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## HOW ARE WE DOING? MONITORING ALASKA'S FISCAL CONDITION

By SCOTT GOLDSMITH

**A**laska's government has been down on its luck this year, with low oil prices, a big deficit, and legal disputes over the budget. Despite all that, Alaska still has substantial assets.

The state's share of Alaska oil reserves is worth—even at low oil prices—about \$16 billion. The Permanent Fund has a balance of \$13 billion and earned \$1 billion last year. Alaska has more development potential. Its household tax base is almost untouched, because residents pay no personal state taxes.

But the state does have a serious money problem that's putting its assets at risk. Since 1988, revenues have fallen short of spending several times (Figure 1). In the past three years, spending has been up sharply, even as revenues declined. At first the gap was barely noticeable. In fiscal 1994, however, the state faces an estimated fiscal gap of \$1.4 billion.

The state got into trouble by continuing to spend more while relying on oil revenues for most general government income. A decade ago, oil prices and oil revenues were much higher. But in recent years, except for a brief period during the 1991 war with Iraq, oil prices have fluctuated between \$10 and \$20 per barrel. Lately they've been near the bottom of that range.

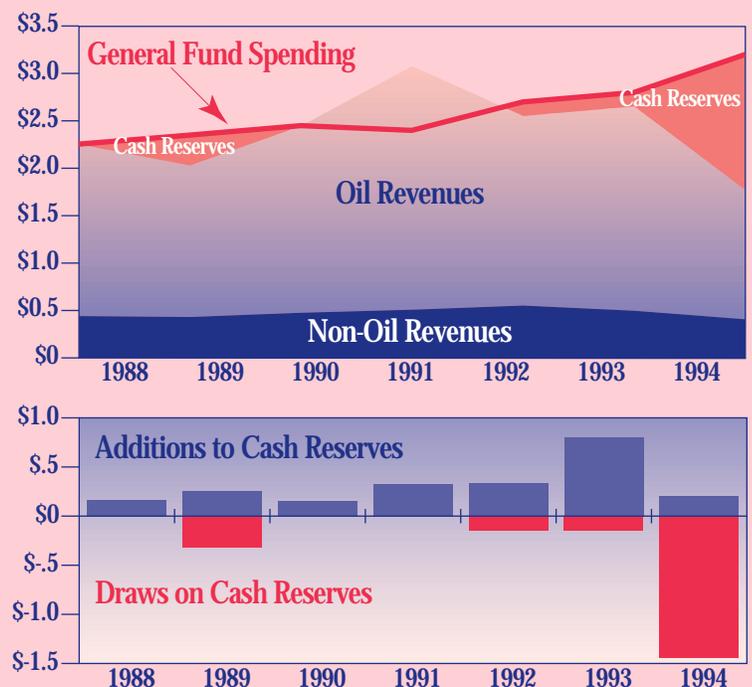
But the underlying problem—independent of oil prices—is declining production: Alaska's production has been dropping since 1988, because new discoveries haven't replaced declining production from the Prudhoe Bay field. Unexpectedly low oil prices combined with unusually high spending for capital projects created the big fiscal gap this year. But even if oil prices recover to \$18 per barrel (which some analysts think is unlikely any time soon), Alaska faces continuing budget gaps as oil production continues to decline. Aggravating the decline in revenues is continuing population growth—meaning more demand for services.

So far the state has balanced the budget mainly by using its cash reserves. The state has reserves because of settlements of tax disputes, earnings from special funds, and surplus revenues from earlier years. Closing this year's fiscal gap will take a third of the reserves, and the

remaining \$2 billion in existing reserves won't last long, if we just keep pouring them into the fiscal gap. If more tax disputes are resolved in the state's favor, new settlements would temporarily bolster the reserves. But whenever they're gone, Alaska could be left with a huge hole in the budget and disruption in the economy, which relies heavily on state money.

We can avoid all that by gradually bringing spending and revenues into balance. Pages 2 and 3 examine what is happening to the state's assets—and why preserving and building them is so important. The foldout details the risks of relying exclusively on cash reserves. Page 4 provides a simple checklist for monitoring the state's progress toward the long-term budget strategy called the Safe Landing.

