The Fiscal Year 2016 Budget:

Legislative Fiscal Analyst's Overview of the Governor's Request

Legislative Finance Division

www.legfin.akleg.gov

Introduction

As required by law, the Governor released his FY16 budget proposal to the public and the legislature by December 15, 2014. The operating budget submitted is an unendorsed "work in progress" that the Governor intends to modify.

The Legislative Finance Division prepared this overview of the Governor's proposal in accordance with AS 24.20.211-.231. The division must analyze the budget as it was submitted; amendments will be reviewed after the Governor submits them and will be included in the "Subcommittee Books" the division produces as a foundation for reviewing the budget of each agency. Because the December 15 budget is merely a placeholder, this overview focuses on the broad topic of the fiscal situation rather than specifics of the Governor's proposal.

Alaska's Fiscal Situation

Alaska's immense deficits are headline news. An FY16 deficit is no surprise—last year's forecast was for annual deficits into the foreseeable future—but the enormity of the FY15 and FY16 deficits is staggering. A discussion of the situation—how it happened, how deficits affect reserve balances, and options to close the fiscal gap—follows.

The fiscal sensitivity graphs prepared last session (see page 12 for updated charts) to show the revenue impact of changes in oil prices did not include prices below $90 per barrel. At a current market price near $50 per barrel, revenue is far short of projections.

The June 2014 fiscal summary for FY15 showed $4.5 billion in revenue and a projected deficit of $1.3 billion. The Department of Revenue (DOR) December 2014 forecast for FY15 is for revenue of $2.6 billion—and that looks optimistic given the continued decline in both price and production—giving a deficit of $3.5 billion in FY15. As shown in Figure 1, the $2.15 billion increase in the deficit is attributable almost entirely to the decline in the price of oil. The $199 million increase in expenditures is attributable primarily to an increase in refundable oil production tax credits purchased by the State.

Figure 1. FY15 and FY16 Fiscal Gap

	FY15			FY16	
	June 2014	December 2014	Change (June to Dec)	December 2014	Change (FY15 to FY16)
Price (per bbl)	$ 105.06	$ 76.31	$ (28.75)	$ 66.03	$ (10.28)
Production (bbls/day)	495,900	509,500	13,600	524,100	14,600
Unrestricted GF Revenue	$ 4,522.9	$ 2,575.0	$ (1,947.9)	$ 2,196.7	$ (378.3)
GF Budget	$ 5,839.4	$ 6,037.9	$ 198.5	$ 5,779.0	$ (258.9)
Surplus/(Deficit)	**$ (1,316.5)**	**$ (3,462.9)**	**$ (2,146.4)**	**$ (3,582.3)**	**$ (119.4)**

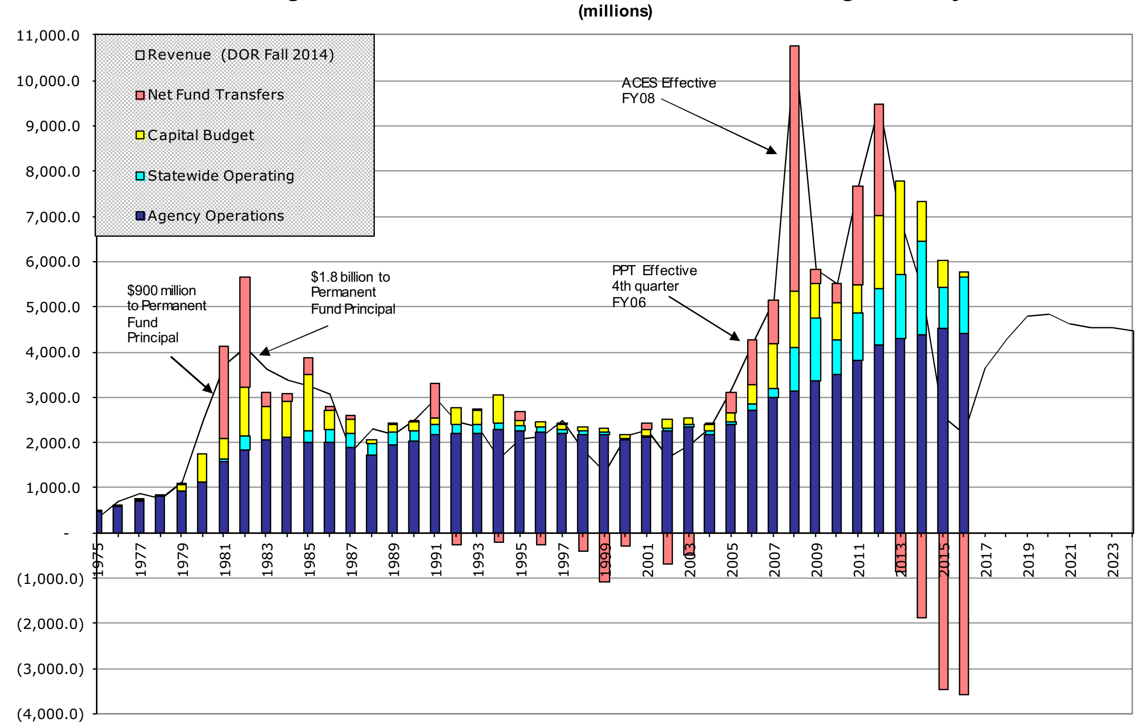
The revenue forecast of $2.2 billion in FY16 is based on a $10 decline in the price of oil (to $66.03) and a 3% increase in production. Some would consider both projections optimistic—the price of oil is now under $50 and some forecasters believe the price will drop to near $40, and oil production in FY15 is running 4% below projections.

