ISER
FISCAL POLICY PAPERS
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Institute of Social and Economic Research | University of Alaska Anchorage

WHAT WE LEARNED ABOUT ALASKA'S FINANCES: FINDINGS 1989-1992

In 1989, the Institute of Social and Economic Research (ISER) published the first Fiscal Policy Paper, warning Alaskans of trouble ahead. The oil revenues that had essentially paid for state government since the mid-1970s would be declining steadily during the 1990s, leaving a growing gap in the state budget. And the fiscal gap would affect not only state government funding, but also Alaska's economy—since state spending supports nearly one in three jobs.

But that first paper also pointed out that there was still time to deal with the fiscal gap. Over the next three years, ISER published six more Fiscal Policy Papers that examined aspects of state spending and pointed out options for dealing with the fiscal gap. The most recent one, published in July 1992, outlines one possible strategy for closing the fiscal gap without cutting essential government services or creating a major recession.

Since the first paper was published three years ago, the state has consistently operated at a deficit. It has covered those shortfalls through a combination of budget restraint, use of reserves, and the temporary oil price spike caused by the war with Iraq. The state has not yet adopted a strategy for dealing with growing deficits, but many state officials, civic organizations, and others are now examining ways to close the gap. To help Alaskans working to solve the fiscal crisis, this publication summarizes the seven Fiscal Policy Papers published from 1989 through 1992. Sets of the full papers are available from ISER. (See details on page 8.)

NO. 1—THE FISCAL GAP (AUGUST 1989)

The problem Alaska faces is easy to explain but tough to solve: Alaska's state government is spending more than it collects. The problem will worsen over time.

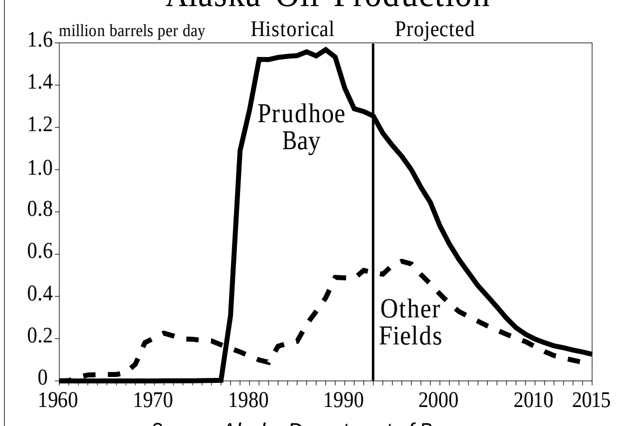
The first seven Fiscal Policy Papers *were sponsored by a grant from ARCO Alaska. We had planned to end the series with Paper No. 7. But recent grants from Alaska businesses have now made it possible for ISER to continue the series in 1993. In upcoming papers we tentatively plan to analyze specific policy steps to begin closing the fiscal gap and to assess economic, social, and demographic changes that will come with the new fiscal era in Alaska.*

The figure below shows the source of Alaska's good fortune in the 1980s and of its trouble in the 1990s. The state owns Prudhoe Bay—the largest oil field in North America— and collects taxes and royalties from production. Production from the field was extraordinarily high throughout most of the 1980s (at its peak in 1987 it accounted for 20 percent of total U.S. oil production), and oil prices were at record high levels for much of that time.

But production from Prudhoe Bay began declining in 1988 and will decline steadily through the 1990s. Likely new petroleum production, higher oil prices, and other economic activity in the coming decade won't generate enough income to offset the loss as Prudhoe Bay is depleted.

Oil revenues have supplied about 85 percent of the state's general fund income for more than a decade. But the state can't keep spending at its current level while its main source of income dwindles. The difference between current spending and existing revenues could reach beyond $1 billion by 2000. (See back page for current gap estimate.)

We'll have to balance future budgets by first scaling down government. But closing the gap entirely through budget cuts would deal the government and the economy a devastating blow. Alaska needs a strategy that includes not only cutting the budget but also increasing taxes, using reserves, using Permanent Fund earnings, and encouraging economic development.



