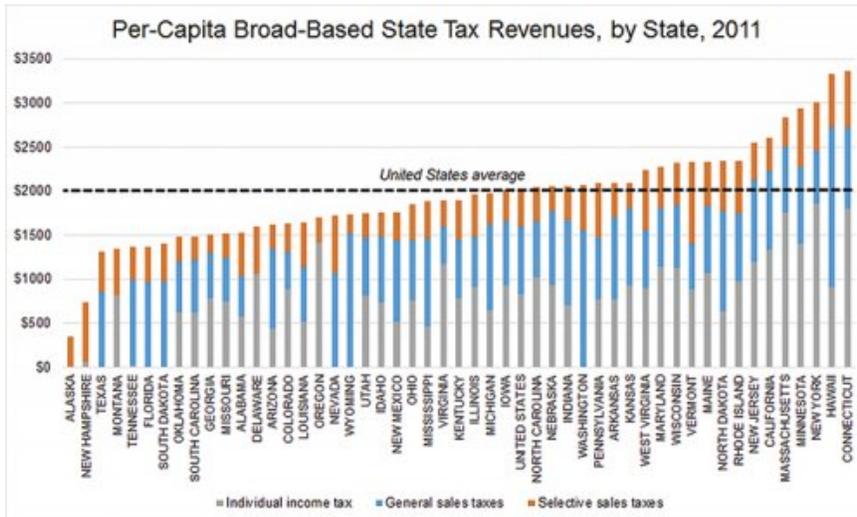


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# Alaska's Budget Crisis: Myth or Reality?

## Alaska's emerging fiscal and economic opportunities

BY NATASHA VON IMHOF



CHARTS COURTESY GUNNAR KNAPP, ISER, UNLESS OTHERWISE NOTED

There are many people who are well aware of the magnitude of our fiscal crisis and are trying to engage the public to help develop a path through this financial quagmire. However, I fear these leaders may be afflicted with what my grandfather used to call "Cassandraism." This is to describe the fate of Cassandra, daughter of the king of Troy. She was granted the spirit of prophecy but got crosswise with the Greek god Apollo. The latter could not take away her gift, but ordained that her prophecies would never be believed.

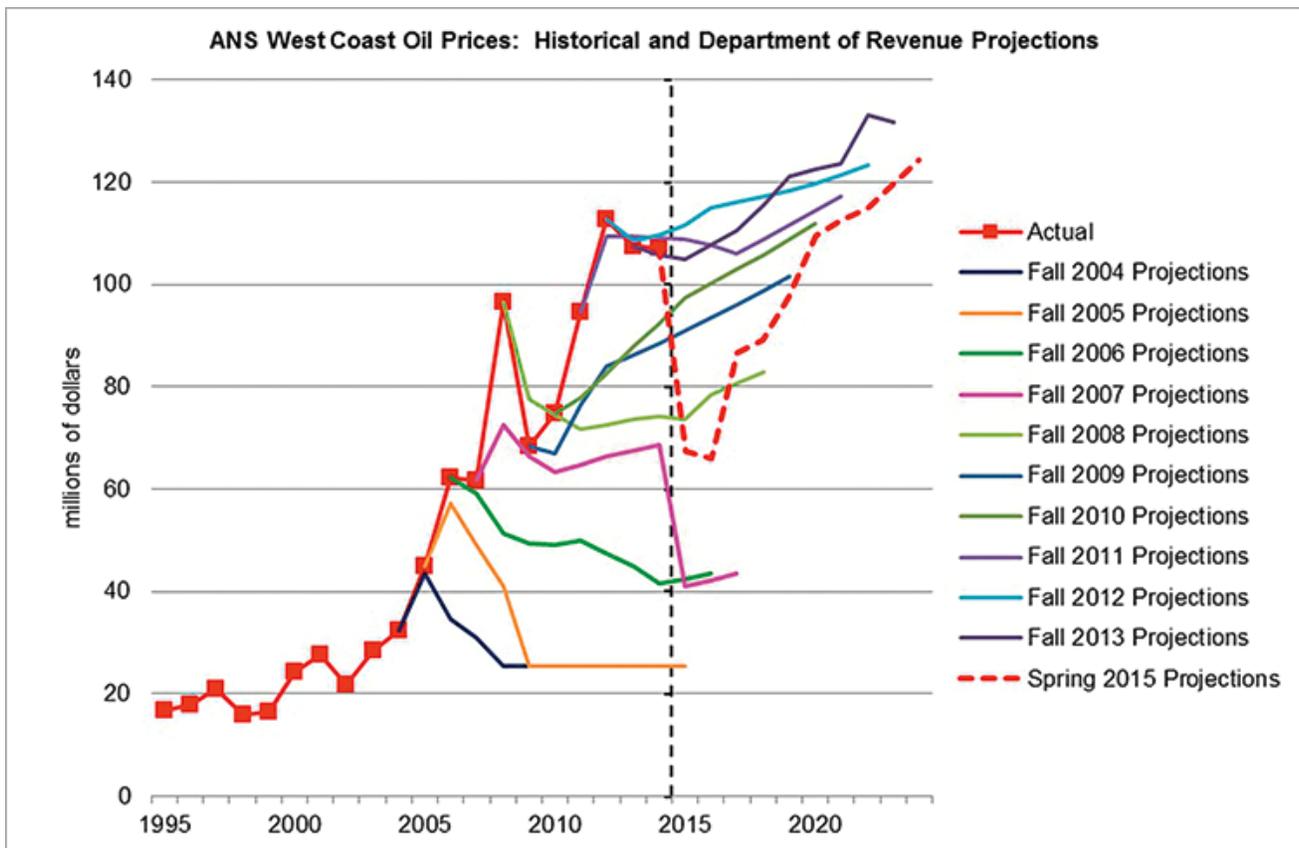
For many, it's difficult to accept that hard times are ahead when the past was so rosy. In the last decade, Alaska State general fund spending grew from \$2.1 billion in FY2004 to \$4.4 billion in FY2014, a 109 percent increase. To put it in perspective, inflation increased only 30 percent during that same time, and population increased just 11 percent. (Revenue Sources Book. Fall 2014. <http://dor.alaska.gov/Portals/5/Docs/PressReleases/RSB%20Fall%202014%20highres%20page.pdf>)

