

Alaska Fiscal Facts and Choices

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Northrim Bank Lecture Series
Matanuska-Susitna College / University of Alaska Anchorage
February 13, 2018

Alaska faces very important fiscal choices

- We can no longer afford to fund state government mostly from oil revenues and savings
- We face direct tradeoffs between
 - Government spending
 - Dividend spending
 - New taxes
 - How much we add to or draw from savings
- I am not advocating for any specific choices
- I am advocating an informed discussion of our choices

Outline

- Some fiscal basics
- A look back
- Our immediate fiscal challenge
- Using Permanent Fund earnings
- Getting to a credible fiscal plan
- Prudent assumptions about future revenues
- Comments on fiscal options
- Conclusions

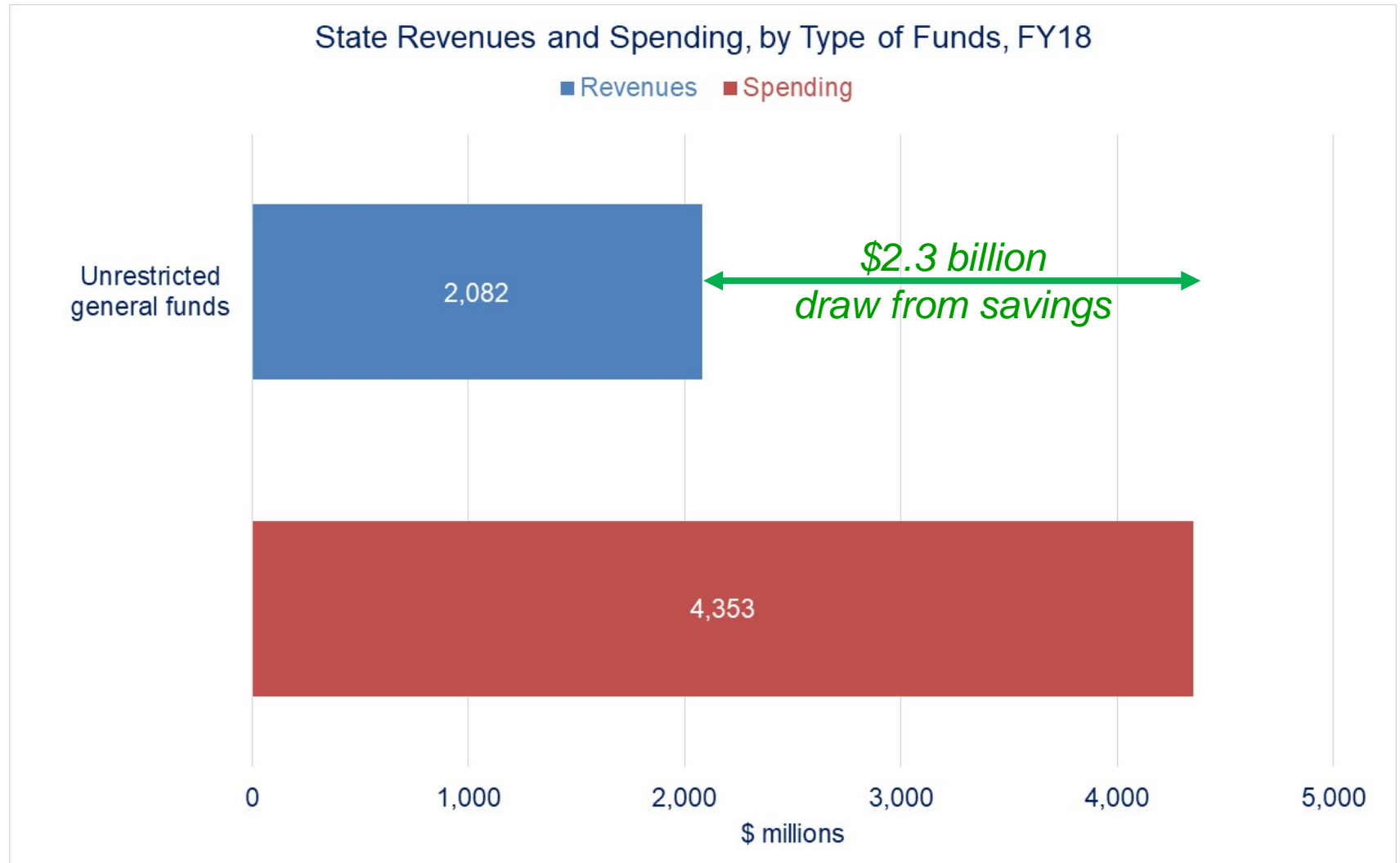
Some fiscal basics

Alaska's finances are very complex.

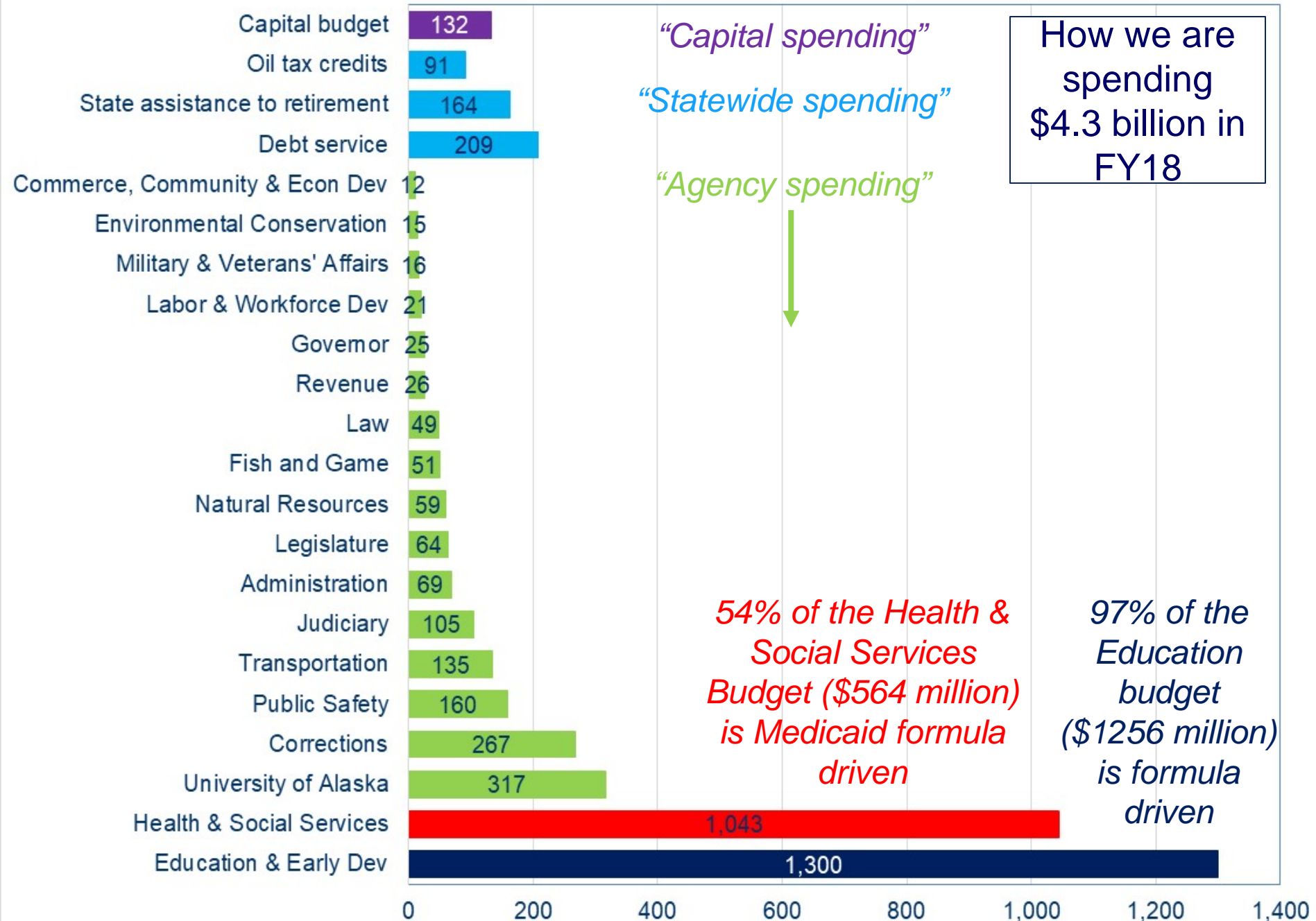
- Many different kinds of revenues, spending and savings.
- Accounting for state finances is
 - Complex
 - Confusing
 - Inconsistent
 - Incomplete
 - Not up-to-date
 - Frustrating
- Politicians use many accounting tricks to try to look better
- State finances are very hard to understand
 - Including for legislators
 - Including for me

Don't believe anyone who tells you the issues are simple.

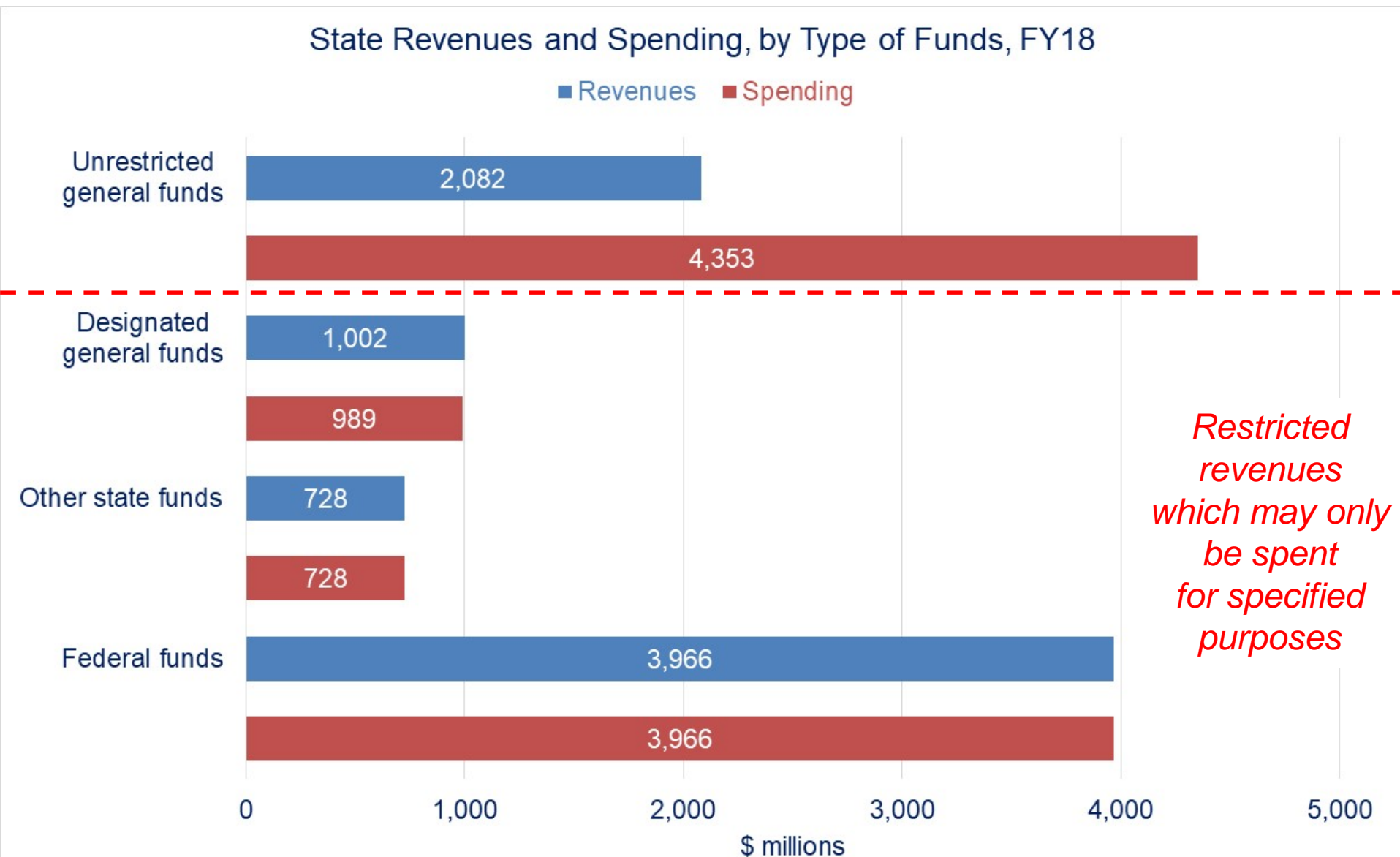
Unrestricted general funds (UGF) may be used for any purpose. Our UGF spending (\$4.4 billion) is far more than our revenues (\$2.1 billion). We are paying for the UGF deficit by drawing down our **savings**.



