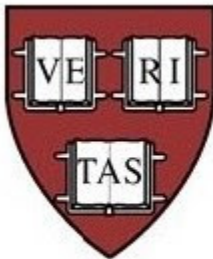


Reflections on Alaska's Fundamental Fiscal Choices

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In fond memory of Bob Mitchell

- A long-time friend
- a fellow singer
- a loyal Yale alumnus



**Robert “Bob”
Andrew Mitchell**

*Dec 14, 1931 -
Mar 4, 2021*

All states—including Alaska—face
three fundamental and inter-related fiscal choices

- how much to collect in taxes and resource revenues from residents and businesses
- how much to spend for state services, capital investments and payments to citizens
- how much to add to or draw from savings

Alaska's fiscal choices differ significantly from other states
because of two fundamental factors

- High costs of state government
 - Greater responsibilities
 - Higher costs
- Resource wealth

We have more needs.
But we're richer.
But not as rich as we used to be.

The nature and consequences of Alaska's fiscal choices have changed drastically over time

- Huge North Slope oil revenues and their subsequent decline
- Growth of the Alaska Permanent Fund and its earnings

Choices that “made sense” when oil revenues were high may no longer make sense—or even be possible

- We can no longer *sustainably* simultaneously afford
 - Current levels of state services
 - Almost no broad-based taxes
 - Large annual dividend payments

We face difficult fiscal choices between some combination of:

- Spending less for state services
- Paying broad-based taxes
- Reducing dividends
- Drawing down our savings

Our fiscal choices will have important implications for our economy and society now and in the future.

My goal is to reflect on these choices and their implications

- Lower your expectations
- Almost everything that can be said has already been said
 - Eloquently
 - For a long time
 - By many people
- I hope to
 - Enjoy the rare luxury of an informed, intelligent audience
 - Offer a longer-term perspective than we are used to
 - Raise questions
 - Promote discussion

Outline

- A theoretical framework
- A look back: our fiscal circumstances and choices since statehood
- Reflections

A theoretical framework

We have to pay for what we spend

Total spending	=	Total revenue	+	Net draws from funds	+	Net borrowing
Government agency spending + Capital spending + Transfers to local government + Transfers to individuals	=	Taxes on citizens + Taxes on businesses + Resource revenues + Investment earnings	+	Draws from funds - Deposits into funds	+	New borrowing - Debt repayment

Current choices affect future options

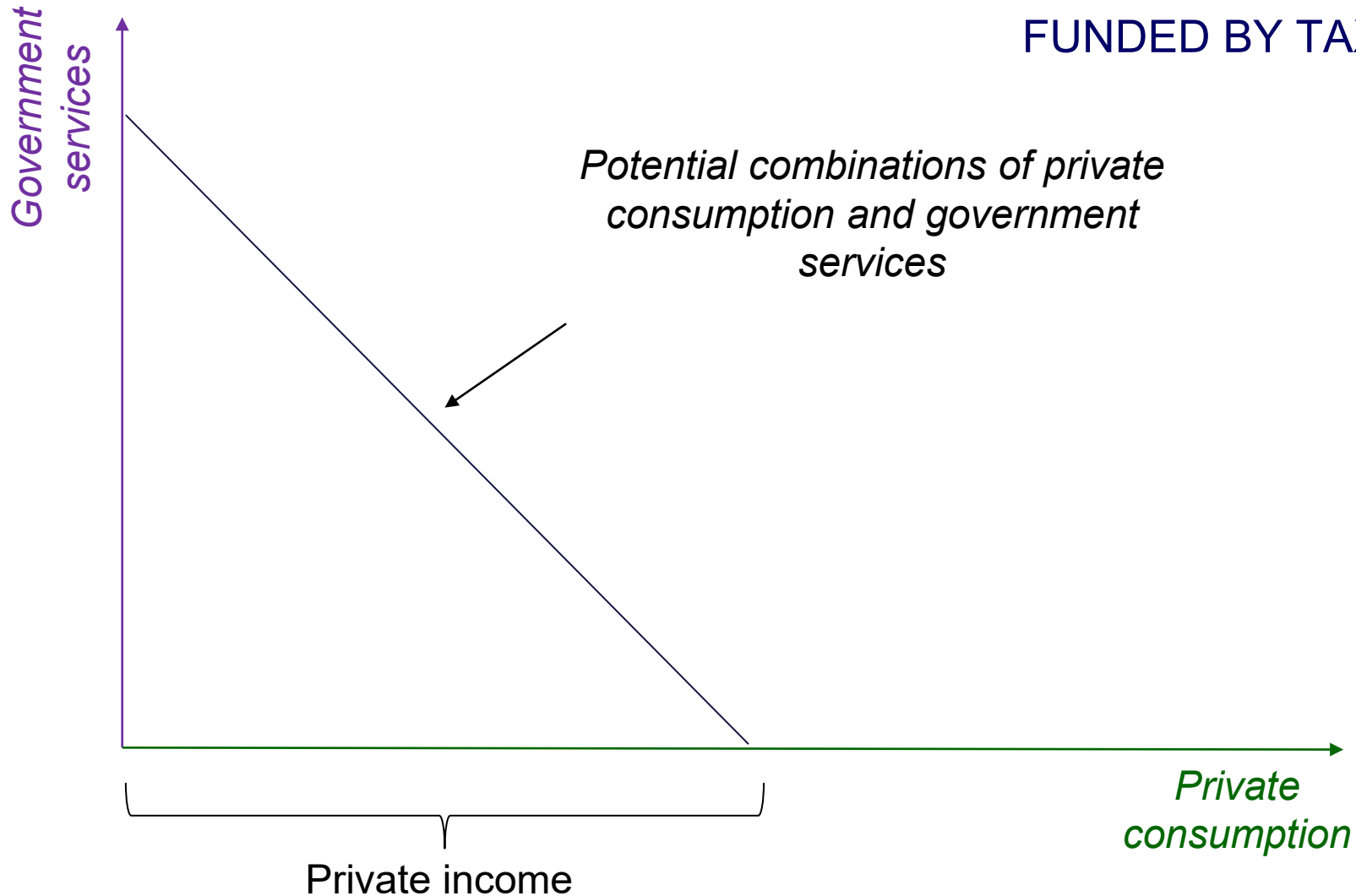
Capital spending affects future maintenance obligations

Net draws from funds affect future investment earnings

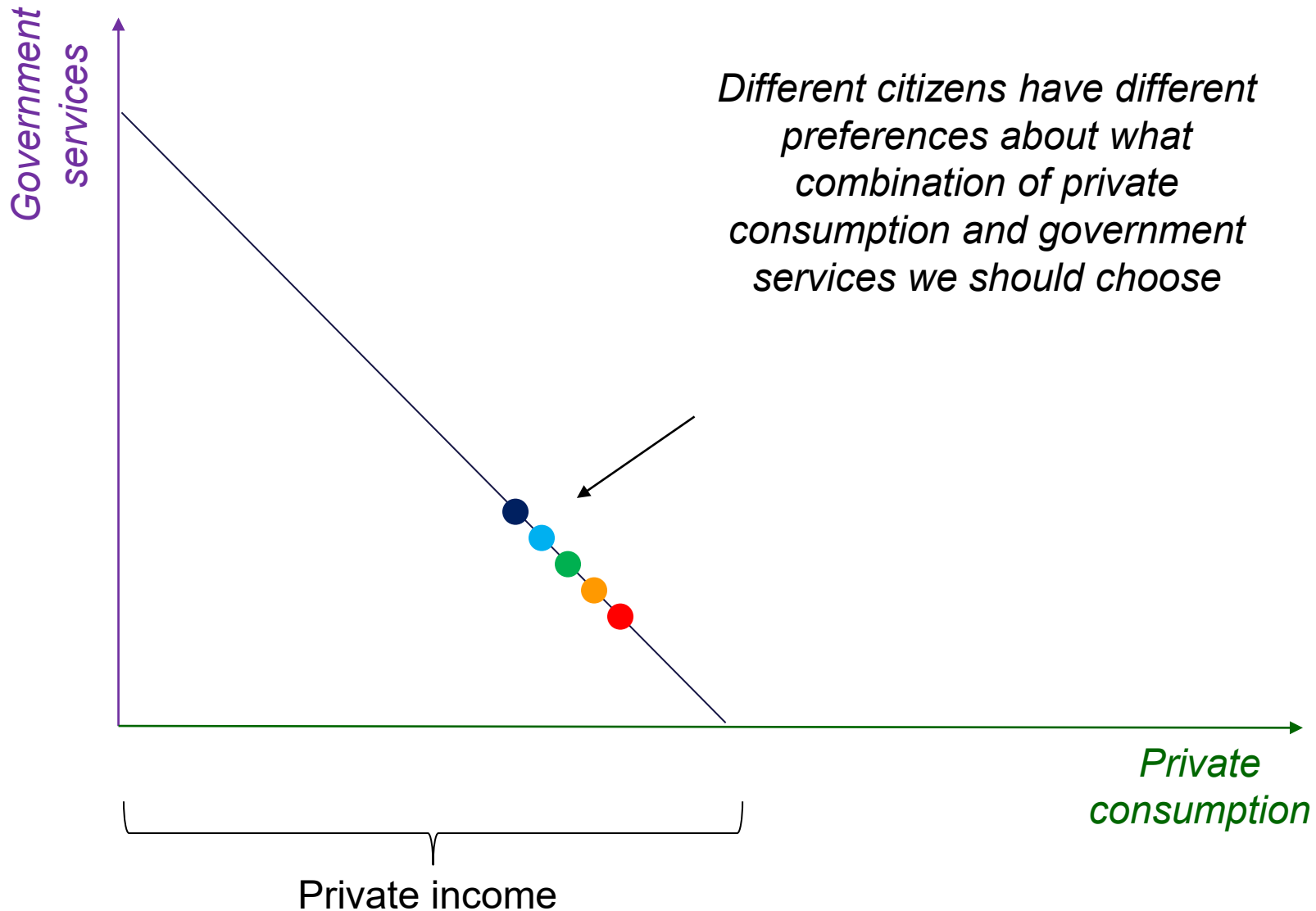
Net borrowing affects future debt repayment

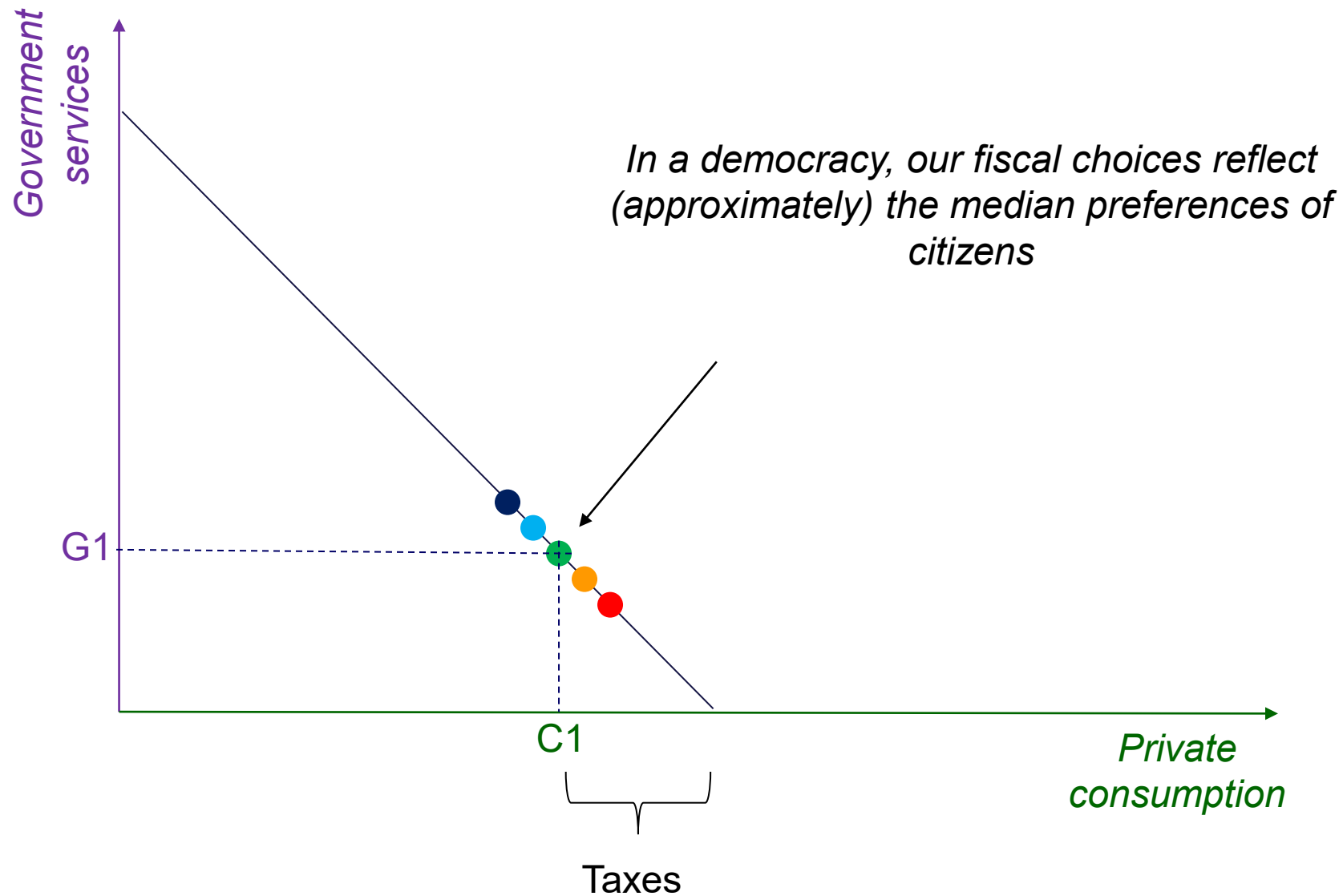
A very simple model of fiscal choices (without savings)

