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Anchorage Daily News

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OPINION

OUR VIEW

Principles of
a fiscal plan

Seven keys to progress

First in a series

Alaska's \$1 billion fiscal gap threatens to swamp our current prosperity in red ink and economic disarray. Nothing the Alaska Legislature could do — or not do — matters more than building sound fiscal foundations. As legislators struggle to craft a workable plan to put state finances onto a sustainable basis, seven key ideas should guide their work.



1. START NOW

The first principle is the most important. The longer we wait, the harder this job will be. The longer we wait, the fewer resources we'll have to deal with the problem. The longer we wait, the bigger the damage to the economy. The worst choice now is to do nothing because the long, slow fiscal deterioration of the past decade threatens to trigger a recession, or worse, if the slide deepens.

2. USE ALL THE OPTIONS

The second principle is to accept the wisdom of every study group and expert analysis that's been done for more than a decade. Alaska has plenty of money and plenty of choices; we just don't any longer have the luxury of a permanent free lunch. We can fix the problem and improve our prospects without much difficulty if we use a balanced approach: taking something from Permanent Fund earnings, ratcheting back the dividend, installing some form of general taxes and encouraging growth by closing the fiscal gap.

3. MAKE IT FAIR

Principle three means to spread the burdens among all Alaskans. This means recognizing the idea of progressiveness: That people who benefit the most from society should give the most back or, at the other end of life's fortunes, that people who live closest to the edge should be burdened less. It is a matter of elemental fairness deeply rooted in American society, and no less true in Alaska even if often forgotten in our 20-year freedom from general taxes.

4. RAMP IT UP GRADUALLY

Principle four would give families and businesses time to adjust. Giving people time to adjust their patterns of spending and investment will make everything easier at the individual level and less damaging at the economy-wide level. If principle four is not followed, its reverse will swiftly become apparent: The sharper the turn required, the greater the short- and long-term damage to families

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and communities.

5. CLOSE THE "ALASKA DISCONNECT"

Principle five means removing a big negative result of growth. Under current laws, every new business, new job or new Alaska citizen actually damages our finances because we have no means of reclaiming the public costs. We are, as Anchorage businessman (and now lieutenant governor candidate) Ernie Hall points out, fiscal liabilities rather than assets. No community can prosper, long term, in that predicament. Thousands of new jobs in a growing economy would mean thousands of new schoolkids, more demand for road maintenance and police, increased use of parks and boat ramps, all the ordinary public accommodations of a prosperous state. In every other state, growth brings fiscal relief. In Alaska it brings more strain. To position ourselves to succeed, we need to close the disconnect.

6. ACCEPT NO GIMMICKS

Sooner or later the free lunch of the current era will change; sooner is better because it is less painful and more likely to lay the foundation for growth. But the political impulse will be to find some excuse to dissemble or delay, some popular gimmick that avoids the problem. Recent examples include proposals for a spending limit, a tax limit or just arbitrary spending cuts. These aren't going to solve the fiscal gap, no matter how much we wish they could. In the long run the economic fundamentals will dominate our choices. The fewer gimmicks we indulge before coming to grips with reality, the better off we'll be.

7. WE'RE ALL IN THIS TOGETHER

A lot of people are running around Juneau saying, in essence, leave me alone and hit somebody else first. That's both understandable and short-sighted. The truth is, very few Alaskans are immune to the risks posed by the fiscal gap. The answer to the don't-hit-me-first appeal is simple: Hit all of us first. We all face the threat; we all have enjoyed the long oil-fueled vacation from responsibility; we all should step up now for a solution.

Alaska cannot and will not prosper without a sound fiscal order. Even in decline, state oil revenues along with federal agencies and grants are a mainstay of Alaska's economy. Put the state's fiscal house in order now and our general prosperity can continue. Avoid the problem much longer and the consequences will be increasingly painful and difficult. And that takes us right back to principle one: Start now.

■ ■ ■

Alaska has the means to repair its fiscal foundations and restore a sense of opportunity and growth. Over the next week we will examine components of a proposal to close the state's \$1 billion-a-year fiscal gap and improve our future prospects.

Today: Principles of a fiscal plan

Monday: An overview of a fiscal plan.

Tuesday: Thinking about spending.

Wednesday: An income tax first.

Thursday: Sin taxes and other revenues.

Friday: What's the Permanent Fund for?

Saturday: Rethinking the dividend.

Sunday: Positioning Alaska for the future.



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OPINION

OUR VIEW

Fiscal sense

Here's how Alaska can win

Second in a series

Alaska's \$1 billion-a-year fiscal gap is a serious problem, but it is manageable if we keep our heads and act decisively. The best way is to keep our balance, to take something from each of several sources while ratcheting up changes gradually. Here is a proposal for how:

REFORM BUT DON'T ROLL BACK SPENDING

Alaska's economy is built largely around public spending, federal and state. This has been true for more than a century and likely will continue. Alaska's wealth, mostly land and natural resources, is owned largely in common. Any change in the fiscal picture must recognize that virtually everyone who lives and works here, public sector or private, depends heavily on government spending. We have already cut state spending by one-third in real terms in the past decade — the only state even to approach such cuts. This is not the time to further roll back services. Impact on the fiscal gap: not much.



START WITH AN INCOME TAX

The first big bite from the \$1 billion fiscal gap should come from a graduated income tax built on the time-honored principle of progressivity. Alaska had just such a system until 1980, when it abolished general taxes in the first big flush of oil revenues. Forty-three states choose an income tax as a mainstay of their fiscal structure; Alaska should too. An income tax with inflation-adjusted brackets based on the pre-1980 system would raise \$660 million. At just half that impact, we could close a third of the gap and keep Alaskans among the lowest-taxed individuals in the U.S. To minimize the difficulties of adjusting, we should increase the tax gradually over five years. Impact on the fiscal gap: \$330 million.

USE ALASKA PERMANENT FUND EARNINGS

For 25 years we've been accumulating savings in the Alaska Permanent Fund by trading the value of our oil in the ground for money in the bank. So far, all we've done with our earnings are pay ourselves dividends and add to the fund's value and growth. Those little blue umbrella pins you see on coat lapels around town are a harbinger of change. They say essentially that "the rainy day has come" and it's time to use our fund for common purposes. Payouts from the fund should be made on an endowment model providing 5 percent of its value in a given year — a figure that research indicates will maximize the payout and preserve the fund. The payout should be split between individual dividends and state services, in a proportion to be determined each year by the Legislature. Impact on the fiscal gap: \$500 million to \$600 million.

DECREASE THE DIVIDEND

Alaska's Permanent Fund dividend has been a remark-

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able experiment, but now we can afford less and less of it. Over time, income supports to citizens should be crafted more on the basis of work or need and less on mere presence. Because we have created the fund and made it grow, we can still afford to pay ourselves a dividend to protect our stake in its future. But the dividend now should be phased back — slowly, so we all can adjust. The balance between individual dividends and support for public services could shift with changing needs, but over the long run we should reduce our dependence on an unearned state dividend check. Impact on the fiscal gap: depends on future legislatures.

ADD SMALLER TAXES AND REVENUES

An alcohol tax increase could raise \$30 million a year or more and would help offset the estimated \$450 million alcohol abuse costs the economy each year. A cruise ship head tax could raise another \$30 million to \$35 million, and a hike in the fuels tax a similar amount. Together these new levies would contribute only about one-tenth the amount needed to close the fiscal gap, but they would diversify and stabilize the tax base and call on industries and consumers of specific high-value items to contribute. Impact on the fiscal gap: about \$100 million.

REVISIT OIL TAXES

Alaska has a fiscal gap because the golden goose of oil isn't as golden as it used to be. The reality is Alaskans can no longer expect oil companies or anyone else to pay nearly all the bills for state government. That said, the fiscal gap is so big and so serious that no industry can be exempted from the solution, not even oil. Impact on the fiscal gap: \$100 million.

■ ■ ■

Taken together, the elements of this proposal would close the state's current \$1 billion fiscal gap and give Alaska the tools for a more sustainable future. They would minimize the negative impacts on the overall economy while providing a more solid foundation for growth.

Everybody, in the end, would give a little to avoid the coming crash and position the state for growth. But it can't be done with a reactionary spirit. The enemy of a better future for Alaska is the absolutism that says, in essence, don't bother me; make it somebody else's problem. The answer is this is everybody's problem, and we should come together as Alaskans to fix it.

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OUR VIEW

Spending

*We all benefit, no matter
which sector we work in*

Third in a series

Alaskans waste far too much time and antagonism on the question of whether we, as a state, spend too much or too little. In the debate over closing Alaska's \$1 billion fiscal gap, we'd do well to lay off the ideology, think hard about what we need and go with what works.

We are privileged with oil revenues that give us a huge head start on funding state needs, but we also face the challenge of a vast expanse of territory and diversity of communities. It costs a lot to live here, and it's worth every penny. State services, too, reflect that reality.

There is no such thing as an ideal level of spending, but there are consequences to our decisions. Schools are run well or badly. Potholes are filled or not. Parks are equipped or neglected. Troopers are hired or fired. Food inspections protect us or not. Research drives progress or stagnation retards it. Culture finds outlets or it withers. Fisheries management improves or regresses. The poor and the sick are lifted or left to private devices and charity. No society succeeds without sound public investments in these and many other endeavors. No society holds the line in the long run except by going into decline.

Is that our purpose?

Our society in Alaska has sweated the obvious fat out of its system with a decade of budget cuts and shrinking expectations. General fund spending declined 33 percent, in real terms, in the past decade. Per capita general fund spending is now more than \$1,100 lower than it was in 1979, at the outset of the oil era.

Further state spending cuts would make us weaker, not stronger. Our mission now is to find new revenues to stabilize our finances and new ideas to make the private economy a stronger partner for development.

THE UPSIDE

For a century, Alaska's economy has been built largely around public spending, both federal and state. As many as half the jobs in Alaska arise from government spending and its multiplier effect. Alaska's wealth, by virtue of public ownership of land and natural resources, is controlled largely by public institutions. This means nearly everyone who participates in the economy here — public sector or private — wins when public spending grows and suffers when it shrinks. Like it or not, we are all involved. For sound economic reasons, then, spending cuts are the most damaging answer to the fiscal gap. All this adds to the importance and impact of state services beyond the conventional benefits of roads, schools, police, public health and the like. Our economy is built this way and can't be significantly changed without major shock.

It's tempting but misleading to overstate the ways rural



B-4 Tuesday, April 9, 2002

Alaska benefits from state spending. Many funding formulas recognize the higher costs there and hence send more dollars to the Bush. Many services are provided by the state in communities with little or no local tax base and few private-sector jobs. But these high public costs in rural Alaska are a big piece of the economic pie in urban Alaska too, where services, contracting, supply, education, transportation and health-care industries are based.

Urban Alaska enjoys the comforts of a modern First World way of life, though not yet the benefits of a fully diversified economy or major population base. Rural Alaska is less fortunate. Over the past 30 years, most of rural Alaska has moved from Third World status to something more like the "Second World." Basic transportation, communication, education, health and social services are provided largely by the state. But the stakes are high: Indiscriminate budget cuts threaten a needless decline back to Third World status. What people often don't stop to notice is that urban Alaska would suffer, too.