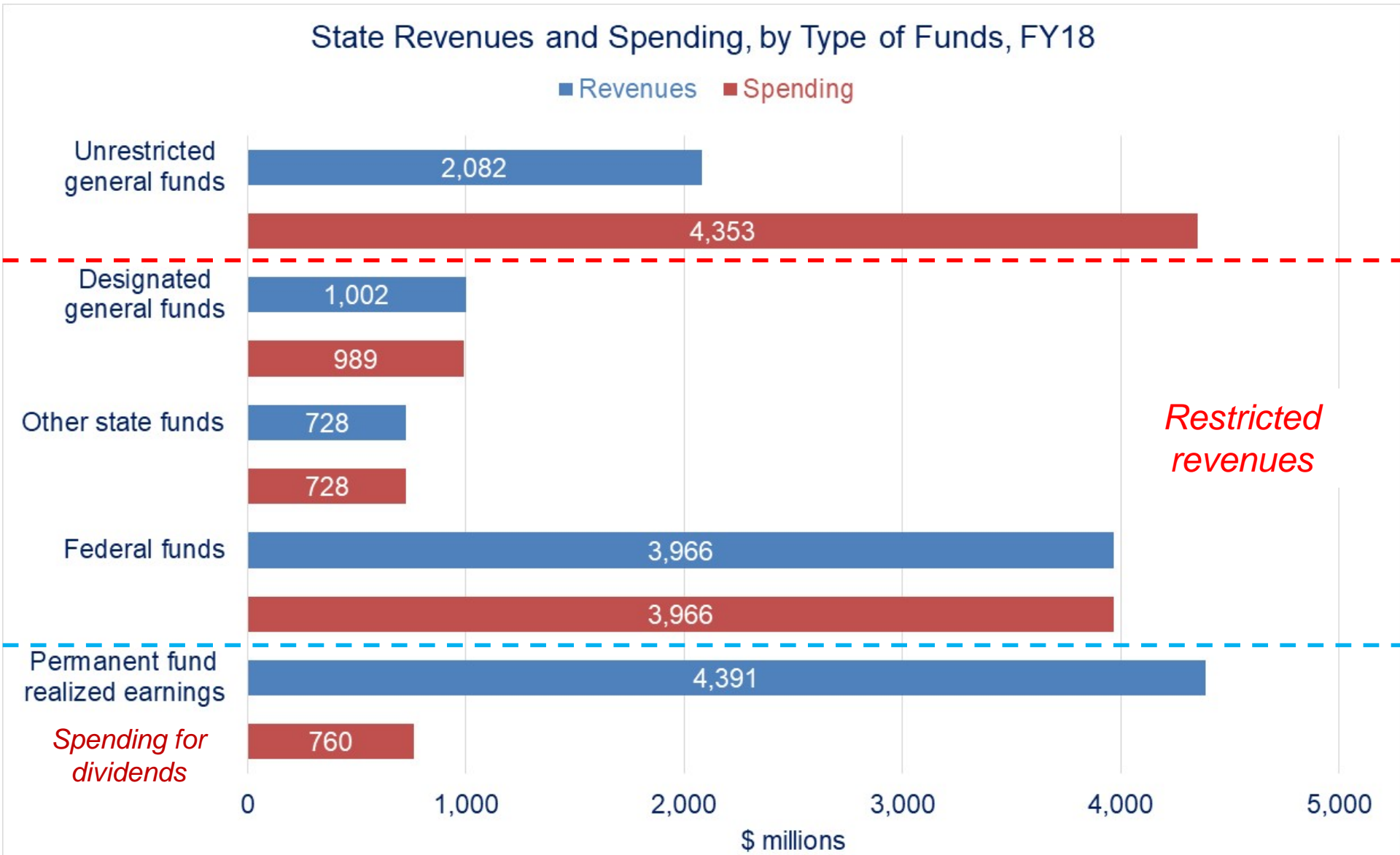
Unrestricted General Fund Budget, FY18 (\$ millions)



We have many other kinds of **restricted revenues** which may only be spent for specified purposes.



Our largest source of revenues are Permanent Fund earnings (\$4.4 billion).
In the past we have only spent Permanent Fund earnings for dividends.
But the legislature may use them for any purpose.

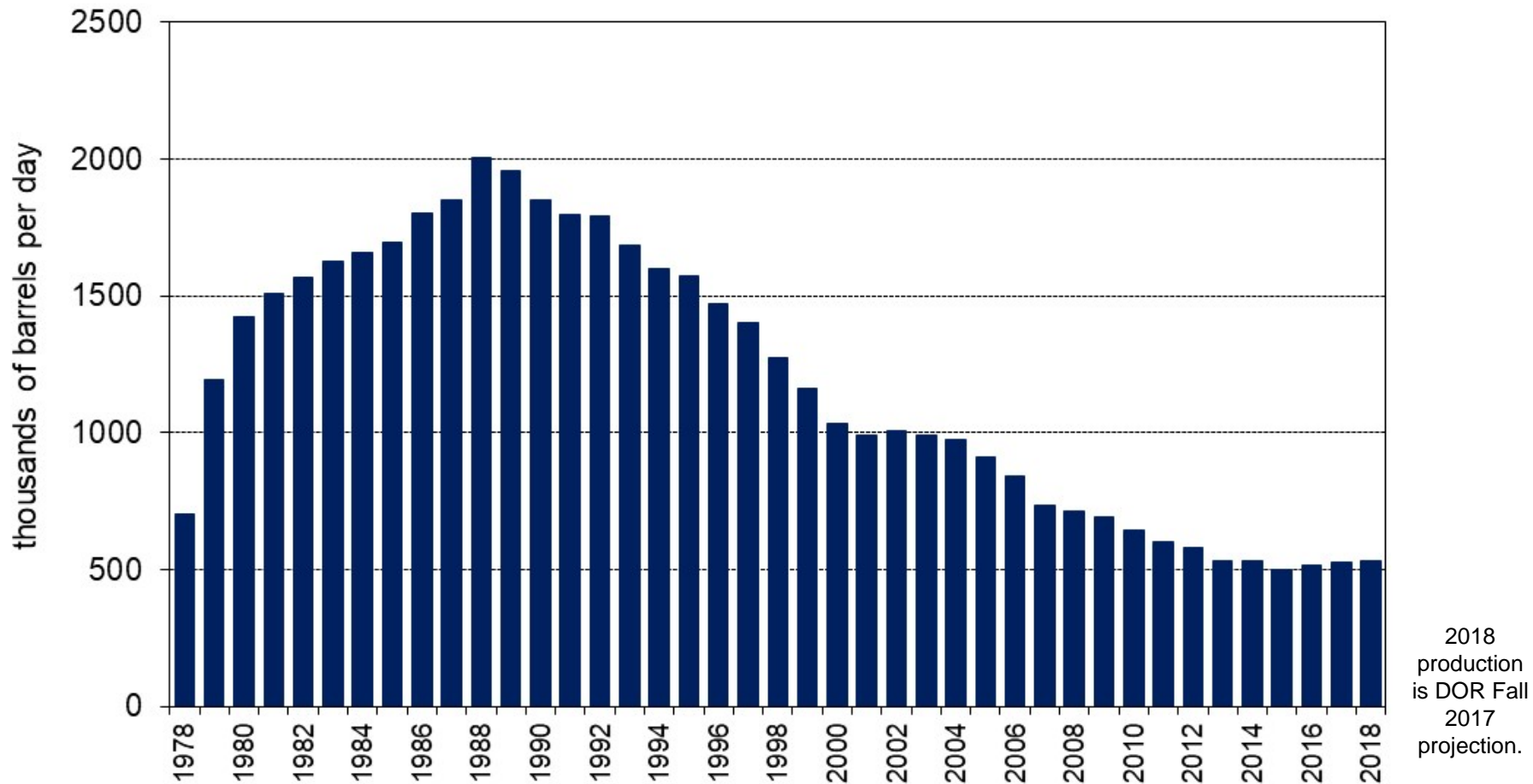


A look back

Oil has driven Alaska's economy and state finances
for as long as most Alaskans remember.

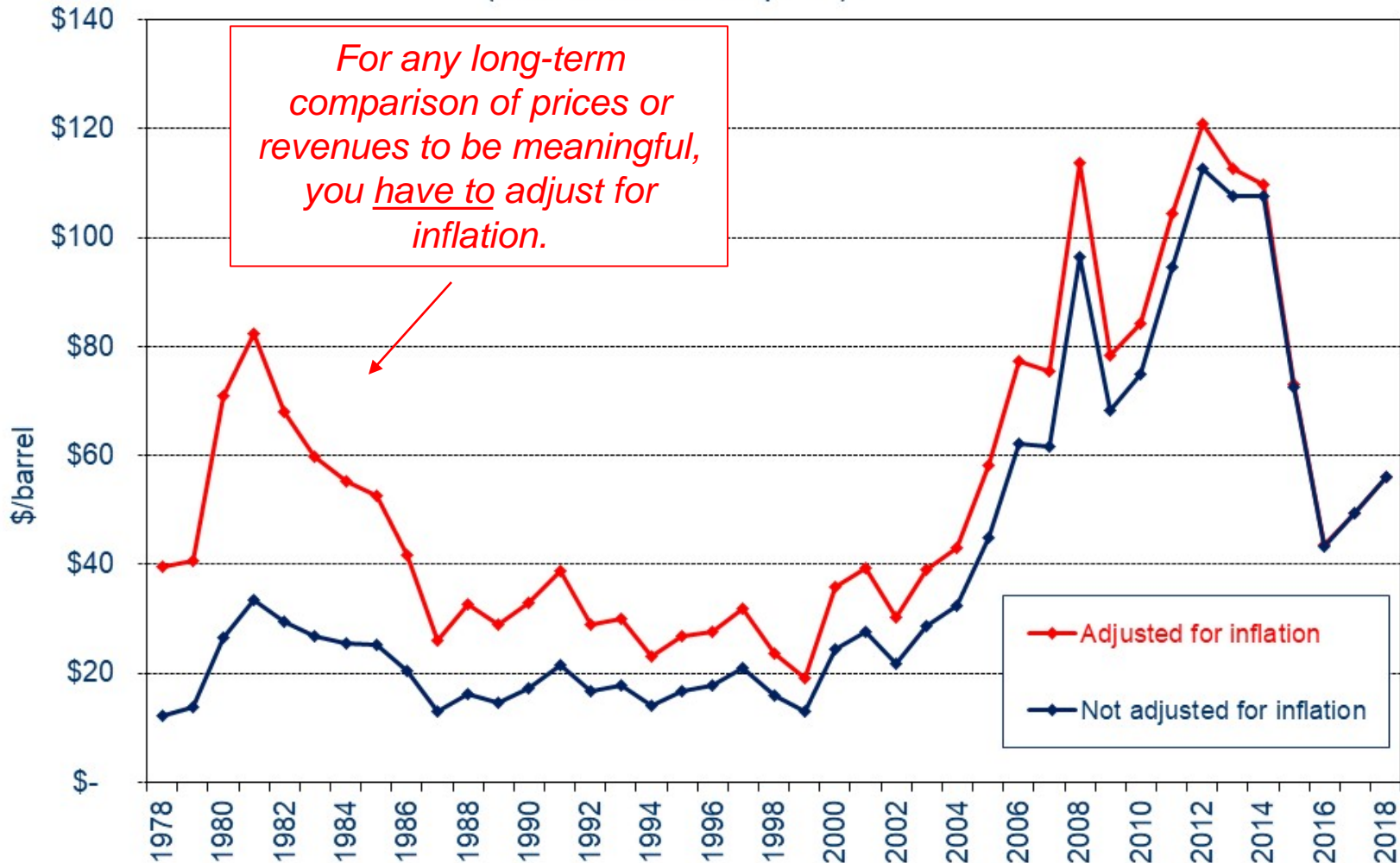
Oil production has fallen by almost 75% since peaking in 1988.
But for the last five years production has leveled off.
A key question is what will happen to future production.

Alaska North Slope Oil Production



Oil prices have fluctuated drastically since North Slope oil production began.