NO RESOURCE INCOME:
ALL GOVERNMENT MUST BE
FUNDED BY TAXES

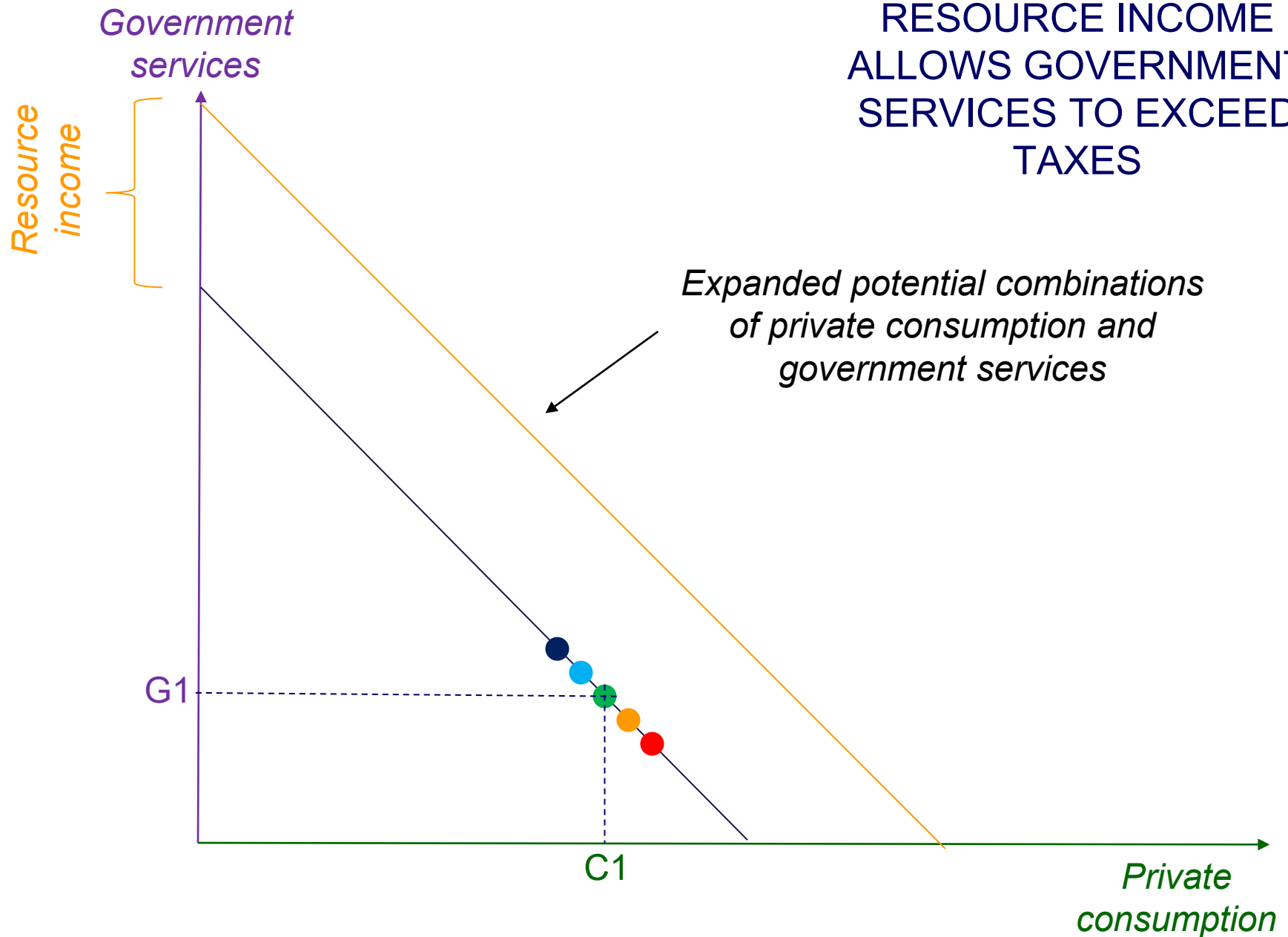


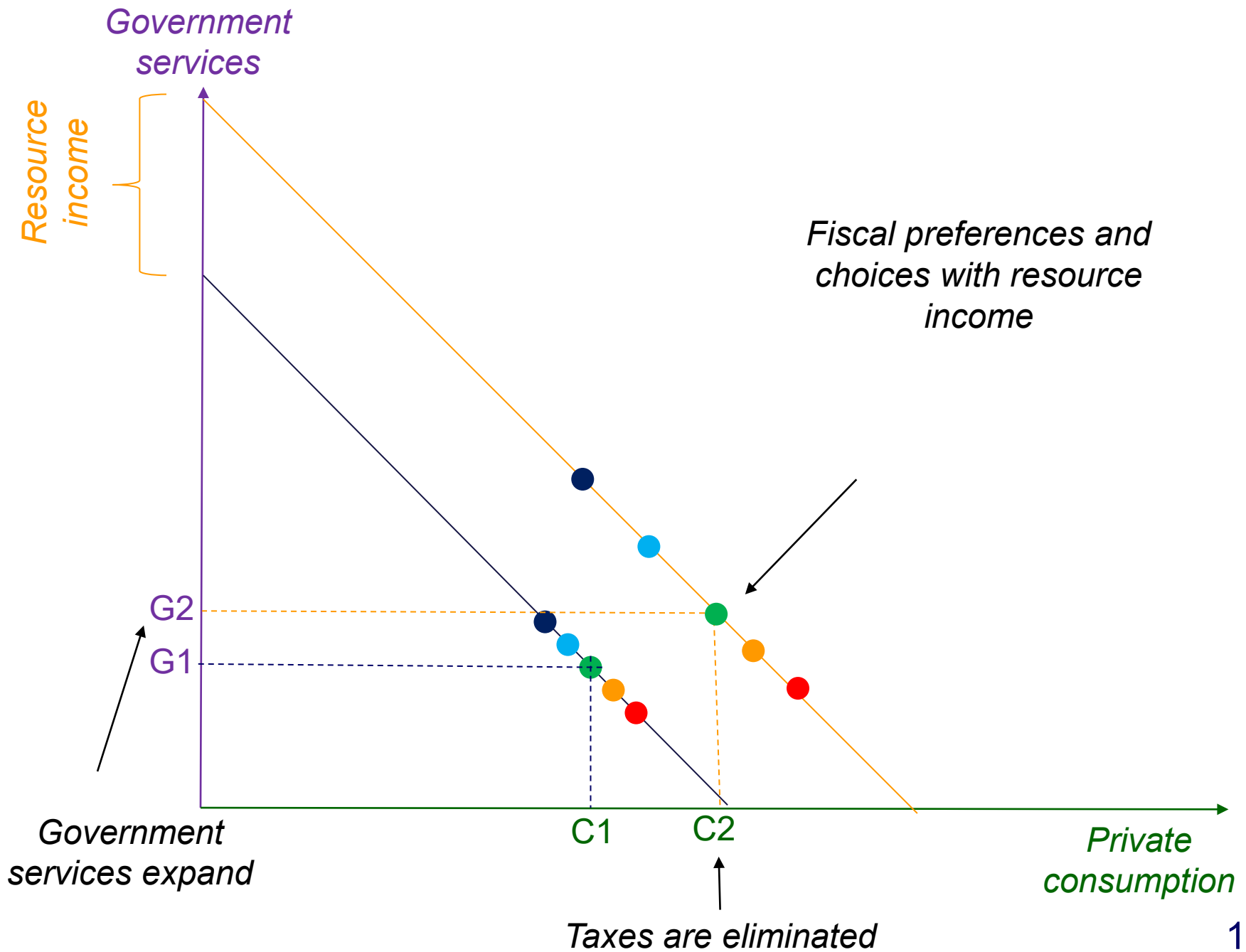
Note: This is, intentionally, a very simple model which leaves out many of the factors affecting fiscal choices in the “real world.” In particular, it does not take account of the fact that not everyone receives the same government services or pays the same taxes: these vary widely for different groups in society. In addition, it ignores the fact that by saving, borrowing and investing, fiscal choices in any given period may affect fiscal options in future periods. Taking account of these factors would make the model much more complicated.





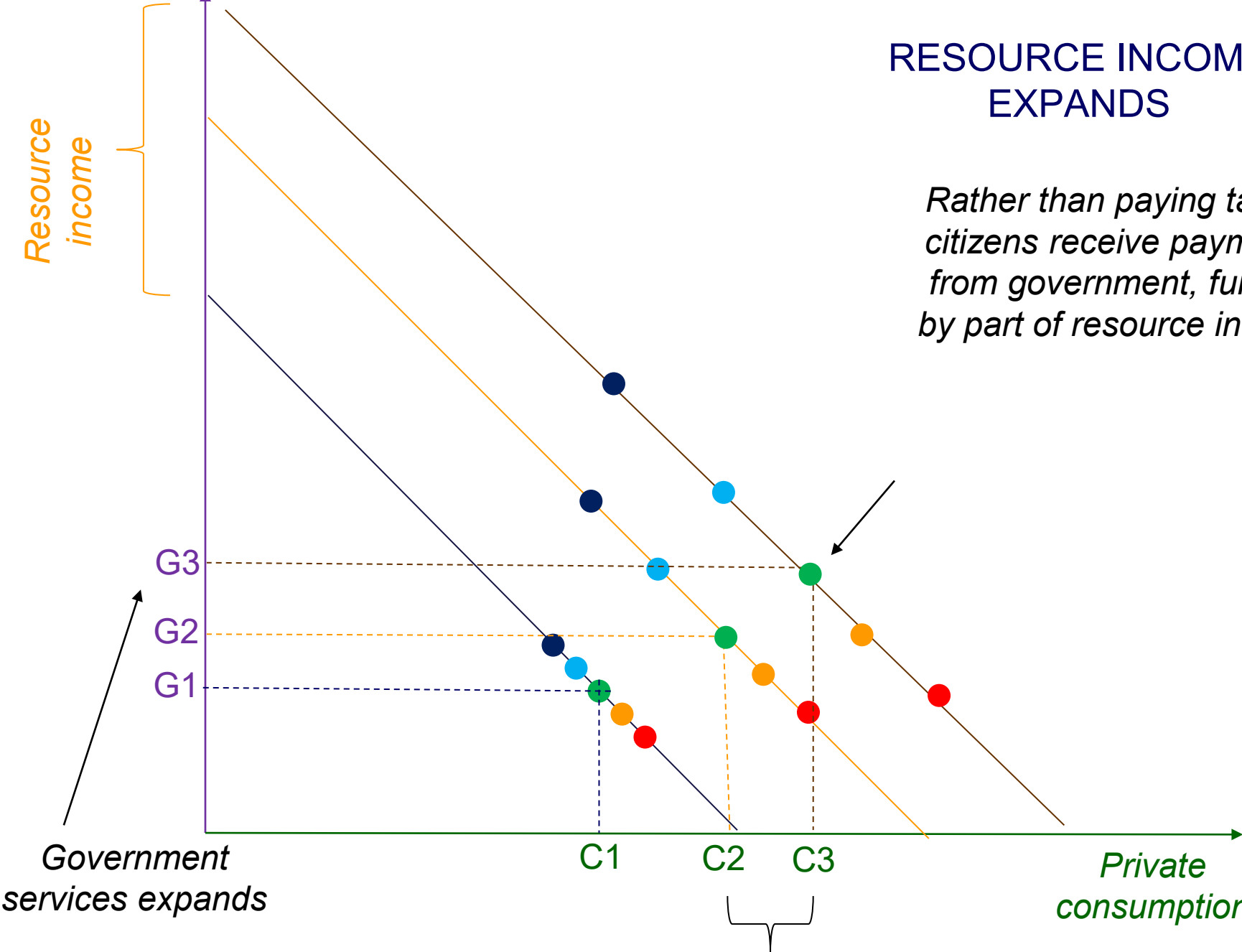
RESOURCE INCOME ALLOWS GOVERNMENT SERVICES TO EXCEED TAXES





RESOURCE INCOME
EXPANDS

*Rather than paying taxes,
citizens receive payments
from government, funded
by part of resource income*