Alaska has been very fortunate to hold vast reserves of oil, which has contributed to unprecedented levels of revenue and spending on a plethora of public service programs and capital investments. Oil revenues started pouring into Alaska's coffers in the mid- late 1970s after the Trans Alaska Pipeline System was completed May, 1977. In a few short years, the state treasury was facing a \$1 billion budget surplus, which spurred two events. First, Alaska voters approved a constitutional amendment establishing the Permanent Fund. Second, Governor Jay Hammond eliminated the state income tax in September 1980.

Since then, Alaska is the only state in the union that does not collect either a state sales tax or levies an individual income tax. Instead, every Alaskan receives a payment each year from the \$54 billion Alaska Permanent Fund. On top of that, the per capita spending is higher than any other state in the union; the state of Alaska spends about \$16,000 per resident. The average for the United States is about \$5,300 per resident. (Per capital Spending in Alaska. <http://kff.org/other/state-indicator/per-capita-state-spending/>)

In a nut shell, oil revenue has allowed Alaskans to grow accustomed to a certain level of amenities, conveniences, and infrastructure, without paying as much personally as typically seen in other states. For Alaska communities that don't pay local property taxes or municipal sales taxes, this is particularly evident.

Plutus, the God of Wealth in ancient Greek religion, can be identified as the one bearing the cornucopia—horn of plenty. Thanks to oil revenue, Alaskans have been able to enjoy our own "horn of plenty" since the pipeline days.



#### Many Prophesize Future Oil Prices

There has been much speculation that the price of oil will rebound sooner rather than later. Some say if we just hang on until then, we will be okay. Unfortunately, it is extremely difficult to project future oil prices, as we can see in the slide below. For the last decade, the future price estimates are just that, estimates. We can't assume that the 2015-plus price projections are right either. Future prices could be lower.

But that doesn't stop people from trying to emulate Cassandra and predict the future. The Wall Street Journal published an article in May 2015 that states the Organization of the Petroleum Exporting Countries (OPEC) doesn't see oil prices consistently trading at \$100 per barrel again in the next decade. In fact, OPEC's most optimistic scenario pegs oil at \$76 a barrel in 2025. (OPEC Article in Wall Street Journal <http://www.oilandgas360.com/opec-sees-oil-price-below-100-a-barrel-in-the-next-decade/>)

Rex Tillerson, the Chairman and CEO of Exxon Mobil, recently spoke at the 2015 IHS CERAWEEK (IHS Cambridge Energy Research Associates) this past April. Tillerson muses that the 2015 price decline is due to several factors coming together. First, demand is weakening in Europe; second, China's demand was overestimated; and lastly, there has been a significant influx in supply from North America shale oil. "The freight train of North American shale tight oil just kept on delivering." (CERA Week. Rex Tillerson Interview. <http://ceraweek.com/2015/>) He went on to add, "This is going to be with us for a while. People need to settle in for a different price environment for the next couple of years."

#### Both a Fiscal Problem and a Political Problem

No state government likes to downsize. On a good day it's difficult. On a bad day, it's devastating. But considering our current fiscal predicament, trying to maintain the same level of spending as previous years without making any material changes in behavior will drain Alaska's reserves much faster than necessary and cause for much greater heartache down the road.

Spending too much now limits options and flexibility later on. What if as a state, we eventually decide to invest in an All Alaska gas-line? We might not have the money to do so if we continue to allocate our savings towards operations. Targeted investments can sometimes provide the economic stimulus to jumpstart the economy.

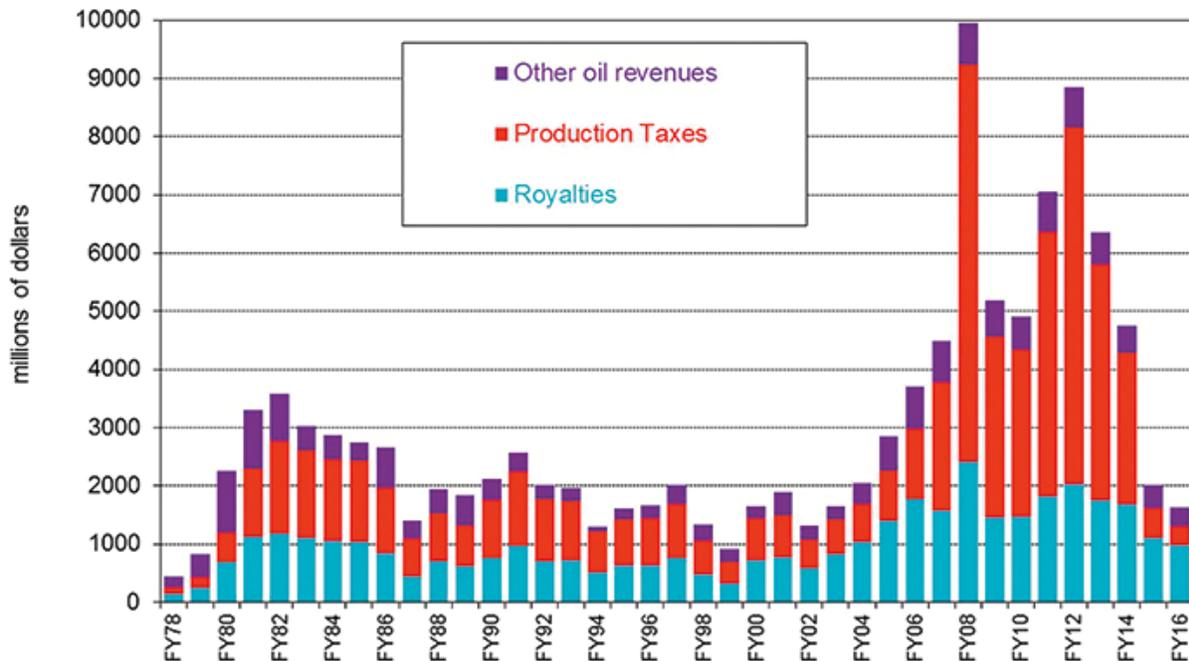
But, buyer beware, it all depends on the type of investment. A good investment has upfront costs, but ultimately should provide superior benefits such as improved efficiency and increased productivity, which could translate to cost savings or increased revenue opportunities. For example, the Alaska Industrial Development and Export Authority is investing \$54 million in Pentex Alaska Natural Gas Company LLC to facilitate the transition to natural gas in and around Fairbanks. This can help lower energy costs considerably for interior residents, improve air quality, and potentially save the Fairbanks Northstar Borough \$1.8 million a year in operating costs. (Fairbanks Northstar Journal. <http://www.adn.com/article/20150518/fairbanks-energy-plan-hits-milestone-state-ponders-54-million-investment>)