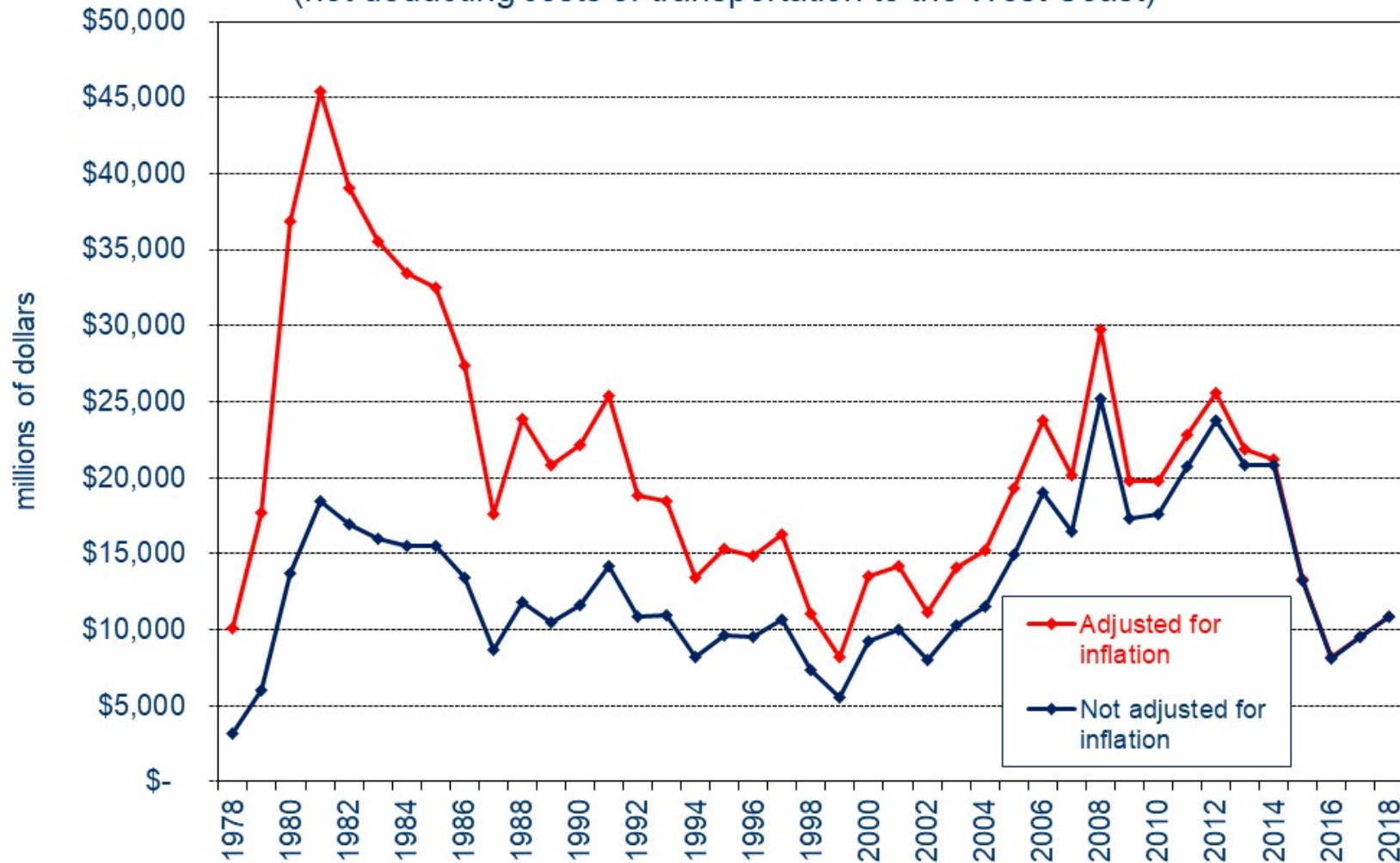
Average Price of Alaska North Slope Oil
(ANS West Coast price)



2018
average
price is
DOR Fall
2017
projection.

The combined effect of fluctuations in oil production and prices has been drastic fluctuations in the value of Alaska oil production.

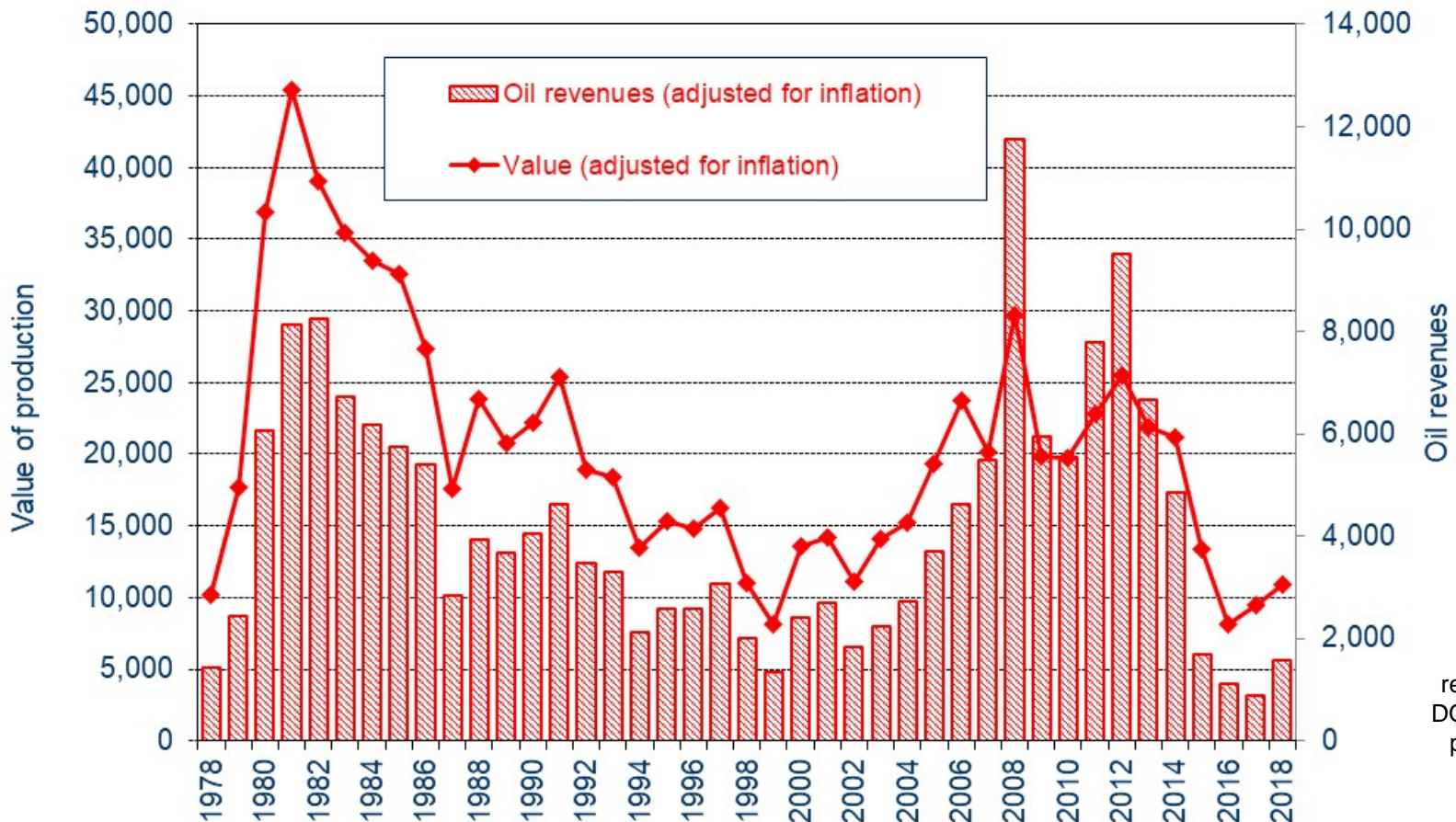
Total West Coast Value of Alaska North Slope Oil Production
(not deducting costs of transportation to the West Coast)



2018 average price value is based on DOR Fall 2017 projected production & price.

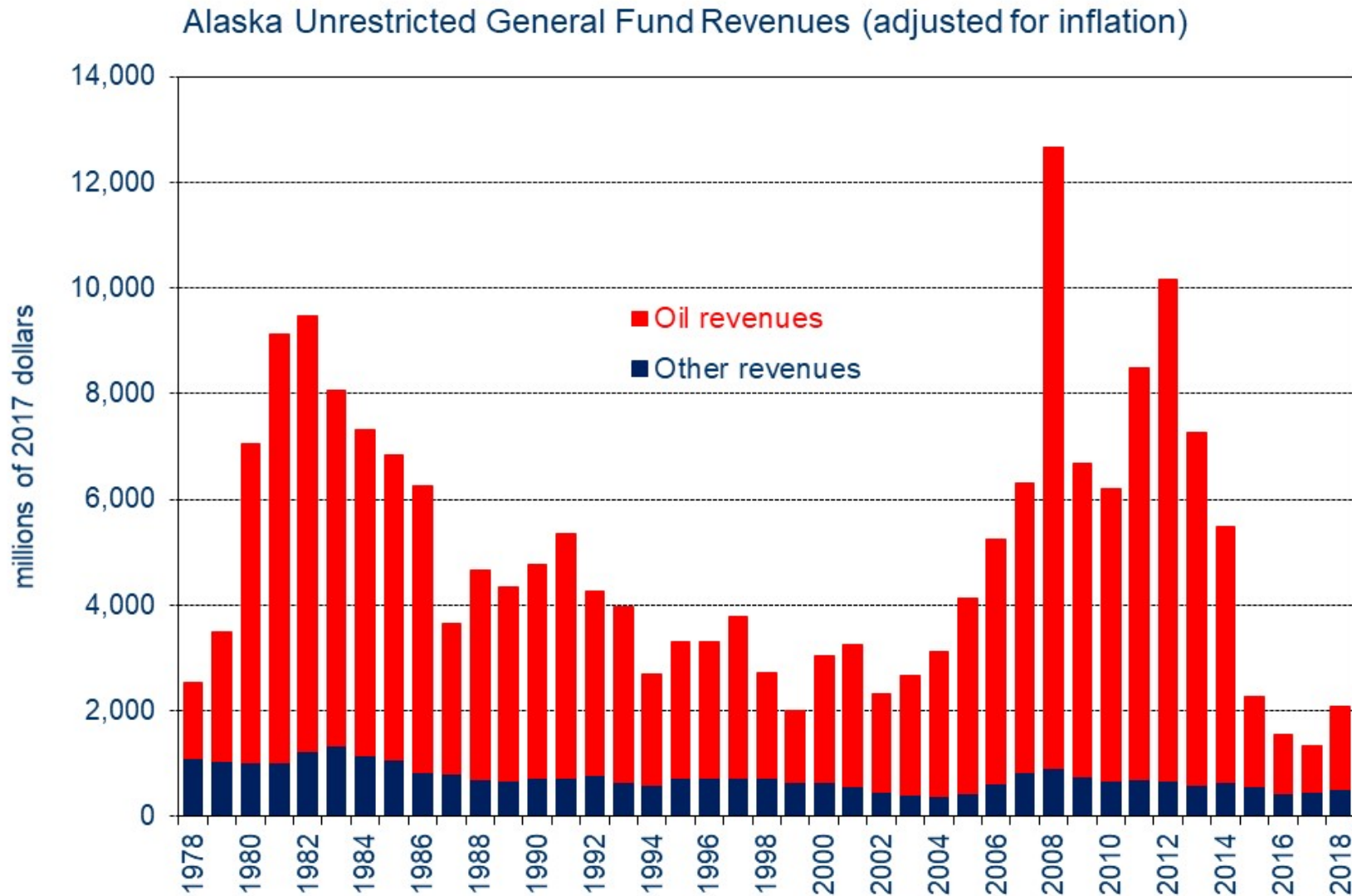
Drastic fluctuations in the value of Alaska oil production were reflected in drastic fluctuations in Alaska oil revenues.
(Other factors, such as changes in oil taxes and costs, also affected oil revenues.)

Value of Alaska North Slope Oil Production and Alaska UGF Oil Revenues)
(millions of 2017 dollars)



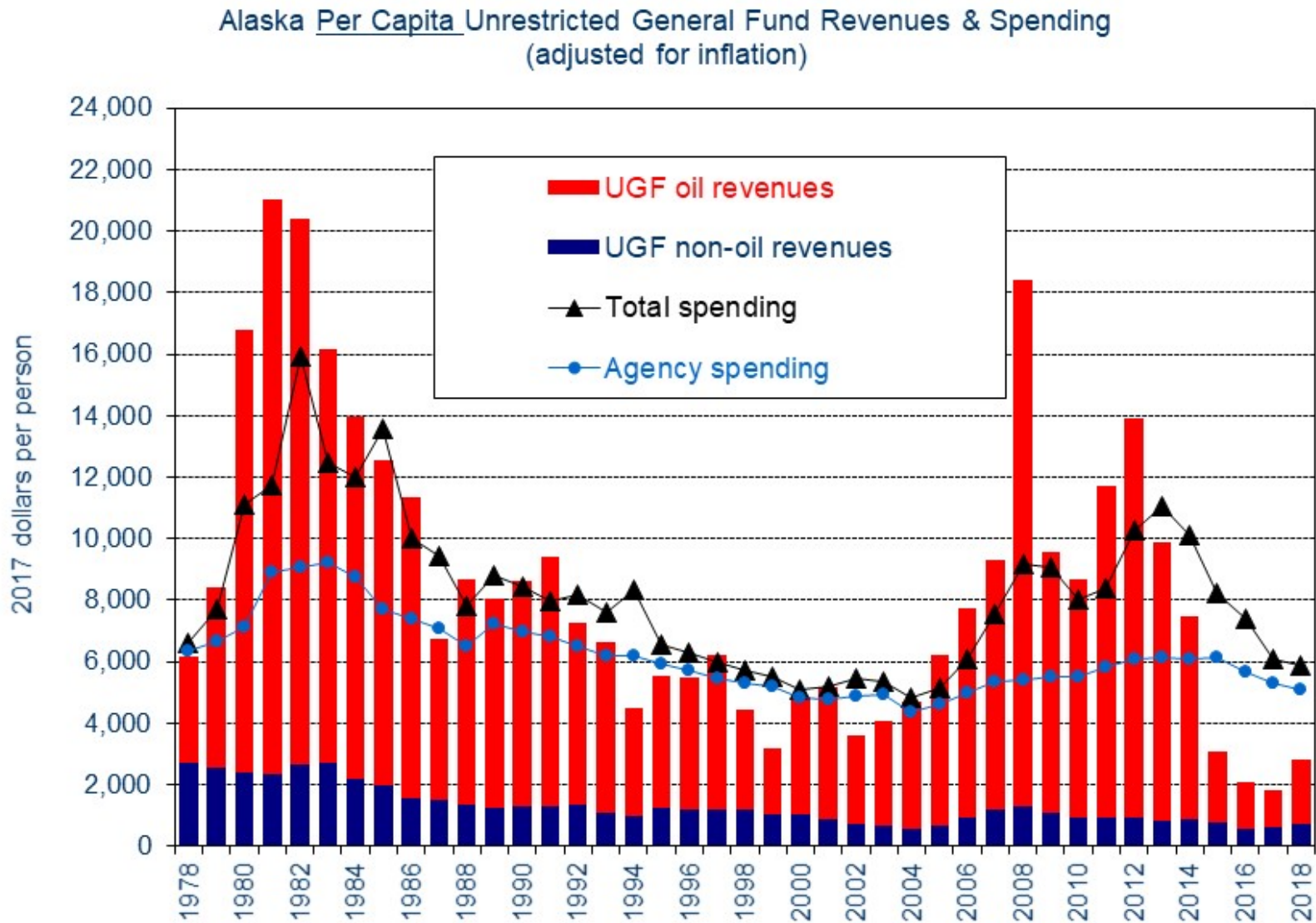
2018 oil revenues are DOR Fall 2017 projections.

