NEW SUSTAINABLE ALASKA PLAN

Vision

To preserve jobs and provide opportunities for all Alaskans, now and in future generations, by establishing a stable and enduring fiscal framework.

Introduction

Alaska faces a period of fiscal uncertainty unrivaled in state history. In the current fiscal year, unrestricted general fund revenue will cover only 40 percent of the budget, leaving a $3.4 billion gap between spending and revenue – despite a 35 percent reduction in state spending since 2013.

Even under optimistic assumptions, neither oil prices nor North Slope production are expected to increase sufficiently to make up for these large revenue shortfalls. Government cost reductions are required, but cuts alone cannot balance the budget. The Legislature's fiscal analysts noted that we could lay off every state employee and it would still not close the budget gap.

If the status quo budgeting approach continues, savings from the state's Constitutional Budget Reserve (CBR) will be required to cover the gap. At current and projected oil prices, these savings will be depleted by the end of fiscal year 2018. At that point the Permanent Fund Earnings Reserve would be needed to address the ongoing shortfall. The Earnings Reserve could last for a couple more years, and then when that fund is depleted, dividend payments would stop, and all that would remain is the Permanent Fund principal. The status quo must be avoided as it will deplete our savings, end the dividend program, and threaten the Permanent Fund itself.

This grave situation resulted in the Standard and Poor's Rating Service revising Alaska's credit rating outlook to negative on August 18, 2015 and calling on lawmakers to address the state's structural deficit. The agency warned:

> *We expect that if lawmakers do not enact significant fiscal reforms to reduce the imbalance within the next year, the state's rating could begin transitioning downward. The rating migration lower would likely persist and accelerate if lawmakers continued to fail to act.*

A credit downgrade would increase the state's cost of borrowing, driving up state and municipal costs when we can least afford it, it would make the natural gas pipeline project much more expensive, and it would create an overall chilling effect on investment statewide.

Most of Alaska's state revenue comes from development of our oil resources. State spending historically trends up or down in correlation with this revenue, which is largely dependent on global crude oil prices. This dependence on volatile revenue hinders Alaska's long-term prosperity by:

- Putting the state's savings at risk of rapid depletion in a prolonged low-oil-price environment;
- Making it difficult to plan program or project budgets over time, thereby compromising the efficiency, effectiveness, and reliability of government services; and
- Creating economic uncertainty that has a harmful effect on commercial investment.

Our current fiscal challenge is in large part a product of this overreliance on a volatile revenue stream.

Fortunately, Alaska has great strengths. We have built prodigious savings. We have tremendous resource wealth in the ground. The U.S. Chamber of Commerce Foundation ranked Alaska second in the nation for business climate. And our individual tax burden is one of the lowest in the nation. We certainly have the tools to solve our budget challenge, we only need to acknowledge the problem and muster the courage to act.

This summary document introduces a path to long-term fiscal stability. By necessity, implementing this plan includes new and politically difficult actions. The Walker-Mallott administration therefore welcomes a full vetting by the Legislature and the public as we reach for a common goal – a truly sustainable, balanced budget.

Background: Sovereign Wealth Approach

The sovereign wealth approach, in simplest terms, uses very large financial assets in a calculated, formulaic, sustainable way, to provide a stable source of revenue. This concept is successfully being used around the world.

Economists have observed that among major oil-producing nations that use this approach, those that can best weather low oil prices share several characteristics:

- They have very large savings accounts - or sovereign wealth funds;
- Spending from such funds is governed by a respected rule-based framework; and
- Fund assets are invested by independent authorities with appropriate government oversight.

Kuwait and Abu Dhabi, with breakeven oil prices of $54 and $55 per barrel respectively, use a successful sovereign wealth framework. Alaska's breakeven oil price – the minimum oil price needed to balance the budget – is currently over $109, in line with other jurisdictions that use a more ad-hoc fiscal system.

Because our predecessors had the foresight to create the Alaska Permanent Fund; we now have the capacity to transform our nonrenewable oil resources into a renewable resource – income generating savings. We have reached that crossover point in our history where our savings are now generating more income than our oil. But to make this transformation we must restructure the fiscal framework of our state to maximize the power of our growing financial assets.