Medicaid expansion is an investment as well. Yes, expanding Medicaid can help the state's economy by pumping millions of federal money into Alaska, similar to road projects. But many investments have hidden costs that sometimes offset and negate the benefits. Right now Alaska pays more for healthcare than any other state in the union. Why? It's due to low population, high transportation costs, geographic isolation, and extraordinary high cost differentials for specialized medical procedures. The convergence of all these factors is unique to Alaska and therefore makes state to state comparison difficult when trying to evaluate the costs and benefits of a Medicaid expansion here in the 49th state.

Federal money also only covers the service rendered. There are other supporting costs that are not covered such as claims processing. The Independent Audit Report dated December 2014 given to the Alaska State Legislative Budget and Audit Committee gave a qualified opinion on Governmental Activities pertaining to the Medicaid claims processing information system. The report states, "The new Medicaid system contained pervasive, significant defects." (Legislative Audit on Medicaid costs. <http://doa.alaska.gov/dof/reports/resource/fy14/Opinion.pdf>) Expansion can add millions of dollars of costs to an already strained and ineffective system.

The Health and Social Services Department is the highest cost driver in our state with a \$2.5 billion annual budget. Of that, Medicaid spending is \$1.3 billion for FY2013. Any increases in this department will take money from other valuable areas such as education and public safety. That is why in this environment with falling revenues, Medicaid expansion should be examined for its fiscal impact and opportunity cost, rather than being used as a political and emotional hot button.

### Unrestricted General Fund Oil Revenues



### Shoulda, Woulda, Coulda

There has been much written recently comparing Senate Bill 21 (SB21), or the More Alaska Production Act, passed in 2013 with the tax structure it replaced, ACES (Alaska's Clear and Equitable Share, 2007-2013)

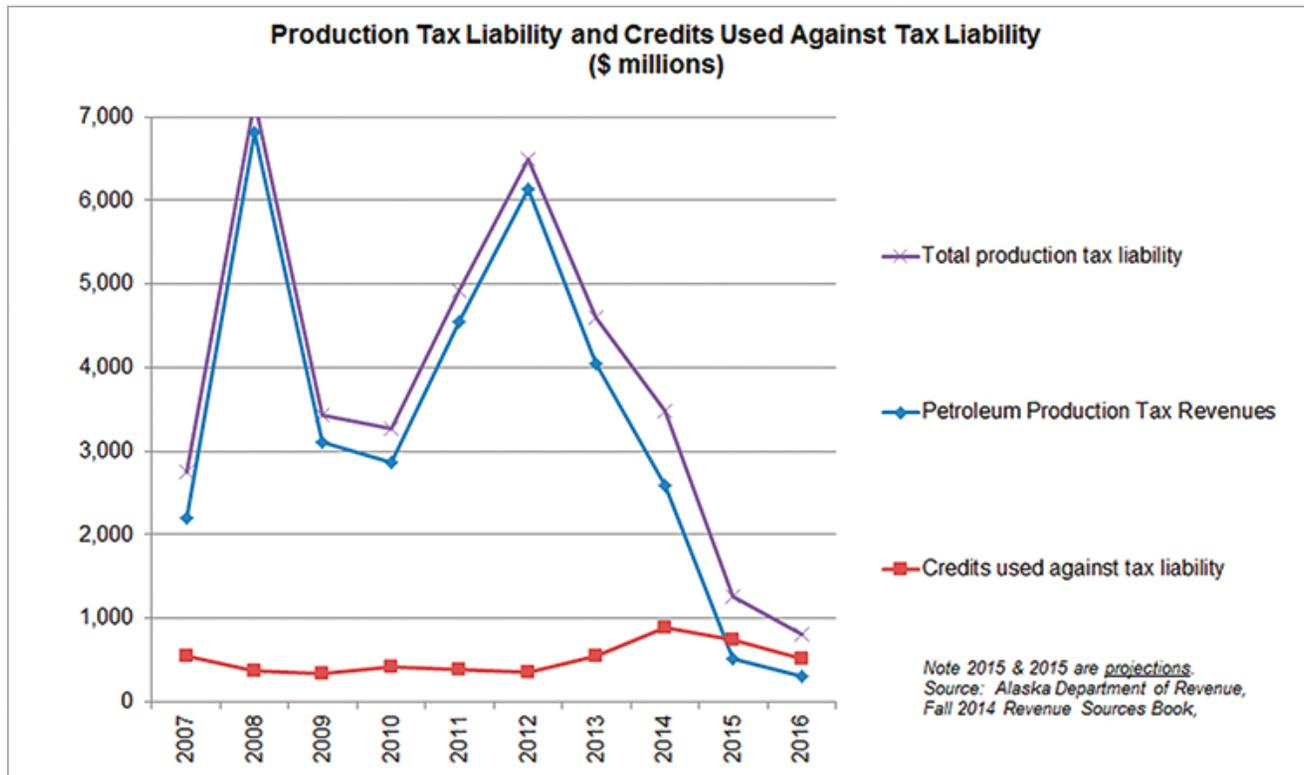
I spoke with Gunnar Knapp, President of University of Alaska Institute of Social and Economic Research. He reminded me, "There are four ways the state receives taxes from oil companies: production tax, royalty income, petroleum income tax, and petroleum property tax. Both ACES and SB21 dealt with production taxes only." Knapp went on to explain that all oil tax revenue has fallen for FY2015, and would have regardless what the tax structure was. It's the drop in the price of oil that has affected the production tax revenue, not the tax structure or tax rate itself.

