



**COMMONWEALTH
NORTH**

**LONG TERM ECONOMIC SUSTAINABILITY
FOR THE STATE OF ALASKA**

A COMMONWEALTH NORTH FISCAL POLICY STUDY

Co-Chairs Eric Wohlforth and Cheryl Frasca

February 2013

Edited by Jim Egan and Joshua Wilson

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For over twenty years, Commonwealth North has been leading an effort to study, highlight, and identify challenges and opportunities in Alaska's fiscal environment. The consistent determination, from a diverse cross section of study participants over the years, is that a sustainable long-range fiscal policy is necessary for Alaska to maintain its strong financial position for generations to come. In this Fiscal Policy Report, Commonwealth North summarizes the base line historical perspective, offers new perspective and provides three key findings to help create a foundation for establishment of a sustainable fiscal policy for the State of Alaska.

Our 2007 study, *At a Crossroad: The Permanent Fund, Alaskans and Alaska's Future*, was originally intended to review, report, and make recommendations about the Permanent Fund. The discussion evolved, however, to give voice to our concern for the stability of Alaska's future economy. Our principal concern is that the State's revenue system is structurally unstable because it relies predominantly upon declining oil production subject to volatile price changes.

In 2010, Representative Alan Austerman and Representative Anna Fairclough convened a mixed task force of Legislators and private citizens. The group was asked to study past efforts and public processes on this fiscal stability issue. Reps. Austerman and Fairclough also saw the urgency of creating a fiscal regime that balances the near-, mid-, and long-term needs of Alaska and Alaskans by developing a budget approach based on a sustainable revenue model.

For this study, our group received briefings from economists and revenue professionals. We hosted more than 40 Legislative candidates, 17 of whom were elected. The meetings took place between August 2012 and January 2013.¹ The discussion topics put to candidates at these meetings were:

- I. Many Alaska organizations, including some Legislators and governors have advocated that the State adopt a fiscal plan to help ensure stability in Alaska's future economy.
 - i. Do you believe the State of Alaska needs a fiscal plan? If yes, what elements should a plan include? If no, what is your approach to the State's fiscal future?
- II. Commonwealth North's 2007 Permanent Fund report recommended that it be managed as an endowment and that any earnings that remain after payment of

¹ Appendix A lists the meetings and legislators and candidates, as well as other attendees.

dividends be available to help mitigate any future instability in state revenue and services.

- i. What are your thoughts about changing the Fund to an endowment-like investment structure and would you support such a change?
 - ii. What do you see as an appropriate use of Permanent Fund earnings that remain after payment of dividends?
- III. The 2007 report also recognized that achieving political consensus on the above topics has been/will be difficult.
- i. What do you see as your role in addressing these issues?
 - ii. What do you see as the public's role? What are you willing to do to engage in a discussion about our collective economic future?

Scott Goldsmith, Professor Emeritus, Institute of Social and Economic Research (ISER), presented the study, *Maximum Sustainable Yield: Wealth Management for the "Owner State."*² The study showed Alaska's fiscal dilemma in graphic terms. Maximum Sustainable Yield is defined in the ISER report as:

[T]he amount the state can spend each year from its petroleum endowment, or nest egg, and still sustain the value of that nest egg for future generations. The nest egg is a combination of the state's financial assets and the estimated value of the petroleum still in the ground. The amount the state can safely spend each year depends on the size of the nest egg, the return it can achieve through prudent management of that nest egg, and the time over which it will need the nest egg to sustain public spending.

The scenarios in this ISER study show that the State's approximate cash reserves of \$13 billion will be fully depleted by the mid to late 2020 decade, with or without revenues from a gas pipeline.

The State is spending money at an unsustainable rate. If this is not checked, extreme measures such as diverting all Permanent Fund Dividends and and/or instituting state taxes could become necessary to sustain spending on State programs by 2023. Of even greater concern, these scenarios assume that the spending will grow at a level that is well below what has been the norm for the last few years.

According to the ISER study, since the inception of Prudhoe Bay oil revenues, the State has saved approximately 25% (\$45 billion) of total oil revenue received (\$175 billion). Amounts saved of this non-renewable resource are not enough to transition the State's predominant reliance on natural resource tax revenues to reliance upon sustainable yields from all financial resources; in other words, effecting a successful transition from reliance on non-renewable resources to reliance on perpetual resources. Alaska should consider oil revenues as an endowment, the ISER Study urges, saying that the Permanent Fund is an endowment only to a limited extent.