**FIGURE 1. RELYING ON CASH RESERVES, 1988-1994**  
(IN BILLIONS OF DOLLARS)



This paper continues the series examining state spending and revenues and the issues Alaska faces as oil revenues decline. It is sponsored by grants from a number of Alaska businesses: *National Bank of Alaska, First National Bank of Anchorage, the Anchorage Daily News, Alascom, Inc., Alaska National Insurance Company, Ketchikan Pulp Company, and Lynden Incorporated.* Contributors to this paper include Lee Gorsuch, Linda Leask, Monette Dalsfoist, and Alexandra Hill.

## Why Is It Important to Build Assets?

**A**ssets are wealth. Some assets, like cash or savings accounts, are financial; some, like houses or property, are physical. Others—education, for instance—are less tangible. Generally, the more assets you have, the better the quality of your life.

The wealth of a state also consists of financial, physical, and intangible assets. One of the most important assets of a state is its tax base—because the size of the tax base determines the state’s capacity to fund education and other services.

In Alaska, much of the tax base is natural resources—the most valuable of which is oil. Alaska is unique among states because it owns a good share of the state’s natural resources, including the North Slope oil fields. The state therefore owns much of the tax base, and the oil reserves are treated as a state asset. In other states the tax base is mainly in private hands.

All states monitor their tax bases to gauge the health of their economies. In Alaska, because the state owns natural resources, another important measure of economic health is the value of the state’s assets. Table 1 shows selected state financial assets: cash reserves, potential settlements from tax disputes, the Permanent Fund, and the state’s share of oil reserves. (Examples of state assets not shown are pension funds and the Alaska Housing Finance Corporation’s mortgage portfolio.)

Alaska’s \$34 billion in financial assets could generate more than \$1.5 billion in annual sustainable revenues for the state. That’s a large amount, but it falls far short of the \$3.75 billion the state will spend this year. In fact, the state used some of its

assets—cash reserves—to help pay for this year’s spending. That’s like a person without a job living off his savings and not looking for work—because even as Alaska dips into its assets to pay bills, it’s not levying any new taxes or looking for other ways to increase non-oil revenues.

Use of the cash reserves is one reason the value of Alaska’s assets dropped between 1993 and 1994. The more significant reason is that the value of the oil reserves declined—a result mostly of much lower oil prices, but also of ongoing production reducing the size of the known reserves.

Still, even at low oil prices, oil is Alaska’s biggest asset. But we’re producing more oil than we’re discovering. How well Alaska maintains its assets and tax base depends on how successful the oil industry is in replacing lost oil production, and how well the state converts the declining oil reserves into a growing Permanent Fund (Figure 2).

Table 2 is a simplified 1994 financial statement for Alaska, showing revenues and expenditures from the state’s major financial accounts. (These figures are estimates because fiscal 1994 is not yet complete.) Although most government activities are funded out of the General Fund, we need to look at all funds to get a clear picture of the state’s fiscal condition.

- *The shortfall in all funds together (\$800 million) was less than the shortfall in just the General Fund (\$1.4 billion) because more money came into the Permanent Fund (in oil revenues and in earnings) than the state paid out in dividends.*

- *The state’s investment earnings were nearly as large as its oil revenues in fiscal 1994—which underscores the importance of building state assets to help replace oil revenues.*

### TABLE 1. TRACKING THE VALUE OF MAJOR STATE ASSETS

(IN BILLIONS OF DOLLARS)

FISCAL YEAR	TOTAL	CASH RESERVES	POTENTIAL SETTLEMENTS	PERMANENT FUND	VALUE, STATE SHARE OIL
1988	\$34.3	\$ .8	\$3.3	\$8.6	\$21.6
1989	30.8	.9	3.4	9.2	17.3
1990	38.1	1.1	3.6	9.9	23.5
1991	48.1	1.4	3.6	10.9	32.2
1992	41.3	2.3	3.5	11.7	23.8
1993	41.8	3.0	3.0	12.4	23.4
1994 (est)	33.8↓	1.9↓	3.0	13.0↑	15.9↓

**Cash Reserves:** Includes General Fund, Constitutional Budget Reserve, and Permanent Fund Earnings Reserve

**General Fund:** Funds general government operations and holds cash reserves not specifically allocated to some other account. In recent years the general fund has included excess revenues from prior years and special purpose accounts, such as the Railbelt Energy Fund.