To understand why oil revenues dropped so much, one has to look at different kinds of revenues separately (slide below). Historically, most oil revenues have been both production taxes (red) and royalties (blue). Royalties are a fixed share of wellhead value (usually 12.5 percent). But there has been a 42 percent drop in oil wellhead value since 2012, which translates to a 45 percent drop in royalty income.

On the production side, the oil production tax in either ACES or SB21 is a tax on profits, which in simple terms is income minus costs. This (above slide) shows that the total tax liability has been falling steadily since 2012 (two years before SB21 went into effect), due to dwindling production, and more recently, decreased income due to the drop in oil prices.

The base tax rate is calculated the same way under SB21 as it was in ACES. But the tax base is so low now, that even hypothetically with a 100 percent tax rate, the state still couldn't recoup the loss.

We are better off in 2015 with SB21 in this price environment than we would have been with ACES because the nominal tax rate for SB21 is a flat rate of 35 percent, while ACES was a sliding rate that fell as low as 25 percent at prices below \$85 per barrel.



**Moving Down the List... Oil Tax Credits**

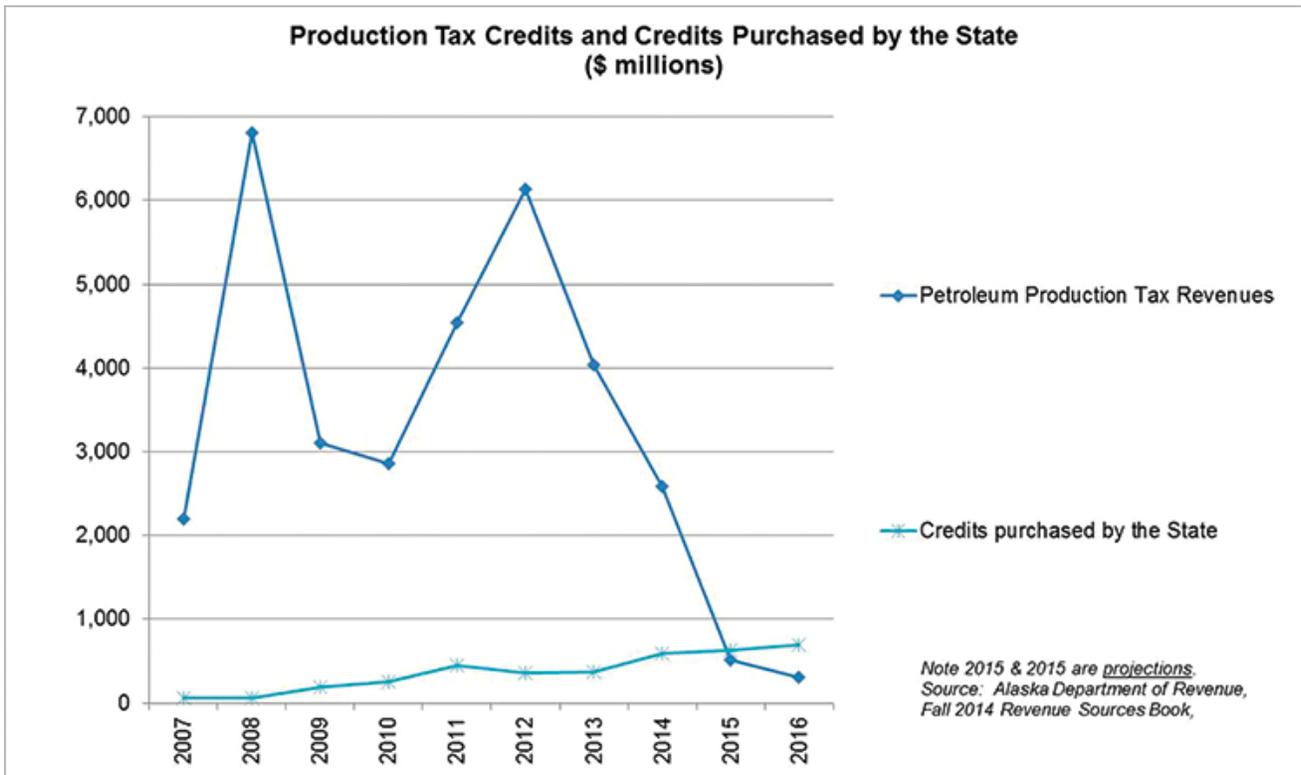
Oil tax credits can be simplified into three categories:

- Production Credits: Stabilize the net tax system over a wide spectrum of prices to incentivize additional investments in North Slope legacy fields which also generates additional production in a relatively short time frame.
- Exploration Credits: These credits are generally for exploration activities such as seismic work that identifies new opportunities for eventual new production.
- Cook Inlet Recovery Act: To encourage investment for subsurface intangible-drilling expenditures and well activity in Cook Inlet.

