Over the past year I have been traveling around the state, talking with many organizations about the fiscal challenge Alaska is facing. My goal is to help Alaskans understand the basic facts of Alaska’s revenues, spending, and saving, as well as the choices we face.

I have been regularly updating this presentation as new data become available and to address new questions I hear. This is the most recent version. As I develop updated versions, I will post them on ISER’s website at: [www.iser.uaa.alaska.edu](http://www.iser.uaa.alaska.edu)

I welcome questions, comments and suggestions at the e-mail address shown above.
Alaska faces an extremely serious fiscal challenge. We are spending three times as much as our revenues. We are paying for the deficit by drawing down our savings.

The more oil prices fall, the bigger the deficit:

- From our savings
- Other revenues
- Oil revenues

The more oil prices fall, the lower our oil revenues.
We can’t continue to run huge deficits like this year’s. We don’t have enough savings.

This Year’s Deficit Compared to our Savings

Projected funds remaining as of the start of FY17:
- What we are spending from our savings this year: $3,608
- Constitutional Budget Reserve Fund: $6,729
- Permanent Fund Earnings Reserve: $7,038
In the next few years, we will **have** to close the funding gap between our spending and our revenues.

We will **have** to make big changes in what we spend or how we pay for it—or both.

Our choices will significantly affect all Alaskans and Alaska’s future.
Alaska’s fiscal challenge: a perfect storm

• Very important
• Very complex
• High uncertainty about our options
• Very little time to address it
• About fundamental political issues
What addressing Alaska’s fiscal challenge demands of us

• Of all Alaskans
  – Become informed about our fiscal reality
  – Recognize that there are no easy solutions

• Of advocates
  – Reality-based proposals for how to solve the problem
  – Opposing others’ proposals is not enough

• Of our elected leaders:
  – Educating Alaskans
  – Hard work
  – Cooperation
  – Hard choices
Major state revenue sources and spending flows

- **Non-Oil Revenues**
- **Oil taxes**
- **Oil royalties**

**Constitutional Budget Reserve Fund**

**General Fund**

**Permanent Fund earnings**

**Permanent Fund Earnings Reserve**

**Permanent Fund Principal**

**Dividend spending**

**Government spending**

**Arrow sizes are proportional to FY16 revenue & spending flows**

**Restricted federal and designated general fund revenues**

**Restricted spending uses**
Alaska has been extremely dependent on oil revenues to fund state government.

From 2005 to 2014, oil revenues averaged 90% of Alaska’s “unrestricted general fund revenues”
Oil prices have fallen drastically over the past year and a half.

The price was $32/barrel on January 28.
Our state revenues are extremely sensitive to oil prices—particularly production taxes, which are based on profits.
Since 2012, our oil revenues have fallen drastically because of lower prices, lower production and higher costs and credits.

From 2005 to 2012 oil prices and revenues rose dramatically.

$7.8 billion drop in oil revenues from 2012 to 2016 (88% drop)
In just four years, most of the money we had been using to pay for state government evaporated.

It’s gone.

That’s why we have a big problem.
Won’t oil prices go back up and save us?

• It happened in the early 2000s when we faced a similar fiscal challenge. It *could* happen again.

• But it probably won’t.

• Even at current very low oil prices:
  – There is a glut of oil on world markets
  – Growth in world oil demand is slowing

Hoping that oil prices rise is not a realistic or responsible solution to our fiscal challenge.
Even if oil prices rise, our future oil revenues will decline as oil production falls.

Alaska North Slope Production
By production area, 1977-2025

Alaska Department of Revenue projections of future North Slope oil production
From 2005 to 2012, even though spending was rising, we ran big General Fund **surpluses**. Since 2013 we have been running big General Fund **deficits**.

The more oil prices fall, the lower our revenues and the bigger the deficit.
We used the surpluses prior to 2012 to build up our savings reserve. Since 2013 we have been rapidly drawing down our reserves. Continued deficits of this year’s level could drain our reserves in 2 years.

**Historical and Projected End-of-Year Balances of State Reserve Funds (excluding the Permanent Fund)**

- **Historical**: 2005 - 2015
- **Projected**: 2016 - 2019

- **Statutory Budget Reserve Fund**
- **Constitutional Budget Reserve Fund**

Source for end-of-year fund balances through 2015 is Legislative Finance Division. Projections beginning 2016 assume drawdown of CBRF by future deficits resulting from general fund spending of $5.2 billion and DOR Fall 2015 revenue projections.
This year’s (FY16) projected deficit is huge.