Strategy

The New Sustainable Alaska Plan calls for action on four fronts:

- Reduce government spending;
- Support key investments for Alaska's future;
- Use the Permanent Fund consistent with a sovereign wealth approach; and
- Adjust existing taxes and implement a modest broad-based tax.

Action is required in the 2016 legislative session to avoid a potential credit downgrade and loss of flexibility as our reserves diminish. None of these steps will require a constitutional amendment.

Reduce Government Spending

First and foremost, Alaskans must establish a lean spending plan and scrutinize all operations and programs to ensure cost-effective delivery of public services. We have already begun. State general fund spending has decreased 35 percent since FY13, from $8 billion to $5 billion. The current-year budget alone (FY16) implements agency operating reductions of $400 million (10%) and resulted in approximately 600 fewer state employees.

The FY17 budget proposes another $100 million in agency operating cuts and we will continue to seek efficiencies within existing programs and to conduct the due diligence necessary to propose other transformational change. This plan also calls for the modification of the state's oil and gas tax credit system to reduce those expenditures, while honoring existing claims and continuing to provide meaningful development assistance.

As we continue these efforts to reduce spending, we must take the time necessary to allow for a thoughtful, collaborative and open process to avoid unintended consequences or harm to Alaskans and our economy.

Action items:

- Reduce agency operating costs;
- Evaluate privatization of some government services;
- Implement cross agency efficiency initiatives to improve services and reduce costs; and
- Reform the oil and gas tax credit system to reduce state expenditures, reward Alaskan hire, and build a new system of direct loans.

Support Key Investments for Alaska's Future

We must maintain our strategic commitment to key investments in Alaska's future. These include responsible capital spending to protect our existing infrastructure, and an effective system of public education to ensure the next generation is equipped to lead. In addition, we must invest in a natural gas pipeline project to ensure the earliest possible construction. Alaskans will benefit from the economic stimulus of pipeline pre-construction and construction jobs, and upon completion, revenue from the sale of Alaska's gas will return billions of dollars annually for decades. This legacy project will further strengthen the Permanent Fund and open opportunities for Alaska's future.

Action items:

- Vigorously pursue Alaska liquefied natural gas project;
- Establish a capital budget using general obligation bonds (2016 and 2018 general elections) to support only those funding requirements that would otherwise require cash payments, such as transportation matches and disciplined deferred maintenance investments.
- Re-introduce a sustainable general fund capital budget only after stabilizing the operating budget, and once it can be shown to be compatible with the performance of new revenue sources.

Transition to Sovereign Wealth Approach

The transition to this approach requires "re-plumbing" the flow of funding in the state's fiscal structure by diverting volatile resource revenue away from the state's annual budget and putting it directly into the Permanent Fund. This new revenue into our sovereign wealth account (Permanent Fund) will capture all future spikes in global commodity markets into our savings, rather than have it fund potentially inflated and unsustainable budgets. In contrast, this approach provides a stable and consistent withdrawal from the earnings of our sovereign wealth, based on carefully calculated formulas and reasonable assumptions. This allows the Permanent Fund to grow over time, while absorbing volatility of oil market price swings. This approach puts Alaska on a stable government spending allowance indefinitely, and for the first time permits long-term strategic budget planning.

Because the current size of the Permanent Fund is only marginally large enough to implement this plan and support a perpetual state spending allowance, the funding source for the annual dividend program needs to be "re-plumbed" as well; shifting it away from the Earnings Reserve to another source.

The dividend program is seen as Alaskans' share of the state's resource wealth. But the current dividend program is largely tied to the performance of global equity markets, not natural resource development. The New Sustainable Alaska Plan addresses this disconnect by tying dividends directly to the state's resource revenue. This is done by distributing a 50 percent share of annual natural resource royalty revenue as dividends to Alaskans each year. This is consistent with Alaska's owner-state constitutional principles. The proposal sets a 2016 transitional dividend at $1000; but dividends are expected to remain in the $1000 range going forward based on current estimates of future royalty revenues. If resource development and associated revenues to the state increase (i.e. a gasline is built), dividends will also increase.