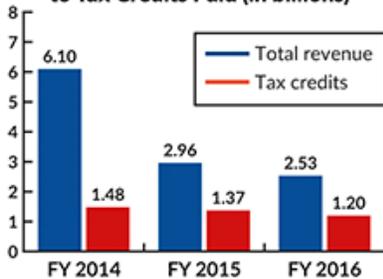
The purpose of all of the Alaska Petroleum tax credits is to attract new investment, more production, and in some cases, new entrant companies to the state. From an economic perspective, what matters is not how the credits compare with current production tax revenues. What matters is how much they do or don't increase future revenues, as in five years-plus.

North Slope credits have the most impact at low prices. This is why we see an inverse relationship during this past year between revenues generated and credits paid. At low oil prices, credits incentivize oil companies to continue to invest and do business in Alaska when the economic and fiscal environment is less than ideal. At current prices of oil, the state of Alaska is exhibiting some delayed gratification now, in exchange for continued employment for its citizens and potentially receiving more in production taxes in the future.

In the aggregate, all the different state oil revenues are providing Alaska about \$2 billion a year. Roger Marks, a former state petroleum economist, writes, "The credits do not work in a vacuum. The entire oil fiscal scheme needs to be viewed as an integrated system, especially in view of the high amount of royalties received at low prices. As a result, the fiscal system is functional and competitive across a broad spectrum of prices." (Roger Marks article <http://www.adn.com/article/20150425/alaska-oil-tax-credits-are-working-they-should-low-prices>)



**Total Oil Revenue Received Compared to Tax Credits Paid (in billions)**



People can debate the credits until the cows come home, but to be fair, we have to have patience and give them time to work. And it appears they are—Cook Inlet production is up 80 percent since 2010. Caelus Energy is developing a new field called Nuna, which is slated to produce twenty thousand barrels of oil per day by 2017. BP plans to complete 522 total well jobs in 2015 at Prudhoe Bay as compared to 355 well jobs in 2012.

**We Have Three Choices**

At this point, we as Alaskans, have three choices:

- Raise revenues from new sources
- Tap into the state's various savings accounts
- Cut spending

A practical solution will most likely involve all three working in tandem.

**Starting from the top: How do we raise revenue?**

We could increase taxes on other industries such as mining, tourism, and fishing. While this could be an additional revenue source, it's important to manage our expectations and understand that these industries don't have the same scale as oil and could only contribute modest increases to state revenue.

But for fun, economist Scott Goldsmith did walk down that rabbit-hole and asked himself, just how much would we need from tourism, mining, and seafood to close that \$3.5 billion gap? He came up with a financial comparison to replace \$7.5 billion in petroleum revenue with taxes on other resources: Gold would have to be \$10,000 an ounce; salmon would have to be \$50 a pound; and every tourist would have to pay the state a \$5,000 tax for visiting Alaska.

We could reinstitute a state income tax and/or a state sales tax. In 2010, John Boucher of the state budget office and former Alaska Department of Revenue Deputy Commissioner Larry Persily put numbers next to those two options. (Potential new (or improved) revenue sources. Boucher and Persily. Jun 2010. <http://www.alaskabudget.com/wp-content/uploads/Boucher-Persily-June-2010.pdf>)

**State Income Tax**

There are three options for calculating personal income tax liability:

- Federal adjusted gross income. A percentage of total income with few (no) deductions.
- Federal taxable income. A percentage of income after all deductions.
- Federal tax liability. A percentage of total federal income taxes owed.

Common sense assumptions most often land on the \$400 million to \$500 million figure for potential revenue generated by a state income tax.

Annual Revenue to the state	% Adjusted Gross Income	% Federal Taxable Income	% Net Federal Tax Liability
\$250 million	1.4%	1.9%	10.4%
\$300 million	1.7%	2.3%	12.5%
\$350 million	2.0%	2.7%	14.6%
\$400 million	2.2%	3.1%	16.6%
\$500 million	2.8%	3.8%	20.8%
\$750 million	4.2%	5.7%	31.2%
\$1 billion	5.6%	7.7%	41.6%

**State Sales Tax**

The estimated income received from a state sales tax is relatively low considering the complexity of managing a state tax on top of the rules in more than one hundred municipalities that already have a local sales tax. In addition, a state tax would impose a competitive burden on local sales in those municipalities that have their own sales tax, possibly damaging the local economy. The estimates are:

\$150 million a year for every 1 percent in a statewide sales tax on retail goods and services sold in Alaska, assuming no exemptions.

\$115 million a year for every 1 percent in a statewide sales tax if food, shelter, and healthcare were exempted.

A state sales tax and/or state income tax helps. But it doesn't close the deficit gap which remains at almost \$3.5 billion at today's spending levels and low oil prices.

But there is an obvious solution that some people are reluctant to discuss. The Permanent Fund has been earning billions of dollars in realized earnings each year.