Source: Alaska Department of Revenue

No. 2—Facts and Fables of State Spending (October 1989)

Alaska's state government was suddenly and surprisingly rich in the early 1980s. And the best part about our overnight wealth was that it came at virtually no cost to us as individuals: the state government's oil revenues paid for virtually everything from a much bigger state budget to subsidized loans to annual Permanent Fund dividends for all residents. Everyone benefited.

Now we're facing the reality of much smaller oil revenues in this decade, as production from the giant Prudhoe Bay field declines. (See page 1.) Cutting the budget needs to be the first step in closing the fiscal gap that could exceed $1 billion by 2000. (See page 8.)

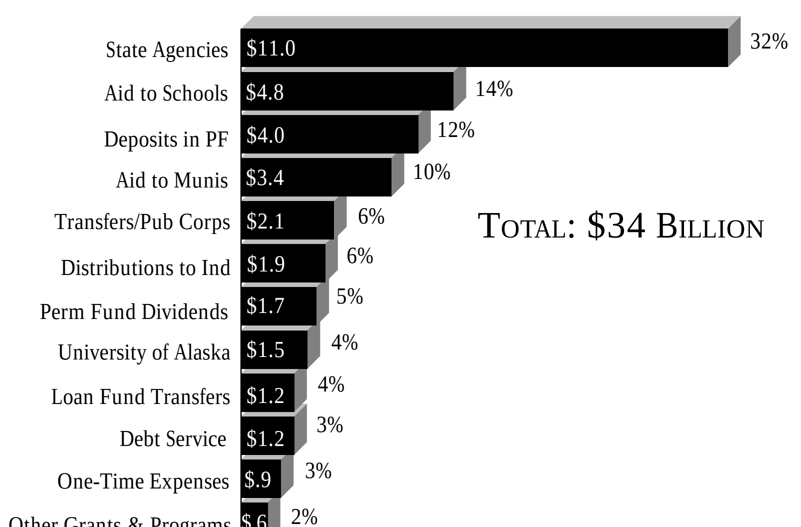
Paper No. 2 describes the many factors that contributed to Alaska's high spending over the past decade, and refutes popular fables about where all the money went. Understanding how the state actually spends its money gives us a basis for beginning the tough process of cutting the budget.

Roughly $34 billion passed through the state's general fund between fiscal 1981 and 1988. That total includes not only operating and capital spending but also some savings and investments. In examining state spending in the 1980s, Fiscal Policy Paper 2 found:

- Only about one-third of state spending went for the state government's operations and capital spending. The rest (as shown in the figure below) went to local schools, the Permanent Fund, local governments, public corporations like the Alaska Housing Finance Corporation, individuals, loan funds, and much more.

Cumulative State Spending, FY 1981-1988

(In Billions of Dollars)



Excludes Permanent Fund deposits mandated by the Alaska constitution.

- State spending did increase sharply in the 1980s, but it started from a base that was already far above the national average. In 1987 Alaska's government spent three times the national average per resident, even after we adjust for Alaska's higher living costs. But in 1967, long before Alaska became oil-rich, the state government spent twice the national average per resident.

- Part of the increase in state spending was due just to population growth and inflation over the past decade.

- A larger share of the increase happened because the state government used its oil revenues to (1) expand existing programs; (2) deliver services in more expensive ways; (3) add many new kinds of spending; and (4) increase wages of public employees.

- Alaska has a number of programs unlike those in any other state, and most were created or substantially expanded in the 1980s. The biggest and most obvious is the Permanent Fund dividend program, but there are others.

- Alaska's local governments became even more dependent on state aid in the 1980s, even though their own tax bases grew. That's because they cut local taxes and expanded services on the strength of state oil dollars.

- The hundreds of capital projects in Alaska in the 1980s added substantially to government costs, even though the state did not incur much new debt. The state government did pay as it went for most capital projects—but all those projects carry operation and maintenance costs. Also, local governments, school districts, and public corporations did take on a lot of new debt in the past decade—and the state bears some of the costs of that debt.

