the Legislative Budget and Audit Committee.

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LEGAL ISSUES

The budget cycle for the State of Alaska is defined in Article IX, Section 12 of the Alaska State Constitution. This section states that:

The governor shall submit to the legislature, at a time fixed by law, a budget for the next fiscal year setting forth all proposed expenditures and anticipated income of all departments, offices, and agencies of the State. The governor, at the same time, shall submit a general appropriation bill to authorize the proposed expenditures, and a bill or bills covering recommendations in the budget for new or additional revenues.

We requested an opinion from the Legislative Affairs Agency, Division of Legal Services (DLS) concerning the legality of a biennial budget appropriation. Legal Services stated that the constitutional provision literally requires the governor to submit a budget for each upcoming fiscal year.

DLS further explained that the legislature could, by statute, require that budget planning be done on a biennial basis. The proposed budget for the second fiscal year can be submitted each year along with the governor's budget for the upcoming fiscal year. The proposed budget for the second year could then be resubmitted by the governor for the next budget cycle, with, theoretically, minor adjustments.

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ISSUES ANALYSIS AND CONCLUSIONS

The following addresses the issues raised by the Legislative Budget and Audit Committee in their request to review the biennial budget issue.

- A. Evaluate the amount of agency staff time, by department, consumed during the annual budget development, documentation, and presentation process.

As stated above under Scope and Methodology, we solicited from the various executive, judicial, and legislative agencies the estimated number of hours spent in the development, documentation, and presentation of their respective operating and capital budgets. We calculated the total personal services cost by multiplying the number of hours by the hourly salary considering bargaining unit and the location. We also calculated the related employee benefit cost for each respective department and included that within the total personal services cost. Agencies also estimated their non-personal services costs.

We also received estimates of the percentage of time legislative staff spent in review and analysis of the annual operating and capital budgets during the FY 90 legislative session. If possible, legislative staff were also asked to estimate non-personal services costs.

Based upon agency-submitted unaudited information, we have determined that the cost to develop, document, review, and analyze the State of Alaska operating and capital budgets under the annual budget cycle approximates \$6 million (see Appendix). However, savings of \$6 million every other year under a biennial budget process would not be achieved because of the numerous variables involved and discussed in this report.

- B. Attempt an assessment of the potential savings that could result from establishment of a biennial budget.

We feel a cost savings would result if the State were to adopt a biennial budget. To realize any potential savings the following assumptions would need to be adhered to:

1. Subsequent legislative, executive, and judicial involvement would be receptive to the priorities and level of services budgeted for under a biennial process for the current biennium.
2. Actual revenues would not significantly fall below that budgeted for either year in the biennium.
3. Because of constitutional restrictions, annual appropriation would be necessary with limited review and debate in the off-budget year.
4. Some fiscal year specific budget-related information would still require processing such as personal services and increment or decrement explanations.

5. The biennial budgets would have two years presented in one set of budget documents, not two complete sets.

Savings in non-personal services totalling \$330,496 can be reasonably estimated. This represents non-personal services costs less a consideration for capital budget printing and supplies which would not, over the two year period, be reduced.

Personal services savings would result; however, the total amount is indeterminate because of the numerous variables. Savings would be recognized in the following areas:

1. Costs associated with training and implementation of the budget, which occurs at the beginning of each budget cycle, would be reduced.
2. Costs associated with actual preparation of the budget documents by the various agencies because they would be presented for a two-year period rather than one.
3. Reduced costs resulting from public hearings or with bringing budgets before boards for their approval prior to submission to the Governor, since this would only be done every other year.
4. Reduced costs in the annual review of documents and presentation to the Governor's Office, legislators, and legislative subcommittees, by the budget analysts, directors, and commissioners at the agency level since this review would only be done once every other year.
5. Cost savings would result from a biennial review and analysis, rather than an annual review, by the Governor's Office, Division of Budget Review, legislative staff, and the Division of Legislative Finance.

Cost savings would not be recognized due to some documentation requirements, specifically:

1. Position detail would need to be updated for each year in the biennium.
2. Forms showing increments, decrements, and transfers within the adjusted base may need to be completed for each specific year in the biennium.
3. Additional review and analysis of two-years' worth of adjustments, decrements, and position information.

If unanticipated expenditures or a shortfall in revenues arise, for either budget year within the biennial budget, agencies will need to handle these through revised programs and/or supplemental requests in order to maintain a cost savings, since this process is less expensive than a formal budget process.

C. Present both positive and negative aspects of a biennial budget process.

The biennial budget cycle is the process of preparation of agency budgets, and consideration of budget appropriation bills that either authorize or limit spending every other year. The preparation phase of a biennial budget cycle includes development, documentation, and presentation of an agency budget for authorization and/or spending limits for a two-year period.

The appropriation phase of the biennial budget appropriation is being defined as the authorization or limitation of spending by the legislature for a two-year period. Based upon the constitutionally required annual appropriation, the State of Alaska could only implement a mixed biennial budget cycle (i.e., biennial budget preparation with annual appropriation).

Advantages of biennial budgeting include long range planning and less time spent on budget preparation. Biennial budgeting, during the off budget year would allow a more thorough analysis of programs at the agency level and more opportunity to consider non-budget matters at the legislative level.