THE DOWNSIDE

State spending paid for with oil revenues has few obvious losers, but long-term dependency is a deepening worry as those revenues decline. The risks are twofold: Deep cuts driven by revenue losses could send the economy into recession, as we saw in 1986 and 1987, or big tax hikes to fill the gaps could take too deep a bite out of industries and individuals. Either way, everyone suffers more if the changes are precipitous, and unsustainable fiscal practices are the ultimate culprit. Virtually everyone suffers in a general decline — through job losses, wage cuts, property value losses, business failures, diminished prospects. The fiscal gap amounts to a train wreck occurring in slow motion. But if we're smart we still can avoid it.

THE BOTTOM LINE

Alaskans may not always appreciate state services, but they use them and need them. The ideologues calling for revolution in state government reflect not the suffering of the masses but the anomalies and contradictions — and, yes, the inefficiencies — of our necessary embrace of government. What's needed is reform, not a rollback. State government is one of the engines of our economy and society; we should keep it oiled and tuned. To diminish our dependence, we should keep working for a strong private sector around and above the public sector.

For good reasons, we spend a lot. For other good reasons, it's not always enough. A much better question is: What should we do to prepare for the future and live within our means? In the long conversation of Alaska's democracy, this is the question that should linger.

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OUR VIEW

Income tax comes first

It's fair, so let's phase it in

Fourth in a series

Progressivity is at the nub of the argument over what taxes will best help cure Alaska's \$1 billion-a-year fiscal gap. There's no way to craft a lasting solution without including a broad-based tax, because without one there's no way to close the "Alaska Disconnect" that makes new growth a liability to everyone.

And with Alaska's budget sinking into red ink, the principle of progressivity — if wisely applied — offers simple guidance: We're all in this lifeboat together, and the strongest among us should pull the biggest oars.

The oars shouldn't be too big to handle easily. Everyone should pull. A progressive income tax must not be confiscatory or it will defeat its own purpose. At the other end of the policy balance, it should not be riddled with exceptions available only to the privileged.

But these are the details of design. The concept of a progressive income tax puts a solid leg under Alaska's revenue structure and is the best means of turning new jobs and growth into an asset rather than a liability. It's a painful but necessary part of a solution.



THE UPSIDE

An income tax based on graduated tax brackets is the fairest way to collect the necessary money from large numbers of Alaskans. Those who enjoy the most fruits of society's opportunities contribute the most. Those with the least pay little. Equity is served — and for many people that is the fundamental value.

But in Alaska there are three other compelling reasons to choose an income tax among the available solutions.

First, an income tax takes the smallest chunk out of the overall economy. A small part of income tax revenues would be contributed by out-of-state workers who currently give back nothing in Alaska. That is reasonable and appropriate. A larger, more important part would be contributed by the federal government because state income taxes are deductible from federal income taxes. (This is a big reason why 43 states have chosen income taxes as a mainstay of their fiscal structure.) All told, Alaskans would pay about 75 cents of every dollar collected under an income tax, according to University of Alaska economist Scott Goldsmith.

Second, an income tax helps close the "Alaska disconnect" whereby new jobs and growth actually leave us worse off than before because they impose new costs that can't be recouped. This perverse incentive not only increases as population grows, but also puts growing un-

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certainty and risk into the investment climate. A rational company examining whether to locate here today has to wonder whether services will survive or industries will be hit suddenly with the bill. Closing the disconnect gives us a better chance of diversifying our economy and broadening our revenue base.

Finally, local governments already depend on sales taxes, the other major tax option. Sales taxes are high enough in many communities; a state sales tax not only could become confiscatory and regressive, but also would tend to drive down retail sales and business. They also would tend to drive up property taxes.

THE DOWNSIDE

Very poor Alaskans would pay no income tax under most proposals thus far. Those who favor a sales tax over an income tax say that everyone should pay something. But a sales tax is not the only way to accomplish that goal. Any fiscal plan that uses Alaska Permanent Fund earnings makes every Alaskan participate by reducing future Permanent Fund dividends received by all.

High tax rates may discourage work or investments. They may drive some work into the underground, unreported economy. They may shift income into unproductive tax shelters.

Some critics contend that an income tax penalizes those who show initiative and get ahead. Those critics forget that not everyone is born with equal advantages. Health, family support, access to education, the stability of a society and the state of its economy all make a huge difference in whether people prosper or fail. These are factors beyond an individual's control. A progressive income tax helps make up for the arbitrary way many advantages and opportunities are distributed in society.

A \$350 million income tax, started all at once, could be quite a jolt to personal finances and to the state economy. To soften the impact, it should be phased in over five years.

THE BOTTOM LINE

Alaska had an income tax before the big oil money rolled in, back when Alaskans really had to pay for things the state needed. The income tax was part of how people pitched in to help build the state.

Today, too many so-called Alaskans want somebody else — the feds, oil companies, out-of-state workers, tourists, drinkers, smokers — to support them in the style of government and giveaways to which we've become accustomed.

That free ride is just about over. One way or another, necessity will end it. The question is how Alaskans should begin contributing something toward our common efforts to build a better future. One answer is a state income tax.

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OPINION

OUR VIEW

Breaking the spell

Time to use Permanent Fund

Fifth in a series

It's time to see the Alaska Permanent Fund for what it is: A blessing of riches to use, not worship, for the public good of Alaskans today and generations to come. It's time to use some of its earnings to pay for public services and make the principal as permanent as we can.



Alaska voters created the Permanent Fund in 1976; beginning in 1983, Alaskans have received a Permanent Fund dividend check. Over 20 years, we've built the fund into a machine churning out bigger and bigger dividends that topped out at almost \$2,000 in 2000.

The Permanent Fund has earned \$25 billion since the first deposit in February 1977, according to Deputy Revenue Commissioner Larry Persily. We've saved \$14 billion and paid out \$11 billion in dividends.

Is that all the Permanent Fund is for?

No.

In 1999, Department of Revenue Commissioner Wilson Condon made a short speech announcing that year's dividend. He reminded Alaskans of Article 1, Section 1 of the Alaska Constitution. There we affirm our natural rights to life, liberty, the pursuit of happiness and the enjoyment of the rewards of our own industry. But Mr. Condon pointed out that the Declaration of Inherent Rights includes responsibilities:

"All persons have corresponding obligations to the people and to the state."

Good stewardship of the \$25 billion Permanent Fund is a vital part of meeting those obligations to one another and to our children. To that end, Alaskans need to see the fund as more than a dividend machine.

First, we should guarantee the fund's permanence by approving a constitutional amendment that would make the fund an endowment, paying out no more than 5 percent of a five-year market value average each year.

Second, we should devote some of those earnings to public services.

THE UPSIDE

Clark Grunning, one of the Permanent Fund's trustees, has said the endowment plan is the best way to guarantee the fund's permanence. Historically, lawmakers have been scrupulous in not only inflation-proofing the fund, but in loading it with extra deposits to speed its growth.

Inflation-proofing is protected only in statute, however, and that would be easy for a future Legislature to change.

Embodied in the Constitution, the 5 percent payout limit would be as close as we can get to written in stone. Given an average annual return of about 8.25 percent and

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an inflation rate likely to average about 3 percent, the amendment would protect the fund from inflation for keeps. It would continue to benefit Alaskans long after this generation was gone.

If we spend some of the earnings of the Permanent Fund to provide state services, to maintain and enhance our roads, schools, public safety and university, we'd be investing in a society that doesn't blunt free enterprise and the private sector but provides the foundation for it. As Mr. Condon said, we must recognize "the need to spend money as a community to protect our freedom as individuals."

THE DOWNSIDE

There's no getting around it: We'd all see a dip in dividends and the joys they bring — not only individual spending or saving, but also less cash circulating in the economy. Those costs are real, and use of fund earnings is a regressive tax that takes a bite from Alaskans too young to crawl and too old to walk. But that regressiveness can be tempered with a graduated income tax.

THE UNCERTAINTIES

The endowment principle is sound — provided averages calculated over 75 years of investment history continue to hold true. We can't know that for sure.

We can't know for sure what other income sources Alaska may have in future years. Will we continue to need a share of Permanent Fund earnings in the hundreds of millions of dollars, or more?

We can't completely chart the future, nor should we try to handcuff Alaskans who will make future decisions. We can act based on what we know, anticipate variables as best we can and share the burden of risk fairly.

THE BOTTOM LINE

Make the Permanent Fund an endowment, and we make it permanent. Spend some of the earnings on state government to fill the fiscal gap, and we draw from all Alaskans to build and maintain a better Alaska. Coupled with a progressive income tax, use of Permanent Fund earnings asks everyone to give, but asks more from those who have more.

Yes, this use of earnings breaks the spell of the fund as untouchable. It's time. That spell is a crippling illusion that weakens us in the long run. The Permanent Fund is not an end in itself, but a powerful means to the end of a more prosperous, stable Alaska. Together, an endowment and wise spending give us the means to provide for ourselves, our children and their children. We'll still have dividends, a benefit no other state in the Union enjoys. And we'll keep Alaska's economy sound. That's no illusion. That's good sense and good stewardship.

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OPINION

OUR VIEW

Phase back the dividend

But there's no need to kill it

Sixth in a series

Alaska draws about \$1 billion a year from savings to support state services at current levels. At the same time, we spend about \$1 billion a year for a program not found in any other state — cash payments to every resident, regardless of need, made through the Permanent Fund dividend program.

Couldn't we fill the \$1 billion spending gap by dropping the dividend and forget all this talk about taxes?

Mathematically, of course we can.

Making that \$1 billion shift, however, would be both economically harmful and inequitable.

Harmful because the \$1 billion in dividends amounts to about 6 percent of household buying power in the state's economy. Taking that much money out of circulation all at once would cost thousands of jobs.

Inequitable because taking \$1 billion entirely from dividends would hit hardest on the disadvantaged. The less money a family makes, the more the yearly dividend does to improve its circumstances. Balancing the budget solely with dividend reductions would put the burden on ordinary citizens while letting the wealthy off easy.

The great debate in progress is whether to raise taxes or cut dividends first. The best choice is to do a little of each — and retain the benefits of progressivity.

THE UPSIDE

Preserving the dividend at its current level is no longer an option except through draconian and self-defeating levels of taxation. Because the problem has been put off too long, the choice now is between phasing down the dividend to retain some of its benefits or eliminating it to stave off broad taxes. The only reason this choice hasn't been made already is that contributions from the Constitutional Budget Reserve have hidden it — but that source is running out.

Giving away \$1 billion a year in dividends may be poor fiscal policy in a state strapped for revenues, but preserving a smaller level of dividend is good social policy. State oil revenues belong to and should benefit every Alaskan; the dividends help make that possible.

The dividend provides a significant source of income to the less fortunate. That's especially important in rural Alaska, where economic opportunities are scarce.

Most families receive more in dividends than they would pay under an income tax. A family of four, for example, would have to enjoy an adjusted gross income of \$250,000 before it would pay more under the flat 2.25 percent income tax proposed by Juneau Rep. Bill Hudson



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than it would lose if the dividend were eliminated. This means 98 percent of Alaska households would be worse off if the dividend were killed than if they paid the Hudson tax.

Under a more progressive tax proposed by Gov. Tony Knowles, the similar break-even point between dividends and taxes would be \$140,000. At least 90 percent of Alaska households would pay more giving up the dividend than paying the Knowles tax.