**Constitutional Budget Reserve:** Established by the legislature to hold cash received from settlements of tax and royalty disputes with oil companies; to be used when regular revenues fall below the previous year’s spending. In early 1994 the Alaska Supreme Court ruled that the legislature had illegally appropriated money that should

have gone into this account. Recently the legislature reached a tentative agreement to satisfy the court order and re-appropriate the money.

**Permanent Fund Earnings Reserve:** Holds earnings not needed to pay dividends or inflation-proof the Permanent Fund. Money in this account is available to be spent on government programs or redeposited in the Permanent Fund. This reserve grows when the earnings of the Permanent Fund are large.

**Potential Settlements:** An estimate of the value today of payments the state might receive from future settlements of tax and other disputes about past oil production and bonus sales. It is a subjective estimate which assumes that the state will receive 50 cents for every dollar claimed. This account declines as disputes are settled and the proceeds are deposited in the cash reserves.

**Permanent Fund:** By law a portion of royalties from the sale of state-owned natural resources goes into this fund. Most growth now results from reinvestment of a portion of the fund’s earnings, which is known as inflation-proofing. In earlier years, special legislative appropriations were important sources of growth. This figure excludes unrealized capital gains and the earnings reserve.

**Value of State Share, Oil Reserves:** The value today of tax and royalty payments the state can expect to receive in future years, based on oil prices and state estimates of current oil reserves. The balance falls as oil is produced and sold, and increases when new reserves are discovered. Since the start of North Slope production, the state has added about one barrel of oil to reserves for every two barrels produced.

## TABLE 2. WHAT HAPPENED THIS YEAR?

An Abbreviated, Consolidated Financial Statement, 1994 (Billions of Dollars)

	GENERAL FUND	ALL FUNDS <sup>b</sup>	
<b>REVENUES</b>			
Current Oil Production	\$1.35	\$1.55	Investment earnings from the Permanent Fund, cash reserves, and other accounts produced almost as much revenue as the sale of oil. Oil revenues were down an estimated 40 percent between 1993 and 1994. All other revenue sources contributed about 10 percent of the total; such revenues have been flat in recent years.
Net Investment Earnings <sup>a</sup>	0.05	1.00	
All Other Sources	0.40	0.40	
<b>Total Revenues</b>	<b>1.80</b>	<b>2.95</b>	
<b>SPENDING</b>			
General Fund Operating	\$2.40	\$2.40	The operating budget was unchanged but the capital budget was up about \$300 million in 1994, resulting in a \$3.2 billion state general fund budget. Spending for Permanent Fund dividends will be about \$550 million, up about \$50 million from last year.
General Fund Capital	0.80	0.80	
Permanent Fund Dividend		0.55	
<b>Total Spending</b>	<b>3.20</b>	<b>3.75</b>	
<b>ASSETS</b>			
Oil Reserves: State Share		\$15.90	The value of Alaska's assets dropped about \$8 billion between 1993 and 1994, mostly because the value of the state's share of oil reserves was down—because of lower oil prices but also because the size of the reserves fell. The draw on cash reserves necessary to fill the general fund fiscal gap was partially offset by an increase in the Permanent Fund balance. The value of potential settlements was unchanged, because interest on disputed amounts offset settlements realized.
Cash Reserves		1.90	
Permanent Fund Principal		13.00	
Potential Settlements		3.00	
<b>Total Assets</b>		<b>33.80</b>	

<sup>a</sup> Excludes \$350 million in Permanent Fund earnings needed to inflation proof the fund.