Based upon questionnaire responses from the twenty-one states that prepare budgets on a biennial basis, 67% feel that their budget preparation costs are lower than if they prepared budgets on an annual basis. Reasons for the lower costs are less involvement with the legislature every other year and smaller central and agency budget staffs.

Three states feel their budget preparation costs were the same as annual budget states. Florida, one of the two states that prepares budgets biennially yet appropriates annually, said they feel biennial budget preparation does not produce a cost savings because they redevelop the budget in the off-budget year. Three states have no idea as to possible cost savings, and one state feels their budget preparation costs are higher. Hawaii feels their costs were higher because a supplemental budget is prepared in addition to the regular biennial budget.

Seventy-one percent of the biennial budget states feel that long-range planning is a biennial budgeting advantage. Iowa, the other state that prepares budgets biennially yet appropriates annually, said the Governor recognizes the importance of long-term planning and as such requires the agencies to project estimates for more than one year. A majority of the responding annual budget states felt that the lack of long-range planning is the major disadvantage of annual budgeting.

The disadvantages of a biennial budget process are decrease in the accuracy of revenue forecasts and expenditure estimates, and reduced legislative oversight resulting from a biennial review and analysis.

Implementation of a centralized, biennial budgetary system will be costly due to varying degrees of existing automation at the different agencies. Some agencies automated budget

systems were produced in-house for use on the personal computers, with at least one agency running their system using the state mainframe computer. Other agencies use commercial software which allows form generation, development of explanations, and flow of numbers. Some software packages used only print explanations and numbers without form generation. Finally, some decentralized components prepare budget information using electric typewriters.

Revenue and expenditure estimates will be less accurate under a biennial budget system. Under an annual budget system, agency budget personnel are forecasting revenues and expenditures 12-24 months from the present, yet under a biennial budget system these agencies will be forecasting 12-36 months in the future.

Some estimated expenditures are affected by factors which are difficult to predict, such as (1) the estimated number of students which is tied to the economic situation in the State, (2) federally mandated changes in federal programs, (3) changes in the consumer price index affecting some formula-funded programs, and (4) changes in personal services costs due to an increase in insurance or salary.

Some executive agencies felt that the legislature would have to relinquish some of the budget oversight to the agencies as programs may be revised more often due to the greater uncertainty in revenue and expenditure estimates resulting from a biennial budget. Budget revisions would involve the development of revised programs and possible supplementals.

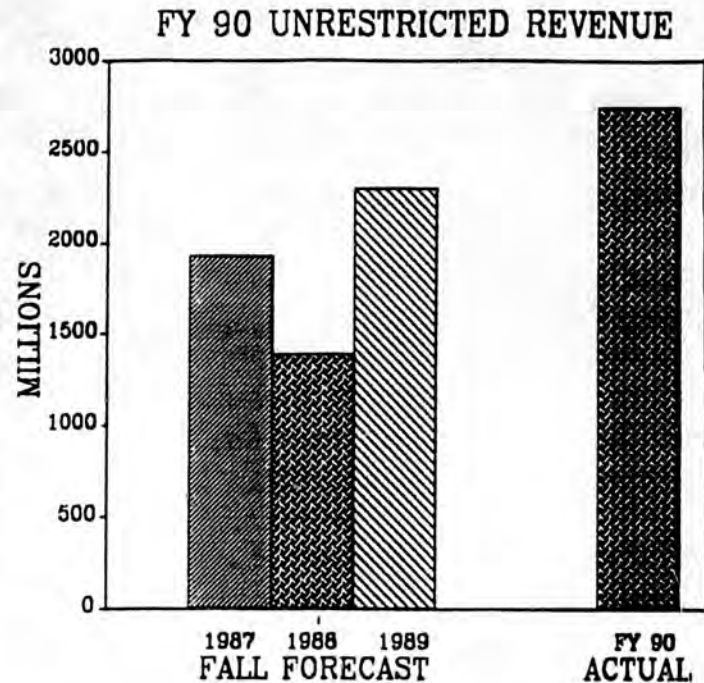
Additionally, biennial budgeting may not be as responsive to the public as annual budgeting. Some programs, such as social services programs, are driven by public needs. Annual legislative review, which includes public participation, would allow participation by the public more often.

Seventy-six percent of the biennial budget states feel that revenue estimates are more difficult to forecast for a two-year period versus one year.

Review of the Alaska revenue sources shows that the majority of our revenue is petroleum-related. According to the State of Alaska's FY 90 Annual Financial Report, when considering both restricted and unrestricted revenue, approximately 62% of our revenue is petroleum-related. Yet, when considering unrestricted revenues only, 85% of the revenue is petroleum-related.