The farther down the income scale a person is, the more painful is the effect of losing the dividend. Killing the dividend, by itself, would be deeply regressive.

Still, a responsible long-term fiscal plan will reduce the dividend. Alaska is beyond the time when it can afford to send \$1,940 checks to every resident without reference to need or work. Alaska oil production has dropped by half, and the state has dug itself into a \$1 billion-a-year revenue hole. We can still have a dividend and all the benefits it brings, but it can't be as big as before.

THE DOWNSIDE

Using fund earnings for state services would shrink the dividend over time. An improved arrangement would convert the Permanent Fund to an endowment with a 5 percent yearly payout. Earnings beyond that payout would automatically inflation-proof the fund; the payout would be divided each year by the Legislature between state services and individual dividends.

To cushion the impact of such a big change, the new approach should be phased in.

Permanent Fund dividends have been woven tightly into the fabric of Alaska's family budgets and economy over the past two decades. Families at the upper end enjoy an extra vacation or build their portfolio a little bigger when dividend checks arrive. Families at the lower end pay bills or buy groceries. Families who depend on subsistence buy ammunition or gasoline. Some people get a new truck, a snowmobile, a couple of tickets to Hawaii or a party with all their friends. Wise kids or parents sock away dividend money for a good start in life — college, job training, a down payment on a home.

Many of us in the middle save some, pay off a few debts, take care of some necessities, treat ourselves to a nice dinner out, and thank our good fortune. The dividends are a windfall we appreciate but don't truly need. It's time to phase them back to a more sustainable level.

THE BOTTOM LINE

Combining modest dividend reductions with a progressive income tax puts the state's fiscal burden where it belongs — on those who can afford it. For low- and moderate-income households, dividend payments will still exceed the state income tax they might pay. Together, shrinking the dividend and bringing back an income tax are an equitable way to fill a substantial portion of the state's fiscal gap.

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OPINION

OUR VIEW

Targeted taxes

Alcohol, gasoline, cruise levies are part of solution

Seventh in a series

The state's financial situation is so serious that the repair job requires many different tools.

Unless an income tax is pushed to onerous rates, it will fill only about 30 to 40 percent of the state's \$1 billion-a-year hole.

An important contribution — roughly \$100 million — can come from three targeted tax measures: increasing the alcohol tax, increasing the motor fuel tax and setting a new tax on cruise ship passengers. These taxes would diversify and stabilize Alaska's revenue base and help balance demands on Alaska citizens and industries.

ALCOHOL TAX: Raise it a dime a drink

Increasing the state's alcohol tax is a two-fer — it's a way to raise revenue and it's good public health policy.

Dealing with the fallout from alcohol abuse — assaults, drunk driving, domestic violence, fetal alcohol syndrome — costs the state hundreds of millions of dollars. The alcohol tax recoups only a small share of those costs. The state collects about \$12 million; the cost to state and local governments for alcohol-related crime is at least \$148 million. The bill is even higher if government health care costs are included.

The state's excise fee on alcohol hasn't been increased since 1983. (Alaska charges a flat fee per gallon of alcohol, rather than a percentage of sales price.) Raising the price would help reduce consumption, especially among underage youths, who tend to be more price-sensitive.

Considering all the social costs associated with alcohol, a state criminal justice advisory panel recommended increasing the state's alcohol user fee by 25 cents a drink. The 10-cent-a-drink proposal being considered in the state House is, if anything, too low. It would boost state revenue by \$30 million, still well short of the state's costs.

The alcohol tax is really a user fee. When alcohol is widely consumed, abuse is inevitable. Dealing with that abuse is costly, and it's unfair to shift so much of the costs onto nondrinkers. Those who drink should pay a larger share of the bill.

GASOLINE TAX: Raise it to the national average

At 8 cents a gallon, Alaska has the lowest motor fuel taxes in the country. In other states, the average tax on a gallon of gasoline is 24 cents. By charging 24 cents a gallon, Alaska would collect another \$48 million.

The gas tax is another user fee. Alaska roads are not-



B-4 Saturday, April 13, 2002

riously expensive to build and maintain. Federal money pays 90 percent of major construction and overhauls, but plowing and patching are done with state funds. This year, the House passed a budget drastically cutting road maintenance. A higher gas tax could provide money to improve road maintenance instead of cutting it.

The number one source of air pollutants in Anchorage and Fairbanks is car exhaust. Increasing the gas tax would help cover some air pollution enforcement costs. It also would make public transit and car-pooling more cost-competitive with single-passenger car traffic; that, in turn, would help reduce auto pollution.

On the downside, a big gas tax increase would fall hardest on those already struggling to get by. It would take a constitutional amendment to guarantee that any gas tax increase is used to improve road maintenance. The gas tax is also the least popular — by far — of Alaska's revenue options, according to opinion polls.

Nonetheless, the state's road maintenance is poor and it's going to get worse. Someone else — the federal government and oil tax dollars — have paid most of the bills for Alaska drivers on the road. These days, the state will have to scrounge for money just to maintain services, let alone improve them. Alaska drivers have gotten a bargain on taxes at the gasoline pump for a long time. Having such low taxes on gasoline and diesel is a luxury the state no longer can afford.

CRUISE SHIP TAX: Charge \$50 per passenger

Tourism is one of the state's largest industries, but it produces little income to the state treasury. The main way the state collects revenue from tourism is the corporate income tax, but the Legislature has exempted the largest cruise ship companies from that tax.

Charging each cruise ship passenger brings in new money from out of state, rather than taking it from Alaskans' pockets. For that reason, it is one of the most popular revenue proposals. A \$50 fee per passenger would raise about \$33 million a year.

Taxes on cruise passengers are common in other jurisdictions. The state should take advantage of this readily available opportunity to raise revenue from one of the state's largest industries.

THE BOTTOM LINE

All three of these revenue measures are reasonable user fees. The use of alcohol inflicts heavy costs on society and the state treasury; a higher alcohol tax helps repay those expenses. With the gas tax increase, motorists would pay more of the bill for maintaining and improving the roads they drive on. Cruise ship passengers use the beauty of Alaska but pay nothing toward the state's costs for stewardship of our natural splendors. The \$100 million available from these three sources will make a small but useful contribution to a long-term fiscal plan.

Sunday: Principles of a fiscal plan

Monday: The parts of a fiscal plan

Tuesday: Thinking about spending

Wednesday: An income tax first

Thursday: What's the Permanent Fund for?

Friday: Retaining the dividend

Saturday: User fees and other revenues

Sunday: Positioning Alaska for the future



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OPINION

OUR VIEW

A better future

Fixing the fiscal gap is key

Last in a series

Alaska's journey into the 21st century has begun on shaky legs. Though the economy is generally strong, major industries — fisheries, tourism, even oil — are struggling. Our politics are wracked by bitter partisanship and drift. State government is a mainstay of our future, yet financially unsound. Only federal spending and the long-run growth of the Alaska Permanent Fund stand out.

And a long-term fiscal gap of \$1 billion per year threatens to shorten the long arc of opportunity provided by North Slope oil development. Though revenues from Prudhoe Bay and other nearby fields give us a huge head start in meeting Alaska's needs, they aren't enough to carry the whole load forever.

The most important thing we can do to improve our prospects is fix the fiscal gap. We have the tools. Together, as Alaskans, we must make it our business to do so.

Events in the Middle East have pushed the price of oil back above \$20 per barrel — \$22.33 and falling at Friday's close. This is both a stroke of luck and a temptation to fool ourselves. It does not change the long-term fundamentals, which show a continuing decline in oil production and revenues. The North Slope produces half as much oil today as it did in 1990 and projections show that decline continuing. The state budget deficit still hits \$1 billion a year for as far ahead as we can see.

We are way ahead of most natural resource economies because we have more tools and more wiggle room. The Alaska Permanent Fund is a \$25 billion treasure, the envy of every other state. We are not overtaxed now; in fact, we are hardly taxed at all. Our single biggest expense is giving money away. Most industries are largely untaxed and, even in decline, oil probably could contribute more.

So far we are simply refusing to use the tools we have. But they are available if we can summon the leadership and vision to wield them. Our budget problem is fundamentally more political than economic. The reason it hasn't been solved sooner — when it would have been less painful — is that no political consensus exists on how.

On these pages for the past week we have explored a package of solutions we believe would remedy Alaska's budget troubles with the least long-term damage to both individuals and the overall economy. The package includes a progressive income tax (worth \$350 million), use of Permanent Fund earnings (\$500 million to \$600 million), smaller user fees and taxes (\$100 million) and, after all that, reworking oil and gas taxes (\$100 million). After a decade or more of budget cuts, the focus now must shift to the revenue side of the ledger. This package does so in a broadly balanced way.

The overarching principle is simple: Balanced contri-

H-2 Sunday, April 14, 2002

butions from several sources will do the least harm and position us best for future growth. The package is essentially conservative — it aims to change our economy as little as necessary while spreading the burdens of that change as broadly as possible. It also aims to work these changes in as progressive a manner as possible — to ask the strongest among us to pull the biggest oars.

Time is against us. The longer we wait, the harder we'll fall. The hope of another windfall — ANWR, missile defense, an even bigger price spike from spreading war in the Mideast — does not lessen the urgency to act now.

The case for these changes is largely negative — avoiding a recession that is likely if we don't put our fiscal house in order before reserves run out in late 2004.

But there's also a more positive case revolving around changing our political habits. Instead of the long, tired argument over how much spending is too much, we need a broader vision of how to build for the future. The starting point for that discussion is a sound fiscal order.

Without a balance between spending and revenues we can't make intelligent decisions. We can't make new investments in good ideas or confidently divest of bad ones. We become stagnant and reactionary — afraid to change, unwilling to dream, immune to opportunities, ever more aware of the state's shortcomings. Without sound fiscal foundations, state government is stuck in anxiety and decline. With them at least there's the chance to make responsible choices and chart future progress.

The fiscal gap is ultimately a test of whether Alaska can hold onto enduring gains built on Prudhoe oil revenues. Those revenues can't carry us forever, much as we wish they might. The failure to create a lasting alternative, and the failure to build a sound fiscal structure, eventually would wash away the gains of the oil era. And because the solution requires everyone to give a little in order to avoid losing a lot, the fiscal gap is a test, too, for whether we can rise above self-interest to achieve the common good.

An honest solution would do more to restore confidence in Alaska's future than any other step lawmakers could take. It would improve the climate for investment and growth. It would leave a better foundation for state services, and give all of us some assurance that the decline of the past decade will not be permanent.

And it would overcome the notion — apparently accepted by too many politicians — that Alaskans will not accept the changes needed to prosper in the 21st century. We believe just the opposite is true. Alaskans have come to understand that we're at a crossroads: We need to fix the fiscal gap soon or we'll betray not only our own prospects, but those of our children as well.

Sunday: Principles of a fiscal plan

Monday: The parts of a fiscal plan

Tuesday: Thinking about spending

Wednesday: An income tax first

Thursday: What's the Permanent Fund for?

Friday: Rethinking the dividend

Saturday: User fees and other revenues

Today: Positioning Alaska for the future

**Conceptual Components of a Long-range Fiscal Plan
For the State of Alaska**

1. Commitment to managing the cost and growth of public services.
2. Management of the Permanent Fund to protect its real value over time while providing a substantial individual dividend and a contribution to the cost of public services.
3. A structured general revenue system that minimizes the need for broad based taxation of individuals and accommodates local governments' revenue structures.
4. Real economic growth.
5. A balanced budget requirement incorporating a mechanism to mitigate the consequences of oil price volatility on the general revenue system.