Although oil revenues have fluctuated dramatically, they have provided most of state revenues for more than three decades. Oil accounted for 86% of total UGF revenues between 1980 and 2014.



2018
revenues
are DOR
Fall 2017
projections.

When we had more oil money, we spent more (and saved some)
When we had less oil money, we spent less (and spent our savings)

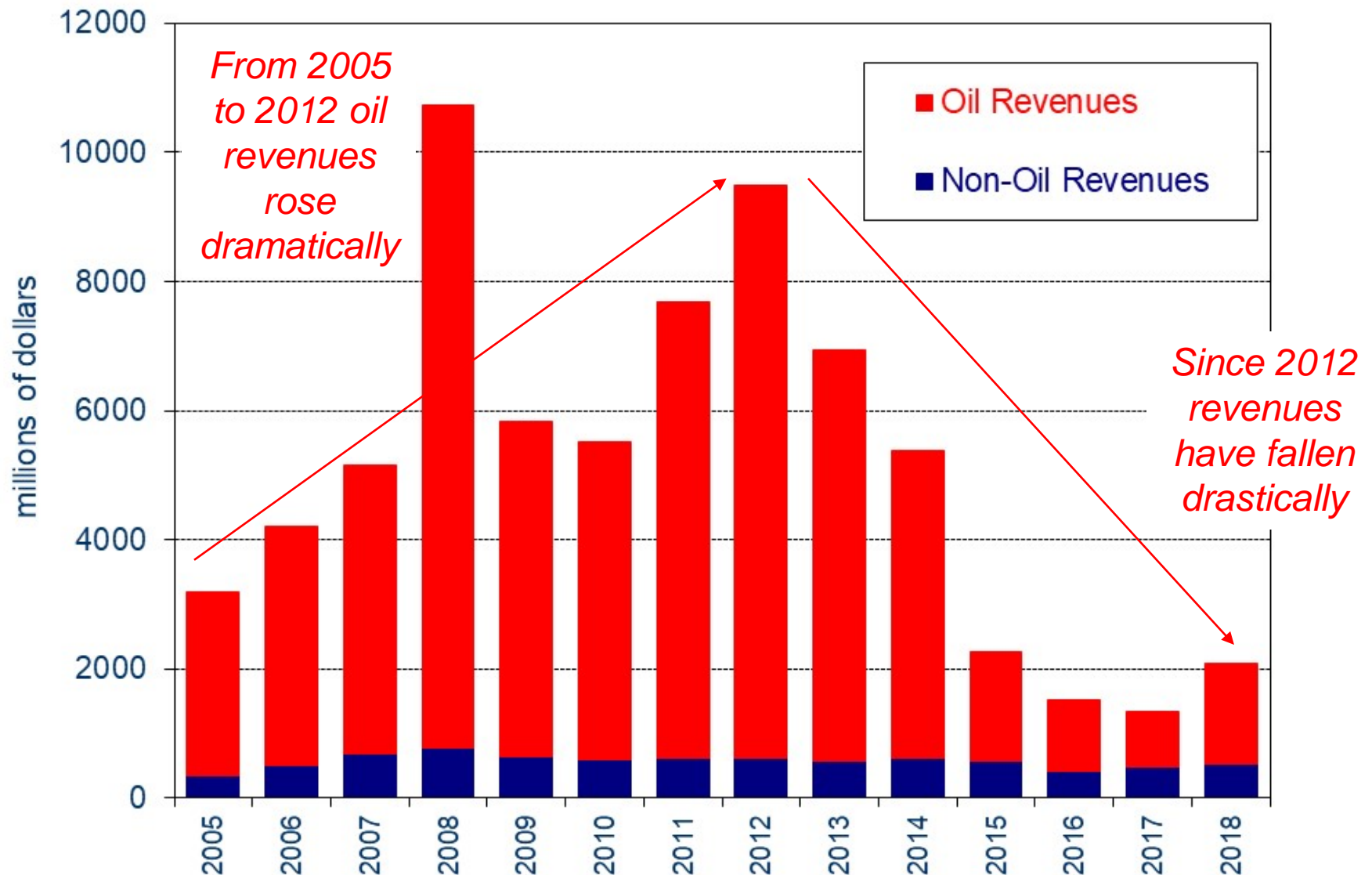


Note: Graph shows per capita revenues and spending.
For any long-term comparison of spending to be meaningful, you have to adjust for population change.

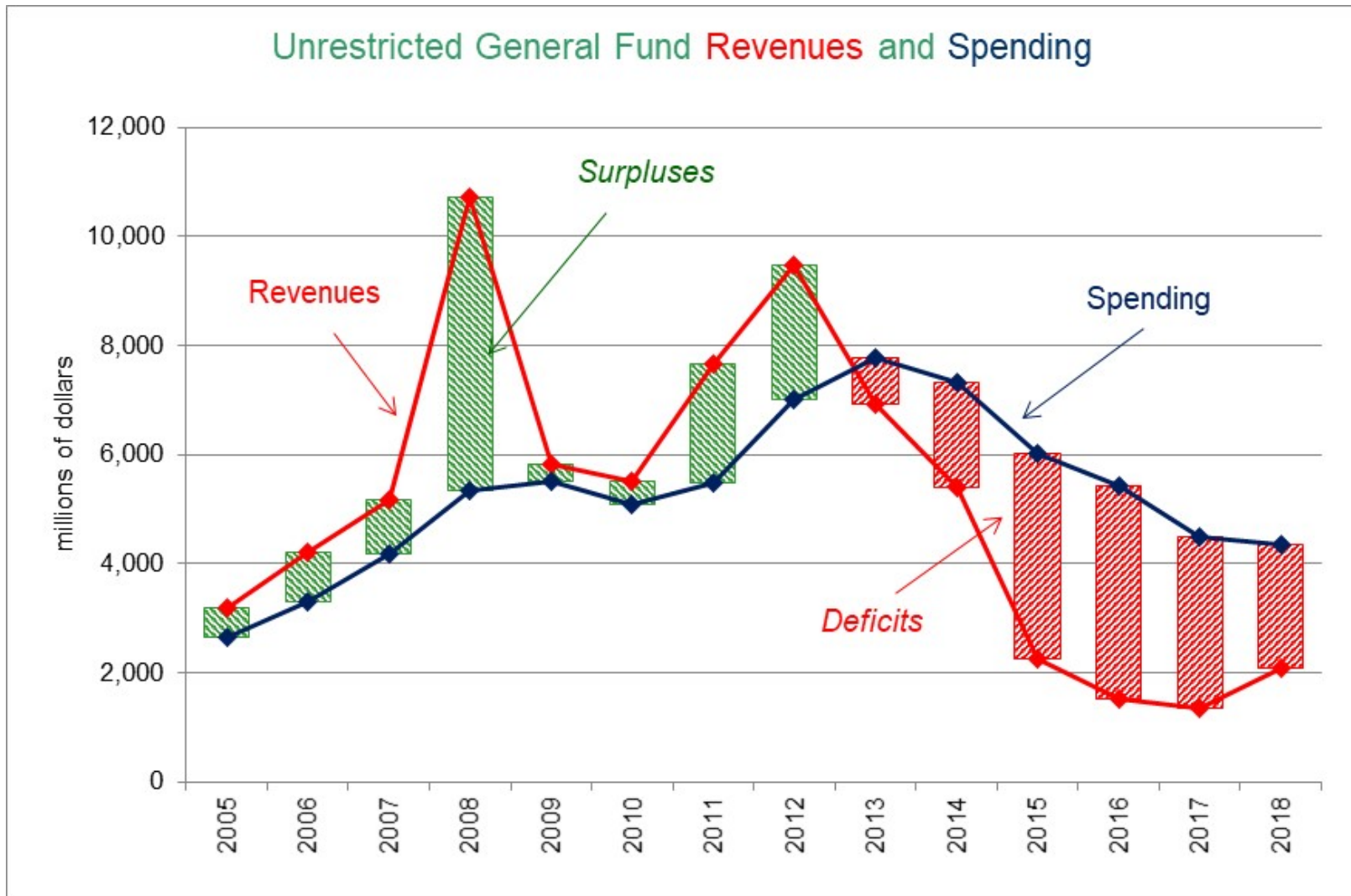
Our immediate fiscal challenge

Trends in state revenues since 2005 . . .

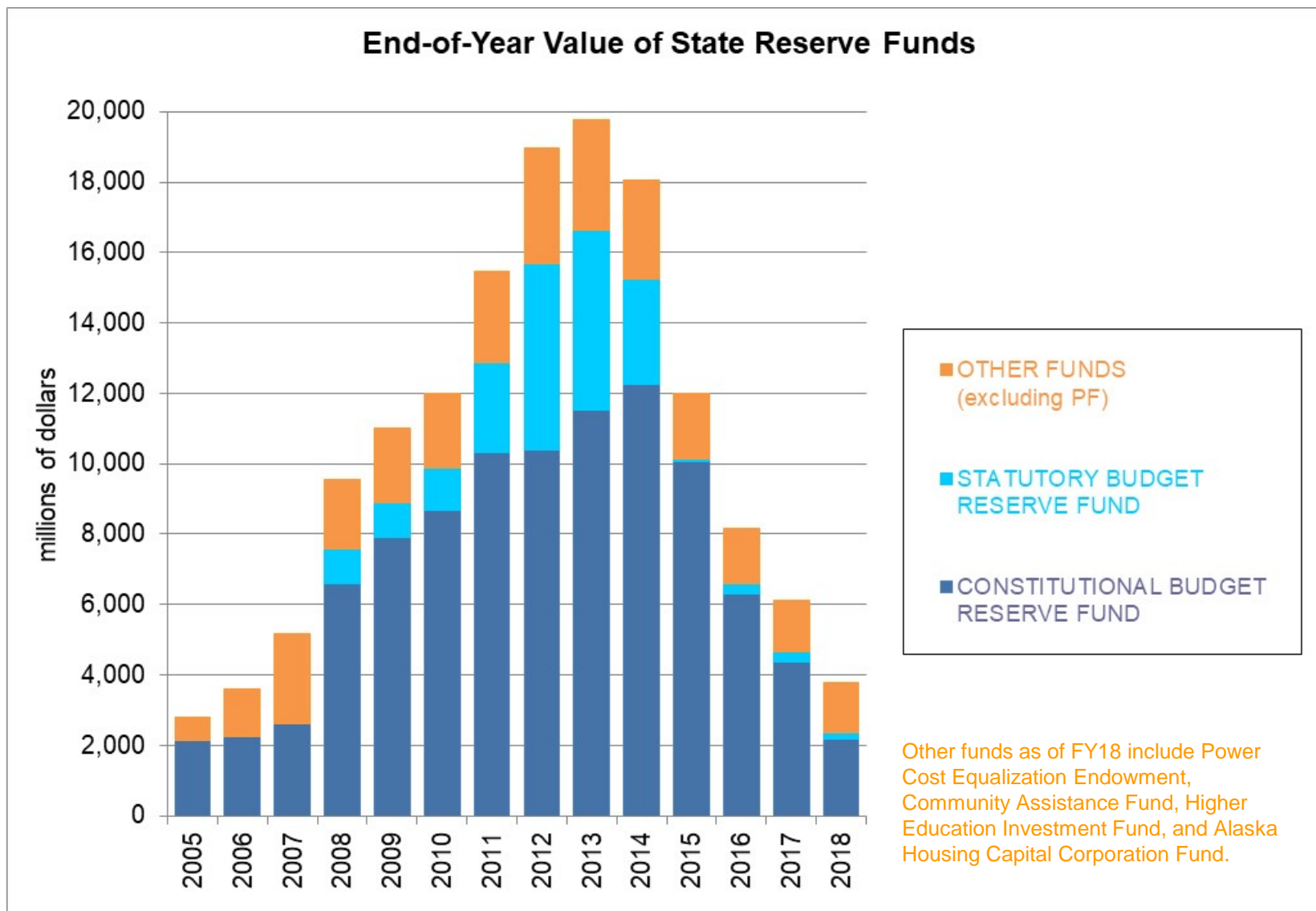
Alaska Unrestricted General Fund Revenues



From 2005 to 2012, even though spending was rising, we ran big surpluses.
Since 2013 we have been running big deficits.