FY16 unrestricted general fund spending

$5.2 billion

$3.6 billion (69% of spending)

$1.6 billion

Projected deficit

$7,100 per Alaskan

$4,900 per Alaskan

Projected revenues

$2,200 per Alaskan

“Per Alaskan” figures are based on 2014 Alaska population estimate of 735,601.
How we are spending $5.2 billion in FY16

General Fund Budget, FY16 ($ millions)

- Capital budget: 118
- Debt Service: 206
- State Assistance to Retirement: 263
- Oil tax credits: 502
- Military & Veterans' Affairs: 18
- Environmental Conservation: 20
- Governor: 24
- Labor & Workforce Dev: 26
- Commerce, Community & Econ Dev: 28
- Revenue: 30
- Law: 54
- Fish and Game: 66
- Natural Resources: 71
- Legislature: 73
- Administration: 78
- Judiciary: 110
- Public Safety: 163
- Transportation: 248
- Corrections: 281
- University of Alaska: 356
- Health & Social Services: 1,171
- Education & Early Dev: 1,302

641 (55%) is Medicaid formula

1,247 (96%) is K-12 formula
Trends in General Fund spending, FY07-FY16

General Fund Budgets, FY07-FY16
($ millions)

- Capital Budget
- Oil tax credits, fund capitalization & special appropriations
- Debt Service & Retirement
- All Other Agencies
- Health & Social Services
- Education & Early Dev


0 1,000 2,000 3,000 4,000 5,000 6,000 7,000 8,000 9,000
25% of oil royalties
(0.3 billion)

Realized earnings
($2.4 billion)

Principal
($45.3 billion)

Inflation Proofing
($0.9 billion)

Earnings Reserve
($6.3 billion)

Unrealized earnings
($5.4 billion)

Dividends
($1.4 billion)

half of realized earnings
over the past 5 years

Dollar values are FY16 flows
and estimated end-of-year values
The Permanent Fund is worth about $52 billion. We can only spend the realized earnings we have saved in the earnings reserve (about $7 billion).
The legislature is allowed to use the earnings for any purpose. We have been using most but not all of the money for dividends and inflation proofing.
The Permanent Fund is earning more than our oil revenues.

**Oil Revenues & Permanent Fund Earnings**

- Permanent Fund realized earnings
- Unrestricted oil revenues

![Graph showing oil revenues and permanent fund earnings](image-url)
Alaska’s fundamental fiscal tradeoffs . . .

Over any period of time

<table>
<thead>
<tr>
<th>What we can spend</th>
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<td>= Our income</td>
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*Over any period of time*

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<td>Net growth in the PF earnings reserve &amp; CBRF</td>
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Alaska’s fundamental fiscal tradeoffs are between:

- Government spending
- Dividend spending
- New tax revenues
- Inflation proofing deposits to the PF principal
- Net growth in the PF earnings reserve & CBRF

Our choices are not between any two of these. Our choices are between all five.
HOW WILL WE FILL THE FUNDING GAP?

Our only significant and practical options are some combination of:

- Cutting government spending
- Cutting dividend spending
  (and using the money to help fund government)
- Adding new taxes
- Saving less
  (and using the money to help fund government)

There are no easy choices.

The funding gap is so large that we will probably need to use all of these options.
The challenge with cutting government spending is figuring out what to cut that isn’t mandated, essential, “penny-wise but pound-foolish,” or too popular to cut.

To fully close the deficit, we would have to cut spending by $3.6 billion—by more than 2/3.
Many Alaskans argue we need to “cut spending first”

But . . .

• Cutting spending *right* takes time
  – to debate the state’s priorities
  – to figure out better ways of delivering services
  – to find efficiencies
• It’s politically hard
• It will get harder

*Cutting spending right will take time.*

*Getting new taxes right will also take time.*

If revenues are still insufficient after these steps, the last option should be new taxes.
Adding new taxes . . .
We have many options—but even all together
they wouldn’t close the deficit

**Some Potential New State Revenues**

Our projected FY16 deficit is $3.608 billion

Source: Alaska Department of Revenue estimates
Alaskans pay much lower broad-based state taxes than residents of any other state.
We could use Permanent Fund earnings to reduce the deficit in two ways:

**Cutting dividend spending**  
(and using the money to help fund government)

**Saving less by reducing inflation proofing**  
or other additions to the earnings reserve  
(and using the money to help fund government)

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**Potential Sources of Permanent Fund Earnings**

- **Projected FY17 dividend spending**: $1,562 million
- **Projected FY17 inflation proofing**: $926 million
- **Projected FY17 earnings retained in the earnings reserve**: $302 million
- **Projected FY17 start-of-year earnings reserve balance**: $7,617 million

*Our projected FY16 deficit is $3.608 billion*

*Source: Alaska Permanent Fund Corporation projections as of 9/30/15*
There are two proposals for “re-plumbing” Alaska’s finances and using Permanent Fund earnings to address the fiscal challenge

- Senate Bill 114
- Governor’s proposal (Permanent Fund Protection Act)
Alaska’s fiscal “plumbing”: status quo

- Non-Oil Revenues
- Oil taxes
- Oil royalties
- Constitutional Budget Reserve Fund
- General Fund
- Government spending
- Dividend spending
- Permanent Fund earnings
  - Permanent Fund Earnings Reserve
  - Permanent Fund Principal

Permanent fund earnings are used for dividends and inflation proofing
SB 114 proposal: “Swap” funding for dividends and government spending

Non-Oil Revenues

Oil taxes

Oil royalties

General Fund

Constitutional Budget Reserve Fund

Government spending

Dividend spending

Permanent Fund earnings

Permanent Fund Principal

Permanent Fund Earnings Reserve

Permanent Fund Earnings

Dividends would be paid from 75% of oil royalties

Annual payout from Permanent Fund earnings to the General Fund based on 5% of average market value over the past 5 years.