Government
services expands

Payments from government

Insights from simple model of fiscal choices

- Fiscal choices depend upon the circumstances
- As resource wealth changes, so do choices about:
 - Government services
 - Taxes
 - Payments to citizens
- Preferences are not uniform
 - Fiscal choices reflect median preferences
 - Very few people may be fully satisfied

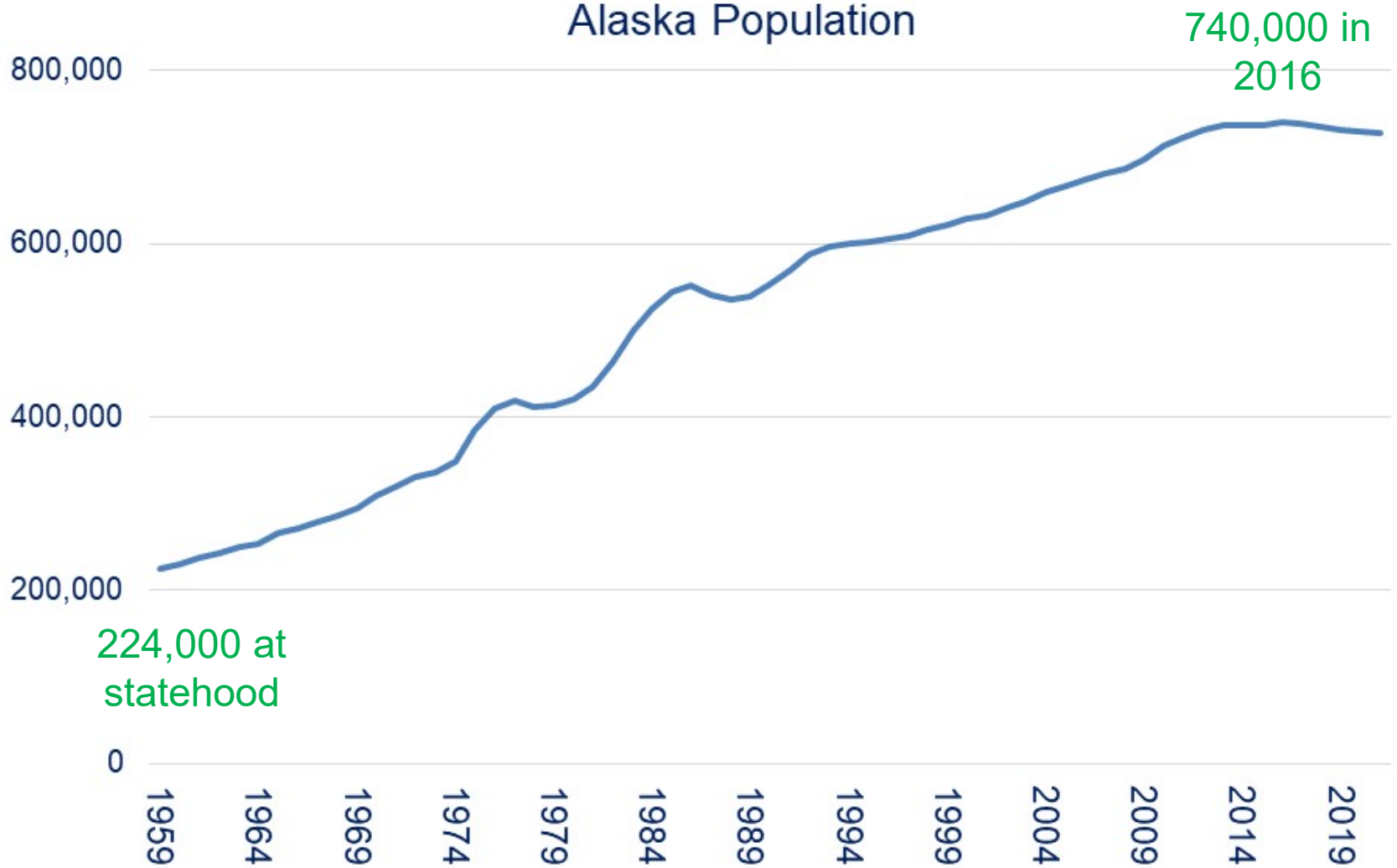
A look back:
our fiscal circumstances
and choices since
statehood

Our fiscal history is pretty darned interesting—and relevant!
But most of us don't know or think about it very much.

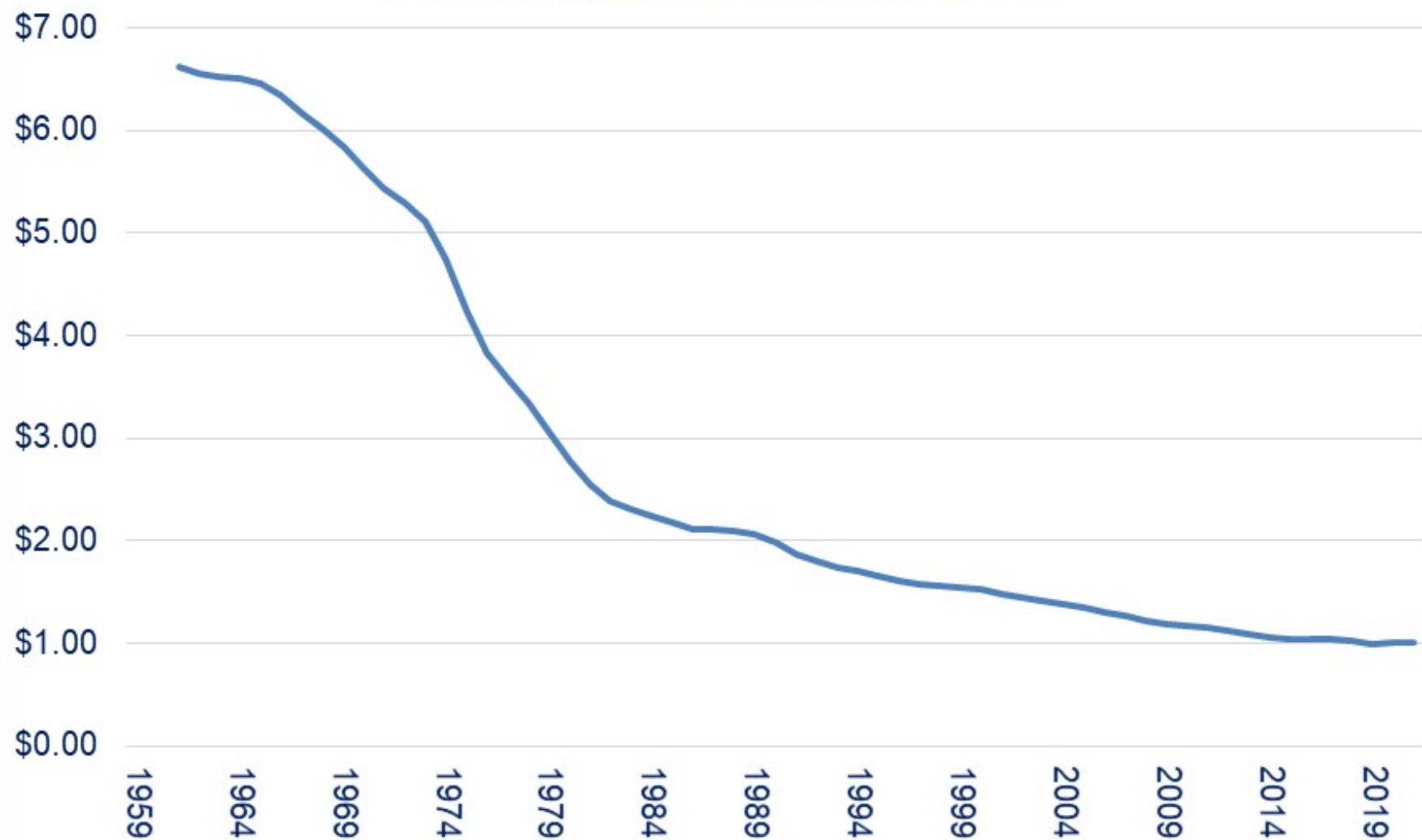
- It feels much more interesting and relevant if you've lived through it
- But most of us aren't old enough or haven't been here long enough to have experienced most of our fiscal history
 - an under-appreciated consequence of high population turnover
- The data aren't easy to find or understand

Note: Most of the revenue and spending data in the following slides are from a very useful collection of "Budget History Data" compiled by the Alaska Legislative Finance Division which is posted on the Division's website at: <https://legfin.akleg.gov/Publications/Publications.php>. A set of "Budget History Graphs" available at the same website includes a number of graphs similar to those I prepared for this presentation. Other data sources include the following: Population: Alaska Department of Labor and Workforce Development Research and Analysis Division, "Population and Components of Change, 1945 to 2020" (<https://live.laborstats.alaska.gov/pop/index.cfm>); Cost of Living: : Alaska Department of Labor and Workforce Development Research and Analysis Division, "Consumer Price Index" for Urban Alaska (<https://live.laborstats.alaska.gov/cpi/index.cfm>) (Note: I calculated a "fiscal year CPI by average the CPI for the first half of the calendar year with the CPI for the second half of the preceding calendar year); Oil production, prices and value and income tax revenues: Alaska Department of Revenue "Revenue Source Books" (<http://tax.alaska.gov/programs/sourcebook/index.aspx>), particularly Fall 2018 (for historical data for FY 1959 through FY 2018); Fall 2020 (for historical data for FY 2019 and FY2020), and Spring 2021 (for projections for FY 2021 and FY 2022); Permanent Fund data: Alaska Permanent Fund Corporation "History and Projections Reports" (<https://apfc.org/report-archive/#14-41-history-and-projections>).