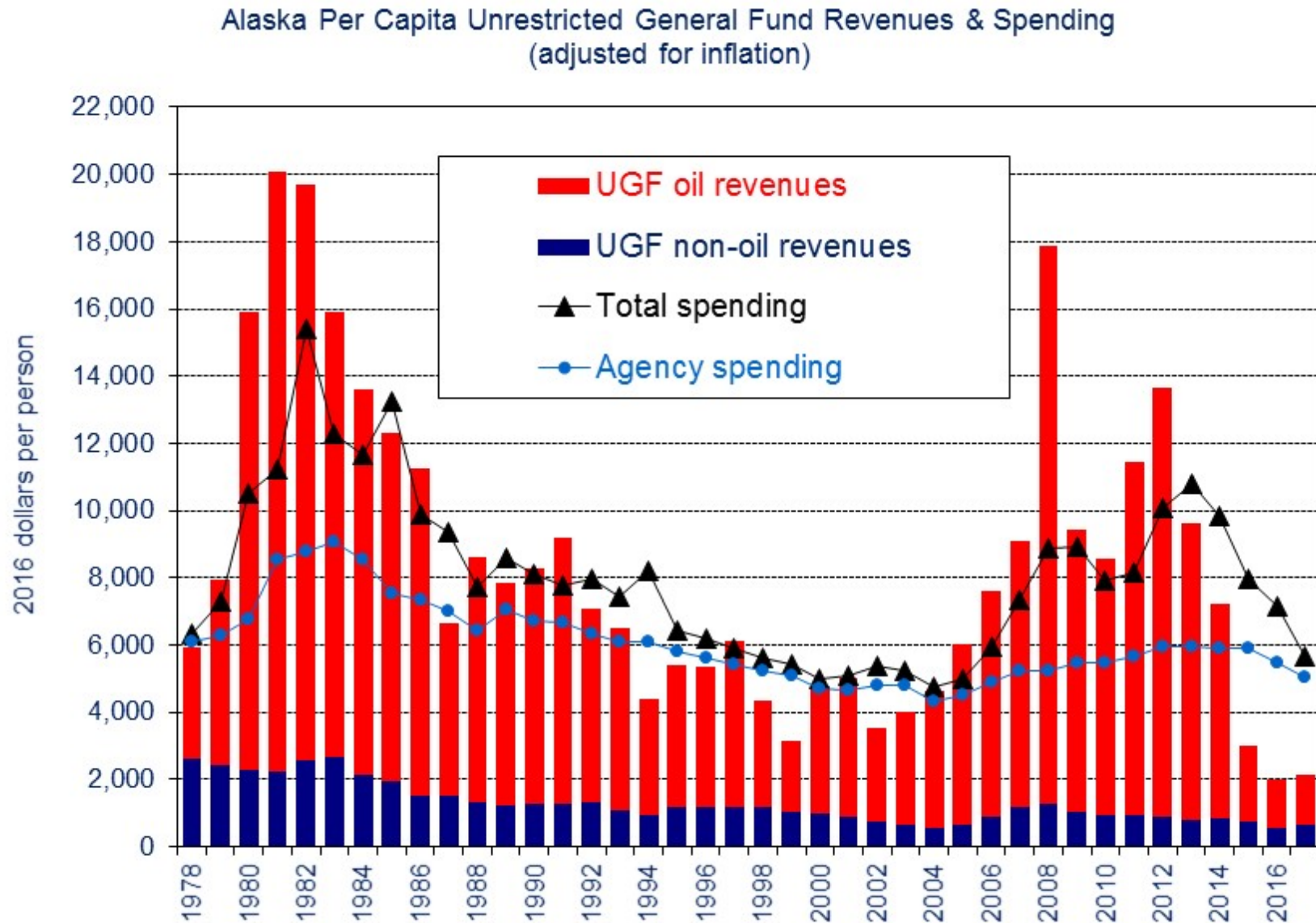


We used surpluses prior to 2012 to build up our savings reserves funds. Since 2013 we have rapidly drawn down these funds, mostly to pay for deficits.



Note: 2018 data are Legislative Finance Division projections.

We can no longer pay for state government from our current revenues and savings.
Oil revenues have fallen too much. We don't have enough savings.
We can't cut enough.



Using Permanent Fund earnings

How the Permanent Fund has worked historically . . .

The constitution mandates that
25% of oil royalties go to the
Permanent Fund principal
(\$0.2 billion)

Each year the fund generates realized
earnings (\$2.2 billion)
and unrealized earnings (\$0.4 billion).
which get added to the fund

Principal
(\$39.4 billion)
May not be spent!

**Inflation
Proofing**
(\$0.1 billion)

**Earnings
Reserve**
(\$7.6 billion)
May be spent!

**Unrealized
earnings**
(\$ 5.1 billion)
May not be
spent until
realized

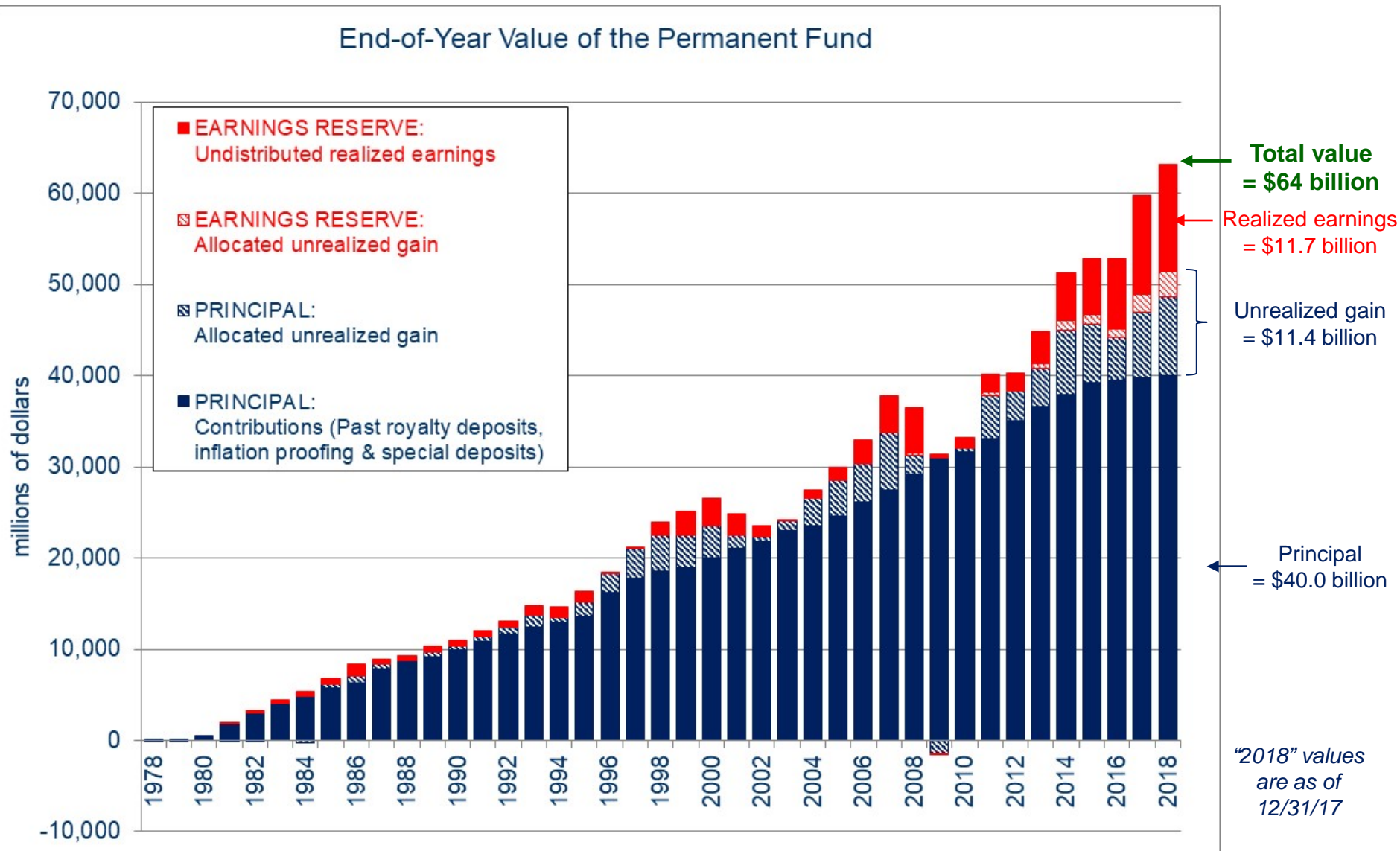
Occasional special deposits
(in years with big surpluses)

Dividends
(\$1.4 billion)

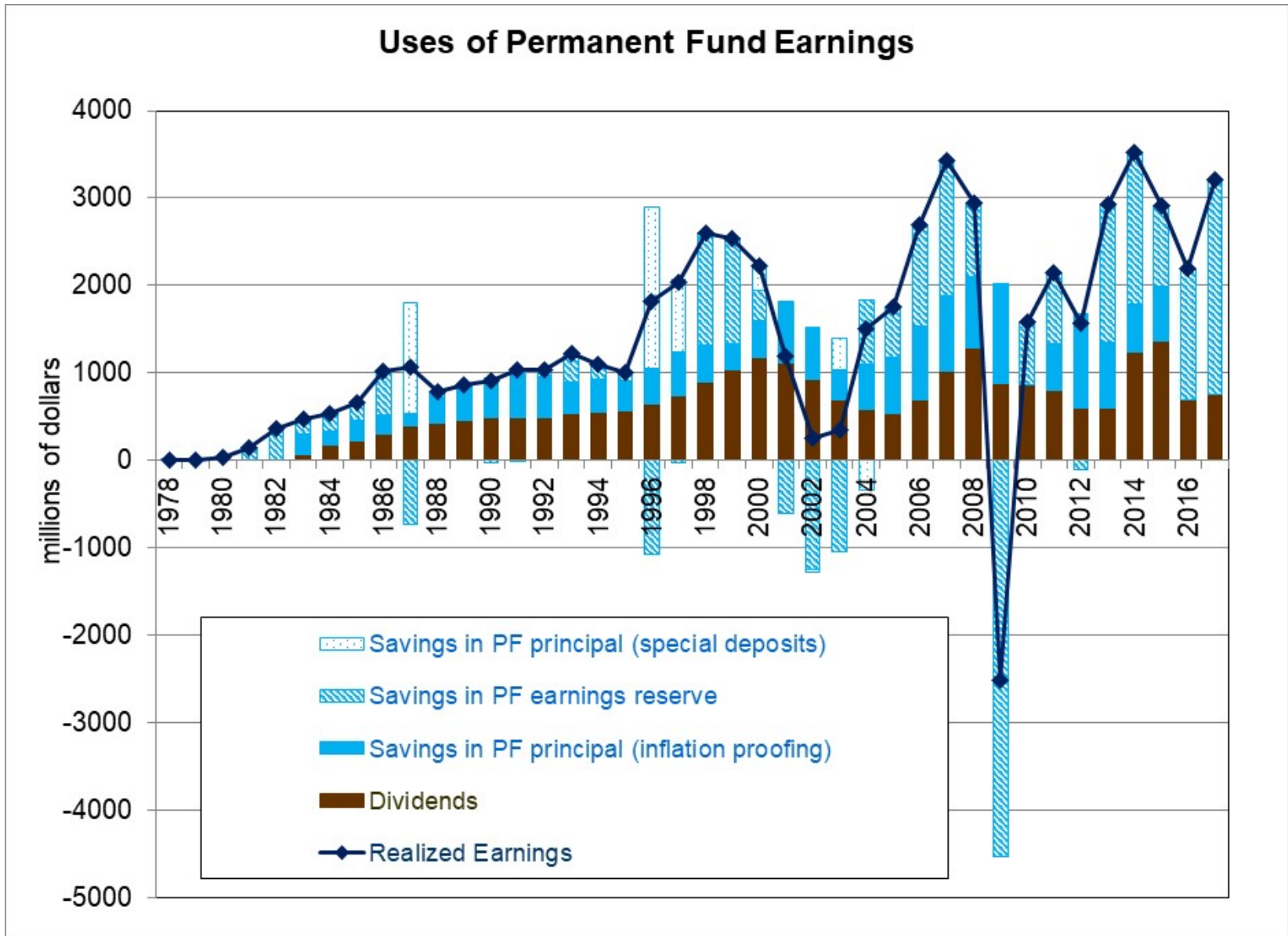
Dollar values are
FY16 flows and
end-of-year values

half of average realized earnings
over the past 5 years

We have saved a lot of money in our Permanent Fund,
which had a total value of \$64 billion on December 31, 2017.
The principal may not be spent but **the realized earnings may be spent.**



We have used approximately half of the earnings for dividends and have saved the other half.