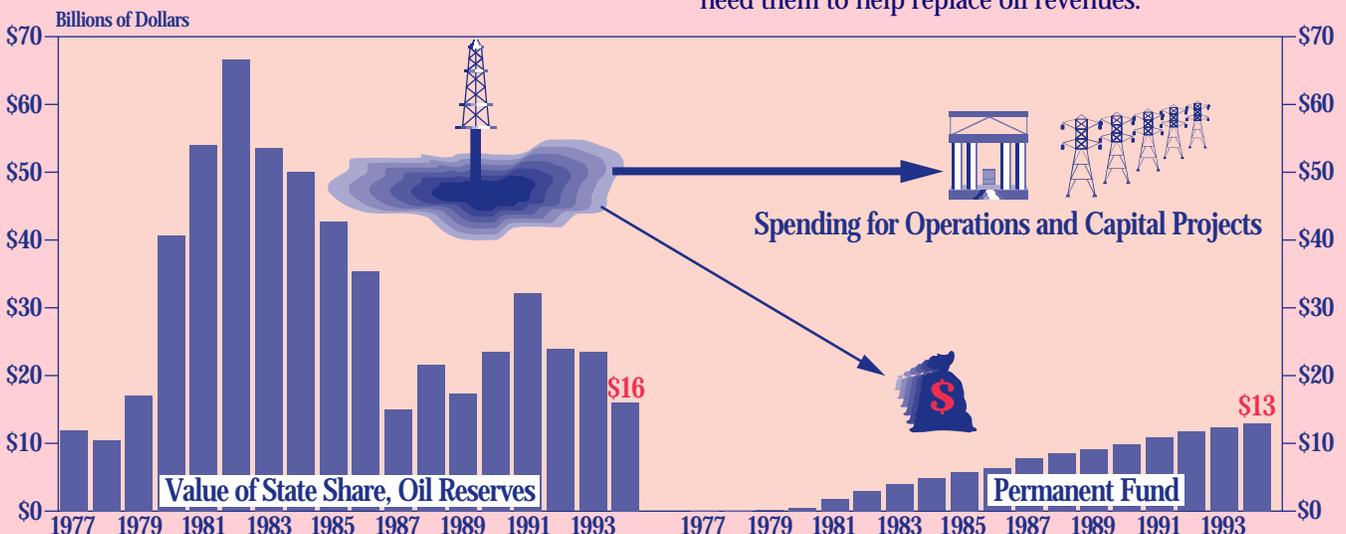
<sup>b</sup> Includes the Unrestricted General Fund, Constitutional Budget Reserve, Permanent Fund Earnings Reserve, State Share of Oil Reserves, Potential Settlements, and Permanent Fund.

## FIGURE 2. TRANSFORMING OIL RESERVES INTO SUSTAINABLE ASSETS

Alaska's oil reserves are getting smaller. Since North Slope production began in 1977, roughly one barrel in new discoveries has been added for every two barrels produced. Alaskans recognized in the 1970s that oil wealth wouldn't last forever. One of the reasons they voted to create the Permanent Fund was to convert part of that oil wealth into an asset that could help sustain essential government services when the oil was gone. The graphs show progress toward that goal over the past 15 years. In any given year, most oil revenues go into current spending, but a percentage goes into the Permanent Fund. In the past the legislature also made special appropriations to the fund.

The value of the state's share of oil reserves is shown as estimated future royalties and taxes. That value has fluctuated with oil prices. It was \$50 billion through the early 1980s, when the reserves were larger and oil prices tripled—creating huge increases in the state's potential royalties and taxes. Today, with diminished reserves and low oil prices, the value to the state is about \$16 billion.