² *Maximum Sustainable Yield: Wealth Management for the "Owner State,"* located at http://www.iser.uaa.alaska.edu/Publications/webnote/2012_08_13-WebNote13.pdf

Subsequent to Dr. Goldsmith's presentation to the Commonwealth North Fiscal Action Coalition, ISER updated its study. The updated study, titled *Maximum Sustainable Yield: FY 2014 Update*³ offers these disturbing findings:

In fiscal year 2014, Alaska's state government can afford to spend about \$5.5 billion. That's an estimate of the level of Unrestricted General Fund spending the state can sustain over the long run, based on the current petroleum nest egg of about \$149 billion -- a combination of state financial assets (the Permanent Fund and cash reserves) and the value of petroleum still in the ground.

Alaska's expenditure of undedicated general funds has exceeded that level for several years.

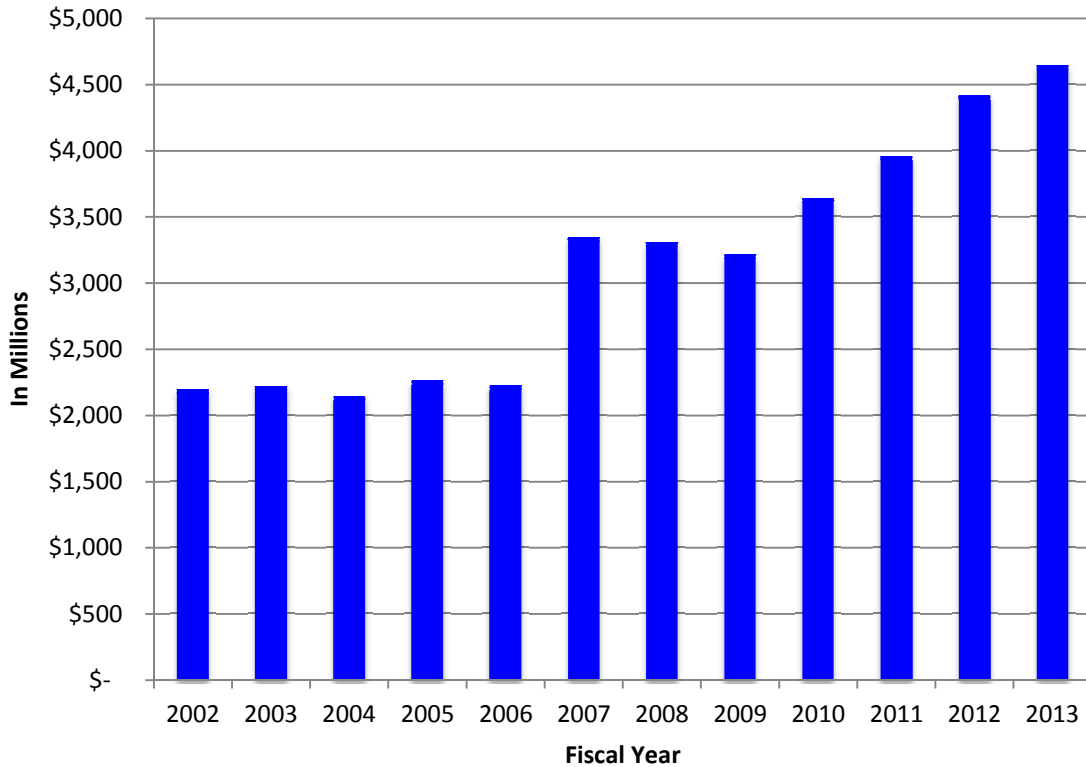
[That course puts] the state . . . on a path it can't sustain. Growing spending and falling revenues are creating a widening fiscal gap. In its 10-year fiscal plan, the state Office of Management and Budget (OMB) projects that spending the cash reserves might fill this gap until 2023 But what happens after 2023?

. . . [r]easonable assumptions about potential new revenue sources suggest we do not have enough cash in reserves to avoid a severe fiscal crunch soon after 2023, and with that fiscal crisis will come an economic crash.

Dramatic increases in the level of spending in recent years dominated the Commonwealth North Fiscal Policy Group discussions. The State's current \$3 billion capital budget is a large driver of this increased spending. As illustrated in the following chart, State general fund operating expenses have grown dramatically in recent years. Percentage growth has far outpaced that of other states, most of which have undergone budget cutbacks.