No inflation proofing
Governor’s proposal: All oil revenues would go to the Permanent Fund, which would make a fixed annual payout to fund government. Dividend payouts would be based on royalties.
“Re-plumbing” our fiscal system wouldn’t change how much money we have or the fiscal choices we face.

“Re-plumbing” could:

• Provide sustainable approaches for using Permanent Fund earnings to help fund state government
• Reduce and change the formula for dividends:
  – Formulas based on royalties rather than Permanent Fund earnings
• Reduce net savings in the Permanent Fund
• Provide more stability and predictability for government funding
  – But only if the legislature follows the formulas
WHEN WILL WE FILL THE FUNDING GAP?

The more gradually we adjust, the smaller the immediate economic impacts.

But the longer we delay:

The bigger the future economic impacts. The greater the risk of forced drastic adjustments.

The greater the risk to investor confidence The greater the risk to our credit rating

The lower our future investment earnings The less savings we leave for future generations
S&P downgrades Alaska's debt rating

Posted: January 5, 2016 - 1:01pm

Standard & Poor's also said it expects Alaska’s credit rating to continue its fall if the Alaska Legislature does not “enact significant fiscal reforms to reduce the state’s fiscal imbalance” during the upcoming 2016 session.
Our fiscal options aren’t so bad compared with most other states.

• Most other states:
  – Don’t have any oil revenues
  – Don’t have any Permanent Fund earnings

• That’s why most other states:
  – Spend much less for government
  – Have income taxes and/or sales taxes
  – Don’t pay dividends
  – Don’t accumulate wealth in Permanent Funds

• Our basic fiscal options are to become more like other states:
  – Spend less for government
  – Tax ourselves more
  – Pay smaller dividends
  – Save less in the Permanent Fund
How can we minimize the economic impacts of how we close the deficit? . . .

Our only significant and practical options are some combination of:

Cutting government spending

Cutting dividend spending
(and using the money to help fund government)

Adding new taxes

Saving less
(and using the money to help fund government)
Of all our options, only saving less would have no short-run economic impacts.

- Reducing how much we save in the Permanent Fund would not:
  - take any money out of the economy
  - have any short-run impacts on jobs or income
- But:
  - Saving less would reduce future Permanent Fund earnings
  - We can’t close the deficit solely by saving less.

All other options—cutting government spending, cutting dividends, and adding new taxes—would have short-run economic impacts.

They would all take significant amounts of money out of the economy. They would all have significant multiplier effects.
The short-run economic impacts of cutting government spending depend critically on what is cut.

- You can’t generalize about the economic impacts of cuts.
- Some cuts would have large impacts
  - cutting government workers
  - In government-dependent regions
- Some cuts would have small impacts
  - cutting purchases from outside Alaska.
- The impacts of cutting government spending also depend on the economic impacts of resulting reductions in state services
  - Instructure development and maintenance
  - Resource management
  - Effects of government service levels on quality of life and labor markets
Our fiscal options vary significantly in **who would be most affected**

- **Saving less** would most affect future generations of Alaskans

- **Cutting government spending** would most affect:
  - government and contractor workers
  - regions with high government employment
  - Alaskans who depend on the government services that are cut.

- **Cutting dividends** would most affect poorer Alaskans and larger families

- **Income taxes** would most affect wealthier Alaskans
The federal government and non-residents can help us reduce the deficit.

- **Lower federal taxes** would help to offset the impacts of taxes and dividends
  - dividend cuts would reduce taxable income
  - income and sales taxes would be deductible
  - Wealthier people who pay higher tax rates would benefit most

- **Non-resident workers and visitors** would help pay income & sales taxes
How can we minimize the economic impacts of how we close the deficit? . . .

- There is no way to close our $3.5 billion deficit without significant economic impacts on Alaska’s economy.

- Fully closing the deficit this year would have a very large impact on an already-weak economy.

- But delaying significant progress would also have large impacts:
  - Business uncertainty and lower investment
  - Alaska’s credit rating

- We will have a smoother transition if we make significant progress this year (including planning for future reductions) than if we:
  - Fully close the deficit this year, or
  - Don’t make a significant start this year
Short-term economic impacts matter—but they should probably not drive our fiscal choices.

- Our fiscal choices will affect:
  - The costs of living and doing business in Alaska
  - What kinds of government services we have
  - What kinds of people choose to live and work in Alaska
  - Our future economic development
  - Who pays for government
  - Our income distribution

- We should think about these kinds of longer-run impacts as we think about our fiscal choices.

- We should think about what kind of state we want Alaska to be