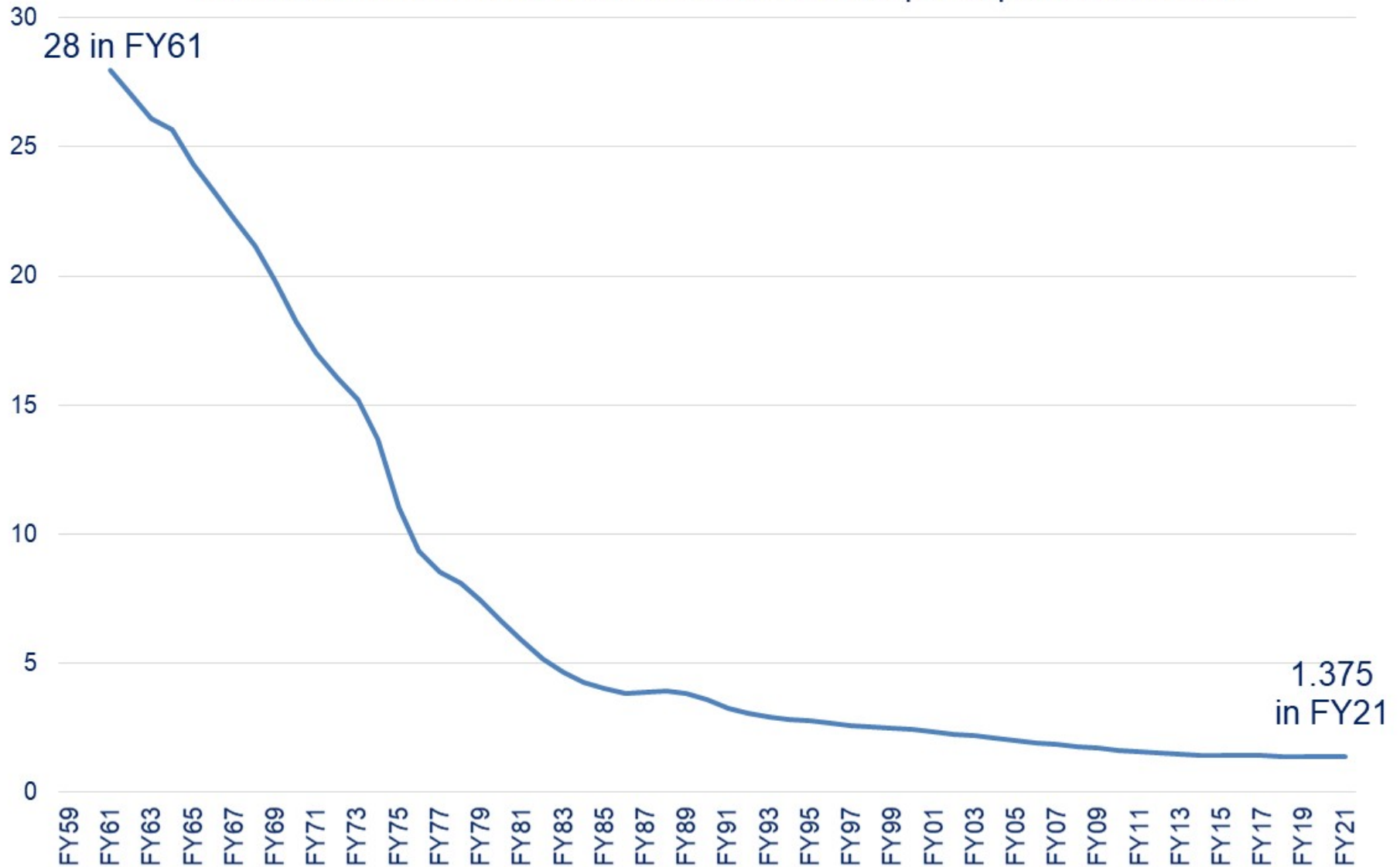
Alaska Population



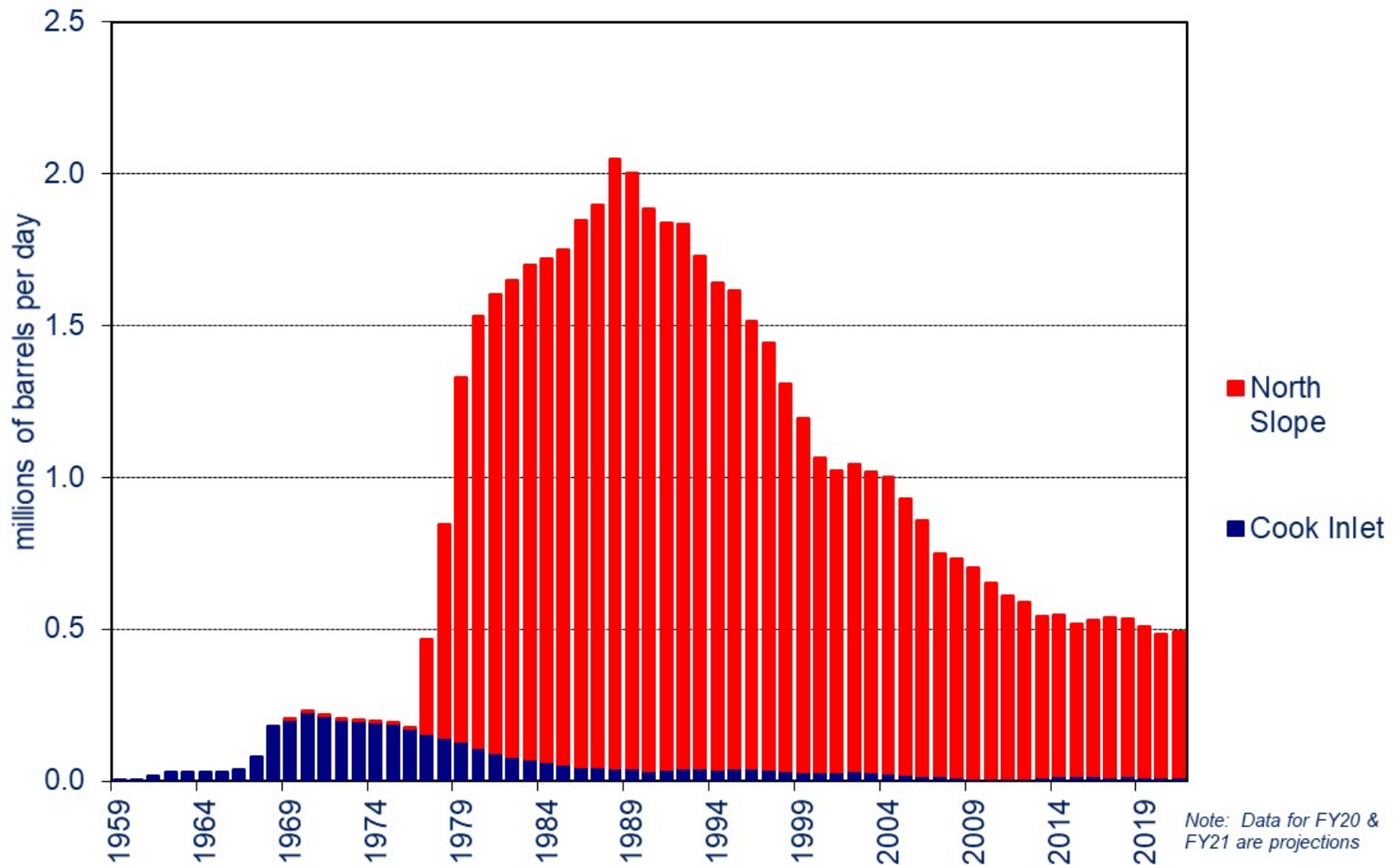
Purchasing power of \$1 in 2020 dollars



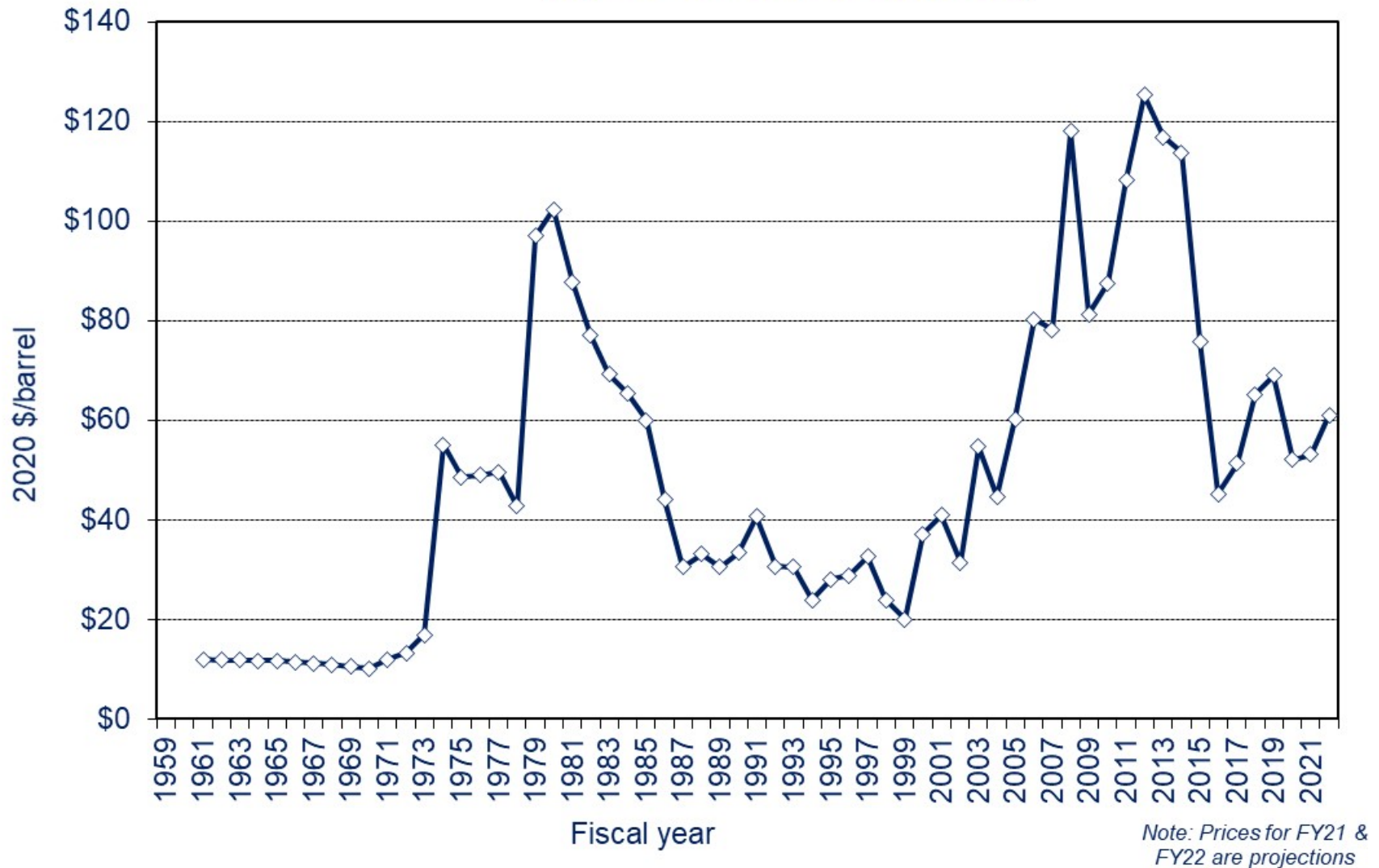
Converter from millions of current dollars to real per capita 2020 dollars