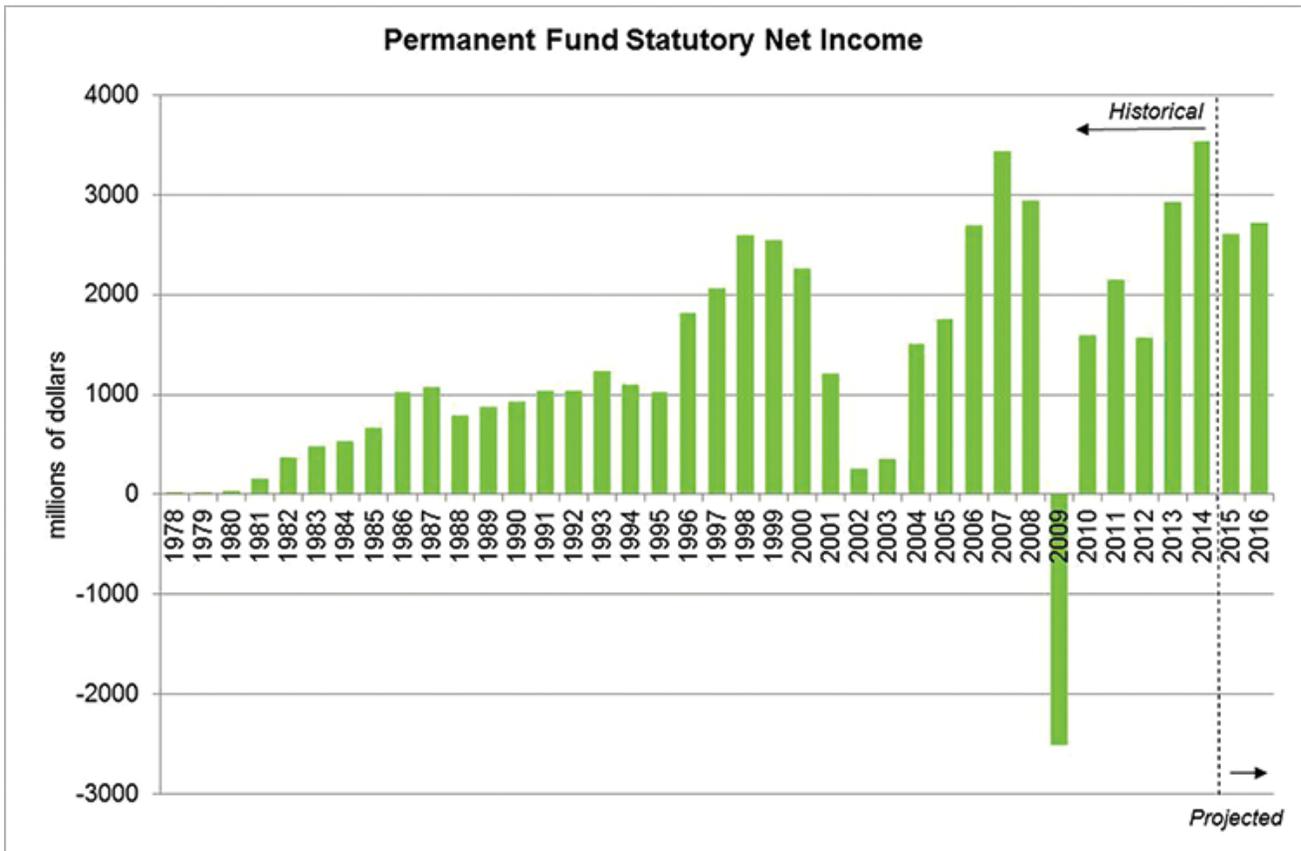
Since 1983, we have been drawing from the earnings reserve to pay for dividends and inflation proofing. But some money was held back and retained in the Earnings Reserve.

What was the Permanent Fund created for? We can look back at the nine volumes of the original Trustee Papers, accessible to the public on the Permanent Fund Corporation website. (Permanent Fund Corporation Trustee Papers. <http://www.apfc.org/home/Content/publications/reportArchive.cfm>)

Volume 5 provides a written account of a speech given by the first Chairman of the Board of Trustees, Elmer Rasmuson, in 1993. Rasmuson writes, "In truth, the Permanent Fund began, chiefly, with a 'negative goal,' to place a part of the one-time oil wealth beyond the reach of day to day government spending." So far, that objective has been met. It has saved billions which would otherwise have been dissipated.

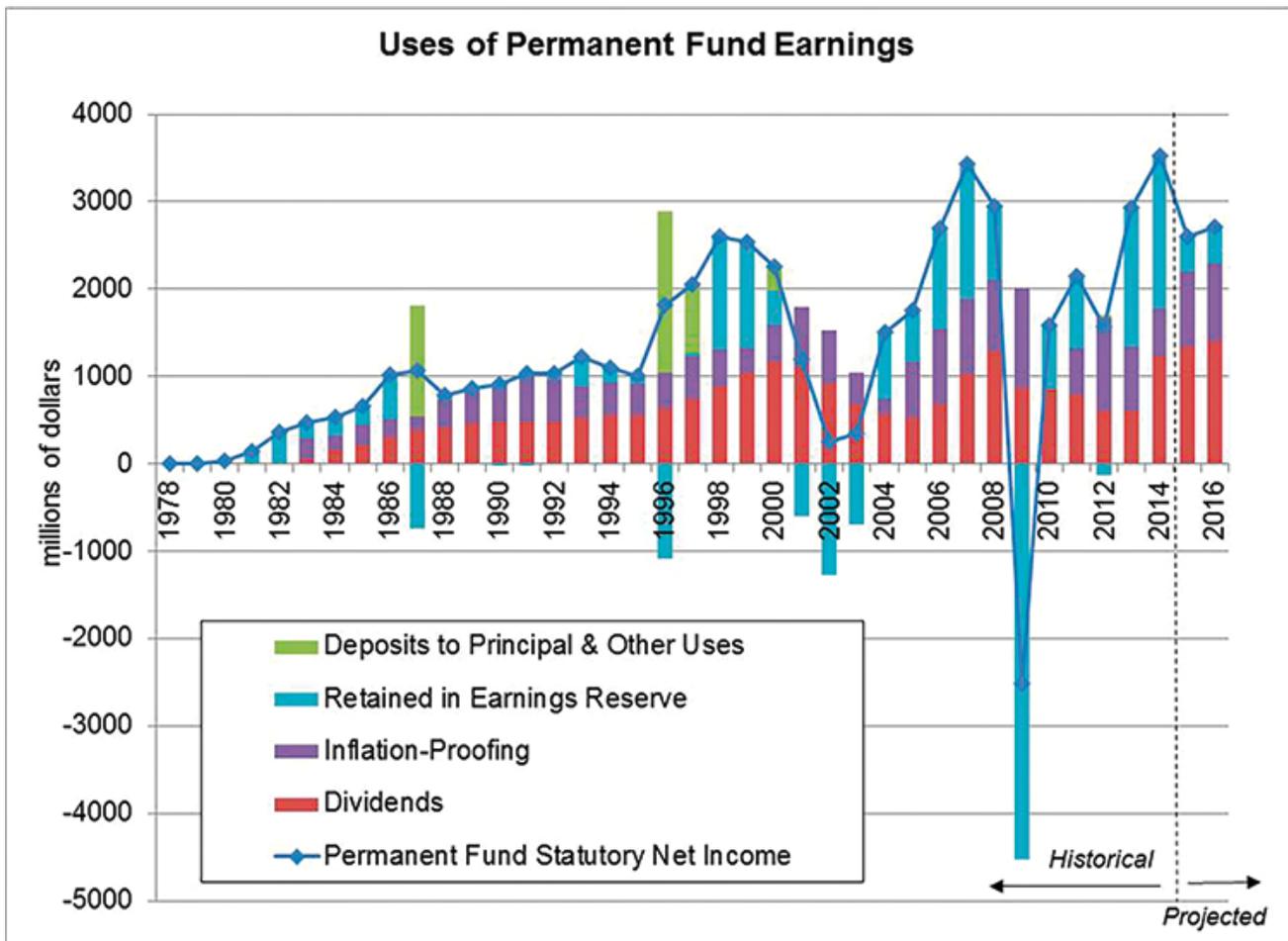
Rasmuson goes on to describe how the board first met in 1980 and during that year, the trustees developed a long term policy to reinvest a portion of the annual earnings to pay for dividends, as well as to inflation proof the fund. Any excess earnings above that are available to spend on anything the Legislature appropriates.