³ *Maximum Sustainable Yield: FY 2014 Update*, located at http://www.iser.uaa.alaska.edu/Publications/webnote/2013_01_03-WebNote14-FY2014MSYupdate.pdf.

State of Alaska Operating Budget Unrestricted General Funds 2002 - 2013



The above chart does not include the following categories of spending: capital budget; supplementals; debt/fund transfers/loans; savings and transfers; direct retirement contributions; and oil and gas credits.

- Virtually every Legislator attending commented on the need for the Governor to take the lead on budgetary and fiscal planning issues.
- Nearly as many said that the 90-day legislative session works against both rational budgeting and the Legislature's ability to create a long-term sustainable fiscal plan for the State.

Finding No. 1: Alaska Needs a Sustainable Fiscal Plan

Alaska is fortunate in being able to fund the costs of state government almost entirely through oil revenues. That was not always the case, however, and likely will not be the case again in the foreseeable future. As oil production continues to decline, and/or if oil prices drop below the relatively high levels assumed in current state forecasts -- oil revenues will become insufficient to fund the continuing costs of the level of state government that Alaskans have come to expect. Under most scenarios reviewed during the course of our study, that situation is only a few years away.

During the course of our review, we have become concerned that the State is not preparing adequately for this predictable eventuality. Even if used entirely to support the costs of state government, earnings from the Permanent Fund would produce only a little more than \$2 billion annually in unrestricted general fund revenues.⁴ By comparison, the State will spend more than \$7.5 billion in unrestricted general funds during the current fiscal year.

On its current course we believe the State is heading toward a time when it will need to cut the level of state spending dramatically which can lead to deep cuts even in core areas such as education, roads, and health care support. Alternatively, to avoid those cuts, the State may need to impose significant income, sales, or property taxes, or perhaps all three. Even then, because of political limitations on the levels of tax that Alaska realistically can impose, the State more likely will be faced with the need to make significant cuts in core areas.

We have come to believe that the future does not need to be this way. We believe that the State can build -- to borrow a phrase from the ISER Report -- a State savings "nest egg," that then can be used to produce revenue to meet the costs of state government when oil revenues are no longer sufficient. This nest egg would operate in much the same way as an individual's retirement account. It would continue to grow over the next few years as oil revenues remain relatively high. The nest egg would be invested for growth during the same period. Later, as oil revenues began to decline below the levels necessary to fund state government, earnings from the nest egg would be used to supplement declining oil revenues. Thus, the State will continue to pay for its core functions without a need to impose significant -- or hopefully, any -- income, sales, or property taxes.

If done correctly, as oil production declines, the State can transition from a revenue based on oil, to revenue built on solid financial resources. When those financial resources are used as a continuing endowment, the principal is preserved. Only the earnings are used to fund state government.

The State would be able to operate in this manner virtually in perpetuity. The State budget would become sustainable, without the need for significant additional personal or business taxes to support it.

⁴ *Maximum Sustainable Yield: Wealth Management for the "Owner State,"* located at http://www.iser.uaa.alaska.edu/Publications/webnote/2012_08_13-WebNote13.pdf

In order to achieve that result, the State needs to start putting significant amounts of its oil revenue stream into savings now, while oil revenues remain relatively high. Current state savings in other accounts, such as the Constitutional Budget Reserve and the Statutory Budget Reserve also should be moved to the endowment account, and not spent.

Moving a portion of the current revenue stream to savings will necessitate reducing current spending. There are significant offsetting benefits, however.

First, the approach will avoid imposing significant taxes on Alaskans after oil revenues are no longer sufficient to fund state government.

Second, the approach will provide a means of sharing the benefits of current oil revenues across generations. Without the approach, only current Alaskans will benefit substantially from oil revenues. Future generations will be left with the obligation to tax themselves to sustain the same benefits of government that the current generation is receiving essentially without cost. Putting a portion of the current revenue stream in savings avoids this intergenerational inequity.

Third, the approach will help stabilize Alaska's economic future. Future investment in Alaska will maintain and grow jobs. Investors are concerned about the potential of future taxes which could be inspired by today's unstable state fiscal policies. On the other hand, investors will be encouraged if they understand that the State has adopted a sustainable and predictable fiscal structure.