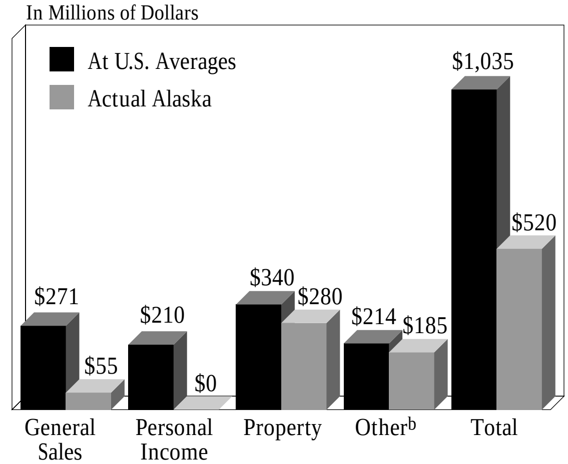
Many factors will complicate attempts to balance the state budget, including the heavy dependence of Alaska's local governments and economy on state spending; the increasing demands of a growing population; the service delivery systems that give local residents more control but at a high price; and the reluctance of Alaskans to pay taxes or give up special programs not based on need.

No. 3—Alaska's Potential Tax Revenues (February 1990)

Spend more and tax less was the philosophy of Alaska's state and local governments in the 1980s. They spent two to three times more per capita than governments in other states, but taxed individuals and businesses only about half as much. They were able to do that because high state petroleum revenues paid for most of state government and a lot of local government.

But in the 1990s we can expect to see Alaska's governments spending less and taxing more as North Slope oil production and state oil revenues fall. (See page 1.) *Paper No. 3* analyzes possible revenues for Alaska's governments, both from today's tax base and potential additions to the tax base. We use national average tax rates as a benchmark to give Alaskans an idea of how much revenue our tax base could generate. We're not advocating that Alaska governments suddenly raise rates to national averages. The paper reports:

Alaska State and Local Taxes
Paid by Individuals and Businesses, 1988
(Actual and at Estimated U.S. Average Rates[a])



Additional revenues at U.S. average rates:

$216	$210	$60	$29	$515

[a]Based on 1985 tax base calculations. Excludes taxes paid by petroleum and other resource producers.

[b]Other taxes include selective sales taxes and non-petroleum corporate income tax.

• Nominal oil prices (not adjusted for inflation) would have to increase 10 percent a year for the next 20 years to compensate for the projected drop in oil revenues as North Slope production falls. Such a long-term, sustained increase in oil prices is unprecedented. Oil prices are volatile. In recent years they fluctuated widely, but averaged about $19 per barrel (in 1992 dollars) with little upward trend.

• Alaska's state and local governments could collect an additional $500 million a year, if they taxed at the 1988 national average rates. Alaskans currently pay about half the national average amount in state and local taxes.

• Assets in public corporations might generate as much as $100 million annually for the state treasury, if the government sold all those assets and invested the proceeds. We're not advocating that policy—assets currently in public corporations provide benefits the state would have to carefully weigh before making such a radical change in policy. However, more modest changes might allow the state to divert some of the corporations' income to the general fund.

• Alaska's two largest resource industries—petroleum and seafood—pay about the same tax rates here as they do nationally. In 1988 the petroleum industry paid about $1.1 billion in state taxes (and another $900 million in royalties because the state is a resource owner). The seafood industry paid about $38 million.

• The smaller mining, timber harvesting, and agriculture industries in Alaska are currently taxed below national rates. Those industries paid less than $5 million in taxes in 1988. If the state had taxed their 1988 production at national rates, it would have collected about $10 million more.

• The economic developments with the most potential to generate large revenues are also the most uncertain right now. A gas pipeline from the North Slope and oil production from the Arctic National Wildlife Refuge (ANWR) could generate about $350 million (in 1988 dollars) in annual revenues by 2005. But the gas pipeline won't be built until the gas producers can find buyers. And ANWR is currently closed to petroleum exploration. Should Congress decide to open it, oil companies would have to find commercial deposits and undertake the necessary development to bring the oil to market—a process that would take more than a decade.

Raising taxes in Alaska will be difficult. Alaska is already a very expensive place to do business, and higher taxes will add to costs. Also, even though individual Alaskans probably carry the lowest state and local tax burden in the nation, many are convinced they already pay more than their fair share—and they have shown willingness to put up with some service cuts and reduced maintenance of roads and facilities rather than pay higher taxes. But by establishing the link between costs and services, new taxes will quickly focus taxpayers' attention on what they're willing to pay for.