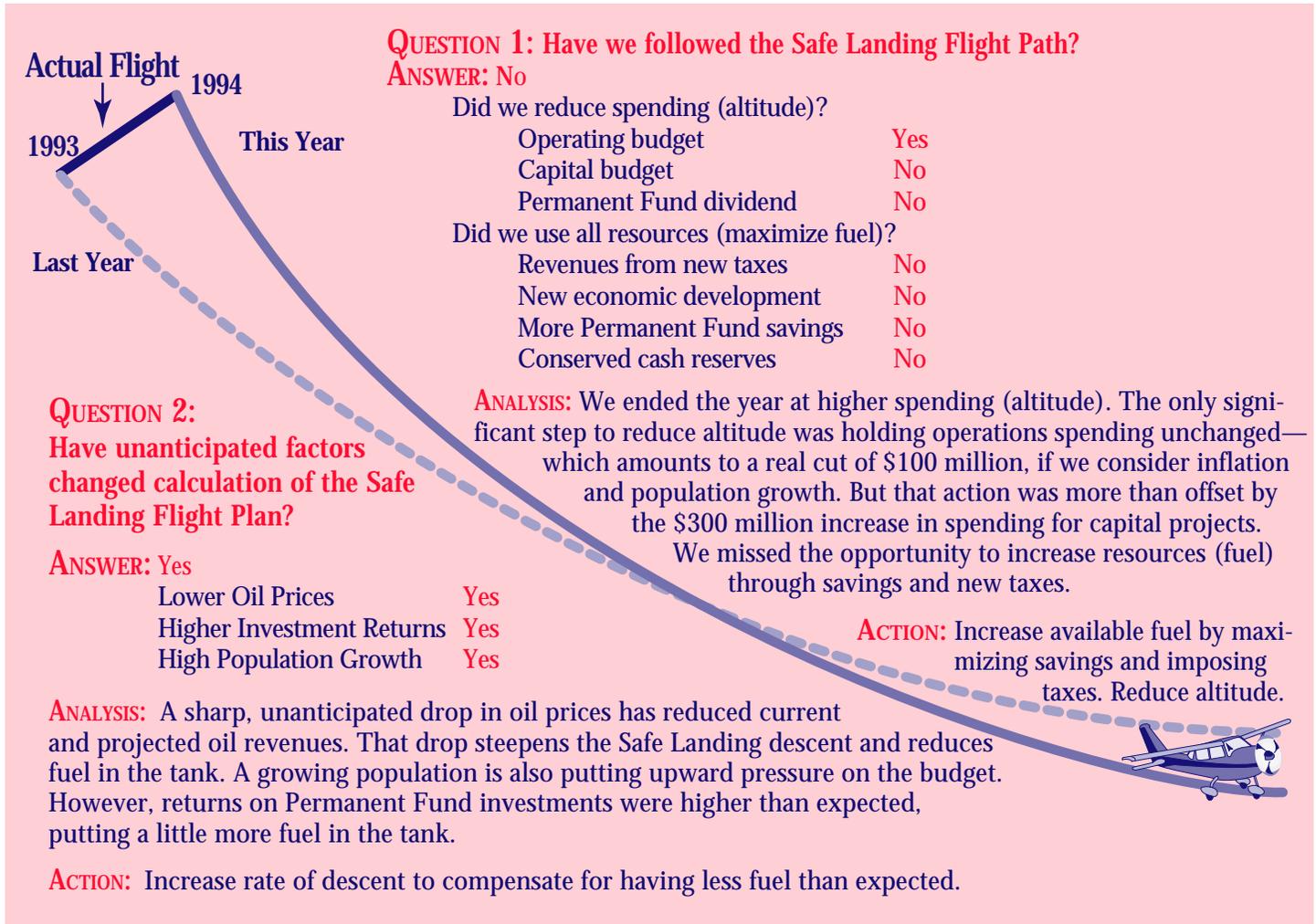
The Permanent Fund has been more stable but smaller. Today, however, with a principal of \$13 billion, it is nearly as valuable as the oil reserves—and soon it will overtake oil as the state's biggest asset. If we put more money into the fund now, its future earnings will be higher—when we'll need them to help replace oil revenues.



# MONITORING OUR PROGRESS TOWARD A SAFE LANDING IN 1994

In 1992, *Fiscal Policy Paper 7* used the analogy of a flight path—the Safe Landing—to describe how Alaska could gradually reduce spending (altitude) and make the most of its resources (fuel in the tank) to carry the state to a Safe Landing (a level of spending it can afford over the long run). What progress did we make toward a Safe Landing in fiscal 1994? As the graphic

shows, the state failed to reduce altitude or maximize fuel—which means calculation of a new flight path, with a steeper descent and less fuel in the tank. Aggravating the problem is the recent unanticipated sharp drop in oil prices, which further steepens the descent and reduces fuel. Oil prices or other factors outside the state’s control can force a change in course.



Institute of Social and Economic Research  
 University of Alaska Anchorage  
 E. Lee Gorsuch, Director  
 3211 Providence Drive  
 Anchorage, Alaska 99508

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