House Ways and Means Committee

Discussion of the Conceptual Components of a Long-range Fiscal Plan

April 29th, 2003

Conceptual Components

Cost Control

**Economic
Growth**

Permanent Fund

**Balanced
Budget
Mechanism**

**General Revenue
System**

Cost Control

HJR 9 – Constitutional Spending Limit

- Less Essential Program Reduction**
- Contain Formula Growth**
- Outsourcing**
- Reduce Statewide Administration**

Permanent Fund

- **Limit Permanent Fund Distribution**
- **Dividend Statute**

General Revenue System

- Hydrocarbon Resources -

- Production and Royalties**
- Property Tax**
- Corporate Income Tax**

General Revenue System

- Excise Tax -

- Alcohol**
- Tobacco**
- Motor Fuels (highway, aviation, marine)**
- Rental Vehicles**

· General Revenue System

- User Fees -

- Licenses and Permits -

General Revenue System

- Public Corporation Dividends -

- **AIDEA**
- **AHFC**
- **Student Loan Corporation**
- **Mental Health Trust**
- **Alaska Railroad**
- **Municipal Bond Bank**
- **International Airport Fund**

General Revenue System

- Insurance Premium Fees -**
- Seafood Industry Taxes and Fees -**
- Gaming -**

General Revenue System

- Broad Based Taxes -

- **Income**

- **Consumption**

Economic Growth

- Real Economic Growth -

- Hydrocarbon
- Technology
- Fish
- Finance
- Manufacturing
- Transportation
- Construction
- Executive Services
- Tourism
- ANCSA Corporations
- Mining and Minerals
- Roads

Balanced Budget Mechanism

- **Maintain Cash Reserve**
- **Revolving “Credit Line” Concept**
- **Mitigate Oil Price Volatility**
- **Reduce Broad Based Taxes when Reserves are Adequate**

ALASKA'S FISCAL CROSSROADS

A DISCUSSION

For years Alaskans have heard about the state's "fiscal gap," which is the result of recurring expenses exceeding recurring revenues (if you were a family, you would describe it as "living beyond your means.") The state has been "living beyond its means" in ten of the last 12 years.

This gap has been filled by spending from the Constitutional Budget Reserve (CBR), a savings account created by voters in 1990 that consists of one-time settlements from disputed oil and gas royalties and taxes. Over the years, \$7.9 billion has gone into the fund; today only \$1.9 billion remains. In spite of high oil prices in this current fiscal year that ends June 30, 2003, nearly \$500 million still will be needed to prop up spending.

In developing the FY 04 budget, the challenge was to begin the process by which the state starts to "live within its means" (budget cuts) or gets another job to bring in more income (new revenues). For the long term, the Administration is committed to growing recurring revenues by developing Alaska's resources to pay for appropriate state responsibilities, such as public safety, transportation, and education.

But for the short-term, it is necessary to make different spending decisions. To get that process underway, Administrative Order 202, issued on the Governor's first day in office, outlined a process by which every department evaluated what it does, how it does it, and what results it is getting for the public dollars invested in those services—a "bottom line" for state government. The results from this evaluation formed the basis for many of the budget recommendations reflected in the proposed budget.

Throughout this process the Administration also was very focused on the bigger picture of the need to minimize the draw that will be required from the CBR to help pay for next year's spending. Again, there were two ways to do this—new revenues and budget cuts. The proposed FY 04 budget accomplishes both:

- \$235 in additional revenues, of which \$114 million is primarily user-related fees, and \$121 million is the deposit of one-time monies in the General Fund;

- \$55 million in operating budget cuts. This number understates the level of reductions; nearly \$190 million in cuts were made but were offset by formula-driven increases and debt payment obligations.

Overall, comparing FY 2004 to FY 2003 General Fund spending:

Revenues:	\$82 million higher
Operating Budget:	\$55 million lower
Capital Budget:	\$25 million higher
Debt, Other Appropriations:	\$11 million higher
<u>Total Spending:</u>	<u>\$20 million lower</u>

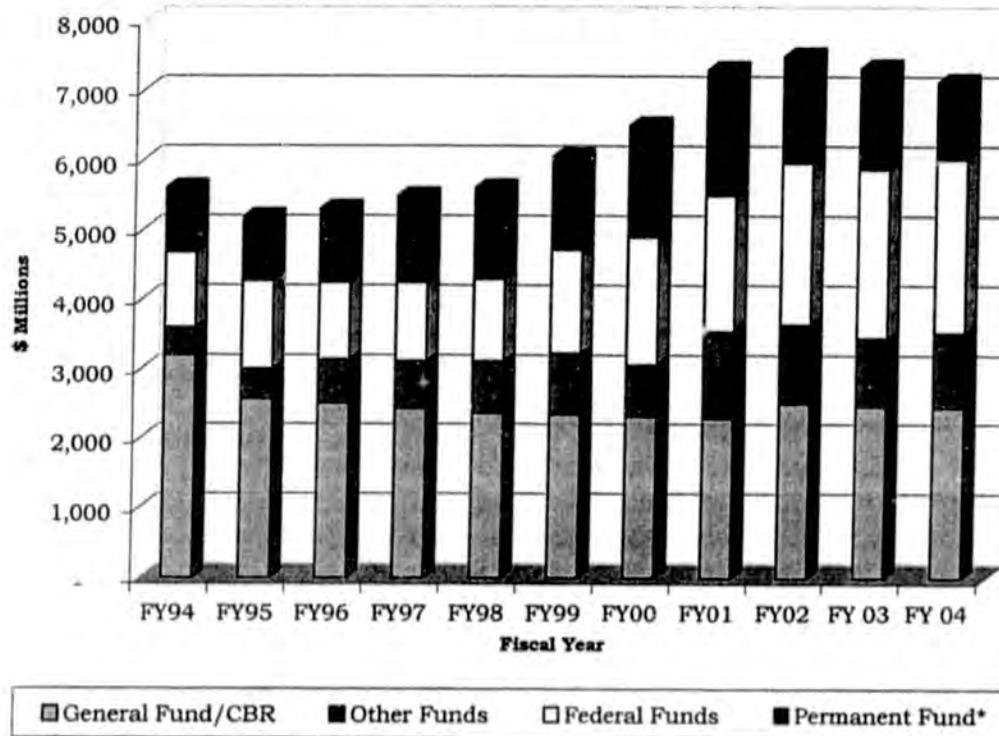
The following information provides background about state spending, revenues, and the context for developing the Fiscal Year 2004 budget.

FISCAL ISSUES

Historical Background

Chart 1 below shows appropriations by fund source for the Governor's FY 04 proposed budget compared to annual budgets in the past decade. What it demonstrates is that the main areas of growth by far in the total state budget have been federal funds and Permanent Fund payments for dividends and inflation proofing.

Chart 1
Appropriations by Revenue Source
Operating and Capital Budgets
FY 1994 - FY 2004 Proposed



Source: Legislative Finance Budget History File

*Permanent Fund includes appropriations for dividends and inflation proofing.

Federal funds have restrictions on how they may be spent and are largely devoted to transportation and health and social service programs. For the most part, the Legislature and Governor do not exercise much control over federal spending. Federal programs also often require a state general fund match (\$356 million in the Governor's proposed FY 04 operating and capital

budgets) or have maintenance of effort requirements. For the past several years, federal match requirements have made up about half of the general fund portion of the state capital budget (\$139 million in fiscal year 2003).

Chart 2 focuses on state-controlled funding sources (excluding Permanent Fund earnings which are discussed in detail in a later section) and shows the relationship between general fund revenue, draws from the constitutional budget reserve (CBR) and other funds during the past decade.

The category of "other funds" in the budget includes such sources as university tuition and Alaska Housing Finance Corporation (AHFC) receipts and has grown as well, mainly to supplement and supplant declining general fund revenue. Beginning in 1992, there has been a concerted effort to separate out services that are fee supported from those that compete for general fund revenues. "Other funds" do not affect the fiscal gap or increase the draw on the CBR. Many fee-supported and self-funding programs have been reclassified from general fund to other state funds, which accounts for some of the growth in the other funds portion of the budget. The other funds portion of the Governor's FY 2004 budget proposal is \$91 million higher than the FY 2003 authorized budget.

General Fund Revenues

The "fiscal gap" between revenues and expenditures is defined solely in terms of state general funds and is the focal point of the Governor's FY 04 budget proposal because reductions in general fund spending help close the gap. The general fund portion of the FY 2004 Governor's proposed budget is \$20 million less than the FY 2003 authorized budget. However what isn't shown in the graph is that nearly \$190 million in built-in general fund cost increases, mostly in formula programs and debt service, had to be cut out of the budget or otherwise accommodated to achieve a \$20 million overall general fund savings.

The state currently produces about half of the 2 million barrels per day of oil that it did at its peak in 1988. The long term decline in production is exacerbated by the fact that new production from smaller fields is taxed at a much lower rate than the declining super-giant Prudhoe Bay and Kuparuk fields. Petroleum royalties and taxes comprise about 84% of general fund revenues. Chart 3 shows historical and projected general fund revenue and demonstrates how the long-term underlying decline in petroleum revenue is affected by periodic spikes and troughs caused by oil price volatility.

Chart 2
State Funding Sources and CBR Draw
Operating and Capital Budgets
FY 1994 - FY 2004 Proposed