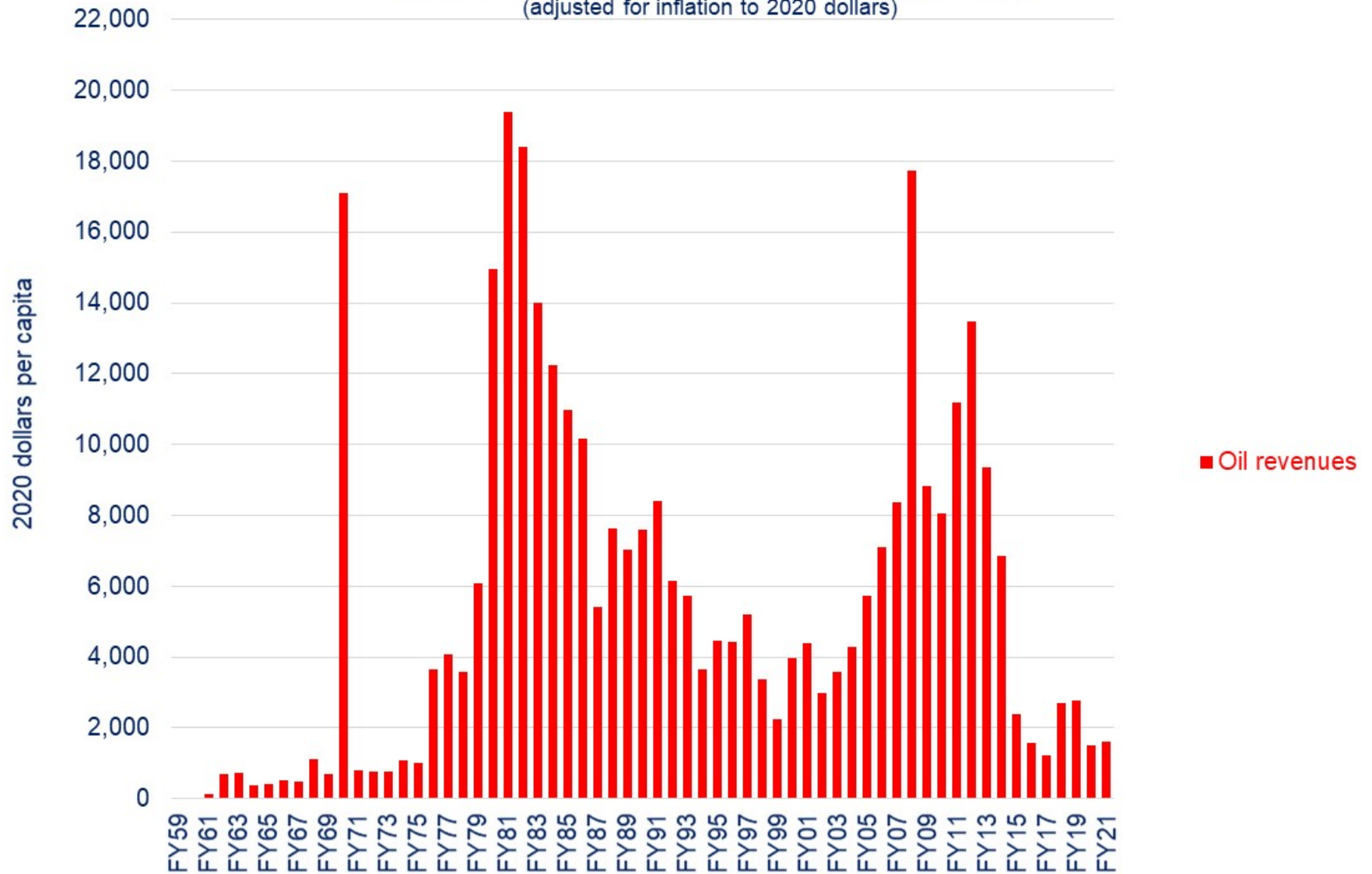
Alaska Oil Production



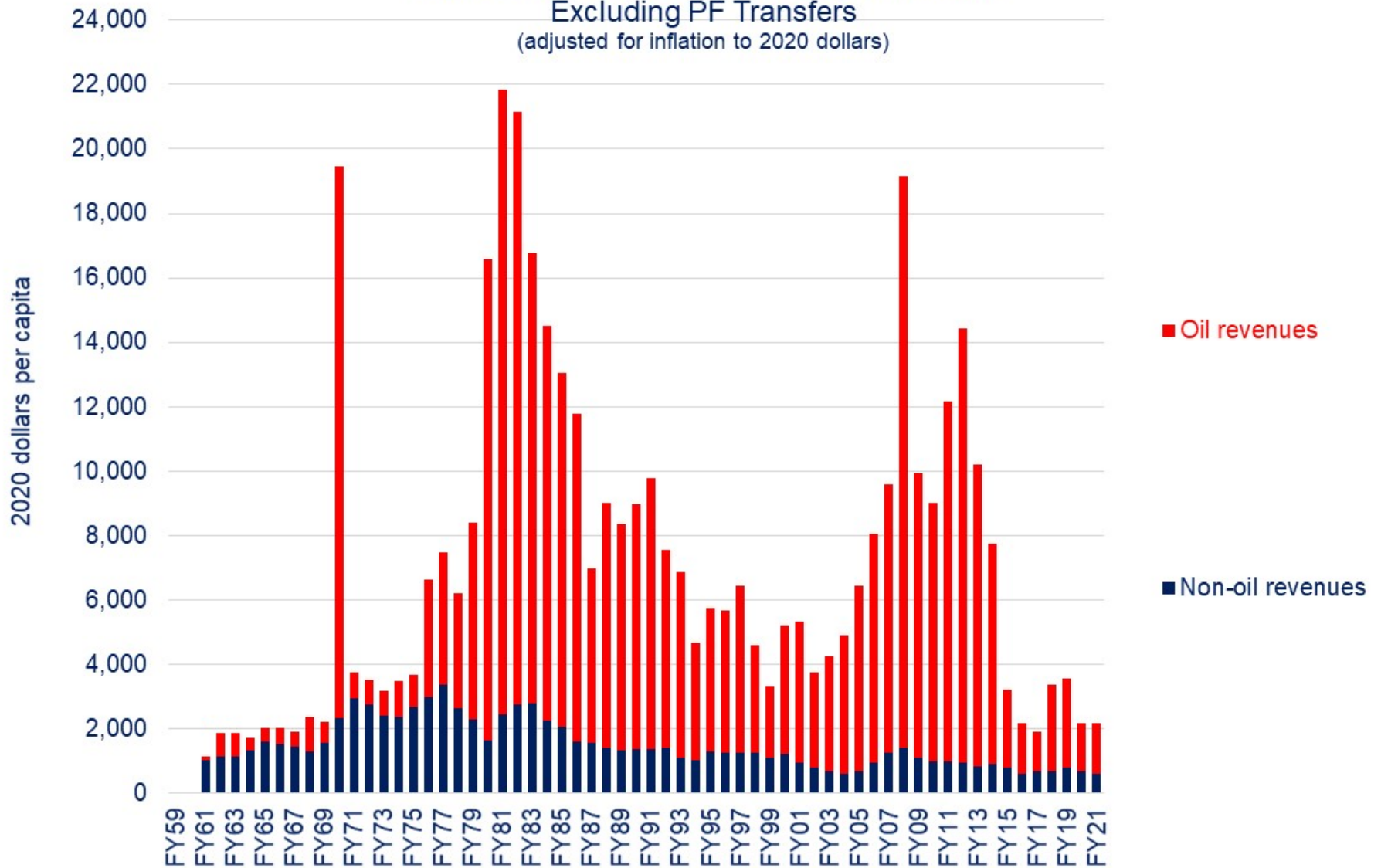
Average Annual Real Crude Oil Price (ANS West Coast) (adjusted for inflation to 2020 dollars)



Alaska General Fund Oil Revenues per Alaskan,
(adjusted for inflation to 2020 dollars)



Alaska General Fund Revenues per Alaskan, Excluding PF Transfers (adjusted for inflation to 2020 dollars)



Alaska General Fund Non-Oil Revenues per Alaskan, Excluding PF Transfers

(adjusted for inflation to 2020 dollars)

2020 dollars per capita

4,000

3,000

2,000

1,000

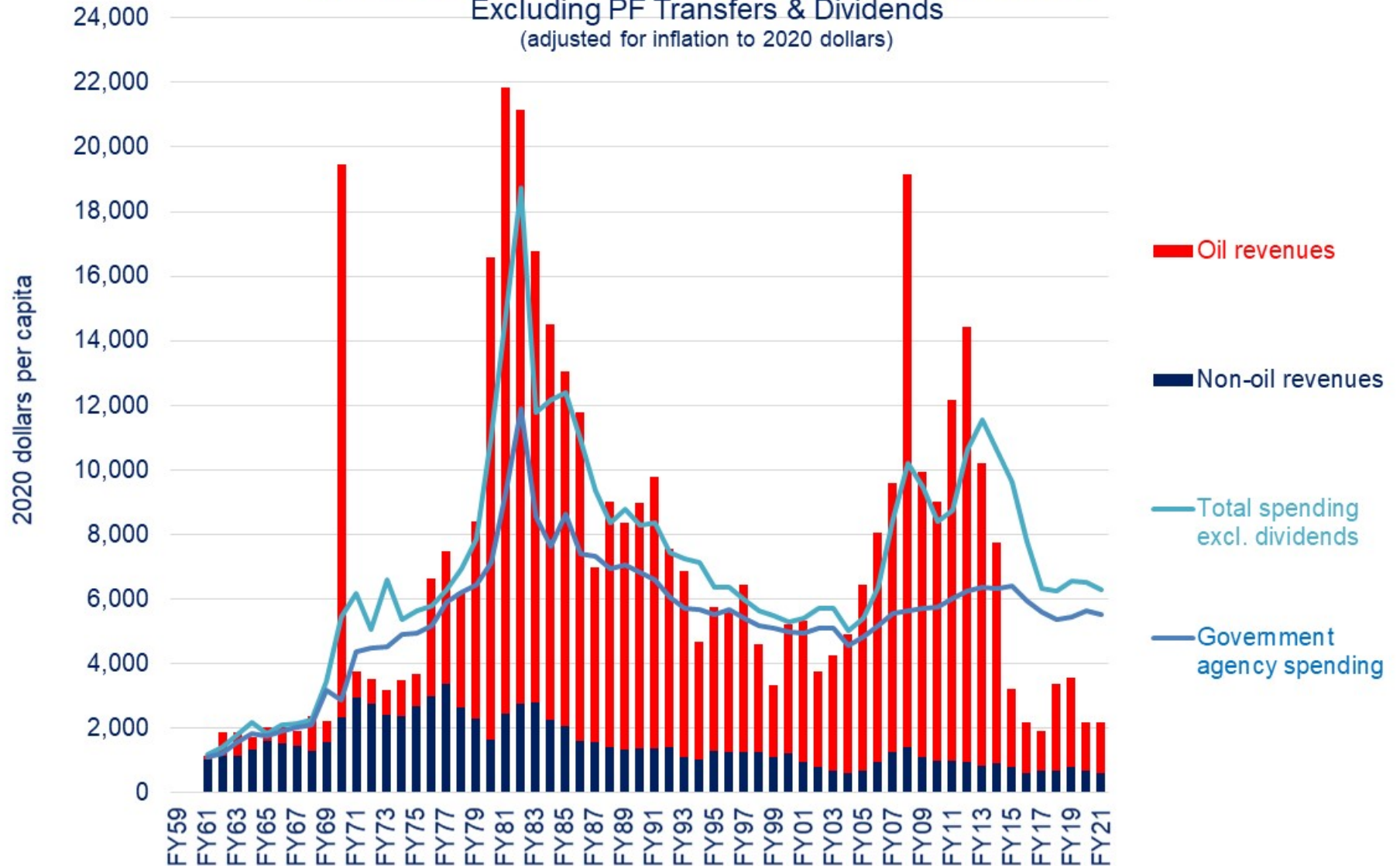
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Other

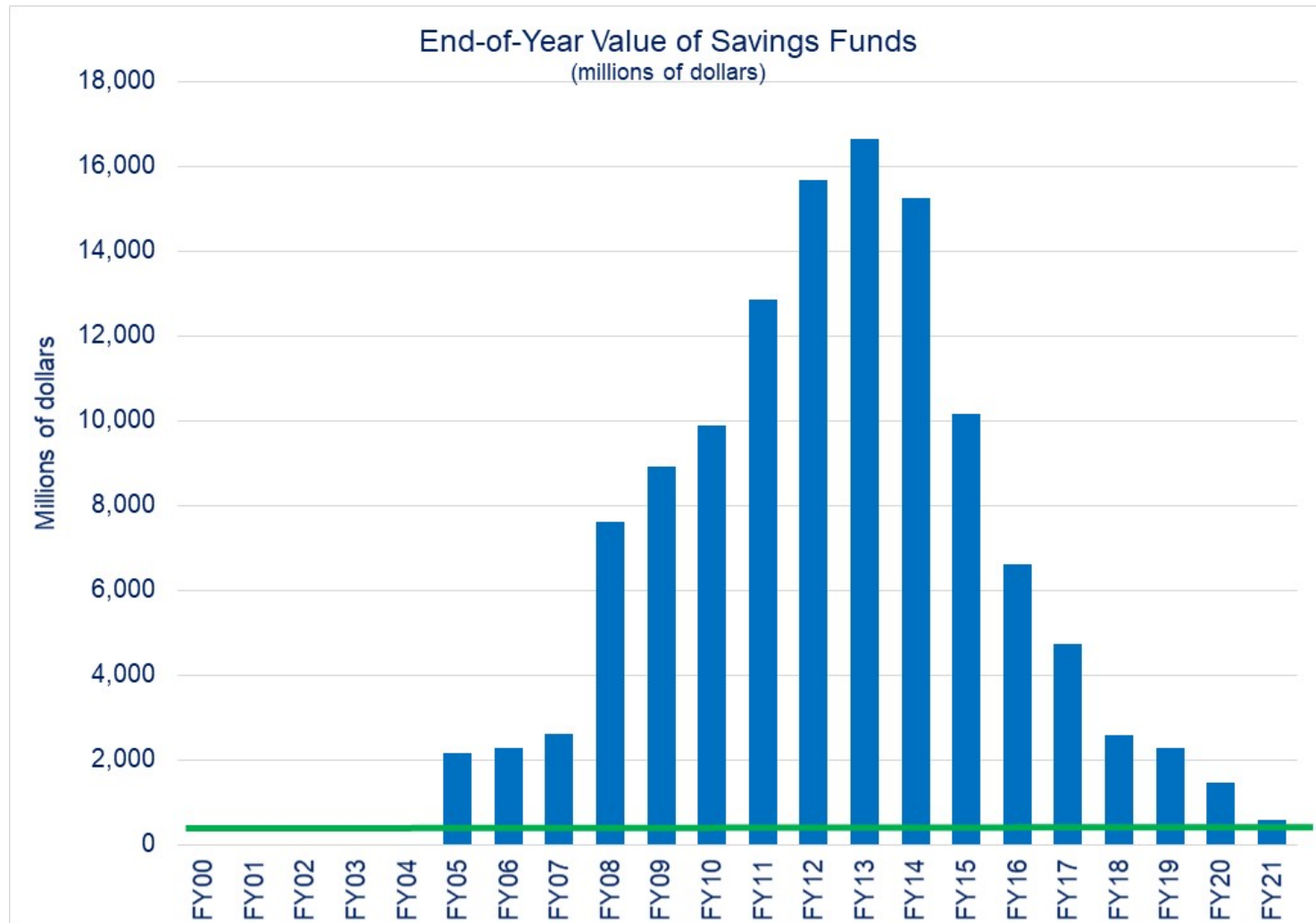
Individual
income tax

1959 1961 1963 1965 1967 1969 1971 1973 1975 1977 1979 1981 1983 1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015 2017 2019 2021

Alaska General Fund Revenues and Spending per Alaskan,
Excluding PF Transfers & Dividends
(adjusted for inflation to 2020 dollars)