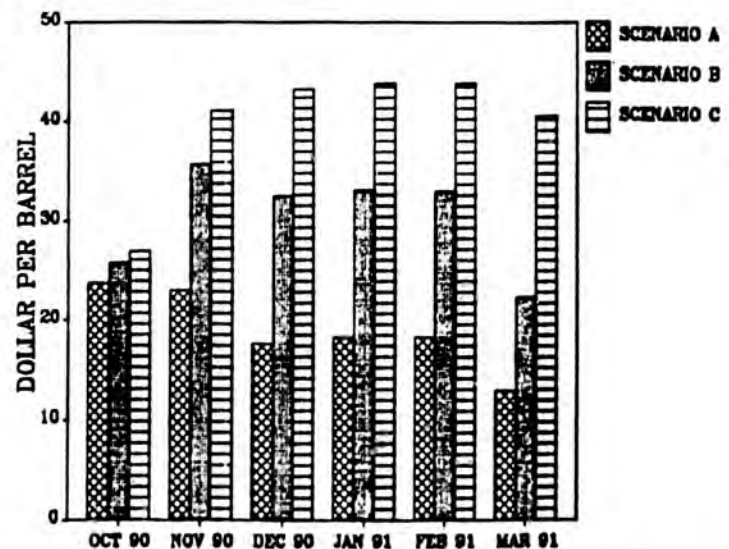
Alaska's revenue sources are unique when compared to other states revenues. According to State and Local Public Finance, 1987, by Ronald C. Fisher (using 1985 data), the five major state and local revenue sources for states are property taxes, sales taxes, state income taxes, federal grants, and user charges. These sources comprise only 23% of the revenue in Alaska.

Review of revenue forecasts prepared in the semi-annually produced State of Alaska Revenue Sources book shows mid-scenario projected revenue forecasts during the fall of 1987 through fall 1989 to be lower than actual revenue received. Normally, as the forecasts were made closer to the fiscal year being considered, the forecast became closer to the actual, yet was still underestimated. One major reason for the differences involves legal settlements. Settlements are only projected for known amounts in the current year's forecast.



In March 1988, consultant John Gault prepared a report for the Department of Revenue titled The Alaska Petroleum Revenue Forecast System. This report considered projections made in the State of Alaska Revenue Sources book between FY 81 - FY 87. In comparing revenue forecasts made in March, just three months prior to the start of the fiscal year, forecasts differed from the actual revenue by amounts ranging from nearly 25% below to over 25% above. This report notes that "these forecast errors are not unusually wide in comparison with other contemporary oil market projections."

The main sources of petroleum-related forecast uncertainty are marker price, market and quality differentials, transportation cost, Trans-Alaska Pipeline System (TAPS) tariff, and production volumes. Price changes pose the greatest uncertainty. Various revenue forecast scenarios between October 1990 and March 1991 differed by up to 200% between the lowest and the highest price estimate per barrel.