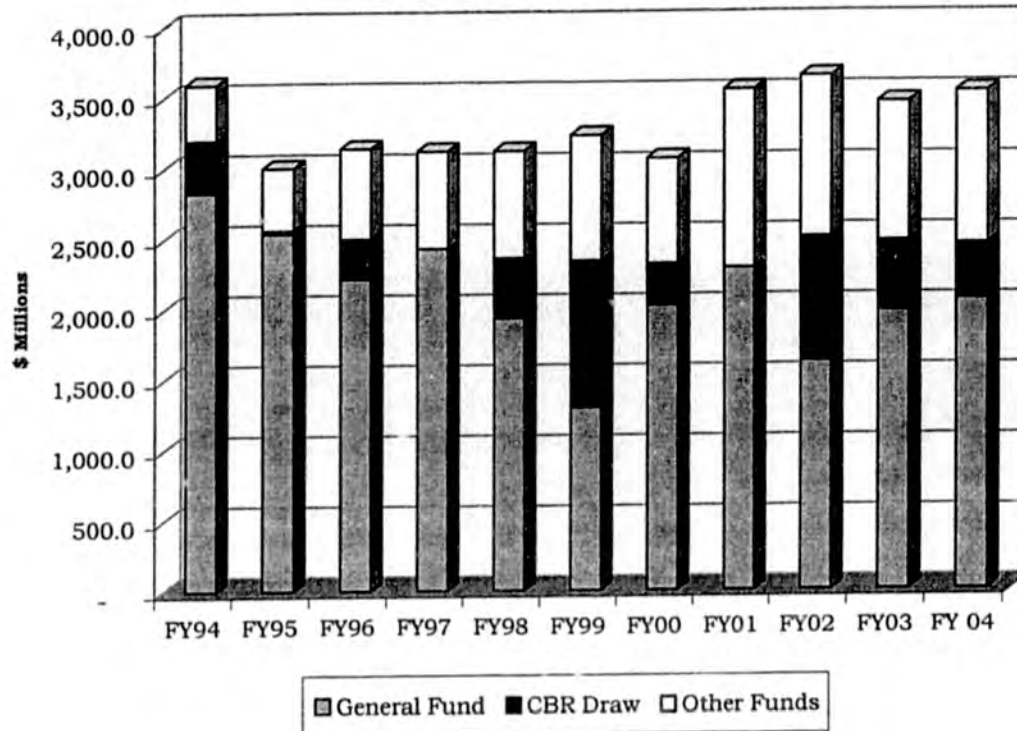
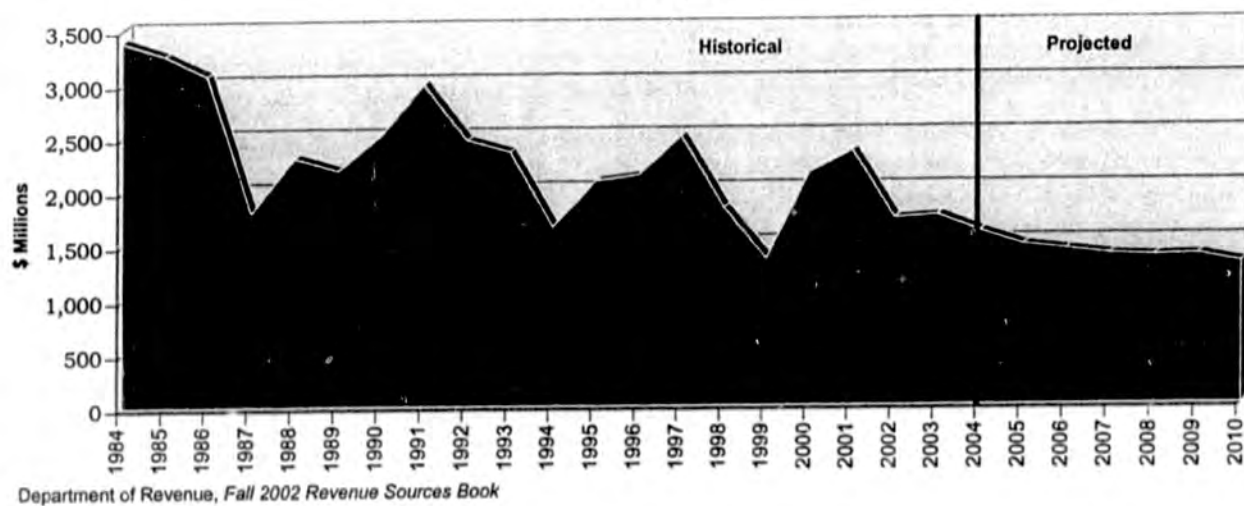


Chart 3
Historical and Projected General Fund Revenue
Status Quo



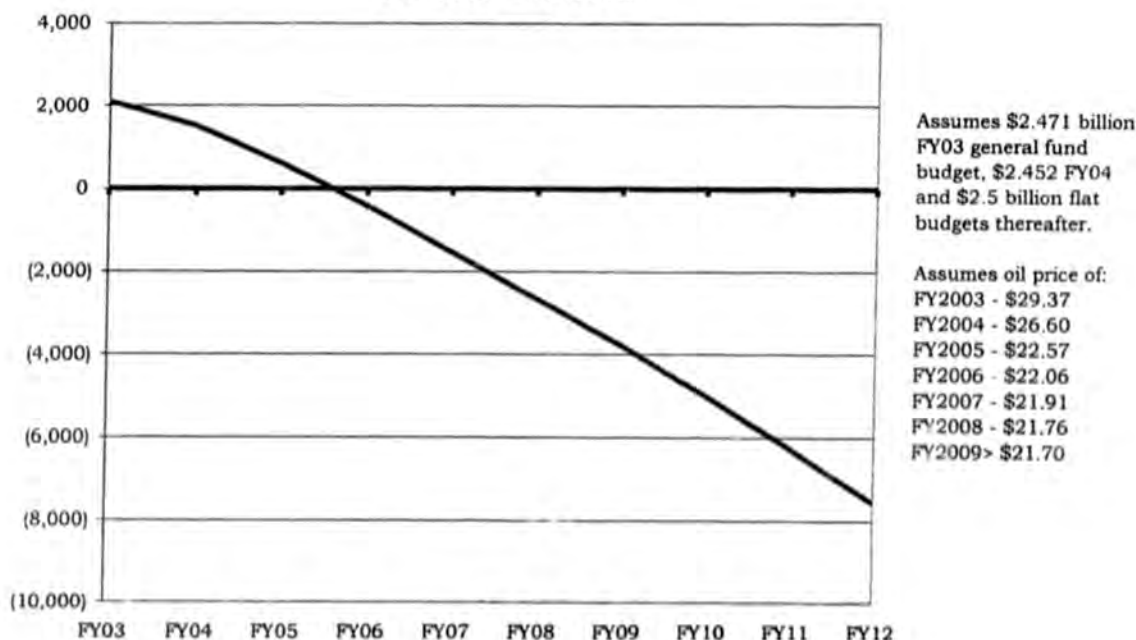
Department of Revenue, Fall 2002 Revenue Sources Book

New oil developments in NPRA and elsewhere on the North Slope will undoubtedly improve the long-term revenue picture but are at least a few years off. (For an excellent discussion of potential oil and gas production opportunities, link to the Department of Revenue *Fall 2002 Revenue Sources Book* at www.tax.state.ak.us.) Likewise the Governor's proposals for industrial roads to mining and other natural resource development prospects will take some time to bring revenue returns to the state treasury. For this reason it is important in the meantime to preserve the balance in the CBR so that it can help bridge until revenues from new development are available.

General Fund Revenues and the CBR Draw

The CBR was established by a constitutional amendment authorized in a statewide vote in the 1990 general election. It was capitalized by oil and gas royalty and tax settlements with petroleum companies and was designed as a buffer to insulate the state general fund from oil price swings that devastated the state economy in the mid '80s. At current production level, every \$1 change in the average price of oil over the fiscal year results in a \$65 million change in revenues. (In the mid-'80s every \$1 change in the price of oil generated \$150 million due to high production in high tax fields.)

Chart 4
CBR Balance
FY 2003 - FY 2012



Virtually all of the large tax and royalty cases have been settled, which means there are no more big deposits to replenish the CBR. During the past decade the CBR has served as a buffer to oil price volatility and it has been used to address the state's structural deficit.

For 10 of the past 12 fiscal years, the state has balanced its budget by drawing money from the CBR – a little over \$5 billion so far of the \$7 billion in total deposits. The FY 03 CBR draw is projected to be \$494 million and the Governor's proposed FY 04 budget projects a \$393 million draw. Even assuming flat general fund budgets and extraordinarily high oil prices, absent any new revenues, the CBR will be depleted in February 2006. If the Legislature approves the Governor's proposed one-time deposits to the general fund (\$121 million) and revenue increases (\$113 million), the date when the CBR is depleted will be delayed by about another 6 months. Chart 4 is a graphical depiction of the Department of Revenue projection of the Governor's FY 04 budget proposal.

The immediate goal expressed in the budget proposal is to slow the rate of CBR decline with a combination of budget cuts, one time fund transfers to the general fund, and new revenue sources so it can continue to function as an oil price buffer. Longer-term, the goal is to close the fiscal gap by balancing expenditures with recurring revenues.

The fiscal summary (*Table 1*) provides a broad outline of the Governor's FY 2004 proposed budget compared to the current year. Individual departmental budget detail is available by following the link:
http://www.gov.state.ak.us/omb/04_OMB/budget/budgethome.htm

Table 1

Fiscal Summary
FY 2003 Authorized Compared to FY 2004 Governor Proposed
(dollars shown in millions)

	General Fund	FY2003 Authorized Federal Funds	Other Funds	Total Funds	General Fund	FY2004 Governor Proposed Federal Funds	Other Funds	Total Funds	Difference General Fund	Total
1 Revenues										
2 Unrestricted General Fund Revenues (A)	1,977.0			1,977.0	1,824.0			1,824.0	(153.0)	(153.0)
3 Proposed New Revenues				0.0	113.6			113.6	113.6	113.6
4 One-Time Deposits to the General Fund				0.0	121.2			121.2	121.2	121.2
5 Corporate Dividends (B)			77.4	77.4			52.0	52.0		(25.4)
6 Federal and Other Funds		2,429.9	906.1	3,336.0		2,497.3	1,022.8	3,520.2		184.2
7 Total Revenues	1,977.0	2,429.9	983.5	5,390.4	2,058.8	2,497.3	1,074.8	5,630.9	81.8	240.6
8 Authorization to Spend										
9 Operating	2,222.3	1,416.4	773.2	4,411.9	2,167.3	1,458.9	792.2	4,418.4	(55.0)	6.5
10 Agency Operations (non-formula)	1,116.0	738.1	1,220.1	3,074.1	1,089.0	721.5	1,245.7	3,056.1		
11 Formula Programs	1,106.4	678.3	117.1	1,901.7	1,078.3	737.3	141.0	1,956.6		
12 Duplicated Authorizations (C)			(564.0)	(564.0)			(594.4)	(594.4)		
13 Capital	109.8	947.7	124.5	1,182.0	134.4	1,003.9	209.5	1,347.8	24.6	165.9
14 Project Appropriations & Revised Programs	109.8	947.7	227.5	1,285.0	134.4	1,003.9	268.1	1,406.4		
15 General Obligation Bonds (D)			463.5	463.5				0.0		
16 Duplicated Authorizations (C)			(566.5)	(566.5)			(58.6)	(58.6)		
17 Debt and Other Statewide	139.1	65.9	115.8	290.8	150.1	34.6	73.1	257.7	10.9	(33.1)
18 Debt Service (E)	11.5	0.0	110.5	122.1	48.0	1.7	122.3	172.1	36.5	50.0
19 Loan and non-Debt Fund Capitalization	57.7	25.2	33.4	116.2	67.5	32.9	11.0	111.3	9.7	(5.0)
20 Supplemental Appropriations	69.9	40.7	(8.2)	102.4	33.0			33.0	(36.9)	(69.4)
21 New Legislation				0.0	1.6		0.7	2.3	1.6	2.3
22 Duplicated Authorizations (C)			(50.0)	(50.0)			(60.9)	(60.9)		
23 Total Authorization to Spend (unduplicated)	2,471.2	2,429.9	983.5	5,884.6	2,451.8	2,497.3	1,074.8	6,023.9	(19.5)	139.3
24										
24 AK Permanent Fund Dividends (and PFD division operations)			682.0	802.0			507.0	509.0		(293.0)
25 AK Permanent Fund Inflation Proofing and Other Transfers			205.0	642.0			590.0	594.0		(48.0)
26 Total AK Permanent Fund			887.0	1,444.0			1,097.0	1,103.0		(341.0)
27 Totals with Permanent Fund	2,471.2	2,429.9	1,870.5	7,328.6	2,451.8	2,497.3	2,171.8	7,126.9	(19.5)	(201.7)
28 Draw from Constitutional Budget Reserve	494.2				393.0				(101.3)	

Notes

A FY2003 Unrestricted Revenues are based on an oil price of \$29.37 per barrel and estimated production of 0.994 million barrels per day. FY2004: \$26.60 and 0.997 mbd

B Corporate Dividends include funds made available to the State by the boards of the Alaska Industrial Development and Export Authority (AIDEA), the Alaska Housing Finance Corporation (AHFC), and the Alaska Student Loan Corporation (ASLC). The AIDEA dividend for FY2003 is \$20.1 million. Under current statutes, there will not be an FY2004 AIDEA dividend. The total AHFC transfer for dividend capital projects, loan programs and debt service is \$103 million for FY2003, and \$103 million for FY2004. Since AHFC's debt payments for general government purpose bonds do not require appropriation, the net transfers appropriated here are \$52 million for FY2003 and \$47 million for FY2004. The ASLC Dividend is \$5.25 million in FY2003 and \$5 million for FY2004.