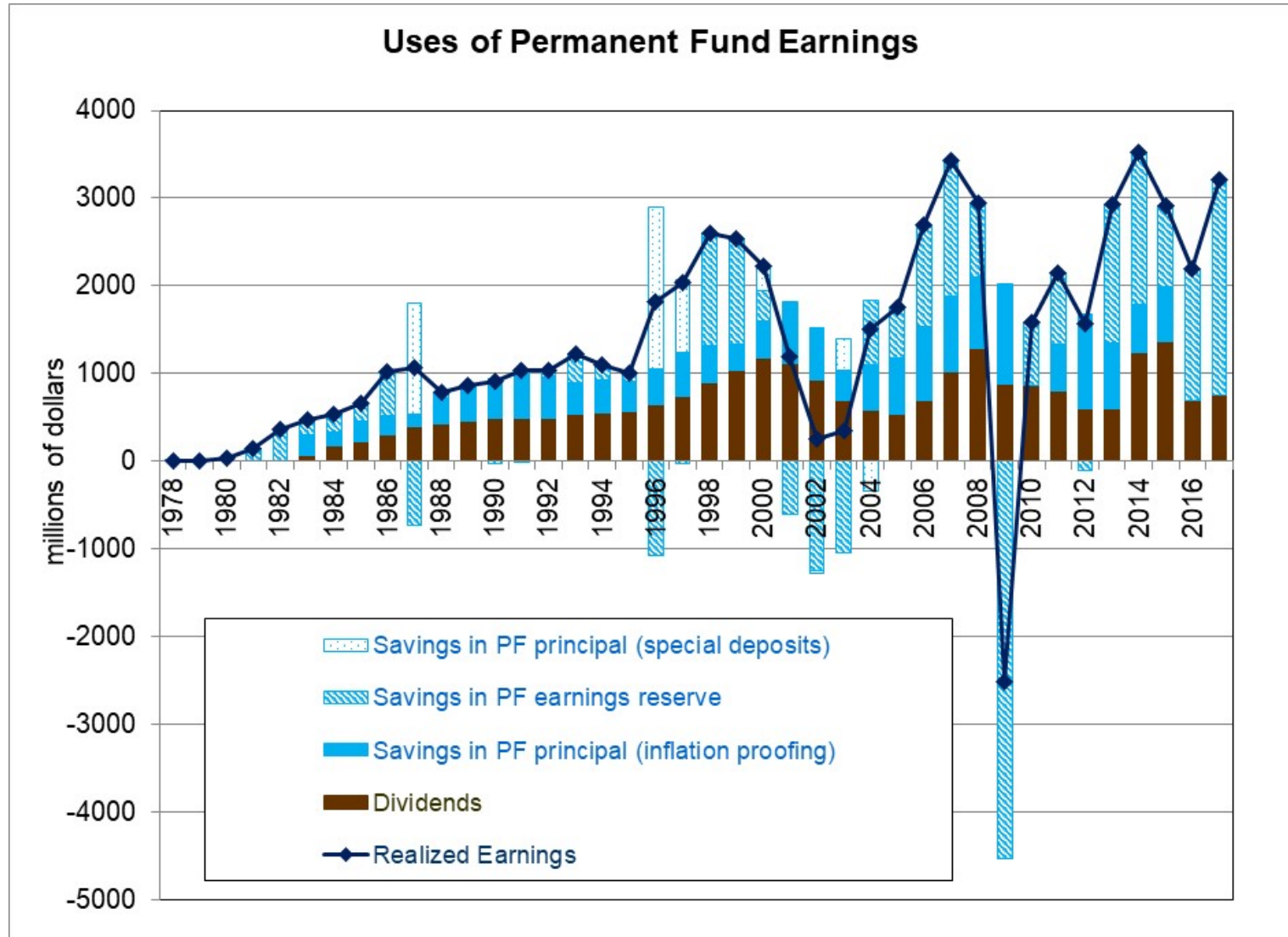


Key fiscal issues:

Should we use PF earnings to help pay for state government?

How much should we use for government?

How much should we use for dividends?



"POMV" proposals for using Permanent Fund Earnings

25% of oil royalties continue to go to the Permanent Fund principal

Each year the fund generates realized earnings and unrealized earnings which get added to the fund

Principal
May not be spent!

***Inflation
Proofing***

**Earnings
Reserve**
May be spent!

**Unrealized
earnings**
May not be
spent until
realized

Annual Percent of Market Value (POMV) Payout
a fixed % of average market value
over the past five years

Government spending

Dividends

We need to begin to use Permanent Fund earnings to help pay for state government in a structured and responsible way:

- We can't fund government without using PF earnings
 - We can't cut enough
 - We can't raise enough new revenues
- But we need to use PF earnings in a way that:
 - Maintains the real value and earnings of the fund over time
 - Doesn't risk depleting the PF earnings
 - Appropriately balances the use of earnings for
 - Government
 - Dividends

Getting to a credible fiscal plan

From today's paper . . .

ANCHORAGE DAILY NEWS

TUESDAY, FEBRUARY 13, 2018

ALASKA'S NEWSPAPER

\$1.00

STATE FINANCES

Can the Permanent Fund save Alaska's budget?

Legislative leaders and governor agree it is largest component to balancing the books but differ when it comes to taxes.

Nathaniel Herz
Anchorage Daily News

Is the \$64 billion Permanent Fund the solution to the state's massive deficit?

Or is it just part of the solution? Alaska lawmakers are grappling with those questions this year as part of their annual budget-writing process.

Leaders from both the House and Senate,

as well as Gov. Bill Walker, agree that the Permanent Fund's investment earnings can sustainably fill most of Alaska's \$2.5 billion budget gap. But they differ sharply about whether additional measures — namely, taxes — will also be needed to avoid draining the state's savings accounts.

The largely-Democratic House majority wants to levy an income tax to complement the fund's earnings — a step that members say will take pressure off both the Permanent Fund and the Constitutional Budget Reserve, an account that lawmakers have already emptied to \$3 billion from \$13 billion four years ago.

Last year, the House voted to pass a version of the tax that would raise \$700 million a year.

But leaders of the mostly-Republican Senate majority oppose that idea.

They argue that a rebound in oil prices, combined with a reversal of longstanding production declines on the North Slope, mean that a restructured Permanent Fund should suffice to stabilize the state's finances — without taxes.

"With oil prices and production, we're within grasp of a balanced budget," Senate President Pete Kelly, R-Fairbanks, said at a news conference Monday. "I think the talk of taxing

Alaskans — we would hope they would put that in the garbage can over on the House side."

While lawmakers diverge on whether a tax is needed, few deny that the Permanent Fund will be the biggest piece of any fix to Alaska's budget problem.

The fund is made up of an array of investments originally seeded with — and still augmented by — oil revenue. Its earnings have historically gone largely to dividends, which are annual checks paid directly to Alaskans.

Those checks, as high as \$2,000,

See **PERMANENT FUND**, A18

From today's paper . . .

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Even if we use Permanent Fund earnings
we may still face continuing deficits of several hundred million dollars . . .

- Particularly if:
 - Oil revenues don't rise
 - Government spending rises
- Continued deficits—even if smaller—are not sustainable
 - Would soon deplete cash savings

Examples of potential deficit with a PF draw for UGF revenues (\$ billions)

	FY18 budget	Add: POMV draw	Add: POMV draw Spending increase	Add: POMV draw Oil revenue increase	Add: POMV draw Oil revenue increase Spending increase
Current UGF revenues	2.1	2.1	2.1	2.5	2.5
PF draw for UGF revenues		1.9	1.9	1.9	1.9
Total UGF revenues	2.1	4.0	4.0	4.4	4.4
Total UGF spending	4.4	4.4	4.6	4.4	4.6
Deficit	-2.3	-0.4	-0.6	0.0	-0.2

We need a credible fiscal plan for how we will pay for state government that ends deficits and resolves uncertainty about Alaska's fiscal future.

- Without a credible fiscal plan
 - We're flying blind
 - We leave businesses and residents uncertain about whether Alaska is a place they want to live and invest in
 - We harm Alaska's economy and delay economic recovery.
 - We risk draining our savings
 - We risk further downgrades to our credit ratings
 - We leave state and local government unable to plan
 - We sap the morale of public workers

Mathematical constraints to our fiscal options
over any given period of time . . .

- We can't spend money we don't have.
 - If we drain our savings we can no longer spend them
- How much we add to or draw from savings affects our future investment earnings.
 - If we draw down the Permanent Fund or other savings, our investment earnings will decline
 - If we grow the Permanent Fund or other savings, our investment earnings will grow

Mathematical constraints to our fiscal options
over any given period of time . . .

Total revenues	Oil revenues
	Other current revenues
	Investment earnings
	New revenues

-

Total spending	Government spending
	Dividend spending

=

Net change in total savings	Net change in total value of the Permanent Fund & other funds
--------------------------------	---

Our future fiscal options are constrained by factors we can't control.
 We need to base our fiscal planning on prudent assumptions
 about these factors.

Fundamental mathematical constraints to our fiscal options	Factors we can't control	Choices which affect each other
---	-----------------------------	---------------------------------------

Total revenues	Oil revenues	x	
	Other current revenues	x	
	Investment earnings	x	
	New revenues		x

-

Total spending	Government spending		x
	Dividend spending		x

=

Net change in total savings	Net change in total value of the Permanent Fund & other funds		x
--------------------------------	---	--	---

Our choices about new revenues, government spending, dividend spending and changes in our savings affect each other.
We can't talk about these choices in isolation.

Fundamental mathematical constraints to our fiscal options	Factors we can't control	Choices which affect each other
---	-----------------------------	---------------------------------------

Total revenues	Oil revenues	x	
	Other current revenues	x	
	Investment earnings	x	
	New revenues		x

-

Total spending	Government spending		x
	Dividend spending		x

=

Net change in total savings	Net change in total value of the Permanent Fund & other funds		x
--------------------------------	---	--	---

Our choices about new revenues, government spending, dividend spending and changes in our savings affect each other.
We can't talk about these choices in isolation.

<i>Choices about . . .</i>	<i>. . . affect feasible combinations of</i>
Government spending	Dividend spending
	New revenues
	Changes in savings
Dividend spending	Government spending
	New revenues
	Changes in savings
New revenues	Government spending
	Dividend spending
	Changes in savings
Changes in savings	Government spending
	Dividend spending
	New revenues

Be skeptical of any fiscal argument that isn't part of a full plan that adds up:

Prudent assumptions about factors we can't control

Choices about revenues, spending and savings that add up

Fundamental mathematical constraints to our fiscal options	Factors we can't control	Choices which affect each other
---	-----------------------------	---------------------------------------

Total revenues	Oil revenues	x	
	Other current revenues	x	
	Investment earnings	x	
	New revenues		x

-

Total spending	Government spending		x
	Dividend spending		x

=

Net change in total savings	Net change in total value of the Permanent Fund & other funds		x
--------------------------------	---	--	---

We also face real political constraints to our fiscal options.
Options that can't pass the House, Senate and Governor are not real.