Rest assured the original trustees did provide some guidance to the legislature regarding the original intent for those earnings. We look to Volume 3 of the Trustee Papers, a testimony by JJ Brecht given to the Senate State Affairs Committee in 1989 for further clarification. This following statement could have easily been written today as it was twenty-six years ago. "Most proposals for use of fund earnings have been met with suspicion and warnings against 'raiding The Fund'. This highly charged environment has led to hesitancy and inaction by Alaska's leaders. The central question has gone unanswered: For what are we saving the money?"



In this same paper, Brecht offers several recommendations for the fund, including using the Permanent Fund earnings as a counter cyclical force in the Alaska economy. "Earnings from the Permanent Fund can and should help level the peaks and valleys of the Alaska traditional boom and bust economic cycles." (Volume 3 of Permanent Fund Corporation Trustee Papers [http://www.apfc.org/\\_amiReportsArchive/1989\\_TP3.pdf](http://www.apfc.org/_amiReportsArchive/1989_TP3.pdf))

The recommendation was not without its fair warning, "We must stop thinking of the Fund as the panacea for all our ills. The Alaska legislature must appropriate funds for sane and reasonable levels of government and promote a stable economic environment in which we can live."



**Sane and Reasonable Spending**

But as the original permanent fund corporation trustee said, it makes the most sense to tap the earnings reserve if we are maintaining a "sane and reasonable" level of Government.

Even if we draw upon the Permanent Fund earnings reserves, it doesn't close the gap entirely if our state continues to spend at historic levels. So, our second option is to continue to look for ways to reduce government spending.

Here is the math so far:

Without a line by line analysis of the state budget, it's difficult to recommend specific budget reductions. To help with this effort, Common Wealth North has recommended to the state to engage in management reviews to help identify redundancies and inefficiencies, as well as help draft appropriate performance measures to gauge program effectiveness. Alaska's budget process could also benefit from a study of what other states have learned as they cut their budgets in the last few years of budget constraints. (Common Wealth North February 2015 Study on Alaska Budget [http://www.commonwealthnorth.org/index.cfm?fa=documents\\_overview&doctype=54](http://www.commonwealthnorth.org/index.cfm?fa=documents_overview&doctype=54))

	In millions
2015 Unrestricted General Fund Revenue 2015	\$ 2,216
State income tax	\$ 450
State Sales tax at 1 percent	\$ 150
Permanent Fund Earnings Reserve	\$ 1,500
<b>Subtotal</b>	<b>\$ 4,316</b>
Proposed 2015 Budget	\$ 5,000
<b>Budget Deficit</b>	<b>\$(684)</b>

**The More Things Change, the More They Stay the Same**

Mnemosyne was the Titan goddess of memory. If she were a real person, I could picture her rolling her eyes and saying, "Come on people!! We've been down this road several times before. 1986, 1990, and again in 1999 oil prices fell, the state went into a tizzy, convened various

roundtables to discuss ways to diversify revenue and reduce spending, yet not much has changed because prices rebounded and the crises was averted."

Yes, but Mnemosyne, this time it's different. Why? Oil production in Alaska is significantly lower, shale oil technology has oversaturated supply thus driving down prices, and Alaska's budget has grown well above inflation. However, if there is any consolation, Alaska is not alone in its struggle to pass a balanced budget. As late as June 2015, twenty five states had not passed budgets. Clearly, our challenges are far from unique, and budget disagreements will continue as long as we engage in a democratic form of government. It comes with the territory. (25 states have not passed a budget. <http://www.adn.com/article/20150607/states-confront-wide-budget-gaps-even-after-years-recovery>)

### 2018 and Beyond

But the real story is what might the state look like in 2018 and beyond? What could happen to private sector jobs if oil prices hover at \$60 a barrel for an extended period?