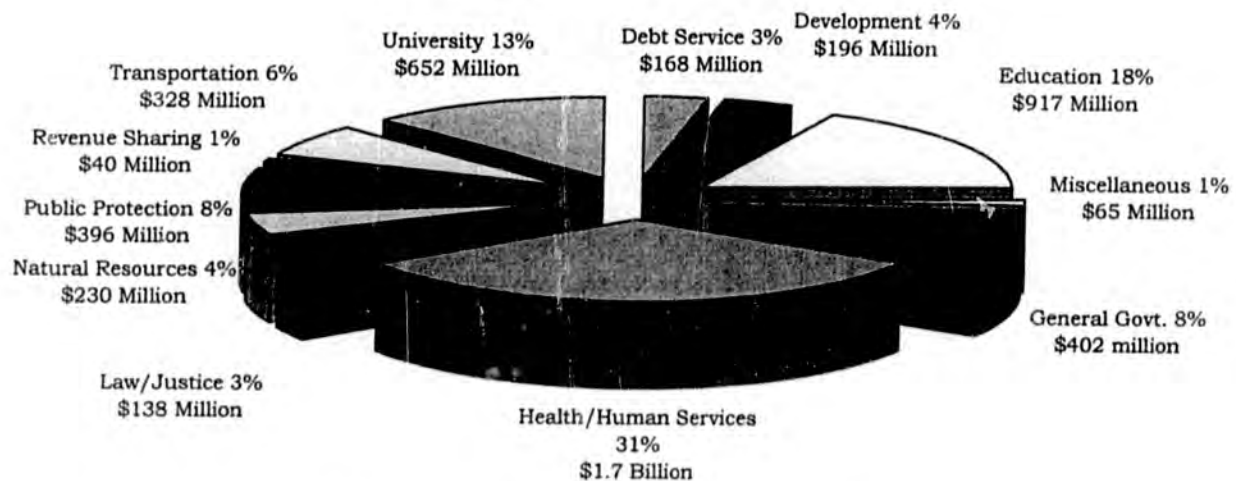
C Duplicated authorizations are in the budget twice, such as when funds flow in and out of a holding account or one agency pays another for services provided.

D General Obligation bonds are included in the FY2003 capital budget, however, are backed out as duplicated authorizations as the actual costs of the bonds will be incurred as debt payments in future years.

E This amount includes capitalization of Debt Retirement Fund. The legislature appropriated \$20.0 million of the general funds amount needed to pay FY2003 debt as an FY2002 supplemental to the Debt Retirement Fund. It was vetoed down to \$11.5 million to match the amount actually needed in FY2003.

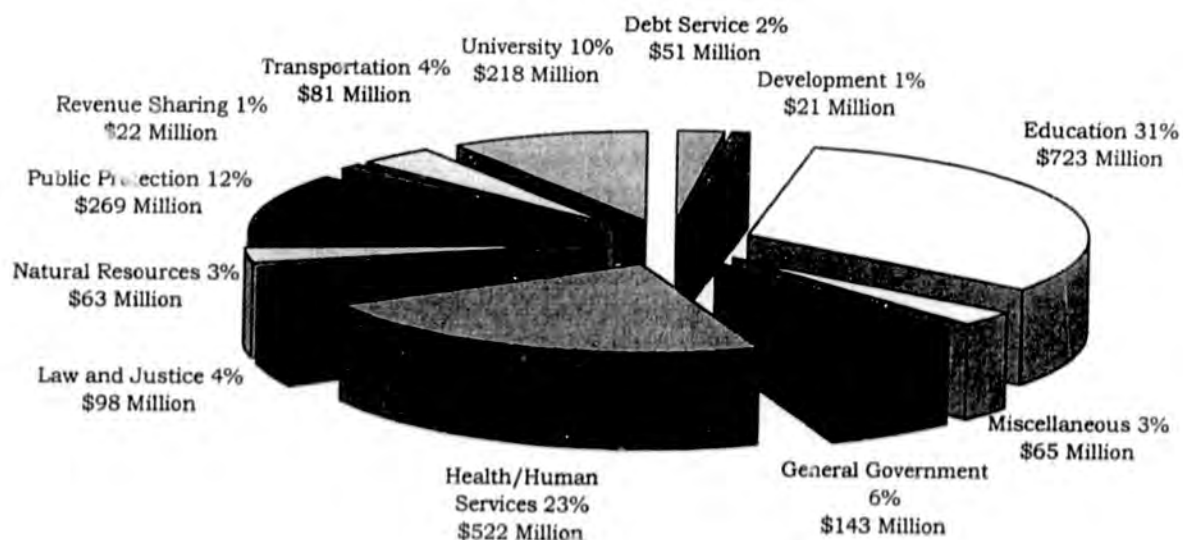
The pie charts (*charts 5 and 6*) provide a sense of the relative share of spending by program area in the FY 04 proposed operating budget in terms of total funds and general funds.

Chart 5
FY 2004 Proposed Operating Budget
All Funds Sources (\$4.4 Billion)
by Program Category*



*Excludes Permanent Fund earnings appropriations for dividends and inflation proofing.

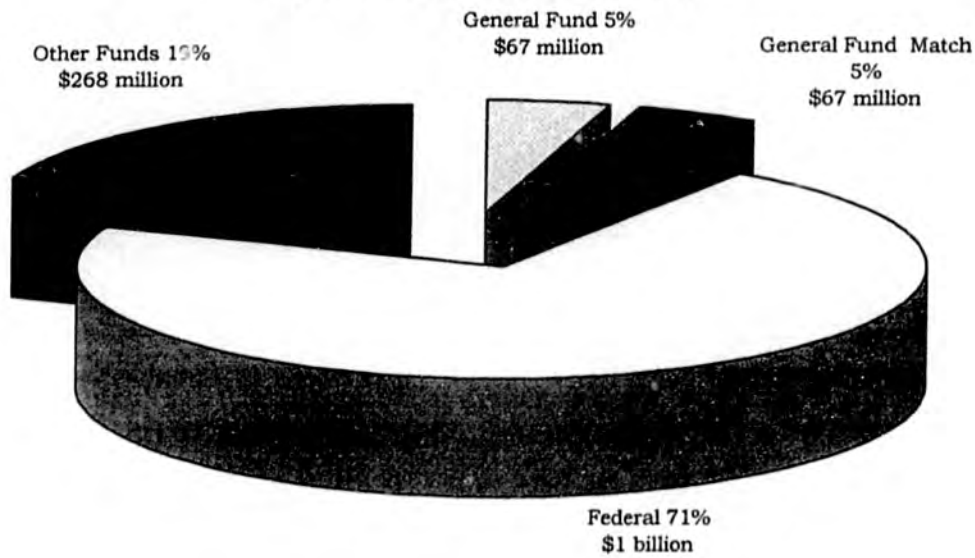
Chart 6
FY2004 Proposed Operating Budget
General Fund (\$2.2 Billion)
by Program Category



*Note that category totals add to more than \$2.2 billion because they include duplications and fund transfers.

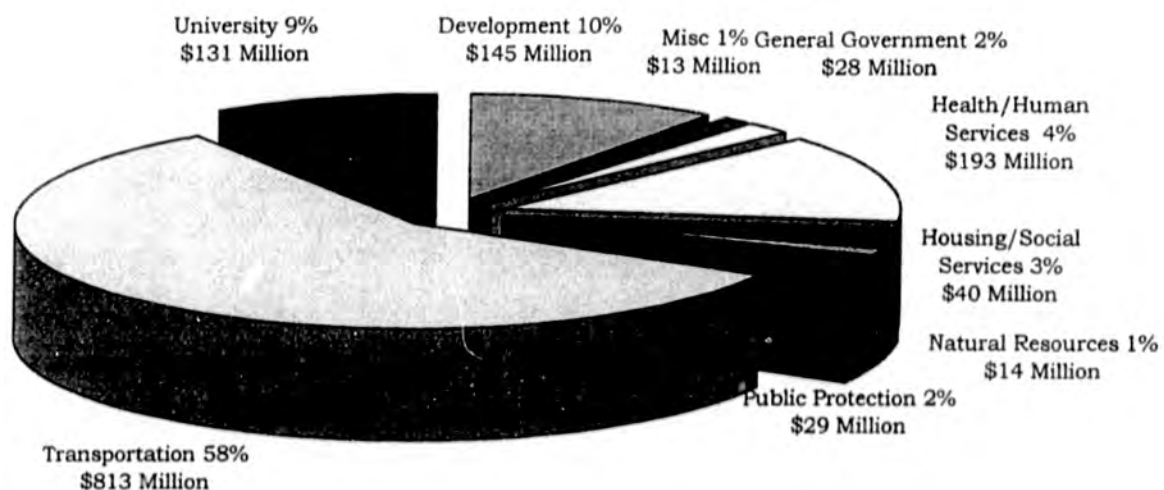
The capital budget is shown in charts 7 and 8 by major funding source and program category.

Chart 7
FY 2004 Proposed Capital Budget
All Fund Sources (\$1.3 Billion)*



*Section dollar totals are greater than total due to rounding.

Chart 8
FY 2004 Proposed Capital Budget
All Fund Sources (\$1.3 Billion)



Spending

In recent years, formula programs and debt service have been primary driving forces in state spending increases. To be successful, any long-term fiscal plan needs to come to grips with these areas of systemic budget growth.

Formula Program Growth

Charts 9 and 10 show formula program growth by fund source and provide some perspective on how their growth affects the state operating budget. Even though the focus here is on *state* spending, it is important to show the growth in federal funding, particularly for Medicaid, because of state match requirements (\$288 million of the \$2.2 billion in general funds for the FY04 operating budget).