The fiscal summary based on the Governor's December 15 budget (see page 10) shows unrestricted general funds spending of $5.8 billion.[1] Although the FY16 budget is about $260 million less than the FY15 budget, Figure 1 shows that the projected FY16 deficit of $3.6 billion is almost $120 million larger than the FY15 deficit.

While it is clear that oil prices have a huge impact on Alaska's fiscal gap, a deficit always involves both revenues and expenditures. The implications of this point are critical to finding a sustainable fiscal path that legislators and citizens find acceptable.

Finding that path requires an understanding of the current fiscal path and options to modify it. Figure 2 shows a history of unrestricted general fund revenue and spending.

Figure 2. Unrestricted General Fund Revenue/ Budget History
(millions)



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[1] The Governor's fiscal summary released on December 15 shows expenditures of $5.4 billion and a fiscal gap of $3.2 billion. The $400 million difference between the Governor's fiscal summary and the Legislative Finance version is the addition of $175 million to purchase production tax credits (per the December Revenue Sources book) and the reclassification of $257 million for state assistance to retirement systems from "other funds" to unrestricted general funds. The Governor's amended budget is expected to incorporate these changes.

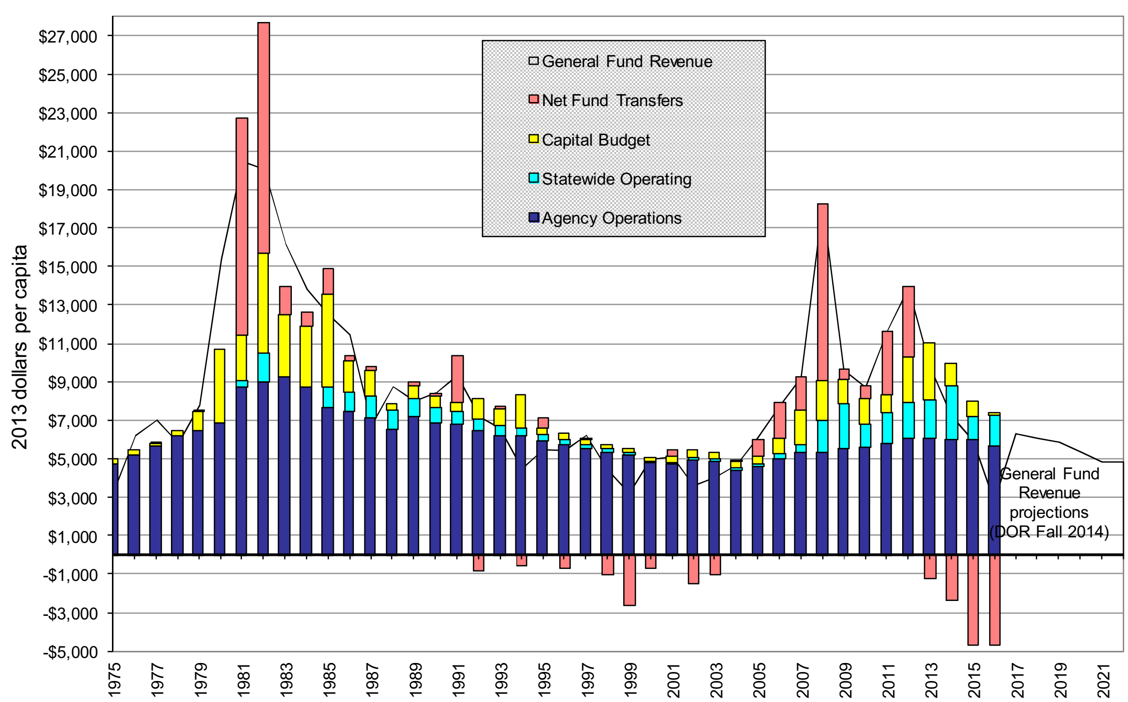
Take-away points from Figure 2 include:

1. The expenditure growth starting in FY05 (and coinciding with massive increases in revenue) is not sustainable, given declining oil production and the DOR price forecast.
2. Surpluses from FY05 through FY12 allowed the state to build tremendous reserves (the red bars).
3. Deficits (red bars below the axis) beginning in FY13 are burning through reserves at a very rapid rate.
4. The revenue forecast assumes a healthy recovery in market prices (to $110 in FY17, climbing to over $130 after FY21).
5. Without expenditure reductions or revenue enhancements, deficits are likely to exceed $1 billion annually after FY16, even with the price recovery incorporated in the DOR forecast.