ISER's *Maximum Sustainable Yield* study discusses one way that such an approach can be undertaken. There may be others. We recommend that the Governor and Legislature consider and hold hearings during this session to identify the best approach, and then push forward to implement that approach soon, while oil revenues provide the opportunity.

The State has an urgent need to develop the practice of creating successive long-term strategic plans with annual budgets based on maximum sustainable yield⁵ of the State's primary assets. Further, the State needs to adjust near term spending, creating and maintaining savings while revenues exceed the maximum sustainable yield. The savings will help alleviate revenue shortfalls predicted by state forecasts and ISER.

A public engagement effort is necessary to advance Alaskans understanding of this need to plan for the future. This educational program will help the public understand the components of the State's budget that are driving the current capital and operating budgets. It is important that Alaskans understand that intentional and smart budgetary and fiscal planning yield intergenerational equity: a fiscal future that is fair to our children and grandchildren. Fiscal planning includes questions such as the following:

⁵ *Maximum Sustainable Yield: FY 2014 Update*, located at http://www.iser.uaa.alaska.edu/Publications/webnote/2013_01_03-WebNote14-FY2014MSYupdate.pdf.

- How much debt should the State issue?
- How large a savings nest egg is needed, considering the volatility of our revenues?
- Should triggers be put in place to automatically reduce State spending by percentages related to reduction in oil revenue or in federal spending in Alaska?

Legislators perceive a lack of public support to control spending. While it is easy to campaign on being fiscally conservative, once in office every legislator receives constant pressure from every stakeholder in every program to maintain and increase spending, and approve spending on new programs. There needs to be a focus on ways to make Legislators feel rewarded for not spending money and finding more efficient ways to deliver services.

Support for such efforts should include a management review that determines ways to deliver services cost-effectively. The last management study occurred more than 20 years ago.

Alaska's budget process could also benefit from a study of what sister states have learned as they cut their budgets in the last four years of budget contractions. Such studies could offer many useful lessons in how to eliminate program redundancies and streamline service delivery. Since 2004, State spending on recurring operating costs has increased from \$4.1 billion to over \$10 billion. Given projected revenues, the State will be unable to continue to afford this level of programs. It is imperative that the State scrutinize the operating budget. Another potential tool for such an examination are elements from Zero-Based Budgeting that include:

- Description and evaluation of each program, including its goals and activities Zero-line item budgeting for the program, with justification for amount budgeted in the prior year and amount budgeted in the current year, and justification for any change in the amount requested for next fiscal year
- Performance measures for the current effectiveness of each program (expressed as results, not descriptions of activities) and the efficiency of each program in delivering services
- Alternatives to current service delivery methods.

A fiscal plan could also include these features:

- Operating budget expenditures are displayed programmatically, instead of grouped by department, as has been customary. This could identify duplicative efforts and reveal consolidation opportunities.

- Programs, or service levels, could be prioritized across department boundaries. Citizens should be engaged in the priority-setting process so they have the opportunity to weigh in on the trade-offs between programs and services.
- The operating and capital budgets would benefit from review committees with BRAC-like appointed boards that could develop capital programs.

Finding No. 2: Permanent Fund distributions should be based on year end market value according to GAAP (POMV).

The citizens and Legislators we interviewed were nearly unanimous in the opinion that the public will reject any change to the existing practice of how Alaska calculates its Permanent Fund distribution. As long as the State enjoys the large surplus it does today, recognizing that most elected officials are opinion followers and not opinion leaders -- the public will reject out-of-hand any proposals for new taxes, or changes in the Permanent Fund. This view is borne out by efforts in the past that failed to change the Permanent Fund distribution from the current annual realized income formula to a distribution tied to a percent of the Fund's market value.

There continues to be support for a statutory Permanent Fund percentage of market value payout formula (subject to the constitutional limit). The Fund is managed for total return, not for income alone, and it makes sense for the payout formula to be consistent with this modern fund management practice.⁶

There is also continued support for the conclusions in our earlier reports that management of the Fund should be strengthened:

- There should be more competitive compensation of its board members;
- The Board selection and evaluation process should be strengthened to include assistance by a recognized firm with existing qualifications in search for and evaluation of board members for similarly sized funds;
- Staff compensation should be subject to review every three years to assure competitive compensation levels;
- Anchorage and out-of-state offices should be opened to maintain better contact with the larger investment world.

