ACTION PAPER

COMMONWEALTH NORTH

BUDGET RECOMMENDATIONS FOR ALASKA

BREAKING THE FALL

Breaking the Fall:
Budget Recommendations for Alaska

Declining oil production and low oil prices are bringing Alaska's state government closer to the financial cliff—but we can still save ourselves from falling over the edge.

The state currently faces a $1 billion budget deficit and will face future deficits, because oil revenues—which pay 85 percent of government costs—are declining.

Commonwealth North (CWN) proposes budget actions the state should take *immediately*, and others it should take over the next four years.

CWN recognizes that some of these actions are politically unpopular and will be strongly resisted. But if we don't begin now, there will soon be a steep fiscal drop that will require far more draconian remedies.

These recommendations grew out of CWN's October 1993 budget conference and subsequent work by a CWN budget committee. All the tools for closing the state's "fiscal gap", as identified by Scott Goldsmith of the University of Alaska Anchorage's Institute of Social and Economic Research, are utilized in these recommendations.

COMMONWEALTH NORTH

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What the State Should Do Now

RECOMMENDATIONS	FISCAL IMPLICATIONS
Cut Spending	
• Freeze the operating budget below current levels.	$60 million reduction in FY 95.
• Reduce the capital budget to below historic levels.	A $100 million budget is $150 million below historic levels and $516 million below FY 94.
• Cap Permanent Fund Dividend expenditures at current levels.	Save at least $34 million in FY 95.
Increase Revenues	
• Increase taxes and user fees. Consider increasing "sin," motor fuel and fish taxes.	Up to $90 million in new revenues annually.
• Change the statutory priority to inflation-proof Permanent Fund first.	Could add $850 million more to principal by 2005, depending on use of Earnings Reserve.
• Encourage increased oil exploration and development.	100,000 bbl/day increase in production yields $50-100 million/year.
Get A Plan	
• Create Alaska Finance Commission with administrative, legislative and public members to produce a four-year financial plan.	Year-to-year predictability and stability of revenues and expenditures.
• Develop a plan for saving, consolidating and providing prudent access to reserves and nonrecurring future revenues.	Existing and future reserves ($1-$3 billion) protected from short-term liquidation. Total reserves available would be predictable.
• Create income tax commission including legislative, administrative, and public members to hold hearings, analyze tax structures and submit a tax proposal to the legislature in Jan. 1995.	Revenues ($250-400 million) from an income tax will take a minimum of two years from enactment to fully realize.

Putting the Budget Tools to Work

Reduce State Spending

In recent years state spending has far exceeded normal recurring revenues. The State has used windfalls, tax settlements, and reserves to fill the gap.

Alaska must cut spending before taking any other steps to balance the budget. The State can significantly reduce spending over time by holding the budget at current levels and absorbing inflation and population growth. Such action would allow the state to maintain basic services and avoid serious disruption of Alaska's economy, which relies heavily on state spending. Officials would be forced to set spending priorities, increase efficiency, and make cuts.

Alaska must immediately draw up a long-term financial plan. Successive administrations and legislatures have simply budgeted from year to year, depleting a large share of reserves, making state spending volatile, and risking Alaska's long-term financial health.

Save Reserves

Despite the State's lack of discipline in spending reserves in recent years, considerable reserves remain—including more than $800 million in the Constitutional Budget Reserve Fund (CBR), $1.1 billion in the Earnings Reserve Account (ERA) of the Permanent Fund and perhaps $1 to $3 billion in outstanding legal disputes.

We assume that the State will spend as much as $800 million of existing reserves this year to meet unexpectedly large deficits for fiscal years 1994 and 1995. We also assume that the legislature will address the nearly $1 billion court-ordered deposit to the CBR. Still, as much as $1.2 billion in reserves will remain—either in the CBR or in the ERA. But, projected deficits for the next two to three years could equal most of these remaining reserves.

Neither the CBR nor the ERA appears adequately protected from easy, short-term access or, on the other hand, structured to allow realistic flexibility to meet unforeseen future circumstances. We must determine a better way to consolidate and husband the reserves we still have and those we expect to get in the future. Any restrictions on these funds that would bind future legislatures would require a constitutional amendment.

Protect the Permanent Fund

The legislature can't spend the principal of the Permanent Fund, but it can appropriate the earnings. About half is used to pay dividends to Alaskans. Paying dividends takes precedence over any other use of earnings.

Earnings should go toward inflation-proofing the Fund first. In the future under current law paying dividends will use so much of the earnings that there won't be enough left to fully inflation-proof the Fund, and there will be no earnings available to help pay for general government.