NO. 4—BIG TICKET SPENDING: TRANSFERS & LABOR COSTS (MARCH

The State of Alaska spends 75 percent of its money in two ways: transferring money to individuals and local governments and paying salaries and benefits of state workers. Anyone considering how to cut the budget has to understand where most of the money goes—and to recognize that labor costs and transfers automatically grow with population and inflation. (See pies below.)

If Alaska is to balance future budgets, state officials will have to consider ways of re-structuring transfer programs and holding down labor costs. *Paper No. 4* profiles the state's ten largest transfer programs and examines state payroll and benefits. (Updated spending figures for those programs are in the box below.) The paper finds:

• Transfer programs are taking more and more of the state operating budget. Between 1970 and 1989—a period when the real state operating budget nearly quadrupled—transfers grew so much faster that they moved from 26 percent to 44 percent of general fund spending. And that general fund spending does not include the Permanent Fund dividend program, which by itself is nearly one-third the size of other transfer programs combined. (Transfers include grants and claims.)

• Only half the state's largest transfer programs are based on need. Continuing unique programs not based on need will undermine funding for traditional government functions as oil revenues decline. The biggest example is the Permanent Fund dividend program, but others include the Longevity Bonus program and the Power Cost Equalization program.

• Programs for the poorest Alaskans—the public assistance and medical assistance programs—accounted for just 11 percent of state money paid out under the ten largest programs in fiscal 1992. However, state costs for federal programs like Medicaid have been growing more rapidly than just about any other budget item in recent years—and those costs are largely beyond state control.

• An alternative to reducing or eliminating services as revenues fall is delivering them more efficiently. Beneficiaries of many of Alaska's transfer programs have no incentive to contain costs. Restructuring programs to create incentives for savings and to require some contribution from those able to pay could increase efficiency and reduce costs.

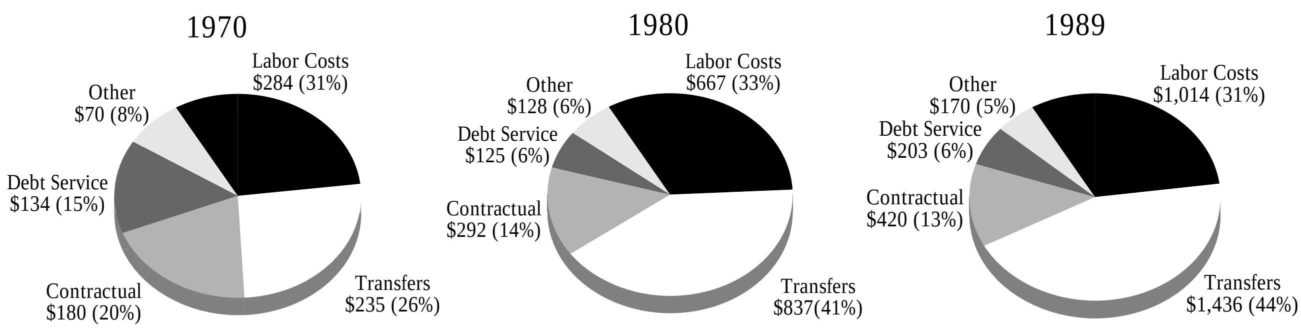
• State labor costs have historically grown along with population, increasing 50 percent in the 1980s, even after an adjustment for inflation. Rather than simply adding workers as the population grows, Alaska needs to look for ways to serve the public more efficiently and to control growth in costs of existing employees.

State Spending for Ten Largest Transfer Programs, FY 1992
(In Millions of Dollars)

1.	School Foundation*	$514
2.	Permanent Fund Dividend	$475
3.	School Debt Reimbursement	$129
4.	Medicaid and General Relief Medical*	$102
5.	Public Assistance*	$62
6.	Longevity Bonus	$62
7.	Municipal Assistance	$47
8.	Revenue Sharing*	$38
9.	Pupil Transportation*	$29
10.	Power Cost Equalization	$15