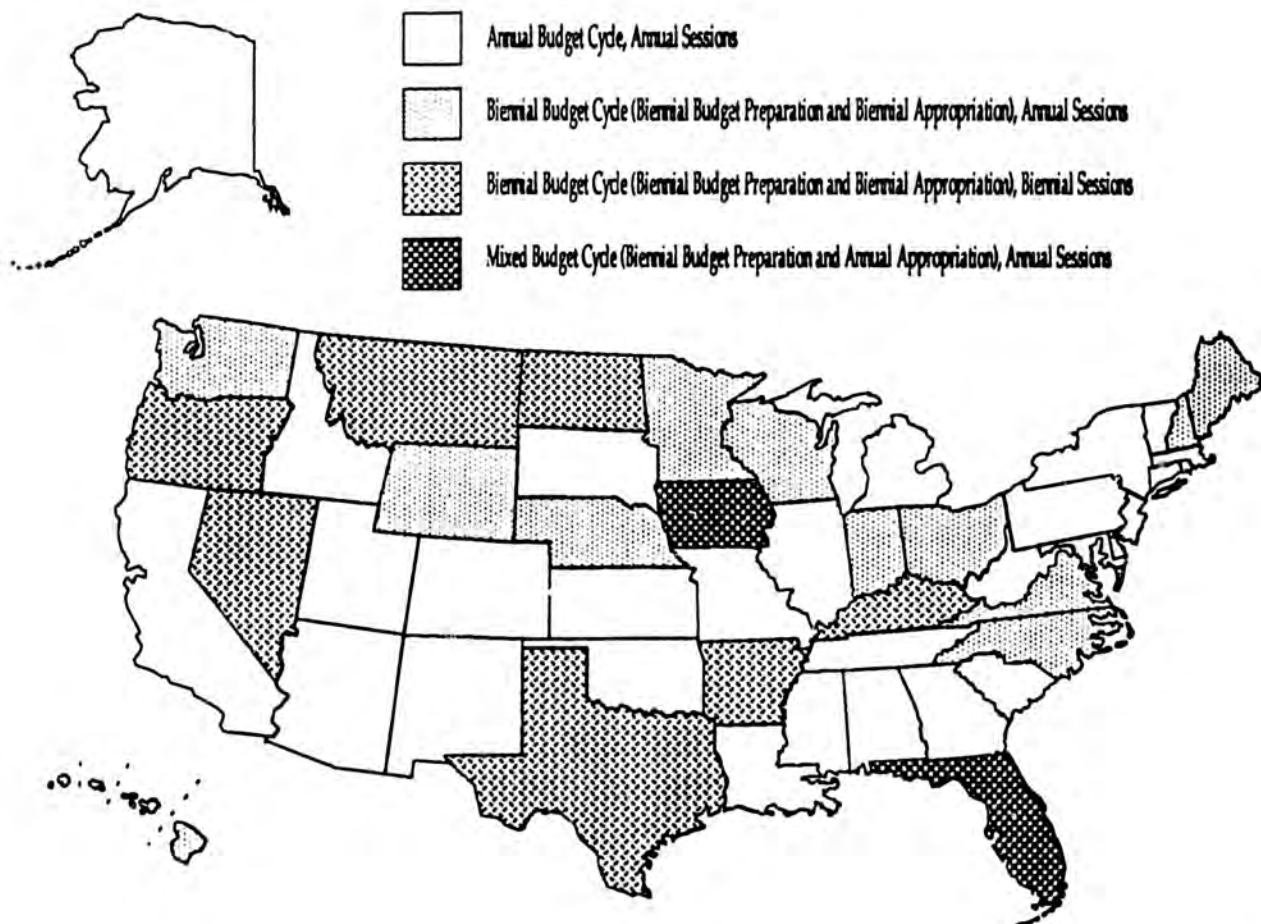
Conclusion

Conceptually, biennial budgeting presents a number of advantages. These advantages include long-range planning and less time and money spent on budget preparation. Biennial budgeting would also provide more time for program evaluation at the agency level and more opportunity to consider non-budget matters at the legislative level.

However, a biennial budget is not practical for the State of Alaska because of historical fluctuations in revenues. Significant revenue fluctuations and annual appropriation by the Legislature may result in redevelopment of the biennial budget in the off-budget year. Also, we believe that if the State changes to a biennial budget preparation, implementation will be costly and the system may be less responsive to the public.

A large percentage of state revenues is petroleum-related and, as such, involves a number of uncertainty factors, the most volatile of those being price. Revenue forecasting becomes increasingly relevant as the supply of oil in Alaska declines. If actual revenues fall significantly below budgeted expenditures presented in a biennial budget, the cost-saving benefit of biennial preparation is lost because legislative, executive, and judicial staff will be required to redevelop the budgets to recognize reductions.

If legislative personnel desire review of the budget documents in the off-budget year, which requires executive agency attendance at subcommittee meetings, presentation time, travel costs, and adjustments to budget documents, cost savings will not be recognized. Legislative review annually may be necessary in order to be responsive to the public. Currently, Alaska Statute 37.07.010 requires the budget system to include procedures for public participation in the development of an annual budget. Biennial review may not be perceived by the public to allow adequate lobbying or participation.



The nationwide trend is towards annual budgeting. Twelve states have changed to annual budget appropriations since 1967. Two of these twelve states only make the appropriation phase of the budget cycle an annual process. Florida, who changed to an annual appropriation in 1981, and Iowa, who changed in 1983, still prepare budgets biennially.

Nineteen states prepare **and** appropriate budgets biennially. Budget cycles for seven of these nineteen states are driven by biennial sessions (see exhibit on page 14). Of the twelve states that biennially appropriate yet have annual sessions, various methods are used to change budgeted amounts for programs during the biennium. Annual session states normally use supplemental appropriation bills to handle their off-budget year adjustments.

In summary, biennial budgeting theoretically should reduce costs associated with budget preparation. However, this would be true for states that have a relatively stable revenue base from which realistic projections can be made. Biennial budgeting may also affect the extent of public participation.

The national trend is moving away from biennial budgets to an annual budgetary basis. We agree with the authors, Lee and Johnson, who wrote, in Public Budgeting Systems, "One of the greatest dangers of a biennial system is that it may complicate, if not prohibit, prompt response to new conditions."

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APPENDIX

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Appendix
Schedule of Annual Operating and
Capital Budget Preparation Costs

<u>Department</u>	<u>Total Personal Services</u> (Note 1)	<u>Non- Personal Services</u>	<u>Total</u>
AGENCY DEVELOPMENT, DOCUMENTATION, AND PRESENTATION			
Office of the Governor	\$ 22,455	\$ 324	\$ 22,779
Department of Administration	154,376	5,438	159,814
Department of Commerce and Economic Development	124,913	4,672	129,585
Department of Community and Reg Affairs (Note 2)	120,713	10,345	131,058
Department of Corrections	105,769	725	106,494
Department of Education	70,917	6,041	76,958
Department of Environmental Conservation	105,922	1,370	107,292
Department of Fish and Game	362,307	58,344	420,651
Department of Health and Social Services	386,534	11,430	397,964
Department of Labor	77,417	1,484	78,901
Department of Law	55,697	400	56,097
Department of Military and Veterans Affairs	42,751	2,041	44,792
Department of Natural Resources	175,162	5,385	180,547
Department of Public Safety	87,308	3,185	90,493
Department of Revenue	108,215	12,871	121,086
Department of Transportation and Public Facilities - Operating	445,888	24,159	470,047
Department of Transportation and Public Facilities - Capital	537,064	29,894	566,958
Commercial Fisheries Entry Commission	7,720	30	7,750
Legislative	35,767	2,670	38,437
University of Alaska (Note 2)	450,000		450,000
Alaska Court System	27,153	500	27,653
TOTAL AGENCY COSTS	<u>\$3,504,048</u>	<u>\$181,308</u>	<u>\$3,685,356</u>
REVIEW AND ANALYSIS			
EXECUTIVE BRANCH			
Office of Management and Budget (Note 3)	782,640	87,930	870,570
LEGISLATIVE BRANCH			
Legislative Finance	484,116	44,372	528,488
Legislative Staff	800,139	19,081	819,220
TOTAL REVIEW AND ANALYSIS	<u>\$2,066,895</u>	<u>\$151,383</u>	<u>\$2,218,278</u>
TOTAL ALL COSTS	<u>\$5,570,943</u>	<u>\$332,691</u>	<u>\$5,903,634</u>