The amount that goes toward paying dividends should first be capped and then reduced $50 million per year over the next several years. The dividend program could continue, although dividends would be smaller. Remaining earnings would stay in the earnings reserve and be available to help pay for general government.

Broaden Tax Base

Increasing some existing taxes and user fees—like alcohol, tobacco, motor fuel and fish taxes—could fill a small part of the gap and help pay for state services.

Alaska will need an income tax in the near future. It could raise an estimated $250-400 million annually, it is progressive, it is deductible against federal taxes and it taxes wages of non-resident workers. It could also help capture and pay for benefits of development, without impeding the competitiveness of the development.

The State should immediately create a tax commission to determine by January, 1995, how best to structure an income tax. It would take at least two years after enactment for full tax revenues to flow into the state treasury.

Promote Economic Development

The lion's share of state revenues in the foreseeable future will—despite the overall decline in production—still be from oil development. Development of new, smaller oil fields is possible and should be encouraged.

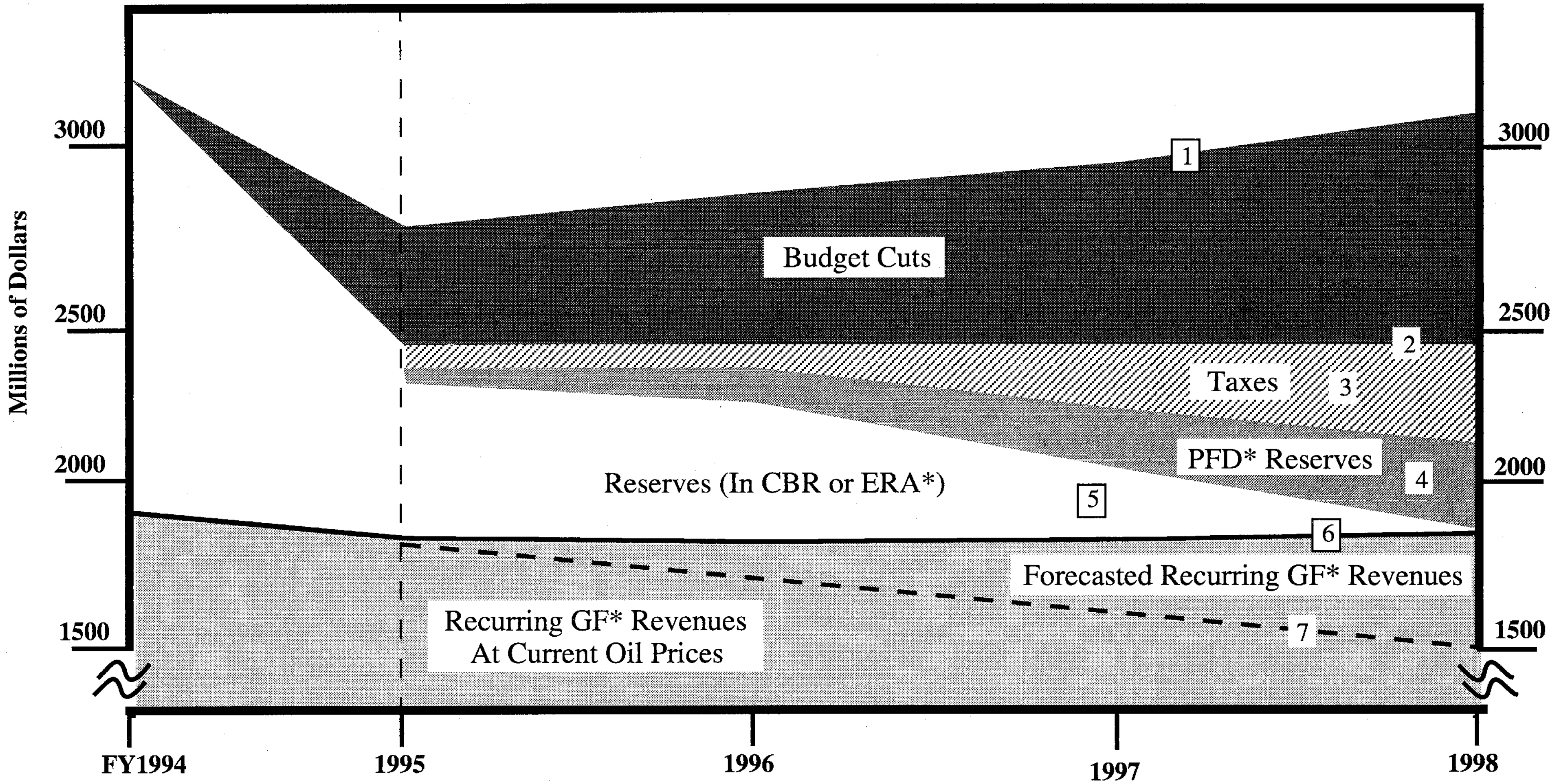
The State should continue to promote development of a gasline to carry natural gas from the North Slope, the lifting of the ban on the export of North Slope oil, and the opening of the Arctic National Wildlife Refuge to oil development. But we can't count on those developments for future state revenues.