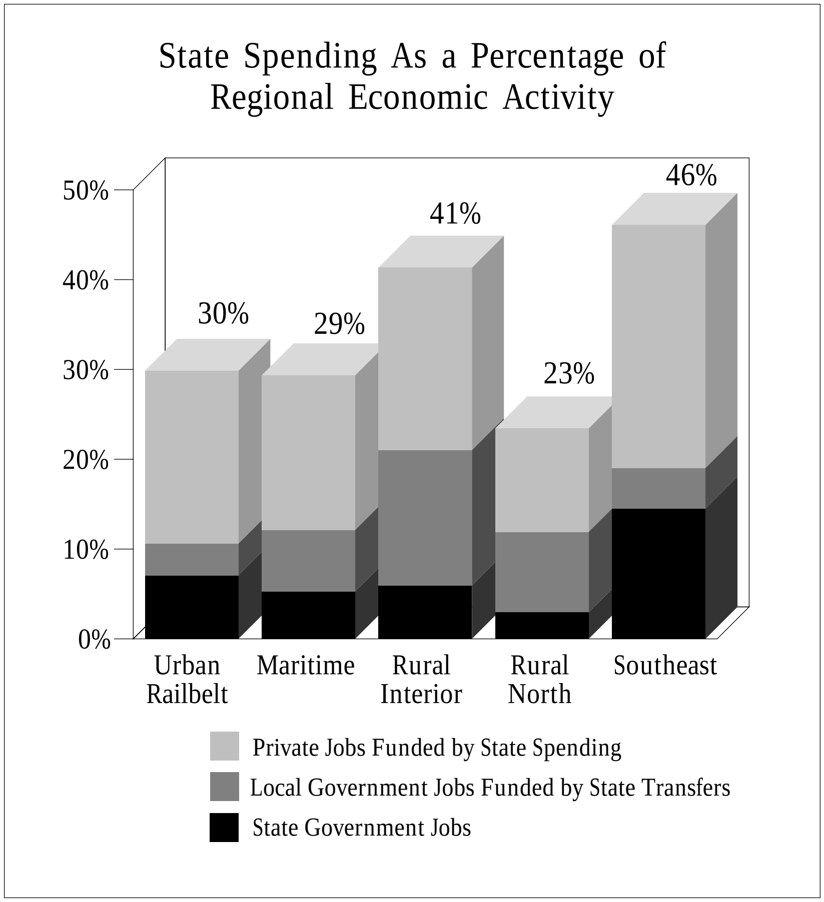
**Programs based on need. Permanent Fund dividends paid October 1991 through October 1, 1992.*

Composition of the Operating Budget
(In Millions of 1992 Dollars)



No. 5—Alaska's Dependence on State Spending (October 1990)

It would be hard to exaggerate Alaska's economic dependence on state spending. State spending supports nearly one of every three jobs in the state—including about 50,000 private jobs and 30,000 public jobs. Three of every ten dollars of personal income—more than $3 billion in 1990—grow out of state spending. In different regions of Alaska, state spending supports anywhere from 23 to 46 percent of all economic activity. (See adjacent figure.)



So it's easy to see why state officials have to consider the economic effects of their fiscal policies. The state faces big and growing budget deficits in the 1990s as state petroleum revenues fall. (See page 8.) State officials have to bring state spending to a level Alaska can sustain and Alaskans are willing to pay for. *Paper No. 5* examines the economic importance of state spending and analyzes the economic effects of different state fiscal policies. The paper finds:

• If state officials try to close the fiscal gap entirely through across-the-board budget cuts, state spending would drop 40 percent by the year 2000 and Alaska could lose as many as 35,000 jobs.

• Alaska can't avoid some economic slowdown as the fiscal gap widens, but by choosing different fiscal policies state officials could save thousands of jobs.

• Some fiscal choices would save jobs at the expense of income. Re-imposing a personal income tax or eliminating the Permanent Fund dividend program might reduce per capita disposable income 2 to 5 percent by the year 2000, but save about 4,000 jobs.

• Policies that save jobs are more likely to keep people in Alaska than are policies that preserve income. When people lose their jobs they are often forced to look for jobs elsewhere. But when they keep their jobs but lose some income they're more likely to stay and spend less.

• Increasing the annual rate of return on the Permanent Fund by 1 percent is a policy that could save both jobs and income. If the increased rate of return were used to increase Permanent Fund dividends, it would help save private jobs and income. If it were used to bolster general fund spending it would help save public and private jobs and income.