Notes to the Schedule

Note 1 - Personal Services Estimates

These estimates included the FY 91 average benefit rate for the department. If the statewide average benefit percentage was lower than the average benefit percentage for the respective department, we used the statewide percentage to provide the more conservative estimate of the personal services benefits.

Note 2 - University of Alaska Estimates

The University had not estimated budget preparation time at the time this report was finalized. Cost estimates used were those provided in the 1987 House Research Report on this same subject.

Note 3 - Division of Budget Review Estimates

Division of Budget Review estimates were not submitted by the Governor's Office. Statement from the transmittal said the "personnel in the Division of Budget Review work extensively on the Statewide budget on an on-going basis." Therefore, estimates from the 1987 House Research Report documentation were used which estimated 90% of staff time and non-personal services is devoted to budget preparation and review.

WALTER J. HICKEL, GOVERNOR

OFFICE OF THE GOVERNOR

OFFICE OF MANAGEMENT AND BUDGET
DIVISION OF BUDGET REVIEW

POUCH AM
JUNEAU, ALASKA 99811
PHONE: (907) 465-3568

August 22, 1991

Randy S. Welker
Legislative Auditor
Alaska State Legislature
Post Office Box W
Juneau, Alaska 99811-3300

RECEIVED
AUG 23 1991

LEGISLATIVE AUDIT

Dear Mr. Welker:

Thank you for the opportunity to review the preliminary audit report on biennial budgeting.

While this Administration has been in office just nine months, it has become evident the current budget process is extremely time-intensive and year round. For this reason, it is difficult to have the time to address major policy issues outside of the technical nature of the budget process. Even though the audit report suggests the fluctuation in Alaska's revenues would make a biennial budget impractical, I believe the concept has other potential public policy benefits which merit further discussion.

Sincerely,

Shelby Stastny **CF**

J. Shelby Stastny
Director

GAIL-

DRAFT VERSION #1 AND VERSION #2 ARE FOR CONSTITUTIONAL AMENDMENT TO PROVIDE FOR BIENNIAL BUDGETING

NOTE: I WOULD RECOMMEND THE SIMPLICITY OF VERSION #1

THE OTHER 4 PAGE DRAFT I'M SENDING IS A BILL SIMILAR TO ONE INTRODUCED BY SENATOR SACKETT IN 1979 TO PROVIDE FOR THE ESTABLISHMENT OF A JOINT BUDGET COMMITTEE AS A PERMANENT INTERIM SUBCOMMITTEE OF THE LEGISLATIVE BUDGET COMMITTEE

AS WE HAVE SPOKEN IN THE PAST, 120 DAYS IS NOT SUFFICIENT TIME TO ANALYZE AND PREPARE A REASONABLE BUDGET TO BE VOTED ON BY THE LEGISLATURE

I WOULD HAVE TO RESEARCH "WHY"? THIS BILL DID NOT BECOME LAW; HOWEVER, I COULD SPECULATE THAT, GIVEN THE YEAR IT WAS INTRODUCED AND THE FACT THAT SENATORS SACKETT AND HOHMAN WERE QUITE POWERFUL DURING THAT TIME AND GIGANTIC OIL REVENUES WERE ANTICIPATED, IT WAS FEARED THAT THIS COMMITTEE WOULD BECOME "ALL POWERFUL" - THAT'S JUST SPECULATION ON MY PART

**SGN
10/26/94**

GAIL-

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COMMITTEE WOULD BECOME "ALL POWERFUL" - THAT'S JUST SPECULATION ON MY
PART

SGN
10/26/94

IN THE HOUSE

BY G. PHILLIPS

HOUSE JOINT RESOLUTION NO.
IN THE LEGISLATURE OF THE STATE OF ALASKA
NINETEENTH LEGISLATURE - FIRST SESSION

PROPOSING AN AMENDMENT TO THE CONSTITUTION OF THE STATE OF ALASKA TO PROVIDE FOR A BIENNIAL STATE BUDGET.

BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:

*SECTION 1. ARTICLE IX, SEC. 12, CONSTITUTION OF THE STATE OF ALASKA, IS AMENDED TO READ:

SECTION 12. BUDGET. THE GOVERNOR SHALL SUBMIT TO THE LEGISLATURE, AT A TIME FIXED BY LAW, A BUDGET FOR THE NEXT TWO FISCAL YEARS [YEAR] SETTING FORTH ALL PROPOSED EXPENDITURES AND ANTICIPATED INCOME OF ALL DEPARTMENTS, OFFICES, AND AGENCIES OF THE STATE. THE GOVERNOR, AT THE SAME TIME, SHALL SUBMIT A GENERAL APPROPRIATION BILL TO AUTHORIZE THE PROPOSED EXPENDITURES, AND A BILL OR BILLS COVERING RECOMMENDATIONS IN THE BUDGET FOR NEW OR ADDITIONAL REVENUES.

