

DRAFT FOR DISCUSSION:
A PATH TO A SUSTAINABLE FISCAL STRUCTURE

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August 24, 2015

PROBLEM STATE FINANCES HEMORRAGING
 PETROLEUM REVENUES ARE UNKNOWABLE, UNSTABLE, UNSUSTAINABLE

SOLUTION A PREDICTABLE, STABLE, SUSTAINABLE FISCAL STRUCTURE

MAIN CHARACTERISTICS OF SUSTAINABLE FISCAL STRUCTURE

- Flexible
- Fair—across stakeholders and time
- Grounded in reality
- Sensitive to economic effects

STRUCTURAL FOUNDATIONS

Preserve the Permanent Fund, including the balance currently in the Earnings Reserve (recognizing that it is part of our asset base). Grow the PF by continuing to deposit a share of oil and other royalties into the fund.

Continue the PF Dividend program in some form. This will protect the Permanent Fund.

Keep a minimum of \$2 billion in the CBR, sufficient to provide a safety value for annual fluctuations in other revenues.

REALITY CHECK

The CBR is hemorrhaging and will soon be depleted.

The only tools that can make a significant sustainable dent in a \$3 billion shortfall before the CBR is exhausted are budget cuts, PF earnings, and broad based taxes. None alone is sufficient, and all together they may not be enough.

MAIN STRATEGIC ELEMENTS OF FISCAL STRUCTURE (DETAILS LEFT TO LEGISLATURE, GOVERNOR AND PUBLIC)

Incrementally cut the budget toward a sustainable level—the level that can be maintained (adjusted for inflation and population growth) taking into account a forecast of future oil revenues, revenues from commercialization of NS gas, and earnings from financial assets. Cuts will negatively impact the economy, but a large share of those cuts can be a phased reduction in the oil and gas investment tax credit which currently accounts for \$700 million of the \$5.4 billion budget.

Budget cuts alone will be insufficient to put the state on a sustainable path so these additional steps should be taken concurrently.

- (1) Establish and implement a mechanism for using a portion of the earnings of the PF to support General Fund spending. (While recognizing the need to continue to protect the PF from inflation and to pay a dividend.) This could be done statutorily if only the realized earnings (statutory net income) were used, or through a constitutional change if the accounting earnings (including unrealized gains) were used. This will not have any negative impact on the economy in the near term. Use of all PF earnings will slow but not stop the growth of the PF.
- (2) Implement a broad based tax—either a personal income tax or a sales tax. This could be phased in to reduce its negative economic impact.

FISCAL DISCIPLINE

A broad based tax (as well as the “delinking” the PF dividend from its current formula) would re-impose the fiscal discipline that has been missing from the state fiscal structure since 1980. Spending from the General Fund would only occur if the public was willing to pay the taxes and use the PF to support it. This minimizes the danger of “overspending”—a problem the state has faced in past years when oil or gas revenues have spiked.

FAIRNESS

Cutting the budget and imposing a broad based tax spreads the “pain” across all Alaskans, if imperfectly. (A broad based tax can be structured to differentially impact different groups of Alaskans.) Reducing the PF dividend would also impact how the “pain” is spread. However the dividend has proven

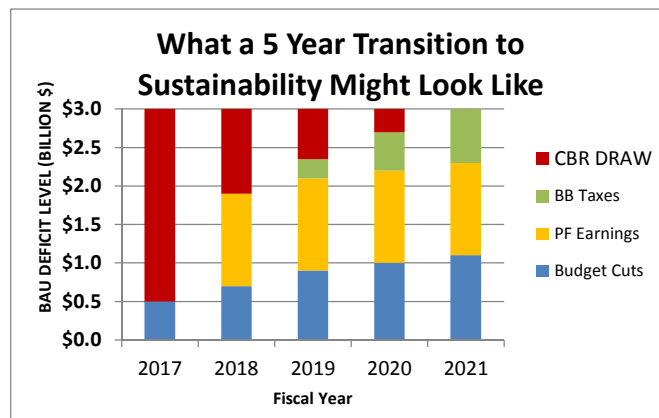
to be an important, if not critical, reason for the continued existence of the fund itself so any reductions should take this into consideration.

INCREASING OIL TAXES and/or MORE “ACTIVE” PF MANAGEMENT

These two “painless” revenue generating alternatives could potentially generate additional revenue but they both involve a high degree of risk and uncertainty. (For example, at the current oil price, there is little oil industry “profit” left to tax.) Without knowing a lot more about their effects, neither should be viewed as a part of a fiscal strategy in the near term. They should be studied as possible sources of additional revenue in the long term. If successful they could reduce the broad based tax or the need to impose further budget discipline.

IMPLEMENTATION

If the PF is off limits, except for its real earnings, and \$2 billion must be retained in the CBR, only about \$4 to \$5 billion will be available in the CBR to ease the transition to a sustainable budget when the legislature meets in 2016 to consider the FY 2017 budget. A hypothetical transition plan might look something like this:



HYPOTHETICAL TRANSITION PLAN (Billion \$)					
	2017	2018	2019	2020	2021
TOTAL TOOL USE	\$ 3.00	\$ 3.00	\$ 3.00	\$ 3.00	\$ 3.00
Budget Cuts	\$ 0.50	\$ 0.70	\$ 0.90	\$ 1.00	\$ 1.10
PF Earnings	\$ -	\$ 1.20	\$ 1.20	\$ 1.20	\$ 1.20
BB Taxes	\$ -	\$ -	\$ 0.25	\$ 0.50	\$ 0.70
CBR Draw	\$ 2.50	\$ 1.10	\$ 0.65	\$ 0.30	\$ -

The figure shows how a \$3 billion annual deficit is gradually reduced to zero over a 5 year period through the imposition of budget cuts, use of PF earnings, and new broad based taxes. The annual CBR draw cushions the transition as it falls each year and disappears with about \$2 billion remaining.

Of course, use of each of these deficit reducing tools would require a number of steps that could take considerable time to implement.

This type of transition allows for flexibility (in the use of budget cuts and new taxes) as conditions change, and also smooths the economic impact over several years.

STRESS TESTING

Because future oil and gas revenues and PF earnings are uncertain, a successful fiscal strategy should be robust to different oil price and gas commercialization and PF earnings assumptions. This strategy is flexible enough to work if revenues turn out to be either higher or lower than currently anticipated.

CONFIDENCE

Articulating and implementing a predictable, stable, sustainable fiscal strategy is not just a government concern. The health of the economy requires that Alaskans and the business community are confident there is a plan to get our fiscal house in order.