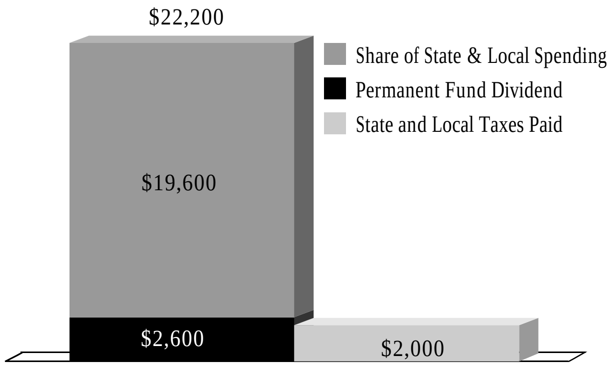
• It would be short-sighted to shift the portion of Permanent Fund earnings used to inflation-proof the fund to general fund spending. That shift would save jobs and income in the near-term, but in the long run the value and earning power of the Permanent Fund would dwindle when it was no longer protected from inflation. A dwindling Permanent Fund would leave us with fewer resources to deal with the fiscal gap in the next decade.

• Combining fiscal policies that raise revenues and reduce costs would save more jobs and income than would cost-cutting or revenue-raising policies by themselves. For example, new tax revenues could preserve more jobs, if the cost of each job were 10 percent less.

• Among the first things to go as state spending falls will be capital aid—and those regions unable to finance projects themselves will see little construction as the fiscal gap widens.

No. 6—Who Will Pay for Balancing the Budget? (April 1991)

What the Average Household Receives from Government and Pays in Taxes



Calculated by dividing total spending and total taxes falling on households by the population and multiplying by 2.8 (average household size).

Alaskans will pay more and get less from state government in the 1990s. But how will the burden of spending cuts and tax increases fall on richer and poorer and urban and rural households? That depends on which fiscal policies state officials choose.

Alaska faces big and growing budget deficits because the petroleum revenues that mostly paid for state government in the 1980s will steadily shrink in the 1990s. This paper assesses how different state taxing and spending policies could affect different kinds of households.

As a measure of those effects, we examine relative losses in disposable household income. Budget deficits will of course have other effects on households, and Alaskans who lose their jobs will obviously face bigger losses than we describe. But relative household income loss is a good measure of the equity of various fiscal policies.

The figure above shows that the typical Alaska household receives in payments and services more than 10 times what it pays in state and local taxes. That figure gives us perspective when we look at the effect of fiscal policies: under current policies, Alaskans at all income levels pay little or nothing for state and local government—because there are no major state taxes and Permanent Fund dividends frequently exceed local taxes. *Paper No. 6* finds:

• The larger a state budget Alaskans choose to maintain, the more they will have to pay. It remains to be seen how much Alaskans are willing to pay.

• The less Alaskans pay, the more government services will decline. Hundreds of million of dollars in budget cuts will cost the average household little in direct income—but a great deal in reduced education, police and fire protection, road maintenance, and other services we receive from state and local government.

• Eliminating Permanent Fund dividends and shifting the money to general government would cost Alaska households the most income but would require the smallest cuts in services—because the dividend money alone would reduce the fiscal gap by $500 million.

• To the extent that state officials cut the budget across-the-board, poor and elderly households will suffer disproportionately because they rely most on transfer payments and subsidies.

• Households on average would lose less income if the state balanced its budget by raising taxes rather than eliminating the Permanent Fund dividend. That's true because businesses would pay a part of new taxes.

• Smaller, more affluent households and most single Alaskans would probably rather give up Permanent Fund dividends than pay major new taxes—because they would likely lose less in dividends than they would pay in taxes.

• Large, poor households could lose several times more than smaller, more affluent households if Permanent Fund dividends were eliminated—because large households collect more dividends and those dividends make up a bigger share of their total income.

• Cutting the Longevity Bonus across-the-board would take some income away from all Alaskans over 65, but basing the program on need would take the entire bonus away from wealthier Alaskans over 65 while protecting the payments of those with less income.