Agency Operating Costs

While the fiscal situation has stimulated criticism of the legislature as guilty of irresponsible spending, Figure 3 brings perspective to that criticism. After adjusting for population growth and inflation, spending on agency operations in recent years is less

Figure 3. Per Capita Unrestricted General Fund Revenues and Budget History adjusted for inflation (expressed in 2015 dollars)



than during the 1980s. A long downward trend in the cost of agency operations reversed beginning in FY05, but that should not be surprising given that:

1. Negotiated increases for state employees added about $150 million annually.
2. Health costs for state employees increased by almost $6,500 per employee per year from FY06 to FY15 (which—with an 11% increase in the number of employees—translates to a total cost of about $75 million annually).
3. Retirement contributions approximately doubled (to 22%), adding about $130 million to the cost of operating state government.

The legislature has minimal control over salary, health and retirement costs. With the addition of K-12 funding and Medicaid—formula programs that account for $485 million and $414 million, respectively, of the expenditure growth—these cost drivers account for about two-thirds of the $1.9 billion increase in annual spending between FY06 and FY15.

Statewide Operating Costs

Turning to statewide operating costs—costs that are not attributable to any particular agency—Figure 2 shows that costs prior to FY08 were so small they could be considered insignificant. The spending category was comprised almost entirely of debt service, which was declining annually because no general obligation debt had been issued in many years.

Look at what has happened to statewide operating costs since FY06:

1. Debt service costs have increased by over $120 million annually, as new bonds were issued to pay for capital projects.
2. Massive investment losses hit retirement systems with billions of dollars in unfunded liability. The State responded by capping municipal and state contribution rates at 22% and making retirement assistance payments to the trust funds. State assistance payments to public employees and teachers retirement systems reached over $630 million in FY14, and could have been over $1 billion in FY15.[2]
3. Refundable oil and gas production tax credits went from zero in FY06 to an estimated $700 million in FY16. When combined with low oil prices, credits are projected to push net revenue from the production tax into negative territory for both FY15 and FY16. For comparison, net revenue from the production tax was over $2 billion in FY14.

Increases in statewide costs account for a large portion of the increases in operating budgets. A critical point here is that statewide operating costs are much more difficult to unwind than are agency operating costs. Bonds have been issued, investment losses have occurred, and addressing production taxes/credits requires legislation. The situation limits flexibility to address statewide costs. As difficult as it may be to pare back non-formula agency programs, it can be done solely through the appropriation process.

[2] In FY15, the legislature passed HB 385 (Chapter 14, SLA 2014) and an accompanying fiscal note that appropriated $3 billion to retirement systems. Without HB 385, state assistance to retirement was expected to exceed $1 billion annually for several years. State assistance is now expected to be about one-quarter of the pre-HB 385 projections. Put another way, the FY16 deficit would be about $750 million larger if the legislature had not adopted HB 385. Nearly half of the State’s payments are on behalf of municipalities.

Capital Expenditures

As one might expect, capital expenditures tend to track available revenue. Recent capital budgets have been some of the largest on record, and they coincided with large budget surpluses that were transferred to reserves. Some people, noting the correlation, think the capital budget is easy to cut. It is not; pressure from constituencies, federal match requirements, numerous phased projects—including, but not limited to, several mega projects—and deferred maintenance needs make cuts more difficult to achieve than some believe.

The Governor submitted a very lean, "leveraged money only" capital budget. Some would argue that it may be too lean—that the final product will incorporate "overlooked items" that will be added by amendment or by the legislature.

The Future

Public reaction to projected $3.5 billion deficits varies between these extremes:

1. "We must reduce expenditures to balance the budget immediately" to
2. "Why worry?—we have billions of dollars in reserves and rebounding oil prices will save us like they always have."

Neither position is practical. Of the $5.7 billion operating budget proposed for FY16, the contractual, statutory, or otherwise "off limits" expenditures listed below sum to $3.2 billion.