According to Kara Moriarty, president of the Alaska Oil and Gas Association, Alaska is not seeing the industry cutbacks that are occurring elsewhere. Many investments have already been made in Alaska, and those investments tend to be much bigger and more long-term. In other locations like the state of Louisiana or Alberta, Canada, well rigs are being dismantled quickly because they are considered short term investments in mobile infrastructure versus long term investments in entire fields, like we have here in Alaska.

For example, several companies currently operating in Alaska, such as Conoco Phillips, Exxon Mobil, Brooks Range Petroleum, Caelus Energy, Repsol, and Great Bear Petroleum, to name a few, have made significant capital investments in fields all across the North Slope, with much of the work occurring before the downturn in prices. To shut down the projects now would add considerable expense.

The good news is, looking at the significant reduction in oil and gas activities in the continental United States and Canada, and the continued investments here in Alaska, we are definitely still in the game.

It appears that the business economy is healthy in Alaska. The government sector, not so much. But it's better than the other way around as its businesses that pay taxes and keep our state afloat. Even if we instituted an income tax, people need jobs to earn income in order to pay taxes.

The global fluctuation in oil prices is something we need to live with like all other states and countries with a large oil and gas economy, but there are things Alaska can do to help mitigate the uncertainty. Staying competitive as an industry and having a stable fiscal environment at a range of oil prices is key. Those are the two elements that both the industry and legislature can control.

### Solutions

**Stable Tax Structure:** If given a choice, businesses generally prefer to invest in environments that are predictable and dependable. A company can only properly manage their after-tax cash flow if they know what they can afford to invest in infrastructure and labor. When governments frequently change tax structures, it sends a message to potential investors that politics, rather than economics, is the driving force behind policy and regulation. This is generally a red flag for business looking to expand into new markets because the regulation risk is too high.

**Worker Productivity and Flexibility:** It is in the state's best interest to keep workers properly trained and employed. One challenge is that labor contracts negotiate compensation packages that are tied to inflation. Over time, the larger challenge tends to be work rules and annual budget cycles that prohibit, or severely limit, the development and implementation of productivity improvements and innovation.

An article in the May 2 edition of The Economist does an analysis on worker wage and productivity, "Making a market less flexible raises the risk that an economic downturn will cause mass layoffs." The article goes on to say, a more flexible job environment actually creates more jobs, though job sharing, project based jobs, as well as can accommodate population transiency. (Economist Article <http://www.economist.com/news/briefing/21650086-salaries-rich-countries-are-stagnating-even-growth-returns-and-politicians-are-paying>)

The state can contribute towards flexible work environments by negotiating state labor contracts that allow for things such as job sharing, job mobility, workplace innovation, cross training, flexible schedules, and manager discretion regarding seniority, as well as fund training centers to keep job skills up to date.

**Increase the Pie:** While natural gas is not as profitable as oil production, it is a respectable source of revenue diversification. John Boucher and Larry Persily published an analysis a few years ago on the potential of a natural gas pipeline. "Adding up production taxes, royalties, corporate income taxes and property taxes, a North Slope gas line could produce between \$1.2 billion and \$1.5 billion a year for the state treasury, assuming the gas is worth \$2 per thousand cubic feet after production and transportation costs."

In addition, there is estimated to be about 47.8 billion barrels of "mean technically recoverable oil" on the North Slope in areas including the ANWR Coastal Plain and the Coleville Canning area. If these areas were open for drilling, the state could benefit greatly from additional tax and royalty revenue through increased oil production.

### Fiscal Crossroads

Alaska is the only state in the union that does not collect either a state sales tax or levies an individual income tax. Instead, revenue from oil production and royalty taxes has been the dominant revenue source for nearly forty years, to such an extent that our state has a \$54 billion Permanent Fund account, a \$13 billion Constitutional Budget Reserve account, and the highest per-capita spending in the union.

Due to a significant increase in oil supply, and a slightly weaker demand, oil prices are expected to stay low for the foreseeable future. While Alaska may be insulated from some of the global downsizing because of the nature of our long-term investments in fields versus in mobile infrastructure, our state should be prepared to define "a new normal" for revenue and spending.

The bottom line is, we have a very large state budget and no way to pay for all of it. At this point, we as Alaskans, have three choices:

- Raise revenues from new sources
- Tap into the state's various savings accounts
- Cut spending

A practical solution will most likely involve all three working in tandem.

Our state is at a fiscal crossroads, and it's worth discussing all our options such as a state income tax, state sales tax, or using some of the Permanent Fund Earnings Reserve to help balance the state budget. While spending the Constitutional Budget Reserve is a quick fix, this limits our future options and may cause us to spend our Constitutional Budget Reserve quicker than necessary. We will always need the Constitutional Budget Reserve to act as a shock absorber during the inevitable period of low oil prices. Draining it removes that measure of financial security.

Regardless, it will be important to engage in community conversations where everyone collectively discusses the magnitude of our budget challenges in order to help prioritize spending and decrease the state budget, as well as explore new sources of revenue.

In addition to revenue and expenses, there are other non-cash ways to help address and mitigate our fiscal challenges. They might include negotiating more worker flexibility in public contracts, management reviews for state departments and programs, and finding ways to "increase the pie" through opening up new oilfields and streamlined permitting.

The recent drop in oil prices has only accelerated the existing problems the state of Alaska has been facing for a while, which is our dependence on a single source of revenue, as well as an unsustainable annual state budget. Alaska needs to shake its "Cassandraism" and begin to believe that the prophecy of lower state spending in the future will most certainly come to pass. Our budget woes are not a myth, but unfortunately, very real.

**NATASHA VON IMHOF IS A LIFE-LONG ALASKAN WHO TAKES AN ACTIVE INTEREST IN ALASKA POLITICS AND HOPES TO HELP SHAPE POLICY TO SECURE OUR STATE'S ECONOMIC FUTURE.**

*This article first appeared in the September 2015 print edition of Alaska Business Monthly.*