• Big budget cuts would hit incomes of rural Alaskans harder than incomes of urban residents, because rural Alaskans rely more on transfer payments and subsidies.

When oil revenues were plentiful and individuals didn't have to bear the burden of state government, state officials could be generous with everyone. Now lawmakers face tough choices about which special transfer programs and subsidies the state can maintain in more austere times. But in considering new fiscal policies, they need to bear in mind that the free-spending policies of the 1980s fostered dependence among many Alaska households, particularly needy families and older Alaskans.

Alaska is poised for either a safe landing or a nose dive. Alaska's state government and economy are in danger because they both rely so heavily on state oil revenue.

Oil revenue from North Slope production makes up 85 percent of the state government's general fund income and produces 30 percent of Alaskans' personal income. State spending supports 50,000 private jobs and 30,000 public jobs.

But North Slope production has already begun declining and will continue to drop. As a result, state oil revenues will shrink. Our estimate of the size and timing of the fiscal gap has changed with changing conditions. (See page 8.) We now estimate that it could reach $1.5 billion by 2000.

If we fail to begin dealing with the fiscal gap now, we could be facing fiscal and economic catastrophe: a government without enough money to provide essential services, and an economy thrown into recession.

Luckily, Alaska has the resources to move toward a government that's smaller but still able to serve its citizens and be a partner with private industry in a healthy economy. *Paper No.7* outlines a fiscal strategy with five major steps. That strategy could keep essential state services and programs intact, avert a major recession, and preserve the earning power of the Permanent Fund. Alaskans can choose when to take the five steps and how heavily to rely on each, but we have to take all five. The figure below illustrates one way the five steps could be combined to fill the fiscal gap:

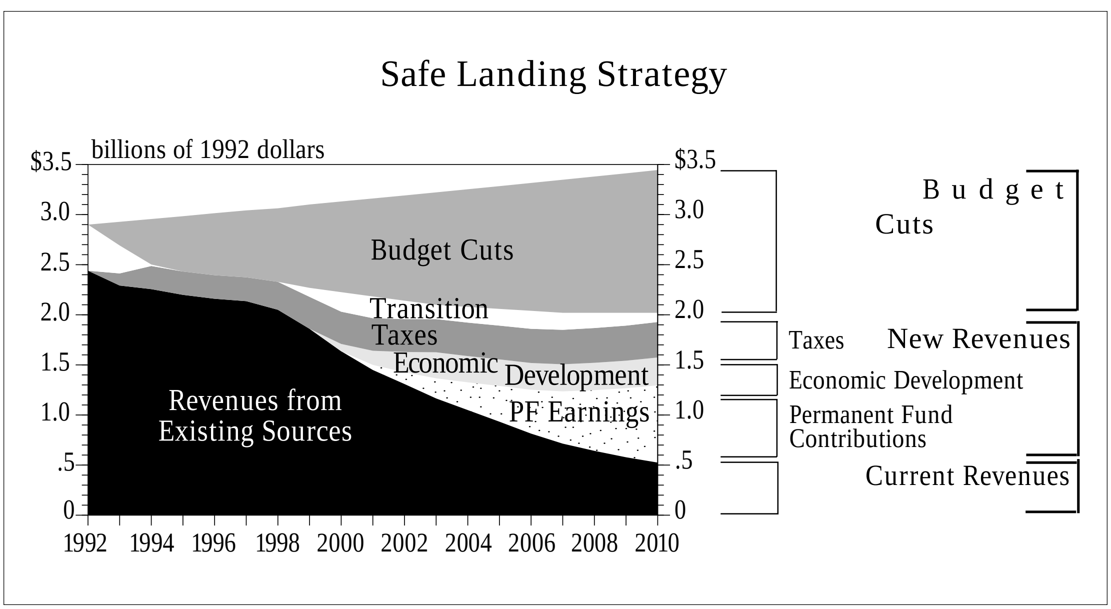
Step 1: Cut spending. Spending cuts could eliminate nearly half the projected fiscal gap under this strategy—which would first freeze spending and then hold growth below the general rate of inflation throughout the 1990s.