The State should provide a positive climate for development. Resource developments other than oil would provide relatively little state revenue under the current tax system. But new developments can benefit local governments through property and other local taxes—which could help offset reduced state aid to local governments. Also, a state income tax could capture the benefits of new economic development and jobs by taxing increased personal income.

WHAT THE STATE SHOULD DO OVER THE NEXT FOUR YEARS

RECOMMENDATIONS	FISCAL IMPLICATIONS
• Hold future budgets below inflation and population growth. Reductions achieved by: - Limiting growth of formula/entitlement programs - Phasing out unique programs not based on need. - Restructuring programs for efficiencies, privatization opportunities, possible local government responsibility and wage, benefit savings.	Up to 5% annual reduction in inflation-adjusted dollars; Reduces state spending by $100-120 million annually, or a cumulative budget cut of nearly $500 million by 1998.
• Reduce, but not eliminate, total Permanent Fund Dividend expenditures over time.	Reducing expenditures by $50 million/year would save $278 million in FY 98. Would permit individual dividends of approximately $675 in FY 98.
• Reimpose a personal income tax.	Could raise $250-400 million in revenues annually.
• Establish a consolidated account for existing reserves and future non-recurring revenues with restrictive access provisions, including super majority vote and maximum annual withdrawal.	Existing and future reserves ($1-3 billion) would be protected from short-term liquidation. Total reserves available would be known and predictable and could be used as needed over many years.
• Emphasize equities in Permanent Fund investments.	Equities have outperformed other investments over time and have earned returns well in excess of inflation. A 1% increase in the Fund's earnings equals $186 million in FY 2000.
• Re-evaluate the inflation-proofing mechanism and dividend program to reflect Permanent Fund unrealized capital gains, earnings and asset allocations.	Currently unrealized gains are not calculated in the Fund's value. The decision to take capital gains may be affected by potential impacts on annual earnings, inflation-proofing and dividends. Some inflation-proofing is occurring through equity investment.
• Provide a positive economic and regulatory climate for future developments.	Diversified development would build an employment base to help offset declining oil revenues.
• Continue to promote the marketing of North Slope natural gas, the opening of Alaska National Wildlife Refuge and lifting of the oil export ban.	A gasline could contribute $250-450 million annually, ANWR development $0.8-$2.5 billion annually and the export ban repeal $150-200 million.

FISCAL IMPLICATIONS OF CWN RECOMMENDATIONS



Notes:
1. Maintenance level budget (operating budget 3% growth, $300 mil. capital)
2. CWN recommended total spending cap ($2.46 billion)
3. Income tax comes in 1/2 year in 1997, full year 1998
4. PFD reductions from status quo; increase $ in ERA available for appropriation
5. Existing reserves remaining in FY98 - about $500 million
6. Dept. of Revenue forecast: FY94, Actuals; FY95, 2/94 forecast; FY96-98, Fall '93 low-case ($15-17/bbl.)
7. Estimated revenues at current oil prices($13.25/bbl.)

CBR: Constitutional Budget Reserve Fund
ERA: Permanent Fund Earnings Reserve Account
PFD: Permanent Fund Dividends
GF: Unrestricted State General Funds

COMMONWEALTH NORTH

Commonwealth North is a non-profit corporation, organized and existing under the laws of the State of Alaska. It addresses state and national public policy issues and involves approximately 400 of Alaska's leaders and concerned citizens representing business, labor, education, public service and the Alaska Native community. It was founded in 1979 on a bipartisan basis by Governor William A. Egan and Governor Walter J. Hickel.

The goals of the organization include: Strengthening the private sector of our economy; Understanding Alaska's role in the larger world; Educating members on major issues affecting our state and nation; Influencing state and national public policy decisions by providing a forum for nationally recognized speakers and conducting studies of critical issues facing the state and the nation.

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