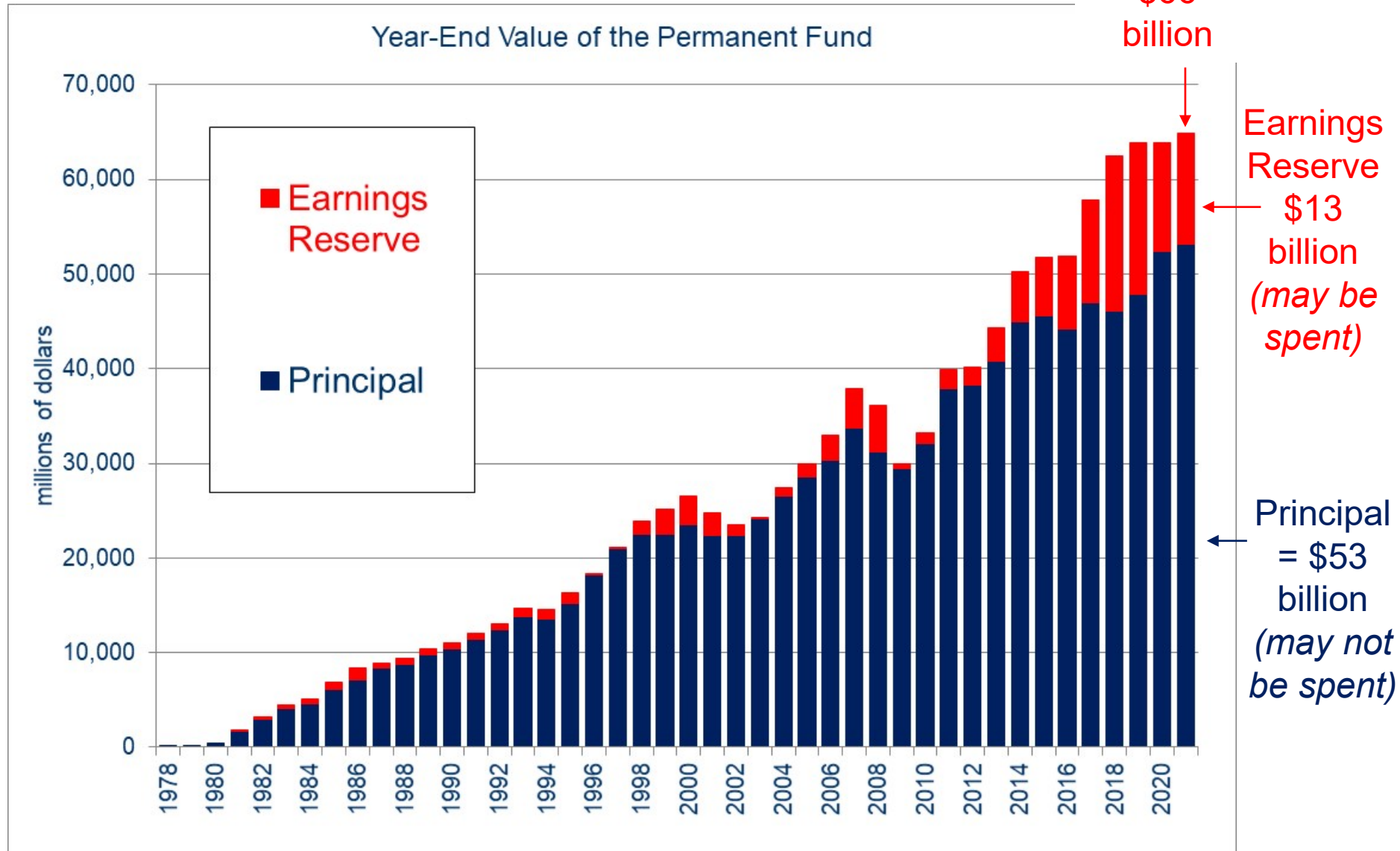


This year (FY21) we will deplete our cash savings to the level we need to maintain for cash flow purposes.



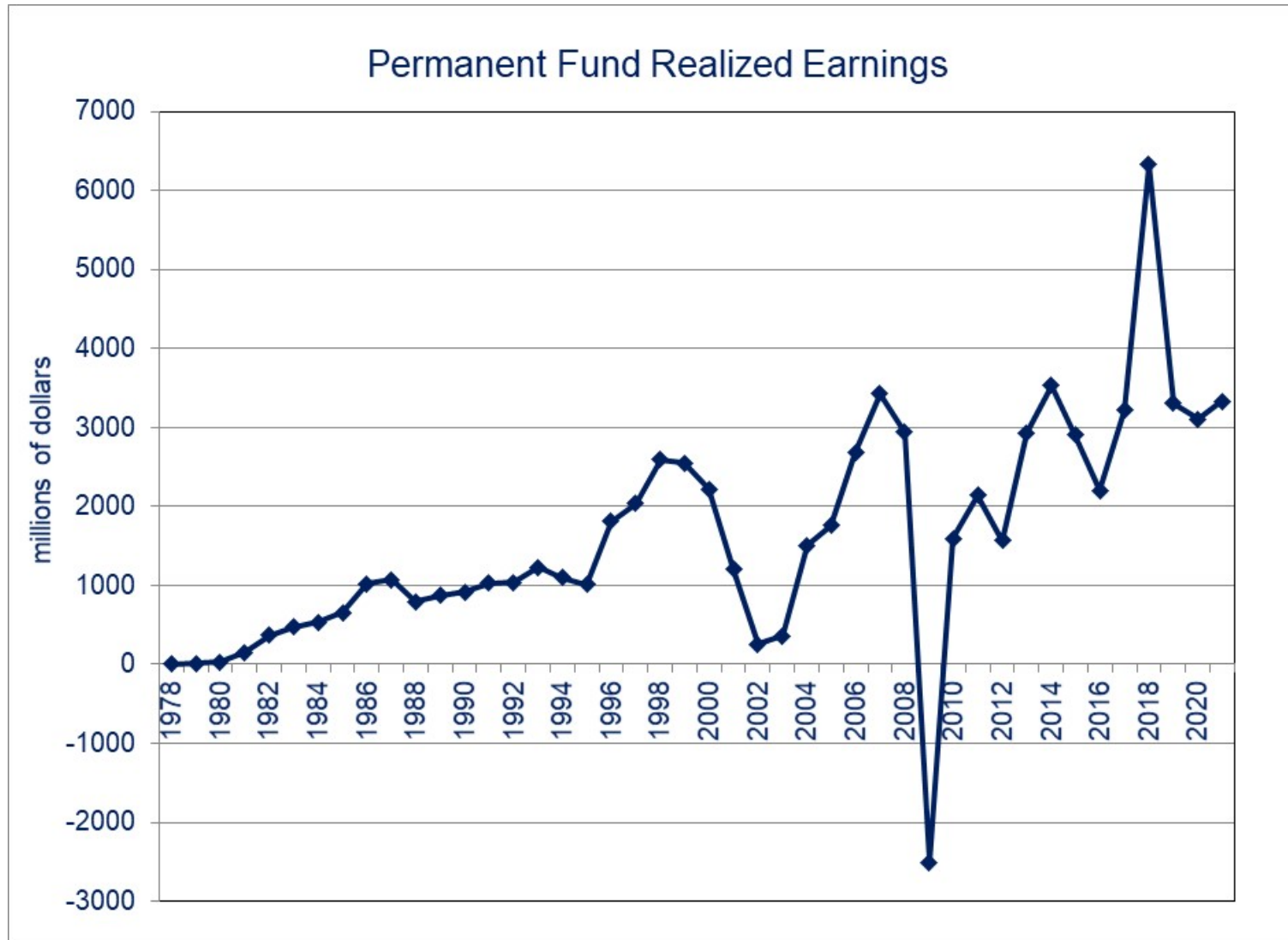
\$500 million =
balance needed
for cash flow
purposes

Permanent Fund Value



Note: FY21 year-end balance is a projection made by the Permanent Fund earlier this fiscal year.

Permanent Fund earnings have grown as the fund has grown.



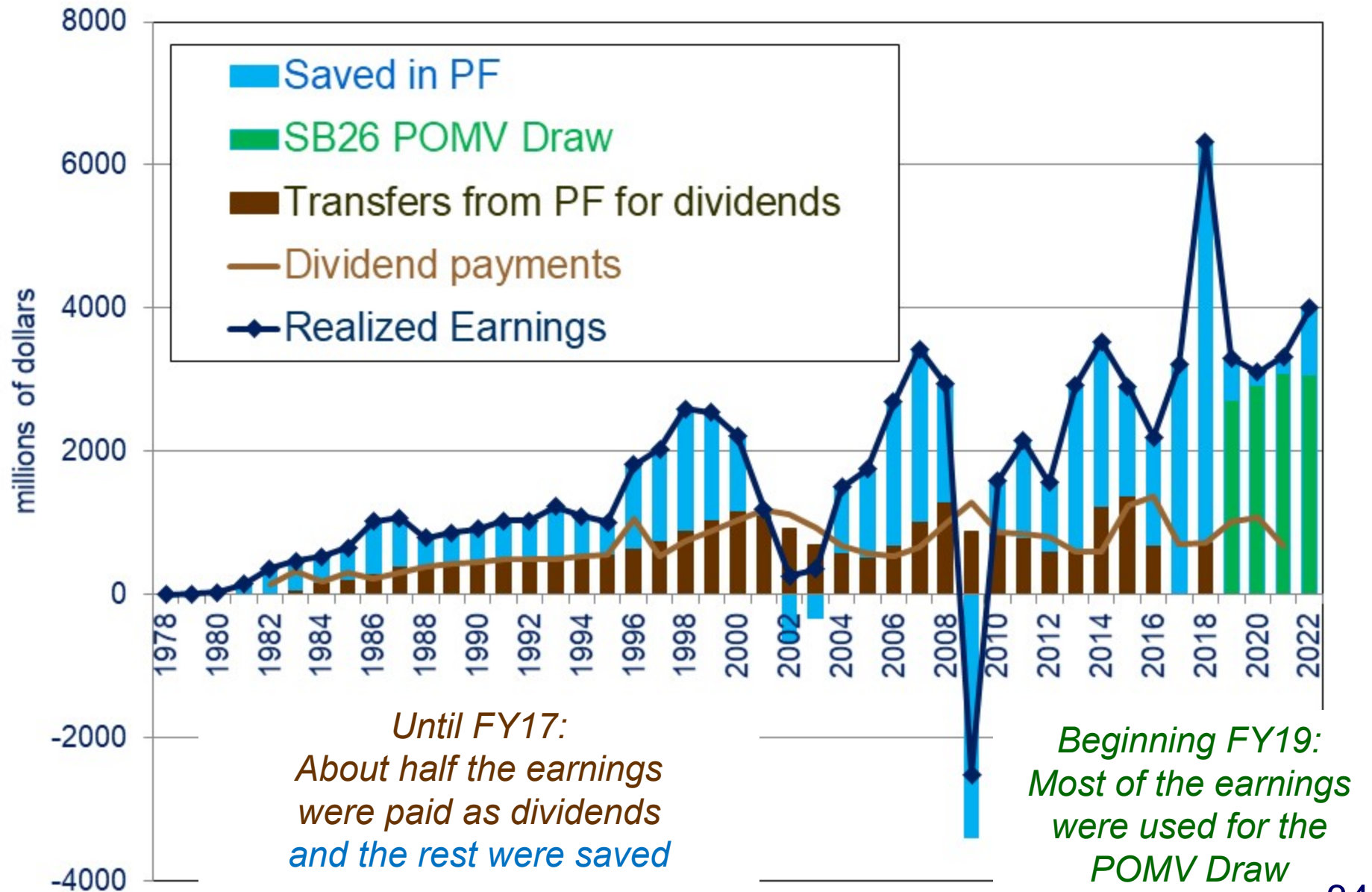
The earnings go into an “Earnings Reserve” which may be spent.³²

In 2018 the legislature passed a bill (SB26)
which significantly changed how PF earnings are used.