Chart 9
Formula Program Growth
by Fund Source
FY 1999 - FY 2003

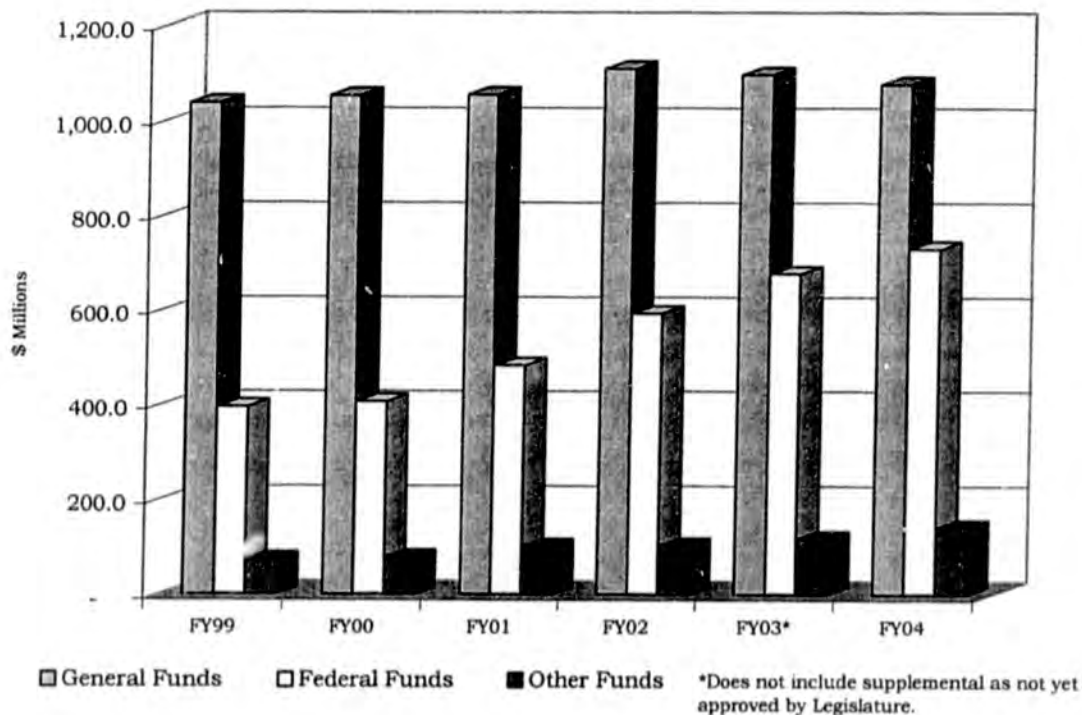


Chart 10
Operating Budgets vs. Formula Programs
General Funds
FY 1994 - FY 2004 Proposed

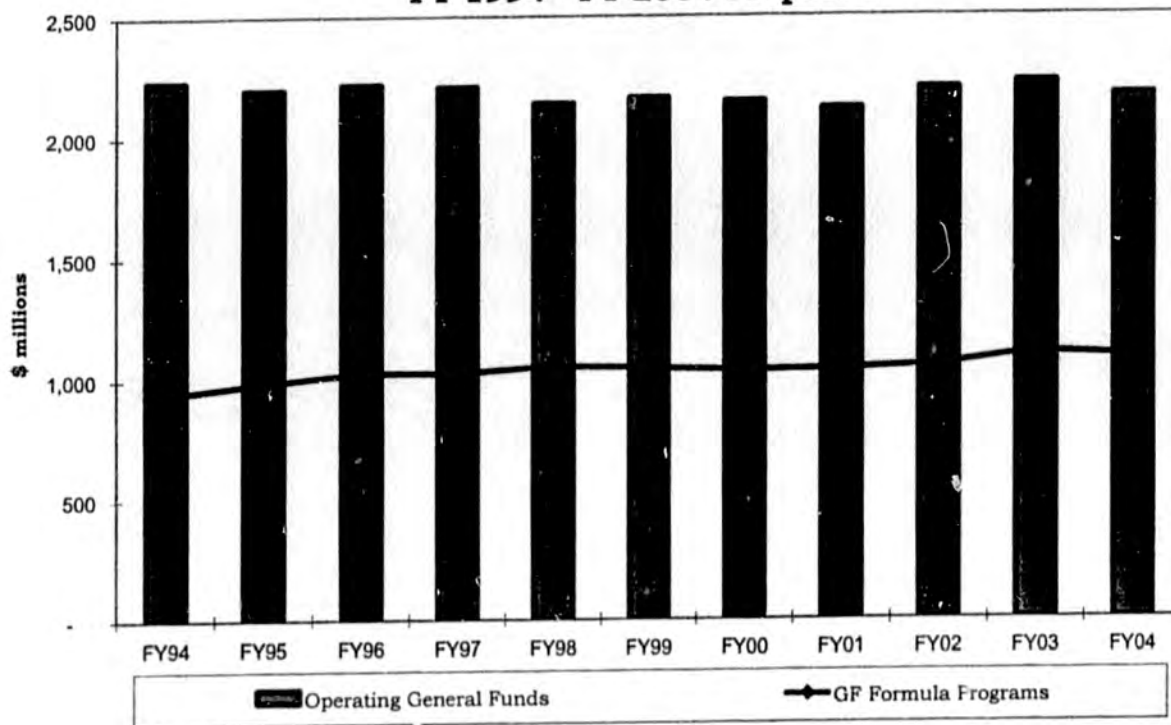


Table 2 is a list of formula programs that highlights changes in the Governor's proposed FY 04 budget. Proposed program cuts eliminate the Longevity Bonus program, reduce Pupil Transportation and the Revenue Sharing/Safe Communities programs. Table 2 highlights formula program changes from FY 03.

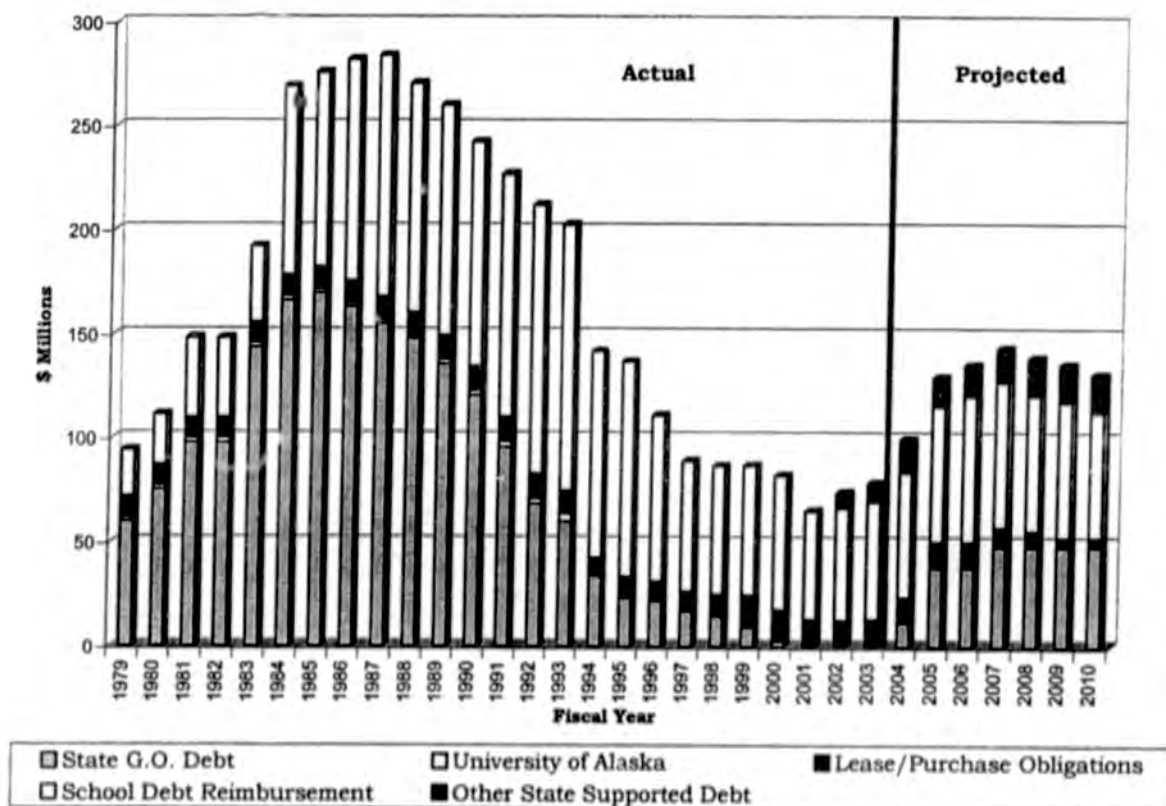
Table 2
Formula Programs
FY 2003 vs. FY 2004 Proposed

Agency	Program	FY 03	FY 04	Change
DOA	Elected Public Officers Retirement System Benefits	1,093.9	1,493.9	400.0
	Unlicensed Vessel Participant Annuity Retirement Plan	75.0	75.0	-
		1,168.9	1,568.9	400.0
DCED	Power Cost Equalization	15,700.0	15,700.0	-
	State Revenue Sharing	12,855.2	9,641.4	(3,213.8)
	Municipal Assistance/Safe Communities	16,775.5	12,581.6	(4,193.9)
	National Program Receipts	15,830.0	15,830.0	-
	Fisheries Business Tax	1,150.0	1,600.0	450.0
		62,310.7	55,353.0	(6,957.7)
Education	Foundation Program	707,324.3	687,668.1	(19,656.2)
	Tuition Students	2,225.0	-	(2,225.0)
	Boarding Home Grants	335.9	185.9	(150.0)
	Youth in Detention	1,100.0	1,100.0	-
	Pupil Transportation	53,933.8	43,188.2	(10,745.6)
	Community Schools	500.0	-	(500.0)
		765,419.0	732,142.2	(33,276.8)
DHSS	AK Temporary Assistance Program	47,653.7	47,653.7	-
	Adult Public Assistance	54,357.5	57,811.5	3,454.0
	General Relief Assistance	1,061.4	1,549.0	487.6
	Longevity Bonus	47,519.3	-	(47,519.3)
	Old Age Assistance-Alaska Longevity Bonus (ALB) Hold Harmless	1,527.9	-	(1,527.9)
	Tribal Assistance	8,612.5	8,612.5	-
	Permanent Fund Dividend Hold Harmless	13,007.9	15,405.5	2,397.6
	Medicaid Services*	820,036.5	930,873.6	110,837.1
	Child Care Benefits	33,102.0	49,836.1	16,734.1
	Foster Care	17,545.8	18,908.9	1,363.1
	Catastrophic and Chronic Illness Assistance	2,000.0	2,000.0	-
	Children's Health Eligibility	2,588.3	2,279.6	(308.7)
	Subsidized Adoptions & Guardianship	14,610.1	19,011.2	4,401.1
	Schools for the Handicapped	6,846.9	6,297.2	(549.7)
		1,070,469.8	1,160,238.8	89,769.0
DMVA	Retirement Benefits	1,322.5	1,322.5	-
				-
	Total	1,900,690.9	1,950,625.4	49,934.5
	General Funds	1,098,588.2	1,078,333.7	(20,254.5)
	Federal Funds	678,301.4	731,314.2	53,012.8
	Other Funds	117,072.1	140,977.5	23,905.4

Debt Service Growth

Another area of recent and future growth in the state budget is debt service. During the past decade, the state was able to leverage non-general fund revenue sources to finance capital projects, e.g., tobacco settlement receipts, and the Alaska Housing Finance Corporation (AHFC) dividend. However that all changed last year when voters approved the first issuance of general obligation bonds since 1980 for transportation and school construction projects. The Legislature also approved a school debt reimbursement program for municipalities and capital project debt reimbursement for various university, harbor and power projects.

Chart 11
State Supported Debt Service
Historical and Projected



The net increase to the state general fund operating budget for debt service in FY 04 is \$36 million. This would have been higher by \$6.6 million if the Governor's proposal had not prorated school debt reimbursement by 10%. (Proration means that if the state approved share of a municipality's debt service is 60%, the Governor's proposal will actually fund it at 54% in the FY

04 budget.) Debt service will increase in the future as additional authorized bonds are sold. Table 3 provides a detailed breakdown of the state's debt obligations and the revenue sources used to meet them.