- There are real political limits to how much we can:
 - Cut spending
 - Cut dividends
 - Raise in new income or sales taxes
 - Increase oil revenues
- Fiscal proposals which exceed these limits
 - Are not real
 - Are actually plans to drain our savings

We should not take any advocates of any fiscal choices seriously unless they can present a full fiscal plan

- *Based on prudent assumptions about:*
 - future oil revenues
 - future investment revenues
- *With clearly defined choices about:*
 - government spending
 - dividend spending
 - new revenues
 - changes in our total savings
- *Which:*
 - Add up mathematically
 - Are politically feasible

We should not take any critics of any fiscal choices or plan seriously unless they can present an alternative full fiscal plan

- *Based on prudent assumptions about:*
 - future oil revenues
 - future investment revenues
- *With clearly defined choices about:*
 - government spending
 - dividend spending
 - new revenues
 - changes in our total savings
- *Which:*
 - Add up mathematically
 - Are politically feasible

Prudent assumptions
about future revenues

Historically we have based our fiscal planning and debates on the most recent Department of Revenue projections



Revenue
Sources
Book Fall 2017

Alaska Department of Revenue | Tax Division | www.tax.alaska.gov

Appendix A

4

Unrestricted General Fund Revenue

Petroleum versus non-petroleum revenue

Fiscal Year	Millions of Dollars									
	Forecast									
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Unrestricted General Fund Revenue										
Total Unrestricted Petroleum Revenue	1,581.1	1,436.8	1,440.1	1,518.6	1,565.2	1,599.5	1,604.3	1,716.7	1,913.7	2,095.4
Unrestricted General Fund Non-Petroleum Revenue	520.5	610.3	623.1	637.1	653.8	675.7	692.8	710.1	727.6	744.4
Total Unrestricted General Fund Revenue	2,081.6	2,047.1	2,063.2	2,155.7	2,218.9	2,275.2	2,297.1	2,426.8	2,641.3	2,839.8



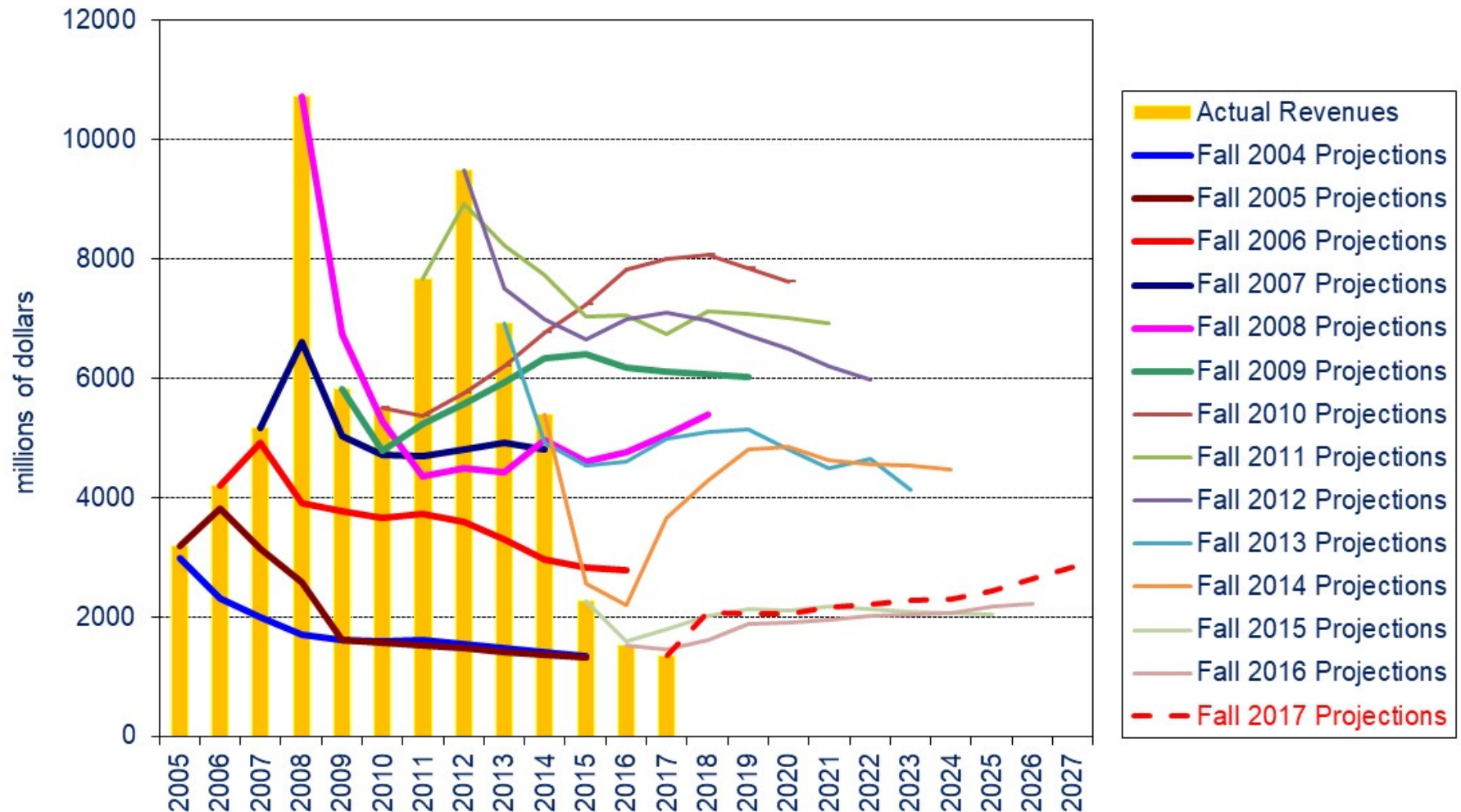
\$2.1 billion in FY18



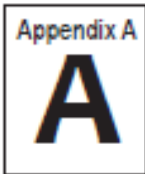
\$2.8 billion in FY27

But actual oil revenues have almost always differed drastically from what the Department of Revenue projected a few years earlier!

State Unrestricted General Fund Revenues:
Alaska Department of Revenue 10-Year Projections

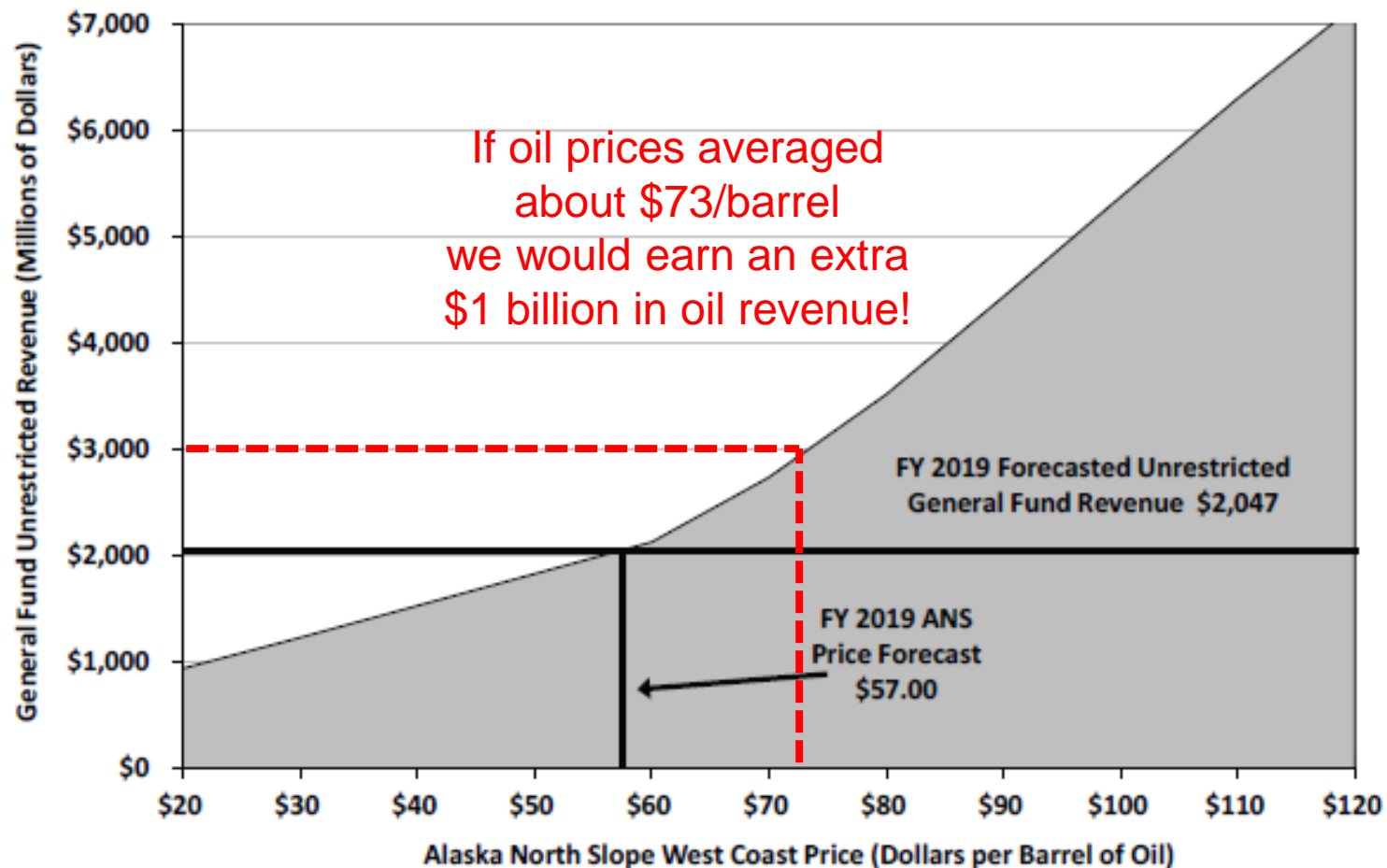


Future oil revenues are very sensitive to oil prices . . .

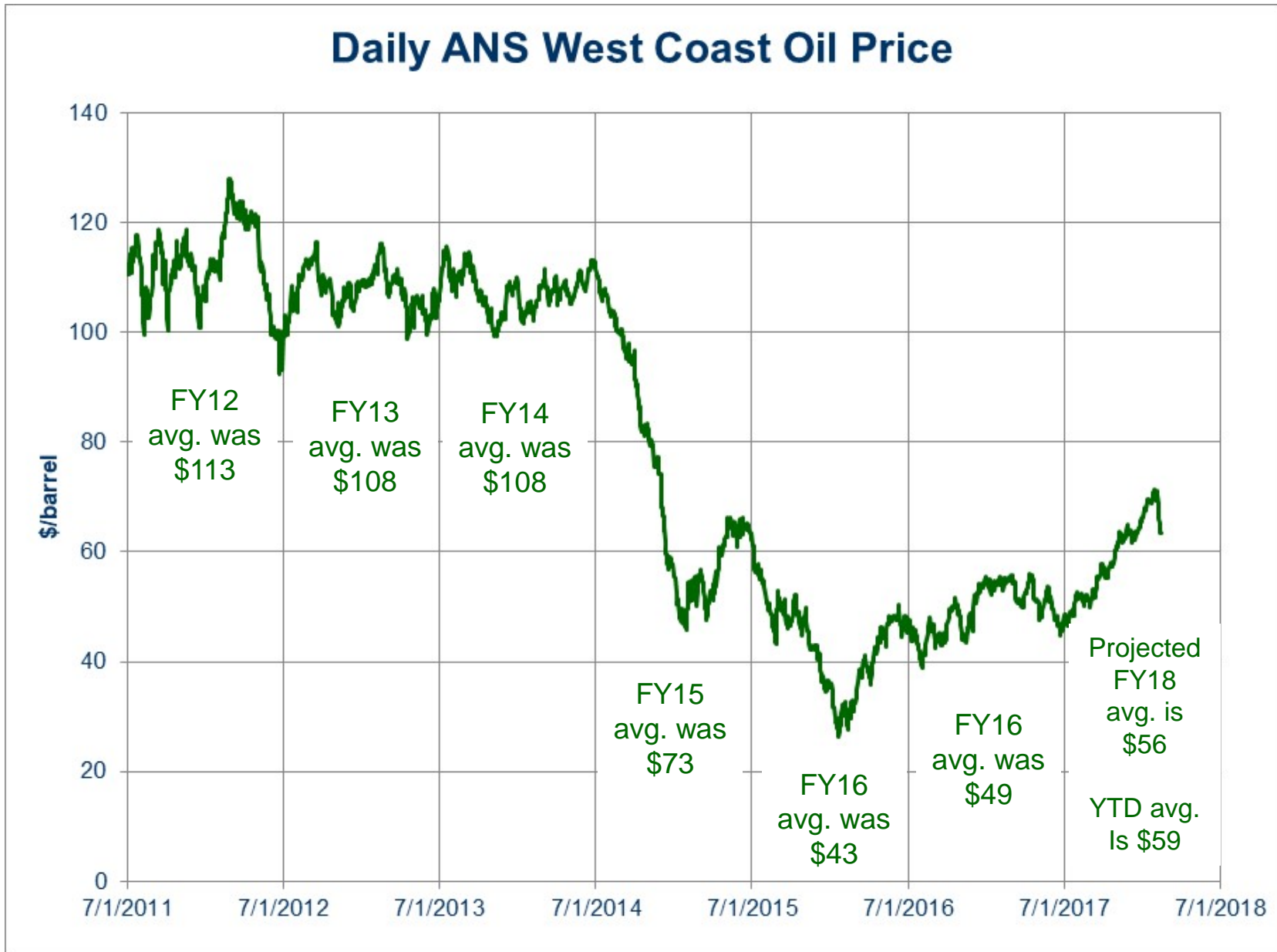


GFUR Relative to Price per Barrel

Price sensitivity for FY 2019



Trends in oil prices since FY12 . . .



The reality is that . . .