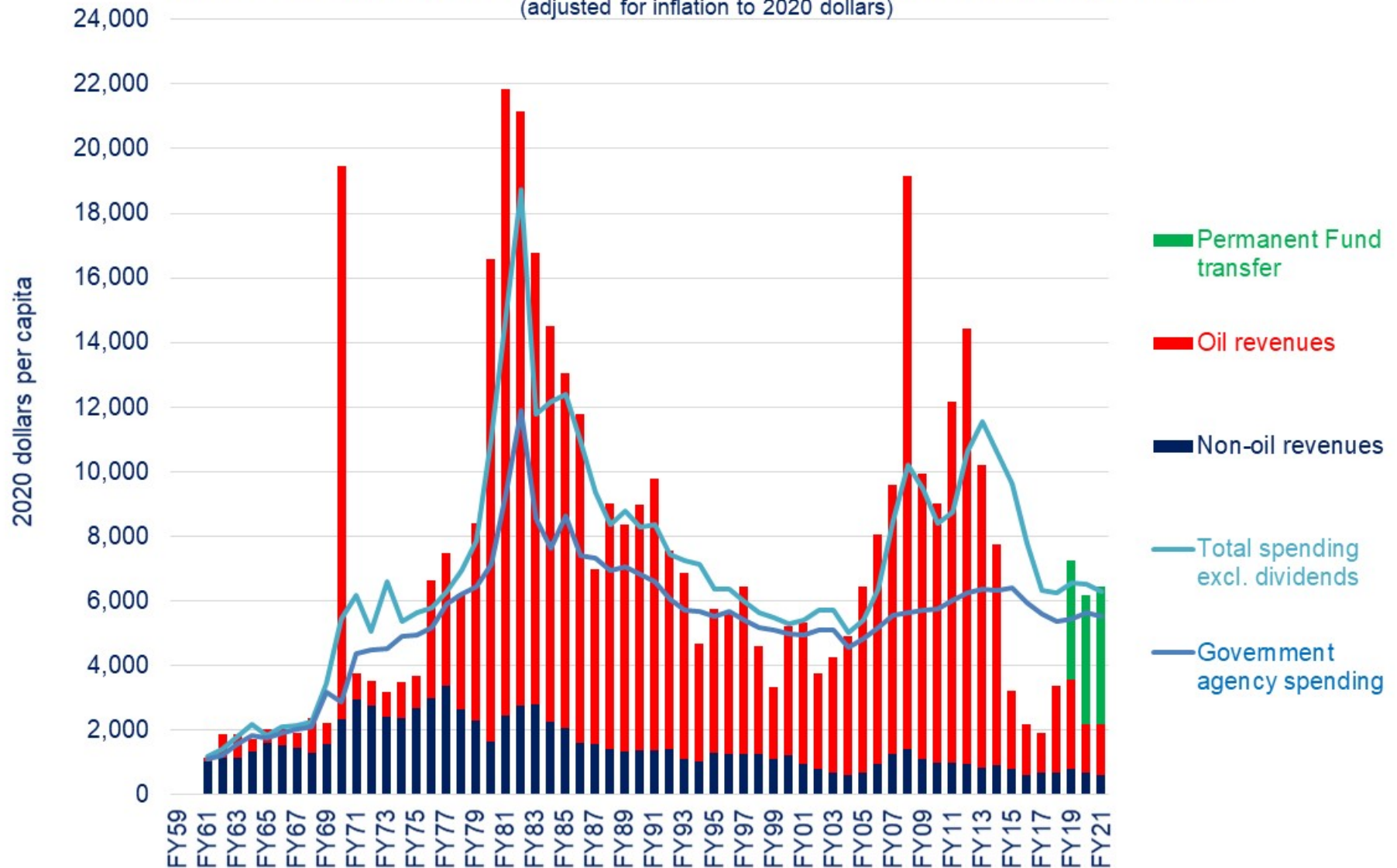
Under SB26, there is an annual
“Percent of Market Value” (POMV) distribution from PF earnings
which the legislature may spend for government or dividends.

Revenue source	Uses before FY19	Uses beginning FY19
Oil revenues	Government	Government & Dividends
Other traditional revenues		
PF earnings	Dividends	Total PF POMV draw = About 5% of average value over the past 5 years

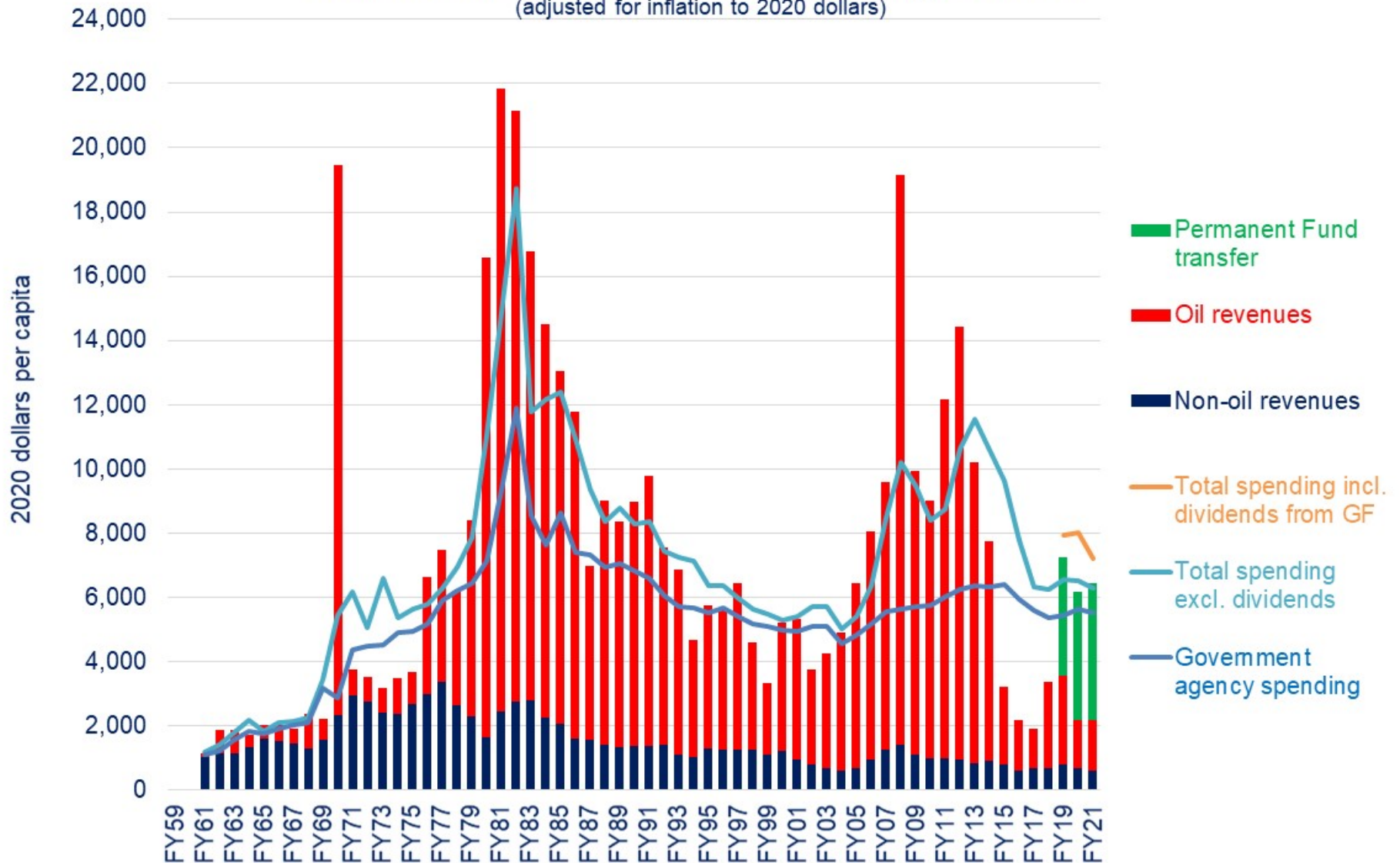
Uses of Permanent Fund Earnings



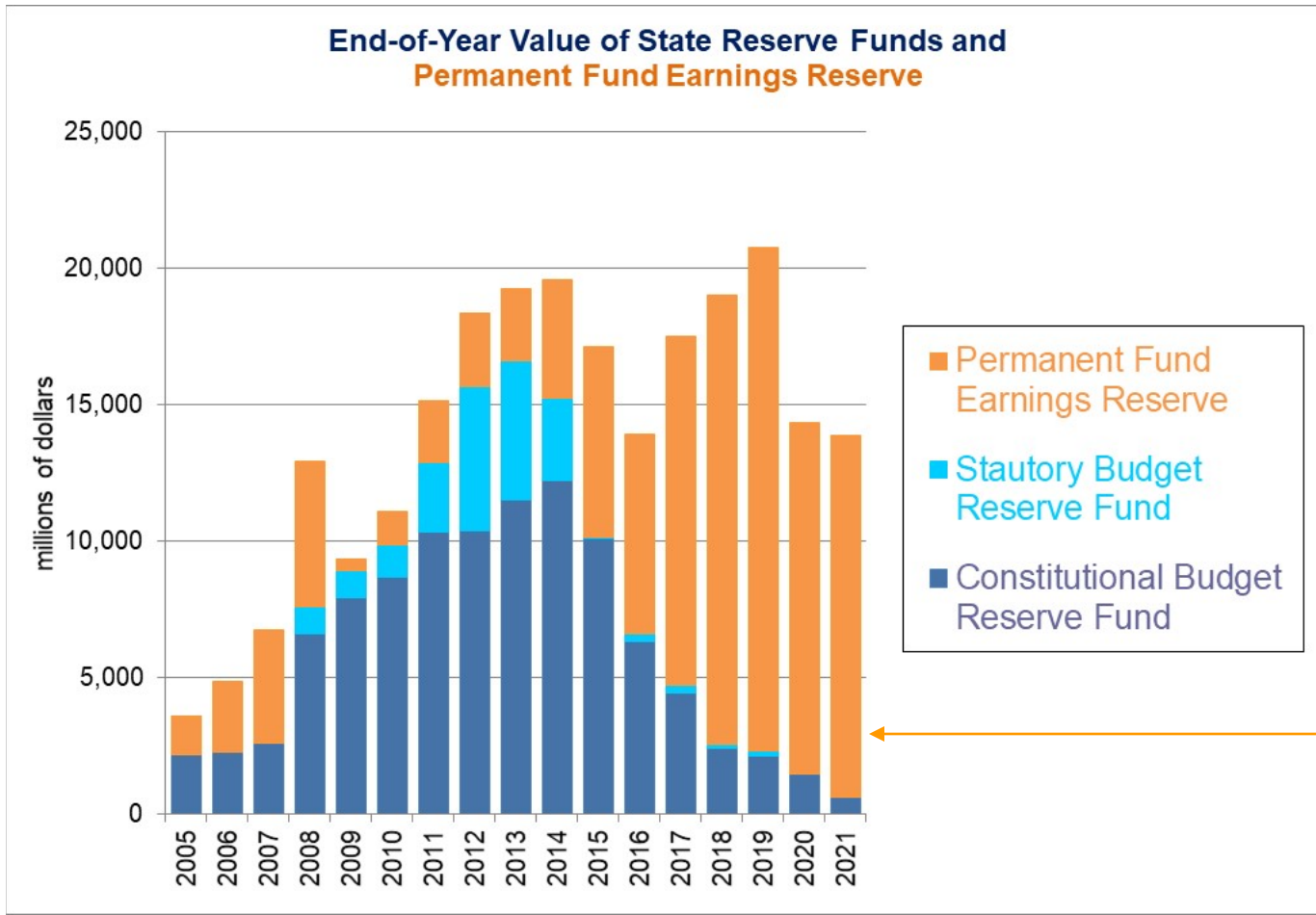
Alaska General Fund Revenues and Spending per Alaskan, Excluding Dividends (adjusted for inflation to 2020 dollars)



Alaska General Fund Revenues and Spending per Alaskan
(adjusted for inflation to 2020 dollars)



Even though we've drained our cash savings,
We haven't run out of money which the legislature *could* spend.
We could draw more than a sustainable 5% from the PF earnings reserve . . .