The remaining 50 percent of annual natural resource royalties and 100 percent of production tax revenue will go into the Permanent Fund. Investment earnings from that Fund will continue to flow to the Earnings Reserve as it does today. This Earnings Reserve, supplemented by a one-time deposit from the CBR, will provide a fixed and sustainable draw to the unrestricted general fund. Depositing a majority of the state's natural resource revenue into the Permanent Fund increases the fund's value over time, while shielding the state budget from annual revenue volatility. No money will be spent from the principal of the Permanent Fund, as it remains constitutionally protected.

Action items:

- Distribute 50 percent of royalty revenues as dividends to Alaskans on an annual basis;
- Deposit the balance of royalty revenues and other resource revenues into the Permanent Fund on an annual basis;
- Establish a calculated sustainable draw from the Earnings Reserve to the unrestricted general fund using a formula that accounts for new revenues going into the Permanent Fund and conservative earning projections; and
- Transfer approximately $3 billion from the CBR into the Earnings Reserve on a one-time basis to provide the initial starting balance required to permit a meaningful sustainable draw.

Adjust and Implement Taxes

Reduced state spending and the sustainable use of our sovereign wealth are expected to cover most of the state's budget deficit. However, the revenue needed to close the remaining gap will require a balanced suite of targeted and broad based taxes; as well as cross-industry tax adjustments. Under this plan, everyone is being asked to participate, from the oil & gas, mining, fishing, and tourism industries; to everyday Alaskans, as well as the many non-residents who only work here (see Appendix A). Yet despite these changes, the tax burden on individual Alaskans will still remain among the lowest in the nation.

The New Sustainable Alaska Plan calls for an increase to alcohol, tobacco, and motor fuel taxes, and implementation of an individual income tax based on a percentage of federal tax liability. Implementation of this modest broad-based tax will also address a weakness in our current system by establishing a link between population and job growth – and the resulting demand for state services – and revenue. Industry based taxes can remain modest across the board, because the burden is being spread among all major sectors.

It is important to note that delaying implementation of the New Sustainable Alaska Plan beyond 2016 will force greater short-term use of the CBR and/or Earnings Reserve. This depletion of our savings would permanently reduce the sustainable annual draw we can get from our sovereign wealth, and therefore increase the amount of revenue needed from taxes in the future.

Action items:

- Adjust targeted taxes on alcohol, tobacco and motor fuel;
- Implement statewide income tax as a percentage of federal tax liability; and
- Implement modest adjustments on cross-industry taxes.

Conclusion

As we move forward, our common interest must be to strengthen Alaska's future and ensure opportunity for all Alaskans, now and in future generations. The New Sustainable Alaska Plan provides a balanced path to long-term fiscal stability: it protects the economy, preserves dividends, and makes the Permanent Fund permanent. It enables the state to continue meeting its obligations – to protect the safety and health of Alaskans, provide quality education, and promote employment opportunities in a growing and increasingly diverse economy.

The future of this great state is in our hands. We look forward to working with lawmakers to set Alaska on a course for long-term prosperity. The time for bold and decisive action is now.

We ask you to take tomorrow and dream; we know that you will see visions we do not see.
-Alaska Constitutional Convention Delegates to future Alaskans, 1956

Appendix A

New Sustainable Alaska Plan Components (Millions of Dollars)

Existing Revenue	$850
Alaska Permanent Fund Protection Act	$3,200
Earnings on Other Savings	$135
Mining (2% increase on top tax bracket)	$12
Fishing (1% increased Surtax)	$20
Tourism (Elimination of municipal cruise head tax exemption)	$15
Motor Fuel (6.8 cent increase on jet fuel, 5.3 cent increase on general aviation; 5 cent increase on Marine; 8 cent increase on Highway)	$45
Alcohol (10 cent increase per drink)	$40
Tobacco ($1/pack increase, includes E-Cigs)	$27
Oil and Gas (Reduce amount spent on tax credits; harden floor & raise to 5%; add loan program)	$500
Individual Alaskans; Income Tax (1.5% of average income – 6% of fed liability)	$200