* SEC. 2. THE AMENDMENT PROPOSED BY THIS RESOLUTION SHALL BE PLACED BEFORE THE VOTERS OF THE STATE AT THE NEXT GENERAL ELECTION IN CONFORMITY WITH ART. XIII, SEC. 1, CONSTITUTION OF THE STATE OF ALASKA, AND THE ELECTION LAWS OF THE STATE.

IN THE LEGISLATURE OF THE STATE OF ALASKA

HOUSE JOINT RESOLUTION NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA

NINETEENTH LEGISLATURE - FIRST SESSION

PROPOSING AN AMENDMENT TO THE CONSTITUTION OF THE STATE OF ALASKA TO PROVIDE BIENNIAL BUDGETING.

BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:

***SECTION 1. ARTICLE IX, SEC. 12, CONSTITUTION OF THE STATE OF ALASKA, IS AMENDED TO READ:**

SECTION 12. BUDGET. IN EACH ODD-NUMBERED YEAR THE GOVERNOR SHALL SUBMIT TO THE LEGISLATURE, AT A TIME FIXED BY LAW, A BUDGET SETTING FORTH ALL PROPOSED OPERATING EXPENDITURES FOR THE NEXT FISCAL BIENNIUM AND ALL PROPOSED CAPITAL EXPENDITURES FOR THE NEXT FISCAL YEAR. IN EACH EVEN-NUMBERED YEAR THE GOVERNOR SHALL SUBMIT TO THE LEGISLATURE, AT A TIME FIXED BY LAW, A BUDGET SETTING FORTH ALL PROPOSED CAPITAL EXPENDITURES FOR THE NEXT FISCAL YEAR. EACH BIENNIAL BUDGET SUBMISSION SHALL SET FORTH ANTICIPATED INCOME FROM ALL DEPARTMENTS, OFFICES AND AGENCIES OF THE STATE [THE GOVERNOR SHALL SUBMIT TO THE LEGISLATURE, AT A TIME FIXED BY LAW, A BUDGET FOR THE NEXT FISCAL YEAR SETTING FORTH ALL PROPOSED EXPENDITURES AND ANTICIPATED INCOME OF ALL DEPARTMENTS, OFFICES, AND AGENCIES OF THE STATE]. THE GOVERNOR, AT THE SAME TIME, SHALL SUBMIT A GENERAL

IN THE HOUSE

BY G. PHILLIPS

HOUSE JOINT RESOLUTION NO.
IN THE LEGISLATURE OF THE STATE OF ALASKA
NINETEENTH LEGISLATURE - FIRST SESSION

PROPOSING AN AMENDMENT TO THE CONSTITUTION OF THE STATE OF ALASKA TO PROVIDE BIENNIAL BUDGETING.

BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:

*SECTION 1. ARTICLE IX, SEC. 12, CONSTITUTION OF THE STATE OF ALASKA, IS AMENDED TO READ:

SECTION 12. BUDGET. IN EACH ODD-NUMBERED YEAR THE GOVERNOR SHALL SUBMIT TO THE LEGISLATURE, AT A TIME FIXED BY LAW, A BUDGET SETTING FORTH ALL PROPOSED OPERATING EXPENDITURES FOR THE NEXT FISCAL BIENNIUM AND ALL PROPOSED CAPITAL EXPENDITURES FOR THE NEXT FISCAL YEAR. IN EACH EVEN-NUMBERED YEAR THE GOVERNOR SHALL SUBMIT TO THE LEGISLATURE, AT A TIME FIXED BY LAW, A BUDGET SETTING FORTH ALL PROPOSED CAPITAL EXPENDITURES FOR THE NEXT FISCAL YEAR. EACH BIENNIAL BUDGET SUBMISSION SHALL SET FORTH ANTICIPATED INCOME FROM ALL DEPARTMENTS, OFFICES AND AGENCIES OF THE STATE [THE GOVERNOR SHALL SUBMIT TO THE LEGISLATURE, AT A TIME FIXED BY LAW, A BUDGET FOR THE NEXT FISCAL YEAR SETTING FORTH ALL PROPOSED EXPENDITURES AND ANTICIPATED INCOME OF ALL DEPARTMENTS, OFFICES, AND AGENCIES OF THE STATE]. THE GOVERNOR, AT THE SAME TIME, SHALL SUBMIT A GENERAL

DRAFT - VERSION #2 - CONTINUED

**APPROPRIATION BILL TO AUTHORIZE THE PROPOSED EXPENDITURES, AND A
BILL OR BILLS COVERING RECOMMENDATIONS IN THE BUDGET FOR NEW OR
ADDITIONAL REVENUES.**