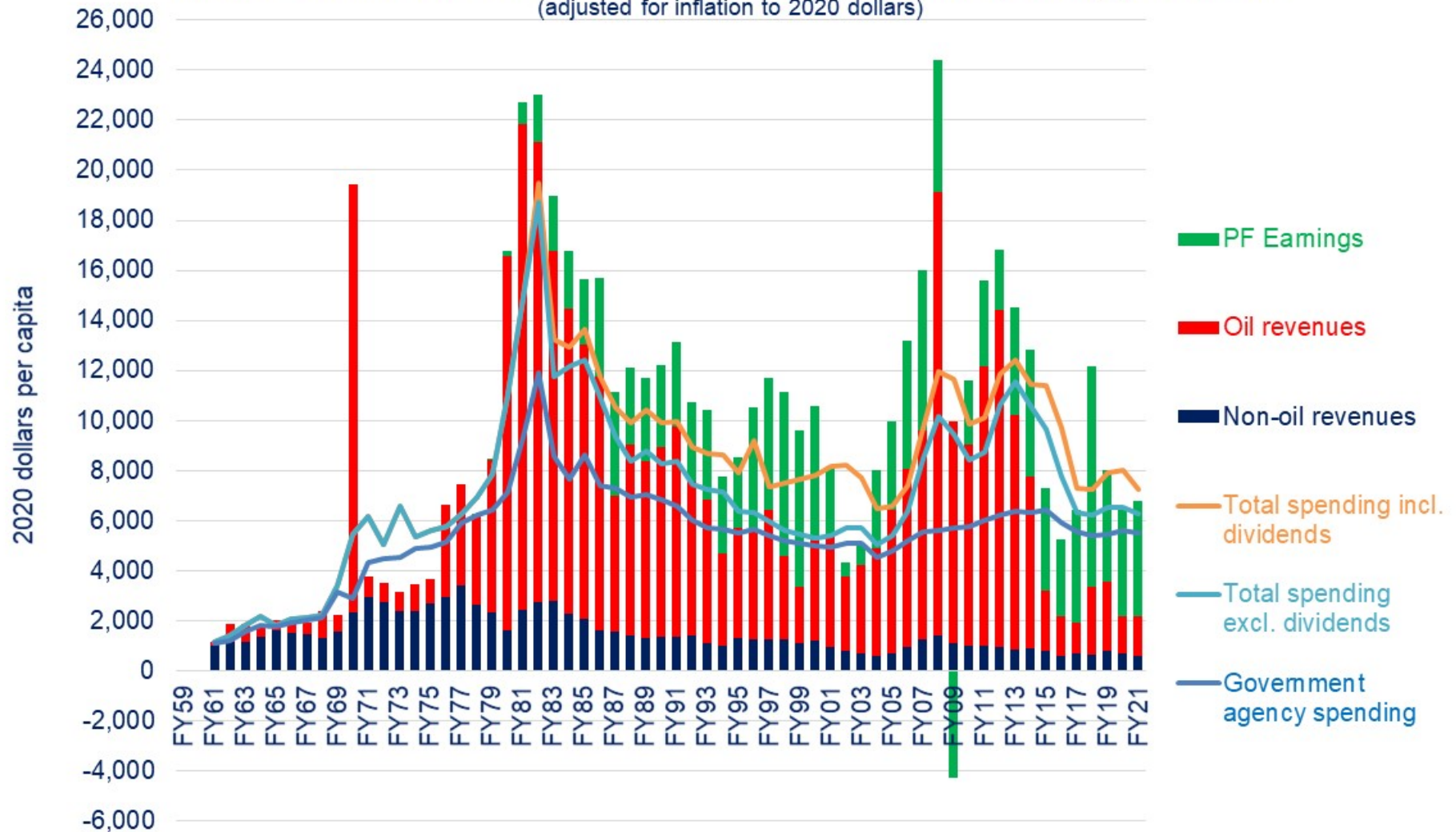
Next year's
5.5% PF draw
will be about
\$3.1 billion.

The Permanent
Fund Earnings
Reserve will
have about \$13
billion.

*Drawing an unsustainable amount from the Permanent Fund
would only put off the hard choices for a few more years.*

Alaska General Fund and Permanent Fund Revenues and Spending per Alaskan

(adjusted for inflation to 2020 dollars)



Note: The purpose of this complicated and detailed graph is to compare how total revenues from oil revenues, traditional non-oil revenues and Permanent Fund earnings with total state spending including dividends (the top orange line). Note that prior to FY 15, total revenues (including PF earnings) generally exceeded total spending (including dividends), while after FY 15 total spending generally exceeded total revenues.

A few reflections on Alaska's fiscal choices

Reflections on savings . . .

It is not obvious how much
Alaska should have saved in the past
or how much we should save for the future

Arguments for saving for the future

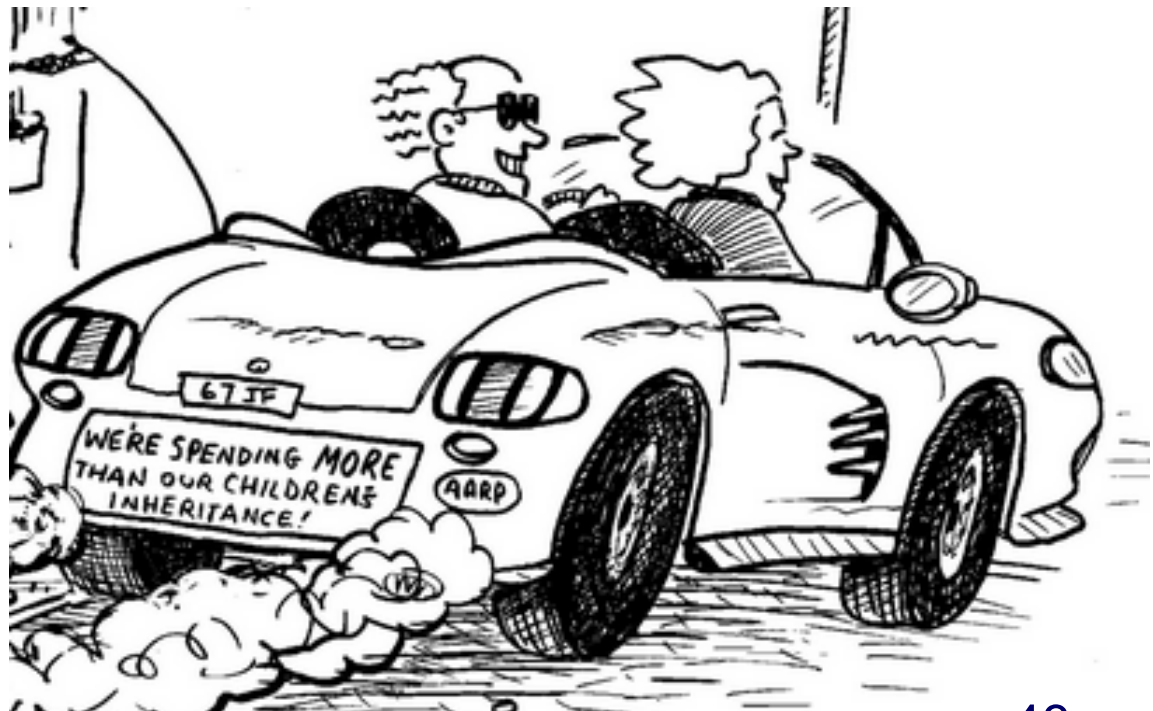
- One-time resource wealth doesn't all belong to our generation
- We'll be around for some of the future
- We should care about our children and future Alaskans

Arguments against too much saving

- Future generations benefit from current investment
 - Infrastructure
 - Education
- Future generations can take care of themselves
 - New resource wealth
 - New technologies
- Why care about the future of Alaska?
 - We could leave if things get bad
 - We're not planning to stay anyway

The arguments are similar to those about

- How fast you should spend your retirement savings
- How much inheritance you should leave for your children



How much of one-time resource wealth should be saved?

Potential “rules”

- Save all of it and only spend the earnings
- Save enough so that all generations benefit equally
 - “Goldsmith rule”
 - Depends on assumptions about future resource earnings and investment returns
- Save at least some of it permanently (Permanent Fund)
- Save at least some for short-term contingencies (CBRF)
- Save some for dedicated purposes (power cost equalization)
- **At least maintain the value of what you’ve saved in the past**

Reflections on government services . . .

Further cuts to government services will be extremely difficult.

There are no more easy cuts.

Citizens need government services.

The private sector needs government services.

But we may still need to cut further.

Government spending for quality of life is not a frill.

- Quality of life is critical to the future of Alaska's economy.
- Quality of life directly affects:
 - The kind of work force we are able to attract and what we have to pay them
 - The extent to which we can attract “footloose” industries
 - The extent to which we can attract entrepreneurs
 - Whether young people stay in Alaska
 - Whether retirees stay in Alaska

In a democracy, most people will always consider some of government spending wasteful and unnecessary.

- Almost everyone benefits from some government services
- Not everyone benefits from the same services.
- Through the legislative process, we compromise on what services are funded.

Reflections on taxes . . .

Yes, taxes can be a burden on the citizens
and businesses which pay them.

Yes, taxes can be a disincentive to economic activity.

But this does not mean that no taxes are ever justified.

Taxes are a necessary evil.

We tax ourselves to fund services we need.

In most states, which do not have high resource and investment revenues like Alaska, citizens and businesses accept that taxes are necessary to pay for at least some essential government services—although of course they argue fiercely about how high taxes should be and what services should be funded.

What happens when citizens don't pay taxes (the “Alaska disconnect”)

- They pay less attention to spending
- They lose a sense of responsibility for paying for services they receive
- New development doesn't pay for itself

Reflections on dividends . . .

The historic dividend formula as well as proposed potential constitutional provisions for future dividends reflect both what's good and bad about dedicated funds

- Then ensure a particular need is met
- They preclude other uses even if our needs change

These formulas guarantee that dividends will be paid—
which is good if you support dividends.

But they also make it difficult to change how much we pay for dividends if our other spending needs change or if our revenues change.

Proposals to pay significant dividends while also imposing significant broad-based taxes pose difficult questions relating to equity and fairness.

- Dividends make Alaska income distribution more fair and equitable.
- Cutting dividends takes the same amount of money from a poor child as from a wealthy millionaire.

BUT

- If we expect the rich to pay more in taxes than the poor, then imposing taxes while keeping dividends will in effect be redistribution of income from the rich to the poor.
- This may be fine if you believe this kind of redistribution of income is appropriate.
- But it is a different matter to ask citizens to pay taxes to support services which they also to consume than to ask them to pay taxes to give money to other citizens.

Other reflections . . .

If resource income declines,
you can't necessarily play the movie backwards

- Fiscal preferences are affected by past choices
 - We get used to choices we have made
 - We attract and retain people who like choices we have made
- Past fiscal choices create future fiscal obligations
 - Operation and maintenance for past capital expenditures
 - Expectations of government services on which people depend
 - Expectations about future tax obligations and government payments

Uncertainty makes difficult fiscal choices harder

- We face huge uncertainty about our future revenues
 - Oil revenues
 - Investment revenues
- It is always possible that revenues will be higher than expected
- It is harder to make difficult choices if they might not be necessary
- Optimism tends to trump prudence.

Our fiscal choices should not be based on
their short-term economic impacts
but rather on the appropriate level of government services
and how best to fund them..

The primary consideration in funding government services should be
the importance of those services to society
—not how many government jobs they create.

The primary consideration in paying dividends should be the
importance of dividend income to Alaskans
—not how many jobs the spending of dividends might create.

The primary consideration in imposing taxes should be the need for
revenue to support government services in comparison with the
burden of taxes on taxpayers
—not the potential effect that taxes might have on spending and jobs.

Institutions matter

We tend to focus our attention on
What choices should we make?

An even more important question may be:
Can our institutions bring about good choices?

We should be thinking about how well these institutions are working and whether there are ways to change them that would result in better choices:

- How we conduct elections
- How the legislature operates
- How we educate Alaskans about fiscal issues
- How we manage the Permanent Fund
- The Alaska constitution

Leadership matters

- To make good choices about the difficult fiscal choices we face we will need good and effective leaders who can:
 - Understand the issues we face
 - Propose good choices
 - Advocate effectively for them to the public
 - Succeed politically in getting them adopted
- We should think about:
 - Where do leaders come from?
 - Do they emerge in response to challenges such as those we are facing?
 - What can we do to develop new leaders and help them succeed?

Social cohesion and citizenship matter

- To address difficult challenges and make difficult choices, we need:
 - A shared sense of society and purpose
 - A willingness to contribute for the common good
- High rates of migration make social cohesion and citizenship harder for Alaska to achieve
- I worry if we have that kind of social cohesion—and whether it may be eroding
- We should think urgently about how we can rebuild and strengthen social cohesion among Alaskans.

Wealth makes it difficult to make sustainable fiscal choices

- Hard fiscal choices are more difficult when we can draw from savings
- We don't have a good record

The Permanent Fund is not necessarily permanent —not even the principal

- There are lots of ways deplete the principal
 - Inflation
 - “Investing” the principal in “needs”
 - Borrowing backed by the Permanent Fund
 - Court-mandated spending to meet constitutional obligations
 - Our children’s education
 - My retirement
 - Amending the constitution

Unsustainable spending from the Permanent Fund
could keep the party going for a long time.
It will be tempting.

Resource wealth is a mixed blessing

- Resource wealth made us much better off in many ways
- But resource wealth creates dependence:
 - Attracts a larger population and economy than we can sustain without resource wealth
 - Facilitates unsustainable choices in where and how we live
 - Encourages capital spending which increases future costs for operations and maintenance
 - Enables and encourages citizens to live here and businesses to locate here without paying for the costs they impose.
- We have not escaped the “resource curse.”