⁶ Nearly all endowment funds utilize an annual payout calculation based on the market value of the fund, rather than earned income, which is what the Permanent Fund currently uses. If the Permanent Fund functioned as an endowment, the annual payout (*i.e.*, dividend payments) would be based on its market value. The primary difference between these two payout methods is the consistency of annual withdrawals. Under a POMV method, the amount available for distribution would be more consistent than an annual distribution (such as for dividends) based on earned income. Of course, a statutory POMV method would be constrained by the constitutional earned income requirement.

Finding No. 3: It's Everyone's Job to do it!

There is strong support for a new statewide, inclusive process to develop a long-range fiscally responsible plan for Alaska. Any such process must focus on the act of determining a responsible budget before any specific proposal is submitted. The plan should include a non-partisan statewide effort where each participant is familiar with the important components of budgeting. Stockholders and budget planners need to understand the pros and cons of accepting temporary budget gaps and the long term implications of prolonged budget gaps.

Any statewide process on a fiscal plan must be carefully designed. A simple two-day conference as in 2004 will not succeed.⁷ All constituencies must help to design the statewide process and be involved in selecting its members, and in setting its agenda.

The constituencies must include the Governor, both houses of the legislature, and, of course, the people.

As it develops the Alaska process, the planning group should consider successful efforts elsewhere in the world.

Success hinges on accepting that we owe an obligation to future Alaskans to responsibly shepherd current resources when they exceed current needs, and to develop sustainable resources for future needs.

Commonwealth North's plea is to encourage a dialogue among all vital constituencies - the public, the Legislature, and the Governor; to inform each of these groups and inspire them to adopt a role in a solution.

Thus, inspired Alaskans can achieve agreement on the need for a balanced and responsible long term fiscal plan. Only then can there be collective agreement leading to hard decisions acceptable to the citizens of Alaska. That consensus is the key to policy action from the Governor and the Legislature.

⁷ 2004 Conference of Alaskans was the most recent, and nearly successful statewide effort, in a series of public deliberative events held between 1995 and 2004 to find solutions for Alaska's fiscal future. A 2001-2002 convening group consisted of a majority of the State House of Representatives. Its efforts produced legislation, which passed the House providing for a division of Permanent Fund income to pay dividends and government operations. The Legislation failed to pass the Senate. Other past efforts in Alaska are summarized in The Alaska Policy Working Group Report to the Alaska State House Finance Committee, March 11, 2011, found at: http://housemajority.org/coms/hfsp/pdfs/Complete_Compiled_Report_to_Finance_Committee_20110311.pdf

APPENDIX A: COMMONWEALTH NORTH MEETINGS & SPEAKERS

August 23, 2012 – **Representative Anna Fairclough**

August 30, 2012 – **Mark Foster**, Mark A Foster and Associates

September 13, 2012 – Candidate Discussion (**Cathy Giessel, Janice Golub, Andy Josephson, Pete Kelly**)

September 20, 2012 – Candidate Discussion (**Kevin Meyer, Lora Reinbold, Anne Sudkamp**)

September 27, 2012 – Candidate Discussion (**Roberta Goughnour, Gabrielle Ledoux, Guadalupe Marroquin, Don Smith**)

October 4, 2012 – Candidate Discussion (**Michelle Scannell, Jimmy Crawford, Phil Isley, Geran Tarr**)

October 18, 2012 – Candidate Discussion (**Bob Bell, Bennie Nageak, Tammie Wilson, Fred Dyson**)

October 25, 2012 – Candidate Discussion (**Eric Feige, Lisa Vaught, Kay Rollison, Click Bishop, Paul Seaton**)

November 1, 2012 – Candidate Discussion (**Roselynn Cacy, Cris Eichenlaub, Berta Gardner, Les Gara, Wes Keller**)

November 8, 2012 – **Scott Goldsmith, Professor Emeritus, Institute of Social and Economic Research**

December 6, 2012 – **Bruce Tangeman**, Deputy Commissioner of the Department of Revenue and **Bill Barron**, Director of the Division of Oil and Gas

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Commonwealth North is a non-profit corporation, organized and existing under the laws of the State of Alaska. Non-partisan in nature, its purpose is to inject enlightened vitality into the world of commerce and public policy. As well as providing a forum for State and National speakers, working committees study critical issues facing Alaska and prepare well-researched action papers, such as this one.

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