- Oil prices are extremely difficult to predict
- A wide range of factors could drive prices higher
 - Political uncertainty in major producing countries
 - Strong world demand
 - Supply shortfalls
- A wide range of factors could drive prices lower
 - Rapidly increasing shale oil production
 - Slowdown in world economic growth
 - Shifts in energy consumption away from oil

The reality is that:

- Our actual future revenues may be much lower or higher than the projections
- We need to base our fiscal planning on prudent assumptions
 - Not necessarily the “most likely” assumptions
 - Considering consequences of lower-than-anticipated revenues
- We need a much more informed discussion of what assumptions are prudent

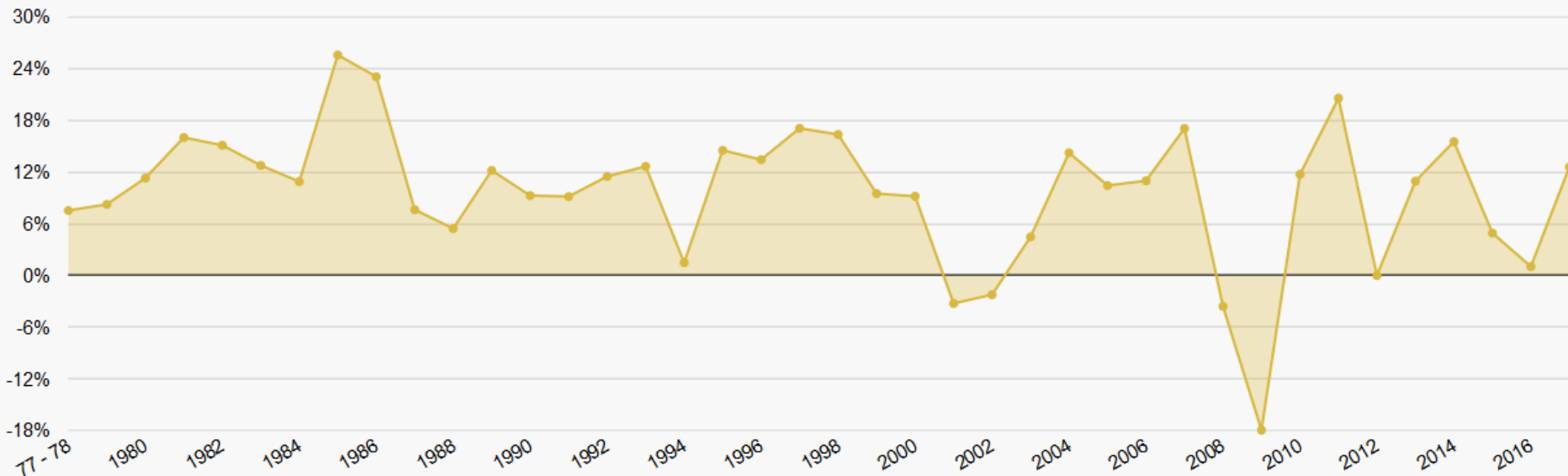
Historically we have based our fiscal planning for investment income on The Permanent Fund Corporation's average rate-of-return assumptions

Assumptions:		Total Return - Inflation = Total Real Return			Statutory Return	
Lo	FY 2018	-1.38%	<input type="text"/>	2.13%	-3.51%	Lo <input type="text"/> 6.40%
Mid	FY 2018 ⁽⁶⁾	5.73%	<input type="text"/>	2.13%	3.60%	Mid <input type="text"/> 7.58%
Hi	FY 2018	12.72%		2.13%	10.59%	Hi 9.01%
FY 2019-2027 ⁽⁷⁾		6.50%		2.25%	4.25%	6.53%

Source: Alaska Permanent Fund Financial History & Projections as of December 31, 2017
<https://apfc.org/report-archive/#41-history-and-projections>

But historically, Permanent Fund rates of return have always fluctuated widely.
They have never been constant.

PERMANENT FUND RETURN



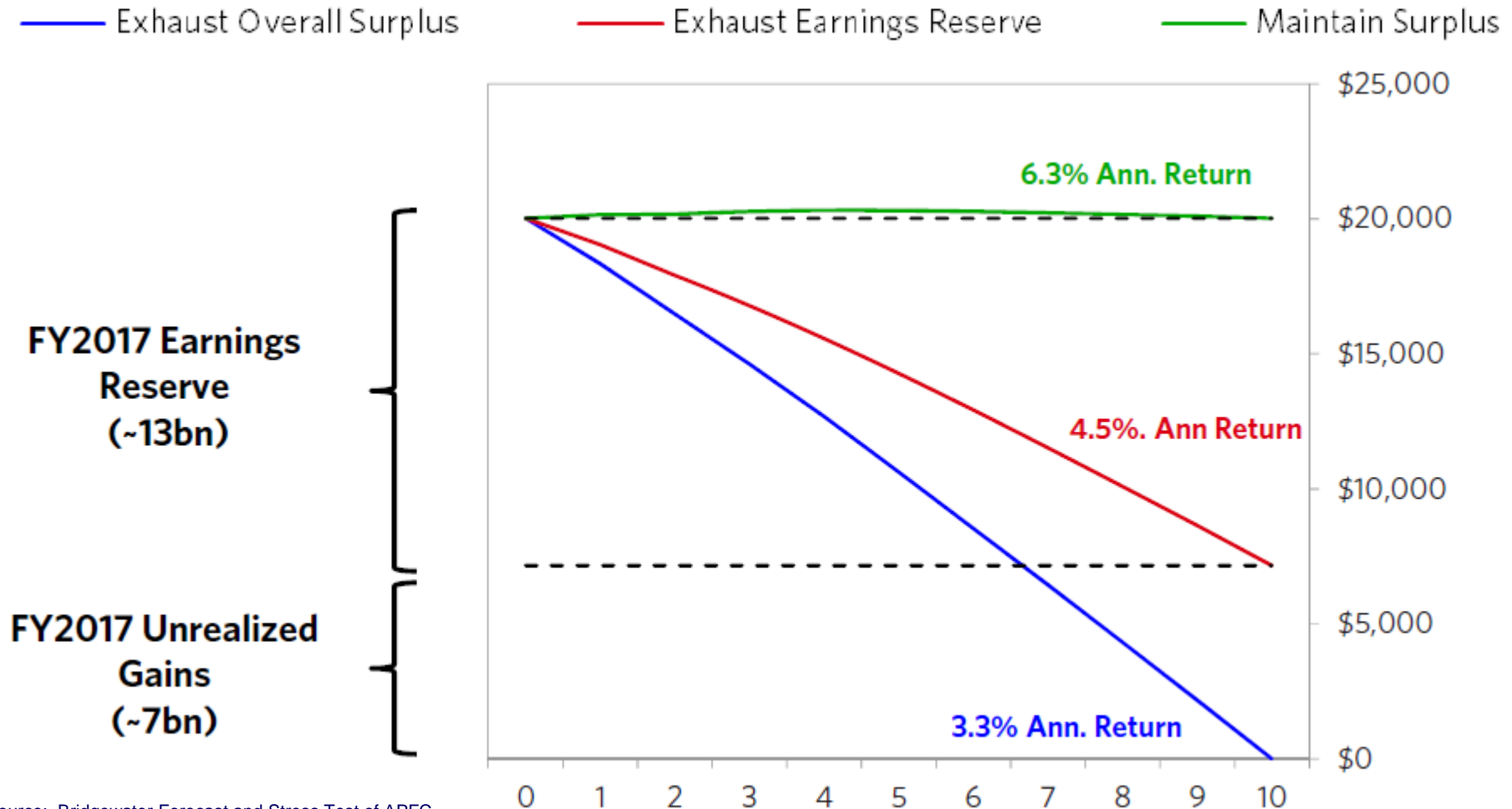
Source: Alaska Permanent Fund Corporation website, "Our Performance": <https://apfc.org/our-performance/>

Three risks in relying on a POMV draw to fund state government and dividends

- Draw exceeds average rate of return
- Years of low returns erase Earnings Reserve
- Change in investment incentives . . .

A recent study found that average returns lower than 6.3% would lower the value of the PF earnings reserve over time.

Expected Path of "Economic Surplus"
(Earnings Reserve + Unrealized Gains)
(2.25% Inflation Proofing; 5.25%/5.00% Distributions)



It's particularly important to base our assumptions about future investment earnings and draws from Permanent Fund earnings on prudent assumptions not only about average rates of return but also potential low or negative returns in some years.

- Any Permanent Fund losses come out of the Permanent Fund earnings reserve.
- As of December, the realized earnings of the PF (\$11.8 billion) were 18% of the total value of the PF (\$64.5 billion).
- If the fund lost 10% (less than it lost in 2009) it would lose \$6.5 billion—more than half the value of the earnings reserve.

The reality is that:

- We can't accurately predict
 - future PF average rates of return
 - actual annual rates of return
- We need to base our fiscal planning on prudent assumptions
 - Not necessarily the “most likely” assumptions
 - We need to consider the potential consequences of
 - lower-than-anticipated average returns
 - periods of low or negative returns
 - We need a much more informed discussion of what assumptions are prudent

Comments on fiscal options

Government spending . . .

- We need serious discussion of the right balance between
 - Government services we need and want
 - What they cost
 - What we are willing and able pay for them
- We need to recognize that
 - Some kinds of spending can't be cut
 - Debt service
 - Retirement obligations
 - Some kinds of spending need to increase
 - Capital spending
 - Investments in economic development
 - Inflation will increase future costs

Government spending . . .

- We can't base a fiscal plan on unidentified cuts
- Cuts aren't real unless
 - You can identify them
 - The legislature can make them
- All of us can point to specific examples of “wasteful spending”
 - That don't mean vastly larger spending cuts are feasible
 - We don't all agree about what is “wasteful”

Dividends . . .

Alaskans have widely varying perspectives about dividends—
with widely varying implications for fiscal policy.

- **Dividends are the people's money—not a gift from government**
 - Cutting dividends to pay for government spending is not an option
 - If we need to pay for spending, we should raise it in other ways
 - Dividends give every Alaskan a stake in Alaska's wealth
 - Dividends protect the fund from bad investments and “raids”
 - Dividends promote a more equitable society
- **Dividends are the government's money and a form of spending**
 - The Permanent Fund was not created to pay dividends
 - The benefits of dividends have to be balanced against
 - The benefits of other kinds of spending
 - The costs of raising revenues in other ways
 - We can't afford to keep paying the same dividends we did when we had more money

Dividends . . .

Different perspectives have different implications for fiscal policy.

- **Dividends are the people's money—not a gift from government**
- **Cutting dividends to pay for government spending is not an option**

Implies

- *we have to accept some combination of significantly:*
 - *Lower government spending*
 - *Higher taxes*
 - *Higher drain on our savings*

- **Dividends are the government's money and a form of spending**
- **We should reduce dividends to help pay for government**

Implies

- *We are asking the poorest child to give up as much as the richest millionaire to pay for government—unless we also impose other more progressive taxes*

New revenues . . .

- New revenues would help to diversify and stabilize our revenues
- Paying income or sales taxes wouldn't kill us
 - Economies function in the other 49 states
 - We need to get beyond the rhetoric that taxes destroy jobs
 - Reasonable taxes which support important public services help economies

New revenues . . .

- Taxes require careful thought and take time to implement
 - If we think we *might* need new revenues, we should be talking about them now
- People pay more attention to spending when they pay taxes
- It's not economically healthy for government and citizens to help pay for services they receive
 - It creates dependency
 - Growth doesn't pay for itself

Savings goals . . .

- Drawing down our savings has been our default fiscal choice
 - Lowest current economic impact
 - Least noticed
 - Least political pain
- But drawing down our savings
 - Reduces our future investment earnings
 - Leaves us more vulnerable to real emergencies
- For more than three decades we grew our savings—which now provide a major source of income.
 - How much should we save over the next three decades?

Roles of state and local governments . . .

- A credible fiscal plan has to work not only for state government but also for local governments.
- Our state government pays for many of the services local governments pay for in other states.
- We could cut state government spending by making local governments responsible for more government services and cutting support for local government.
 - But that would drive up local government costs and taxes

Conclusions

We should be thinking and talking about *many* considerations in making our fiscal choices

- How fair are they in how they affect different Alaskans today?
- How will they affect future Alaskans?
- What are their short-term economic impacts?
- What are their long-term economic impacts?
- How might they influence how Alaskans engage with government?

Fundamentally, our fiscal choices are about
what kind of state we want
and what kind of future we want for Alaska.

What does addressing Alaska's fiscal challenge demand of us?

- Of all Alaskans
- Of advocates for fiscal choices
- Of our elected leaders

What addressing Alaska's fiscal challenge demands of all Alaskans

- Become informed about our fiscal reality
- Recognize that there are no easy solutions
- Recognize that no-one gets everything they want in a democracy
- Recognize that not paying for what we spend
 - leaves less for future Alaskans
 - reduces our future earnings
 - can't continue very long

What addressing Alaska's fiscal challenge
demands of advocates for fiscal choices:

- Reality-based proposals
 - Mathematically real
 - Politically real
- It's not enough to say what you oppose
- You need to say what you propose

What addressing Alaska's fiscal challenge
demands of elected leaders:

- Educating Alaskans about fiscal constraints we face
- Serious debate of the fundamental political issues we face:
 - Tradeoffs between government spending, dividends, revenues and savings
 - Different options for raising new revenues
 - Our responsibility to save for future generations
- Objective and informed discussion of:
 - prudent assumptions about future revenues
 - implications of fiscal options over time
- Compromise