*** SEC. 2. THE AMENDMENT PROPOSED BY THIS RESOLUTION SHALL BE PLACED
BEFORE THE VOTERS OF THE STATE AT THE NEXT GENERAL ELECTION IN CONFORMITY
WITH ART. XIII, SEC. 1, CONSTITUTION OF THE STATE OF ALASKA, AND THE
ELECTION LAWS OF THE STATE.**

**10/21/94
SGN**

DRAFT

IN THE HOUSE

BY G. PHILLIPS

HOUSE BILL NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA
NINETEENTH LEGISLATURE - FIRST SESSION

FOR AN ACT ENTITLED: "AN ACT RELATING TO THE LEGISLATIVE BUDGET AND
AUDIT COMMITTEE; ESTABLISHING A JOINT BUDGET
SUBCOMMITTEE; AND PROVIDING FOR AN EFFECTIVE
DATE."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* SECTION 1. AS 24.20.161 IS AMENDED TO READ:

SEC. 24.20.161. MEMBERSHIP. THE LEGISLATIVE BUDGET AND AUDIT
COMMITTEE IS COMPOSED OF 10 MEMBERS: (1) THE CHAIRMEN OF THE SENATE
AND HOUSE FINANCE COMMITTEES; (2) ONE MAJORITY AND ONE MINORITY
MEMBER SELECTED FROM EACH OF THE SENATE AND HOUSE FINANCE COMMITTEES
AND APPOINTED BY THE PRESIDENT OF THE SENATE AND SPEAKER OF THE HOUSE
RESPECTIVELY; AND (3) TWO [THREE] MEMBERS APPOINTED FROM EACH HOUSE
BY THE RESPECTIVE PRESIDING OFFICER. [THE CHAIRMAN OF THE FINANCE
COMMITTEE MAY CHOOSE NOT TO SERVE ON THE COMMITTEE. IF THIS OCCURS,
THE PRESIDING OFFICER OF THE APPROPRIATE HOUSE SHALL APPOINT A
REPLACEMENT FROM THE FINANCE COMMITTEE. THE MEMBERSHIP FROM EACH
HOUSE SHALL INCLUDE AT LEAST ONE MEMBER FROM EACH OF THE TWO
MAJOR POLITICAL PARTIES.] THE COMMITTEE SHALL SELECTS ITS OWN
CHAIRMAN.

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*** SEC. 2. AS 24.20 IS AMENDED BY ADDING A NEW SECTION TO READ:**

SEC. 24.20.195. JOINT BUDGET COMMITTEE. (A) THE JOINT BUDGET COMMITTEE IS ESTABLISHED AS A PERMANENT INTERIM SUBCOMMITTEE OF THE LEGISLATIVE BUDGET AND AUDIT COMMITTEE. THE SUBCOMMITTEE IS COMPOSED OF THE SIX MEMBERS OF THE FINANCE COMMITTEE SERVING ON THE LEGISLATIVE BUDGET AND AUDIT COMMITTEE IN ACCORDANCE WITH AS 24.20.161(1) AND (2).

(B) THE JOINT BUDGET COMMITTEE SHALL

(1) REVIEW STATE REVENUE PROJECTIONS AND MAKE RECOMMENDATIONS CONCERNING REVENUES TO THE LEGISLATURE, AS PROVIDED IN THE EXECUTIVE BUDGET ACT (AS 37.07); AND

(2) REVIEW REQUESTS FOR STATE AGENCY ANNUAL PROGRAM APPROPRIATIONS AND SUPPLEMENTAL APPROPRIATIONS, AND MAKE RECOMMENDATIONS ON THESE REQUEST TO THE LEGISLATURE IN THE FORMAT OF AN APPROPRIATION BILL, ACCOMPANIED BY THE DOCUMENTATION FOR APPROPRIATION BILLS PREPARED BY THE LEGISLATIVE FINANCE DIVISION.

*** SEC. 3. AS 37.07.070 IS AMENDED TO READ:**

SEC. 37.07.070. LEGISLATIVE REVIEW. THE LEGISLATURE SHALL CONSIDER THE GOVERNOR'S PROPOSED COMPREHENSIVE OPERATING AND CAPITAL IMPROVEMENTS PROGRAMS AND FINANCIAL PLANS, EVALUATE ALTERNATIVES TO THE PLANS, MAKE PROGRAM SELECTIONS AMONG THE VARIOUS ALTERNATIVES AND DETERMINE, SUBJECT TO AVAILABLE REVENUES, THE LEVEL OF FUNDING REQUIRED TO SUPPORT AUTHORIZED STATE SERVICES. THE OPERATING AND CAPITAL BUDGETS OF EACH AGENCY SHALL BE SEPARATELY REVIEWED. DURING EACH REGULAR SESSION OF THE LEGISLATURE, LEGISLATIVE REVIEW OF THE PLANS: THE GOVERNOR'S SUPPLEMENTAL

DRAFT

APPROPRIATION BILLS AND THE GOVERNOR'S BUDGET AMENDMENTS SHALL BE ACCOMPLISHED ACCORDING TO THE FOLLOWING SCHEDULE: [GOVERNED BY THE FOLLOWING TIME LIMITS:]

(1) REQUESTS BY THE GOVERNOR FOR SUPPLEMENTAL APPROPRIATIONS FOR STATE AGENCY OPERATING AND CAPITAL BUDGETS FOR THE CURRENT FISCAL YEAR MAY BE INTRODUCED BY THE RULES COMMITTEE ONLY THROUGH THE 30TH LEGISLATIVE DAY.