Table 3
FY2004 Proposed
Debt Obligations and Revenue Sources
(\$ thousands)

Debt	FY2003	FY2004	Inc/(Dec)
School Debt Reimbursement (estimated maximum per school districts)	52,536.0	59,421.7	6,885.7
Lease Finance			
API Replacement	1,635.9	706.0	(929.9)
Palmer Airport Fire Facility	759.7	756.8	(3.0)
Spring Creek Correctional Facility	4,002.0	3,991.2	(10.8)
Palmer Courthouse	415.5		(415.5)
Kenai Courthouse	566.4		(566.4)
Anchorage Times Building	789.4	789.3	(0.1)
Soldotna DOT Maintenance Facility	636.6	639.3	2.7
Anchorage Health Lab	2,287.6	2,319.1	31.5
Fairbanks Courthouse	2,899.5	2,900.3	0.8
Trustee Fees	100.0	100.0	0.0
Total Lease Finance	14,092.7	12,201.9	(1,890.7)
Atwood Building	3,549.4	3,549.4	0.0
AHFC Debt	50,000.0	56,002.0	6,002.0
HB528- University		1,412.9	1,412.9
HB528- Harbors		1,212.1	1,212.1
HB528- Power Projects		3,705.8	3,705.8
General Obligation Bonds- Education and Museum		6,693.5	6,693.5
General Obligation Bonds- GF Transportation		3,211.6	3,211.6
General Obligation Bonds- GARVEE Transportation		2,000.0	2,000.0
Tobacco Securitization- 2000	10,095.8	8,801.7	(1,294.1)
Tobacco Securitization- 2001	10,095.8	8,801.7	(1,294.1)
Total Debt	140,369.6	167,014.3	26,644.7
Fund Sources			
School Fund (Cigarette Tax)	31,600.2	28,600.0	(3,000.2)
AHFC Dividend (corporate debt)	50,000.0	56,002.0	6,002.0
Debt Retirement Fund Balance 1)	2,350.0	7,869.8	5,519.8
Tobacco Securitization- 2000	10,095.8	8,801.7	(1,294.1)
Tobacco Securitization- 2001	10,095.8	8,801.7	(1,294.1)
Investment Loss Trust Fund balance	100.0	2,944.7	2,844.7
ACPE Dividend	783.1		(783.1)
AHFC Dividend (DRF)	18,700.0		(18,700.0)
FY2002 Supplemental to Debt Retirement Fund	11,531.7		(11,531.7)
Atwood Building bond interest earnings		1,636.9	1,636.9
Atwood Building earnings from private tenant rent		1,081.6	1,081.6
Municipal Bond Bank interest on reserve account		775.0	775.0
Lease Retirement Account investment earnings		461.3	461.3
GARVEE Transportation Bonds Federal Revenue (estimate)		1,700.0	1,700.0
GARVEE Transportation Bonds AATP Match (estimate)		300.0	300.0
General Funds Required	5,113.0	48,039.7	42,926.7
Total Fund Sources	140,369.6	167,014.3	26,644.7
General Fund Appropriations			
Appropriation to Debt Retirement Fund	8,000.0	40,877.9	32,877.9
Appropriation to Administration for Atwood Building Debt	3,549.4	830.9	(2,718.5)
Appropriation to University for HB528 Debt		1,412.9	1,412.9
Appropriation to Transportation and Public Facilities for HB528 Debt		1,212.1	1,212.1
Appropriation to Community and Economic Development for HB528 Debt		3,705.8	3,705.8
Subtotal General Fund Appropriations	11,549.4	48,039.7	36,490.3

1) Reduce FY 2003 school debt reimbursement based on actual entitlements, plus increased cigarette tax receipts added \$6,436.3 to the debt retirement fund balance.

The cost to the state for financing future debt is dependent on the state's credit rating. Currently the state enjoys an excellent credit rating – Aa2 Moody's, AA for both Standard and Poors and Fitch. While none of the rating agencies seem disposed towards downgrading the state's credit rating, they are quite aware of Alaska's long term fiscal situation and are watching closely to see how it is addressed. The importance of bringing recurring revenues and expenditures in line will have a significant impact on the state's future bond ratings.

Long Term Fiscal Plan

Some analysts believe that the most viable option under discussion for bridging the fiscal gap is the Percentage of Market Value (POMV) proposal that has been recommended in the past by the Permanent Fund trustees. The trustees say that the POMV payout proposal would solve a major portion of the fiscal gap, guarantee that Permanent Fund dividends will continue and extend the life of the CBR before additional revenue measures need be considered.

The basic elements of the Board's proposal are straightforward: Five percent of the market value of the Permanent Fund would be paid out each year (about \$1.2 billion). The trustees have made no recommendations on how the payout is to be spent. (For modeling purposes we assume it is split evenly between dividends and the general fund.) On average, the Fund is expected to earn about 7.95% per year so the payout rule would add 3% each year to the value of the Fund to offset the effects of inflation and maintain its real value into the future.

The 5% payout rate is at the upper end of what other endowments have found to be sustainable and was chosen by the Fund trustees as a balance between spending for the current generation of Alaskans and maintaining the purchasing power of the Fund for future generations.

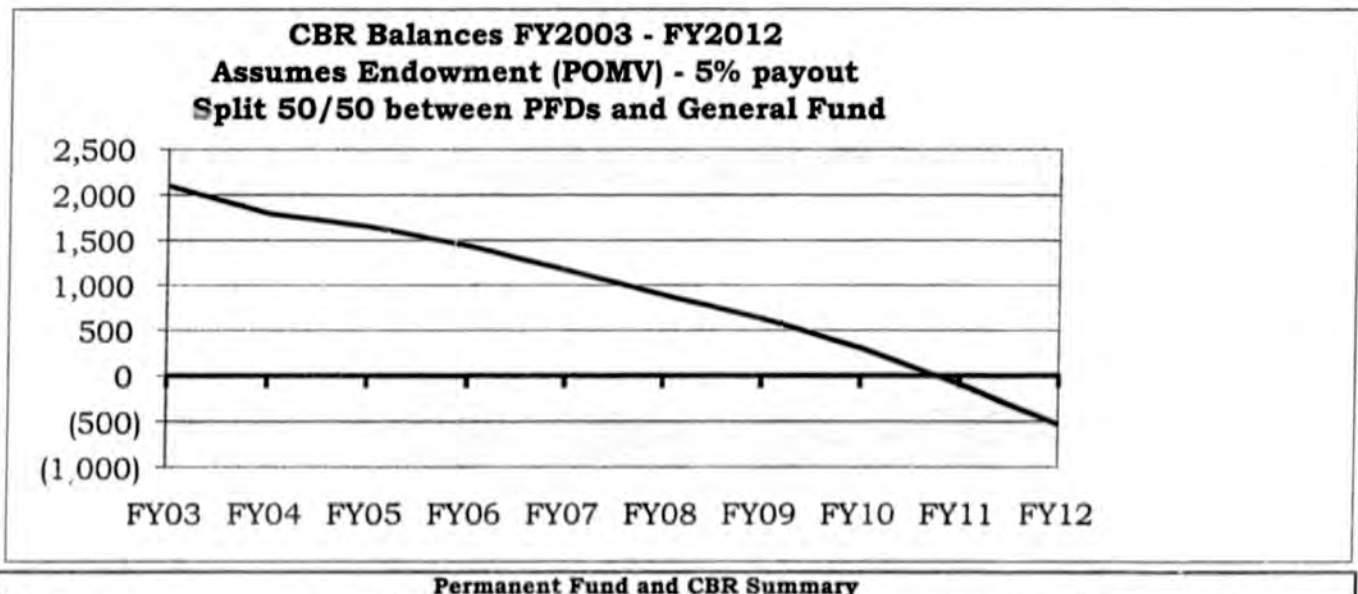
Currently dividends are paid out of the Earnings Reserve Account (ERA) of the Fund. Because of market losses, the balance in the ERA in September 2002 was zero, prompting speculation that funds might not be available to pay a 2003 dividend. A POMV approach would ensure that there would be funding available each year to pay dividends regardless of market volatility.

The Governor has said that no change will be made to the Dividend Program without a vote of the people. If offered as a constitutional amendment, a POMV formula as proposed by the Trustees would require a 2/3 vote approval of each house of the Legislature and then be approved by voters in a statewide election. If approved in 2004 by voters, with an effective date of January 2005, \$623 million would be available for dividends and an equal amount to the general fund.

If the state were not to adopt the POMV approach, but instead continue the status quo, the CBR can be expected to be drained completely by February 2006. Without a major source of new revenue at that time, there would be no choice but to make severe cuts in state programs or use Permanent Fund earnings, which could put both the dividend and inflation-proofing at risk.

The POMV provision by itself would extend the projected depletion date for the CBR to August 2008. Combined with the Governor's FY 04 budget and legislation proposals, the date of CBR depletion is pushed out to April 2011, giving time for additional recurring resource development revenues, such as those that would come from production of natural gas from the North Slope or from ANWR.

Chart 12



Permanent Fund and CBR Summary										
	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12
Permanent Fund Earnings to General Fund	-	-	623	629	646	673	698	719	742	764
Permanent Fund Expected Earnings	(516)	1,651	1,756	1,813	1,872	1,932	1,993	2,054	2,116	2,178
End-of-year market value of Permanent Fund	22,694	24,173	24,953	25,766	26,596	27,425	28,266	29,114	29,967	30,823
End-of-year Earnings Reserve balance	382	614	-	-	-	-	-	-	-	-
End-of-year CBRF balance	2,100	1,796	1,655	1,438	1,169	892	633	304	(88)	(533)
Projected Dividend (by Calendar Year)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Status Quo	1,120	820	550	700	950	1,220	1,410	1,540	1,660	1,760
POMV 5% Model	1,120	820	1,000	990	1,010	1,040	1,070	1,090	1,120	1,140
Projected Date of CBR Depletion										
Status Quo	February '06									
POMV 5% Model	April '11									
Department of Revenue Shortcut Model										

Summary

The initial focus of the Governor's proposed FY 2004 budget is on the fiscal gap between general fund revenues and expenditures. The first step is to slow the drawdown of the CBR balance to maintain its usefulness as a buffer to oil price volatility. The proposed budget cuts nearly \$190 million in built in general fund cost increases, mostly in formula programs and debt service to achieve \$20 million in overall savings compared to FY 2003. The Governor also proposes \$113 million in new revenues from a variety of sources and one time transfers of \$121 million in funds from other sources to the general fund. Altogether these actions (plus higher oil prices) would decrease the draw on the CBR from \$494 in FY 2003 to \$393 million for the Governor's FY 2004 proposed budget. This compares to the 842 million CBR Draw that was projected when the Legislature approved the current year budget last May.

For the longer-term, the Governor has asked the Permanent Fund trustees to make recommendations on how to best protect the Permanent Fund itself as well as how to provide stable and predictable distribution of earnings for dividends. If a similar POMV proposal as that discussed in this overview could extend the life of the CBR to August 2011. This would allow more time for resource development revenues to come on line and postpone the day when broad-based taxes need be considered.