Step 2: Use Permanent Fund earnings. Permanent Fund earnings could fill one-quarter of the fiscal gap by 2010—more than petroleum revenues, personal income taxes, or likely new economic development. To generate earnings that large in the next century, the state would need to increase the fund principal by re-investing earnings that now go to the Permanent Fund dividend program. Reducing and then eliminating the program would be tremendously unpopular with Alaskans who have grown accustomed to the annual state payments. But Alaskans would still receive substantial but different benefits—the earnings would help stabilize the government and the economy and help pay for basic services that would otherwise have to be eliminated or paid for with higher taxes.

Step 3: Encourage economic development. Economic development could fill about 10 percent of the fiscal gap by 2010—but exact levels of future development are impossible to predict. The state can best encourage economic development by managing the fiscal crisis (thus creating confidence in industry) and adopting stable yet flexible tax and royalty policies that assure a fair share for the state from future resource development.

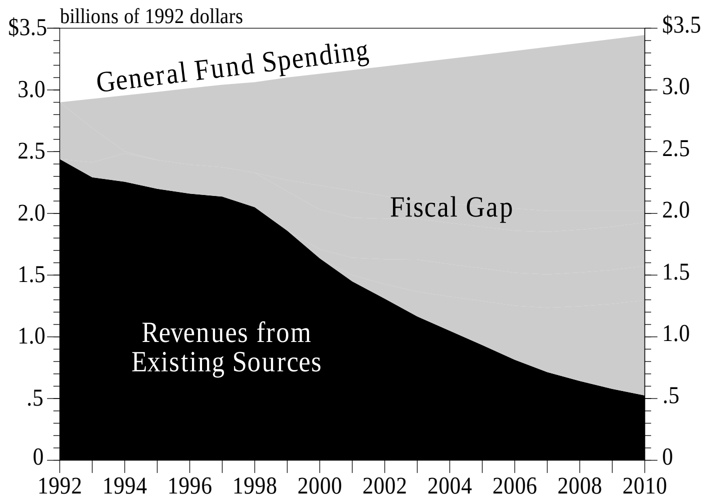
Step 4: Levy taxes. A personal income tax could fill roughly 13 percent of the projected fiscal gap by 2010. This strategy calls for imposing an income tax as soon as 1993—to help the state get through the next few years without spending its reserves. Alaska households pay virtually no state taxes now.

Step 5. Manage transition funds. The state government should deposit existing reserves (except the Permanent Fund) and any settlement payments it receives into accounts to be managed as transition accounts. The current policy of spending reserves to try to plug the widening fiscal gap both disguises the problem and reduces our future options. In combination with other strategic steps, these funds could cushion the transition to a smaller government and act as a shock absorber when year-to-year fluctuations in oil prices affect state revenues.



Estimated State Fiscal Gap

(As of November 1992)



Estimated gap assuming current spending trend (constant real per capita) with no new revenue sources and oil prices at $19 per barrel.

This is our estimate of the state fiscal gap as of late 1992. The estimated fiscal gap has changed several times since we began publishing the *Fiscal Policy Papers* in 1989, and it will undoubtedly change again. It changes as projected world oil prices, state oil revenues, and state spending trends change. But regardless of the precise size and timing of the fiscal gap, the fundamental problem remains the same: Alaska's state government will face growing budget deficits as oil production and therefore also oil revenues decline.

About the Authors

The principal series author, Scott Goldsmith, is an ISER economist with 17 years' experience analyzing state finances. Lee Gorsuch, ISER director, guides the design and presentation of the series. Other contributors include Alexandra Hill and Teresa Hull, ISER research associates, Matthew Berman, ISER economist, Jay Hogan, former director of the Alaska Division of Budget Review, and Mary Lou Madden, currently with the Alaska Commission on Post-Secondary Education. Linda Leask edits the series and Monette Dalsfoist prepares layout and graphics.

Many state officials and private citizens also helped us enormously by reviewing drafts of the papers, and we thank them all. The series to date has been financed by a grant from ARCO Alaska. It will continue in 1993 with grants from several Alaska businesses.

Reprints of Fiscal Policy Papers and Notes

In January 1993 ISER will have sets of the seven *Fiscal Policy Papers* and three *Fiscal Policy Notes* published so far. The price of the full set, in a presentation folder, is $10.00. You can order sets by sending a check or purchase order to:

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