(2) BY THE 45TH LEGISLATIVE DAY, THE LEGISLATURE SHALL HAVE ESTABLISHED BY CONCURRENT RESOLUTION THE TOTAL AMOUNT OF STATE GENERAL FUNDS THAT SHALL BE AVAILABLE FOR APPROPRIATION FOR THE BUDGET YEAR AND THE TENTATIVE ALLOCATION OF THE FUNDS AMONG PROGRAM CATEGORIES IN BOTH THE OPERATING AND CAPITAL BUDGETS. THE RESOLUTION SHALL BE INTRODUCED BY THE JOINT BUDGET COMMITTEE.

[2] (3) REQUESTS BY THE GOVERNOR FOR BUDGET AMENDMENTS TO STATE AGENCY BUDGETS FOR THE BUDGET FISCAL YEAR MAY BE RECEIVED AND REVIEWED BY THE FINANCE COMMITTEES ONLY THROUGH THE 60TH LEGISLATIVE DAY.

(4) BY THE 90TH LEGISLATIVE DAY, THE HOUSE IN WHICH THE GENERAL APPROPRIATIONS BILL WAS INTRODUCED BY THE GOVERNOR SHALL HAVE CALENDARED FOR SECOND READING A VERSION OF THE GENERAL APPROPRIATIONS BILL AS REPORTED BY THE JOINT BUDGET COMMITTEE. THE BILL SHALL BE REPORTED WITH DOCUMENTATION TO EXPLAIN THE PROPOSED APPROPRIATIONS AND RELATED STATEMENTS OF INTENT. IN ADDITION, A LIST OF OTHER APPROPRIATIONS OR MEASURES WITH FISCAL IMPLICATIONS

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**PENDING BEFORE THE LEGISLATURE SHALL BE INCLUDED WITH DOCUMENTATION
FOR THE CALENDARED BILL.**

*** SEC. 4. AS 24.20.201(B) IS REPEALED.**

*** SEC. 5. THIS ACT TAKES EFFECT JANUARY 1, 1997.**

GAIL:

AT LONG LAST HERE IS YOUR BIENNIAL STATE BUDGET BILL DRAFT.

I HAVE SCANNED THE STATUTES FOR ALL THE NECESSARY CHANGES; HOWEVER, I WOULD SUGGEST YOU HAVE LEGAL SCAN BY COMPUTER ALL THE STATUTES AND 1993 AND 1994 SUPPLEMENTS TO LOOK FOR THE WORD "ANNUALLY", "ANNUAL BUDGET", ETC. - AN EXAMPLE WOULD BE SEC. 37.14.415 BUDGET AND REPORTS THAT MAY NEED TO BE AMENDED.

**SGN
11-23-94**

DRAFT

IN THE HOUSE

BY G. PHILLIPS

HOUSE BILL NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA
NINETEENTH LEGISLATURE - FIRST SESSION

FOR AN ACT ENTITLED: "AN ACT ESTABLISHING A BIENNIAL STATE BUDGET; AND
PROVIDING FOR AN EFFECTIVE DATE."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* SECTION 1. INTENT. IT IS THE INTENT OF THE LEGISLATURE THAT THE PLANNING AND PREPARATION OF THE STATE BUDGET BE ON A BIENNIAL BASIS. THE BIENNIAL BUDGET SHALL CONTAIN APPROPRIATIONS FOR THE SUCCEEDING TWO FISCAL YEARS AND STATE AGENCIES SHALL PREPARE THEIR BUDGETS ON THIS BASIS. HOWEVER, THE LEGISLATURE FURTHER INTENDS THAT REPORTING AND AUDITING REQUIRED OF STATE AGENCIES BY LAW REMAIN ON AN ANNUAL BASIS, FOR EACH FISCAL YEAR OF THE BIENNIAL BUDGET.

* SEC. 2. AS 05.40.210 IS AMENDED TO READ:

SEC. 05.40.210. BUDGET AND APPROPRIATIONS. THE AUTHORITY SHALL SUBMIT ITS BIENNIAL [ANNUAL] BUDGET TO THE LEGISLATURE THROUGH THE GOVERNOR AS PROVIDED FOR STATE AGENCIES BY AS 37.07 (EXECUTIVE BUDGET ACT). THE AUTHORITY SHALL EXPEND MONEY APPROPRIATED BY THE LEGISLATURE AS AUTHORIZED BY THE LEGISLATURE.

* SEC. 3. AS 14.17.255(B) IS AMENDED TO READ:

(B) MONEY TO CARRY OUT THE PROVISIONS OF AS 14.17.010 - 14.-17.190 MAY BE APPROPRIATED [ANNUALLY] BY THE LEGISLATURE INTO THE PUBLIC SCHOOL FOUNDATION ACCOUNT. IF AMOUNTS IN THE ACCOUNT ARE