Program	Program Cost (millions)
Debt Service	$ 228
Retirement Assistance	$ 263
Production Tax Credits	$ 700
K-12 Formula	$ 1,300
Medicaid	$ 693
Total	**$ 3,184**

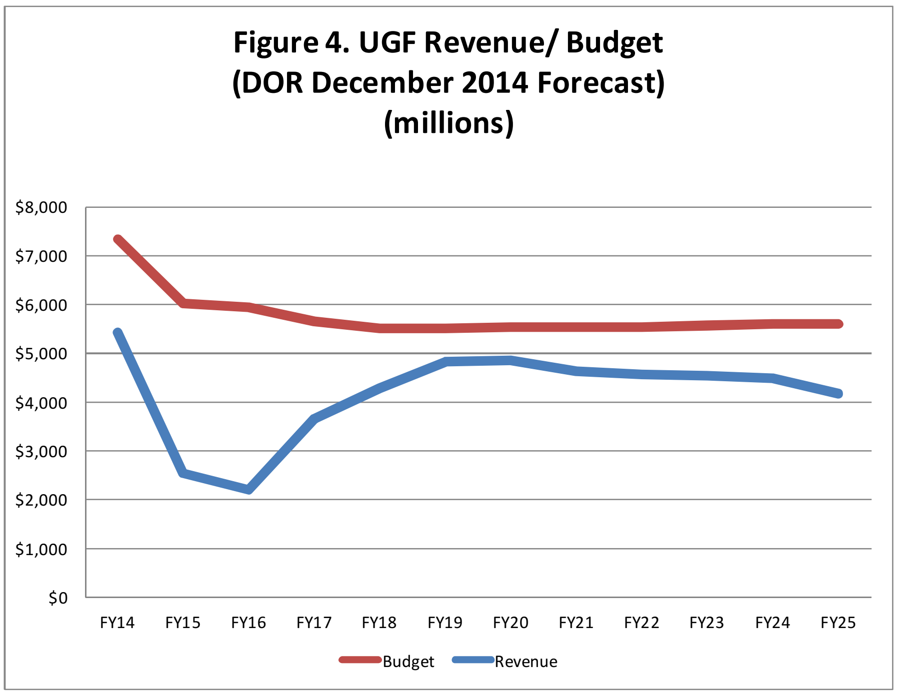
From both mathematical and practical perspectives, it is virtually impossible to cut our way to a balanced budget. To limit spending to the $2.2 billion FY16 revenue projection, we would have to cut $1 billion from the programs listed above *plus* eliminate all agencies and non-formula programs. In terms of personnel, unrestricted general funds pay salaries and benefits for approximately half of the 24,000 state employees. Terminating those 12,000 employees would reduce costs by about $1.3 billion.

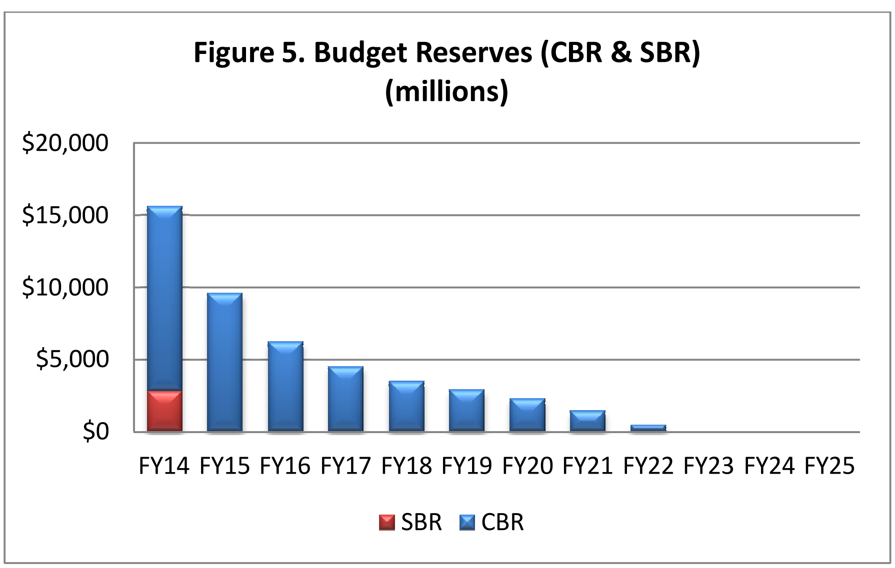
Turning to the other extreme: oil prices may recover and the fiscal gap may vanish. Or not. Before opting to postpone corrective action, it is instructive to know the facts and the risk. To say that our large deficits are consuming reserves is stating the obvious. Figures 4 and 5 (next page) bring specifics into the discussion.

Figure 4 combines the Department of Revenue forecast of unrestricted general fund (UGF) revenue with a scenario of UGF expenditures to determine deficits. Figure 5 shows the effect those deficits have on reserve balances. The expenditure scenario is for "no growth" meaning that agency operating expenditures do not keep pace with inflation.

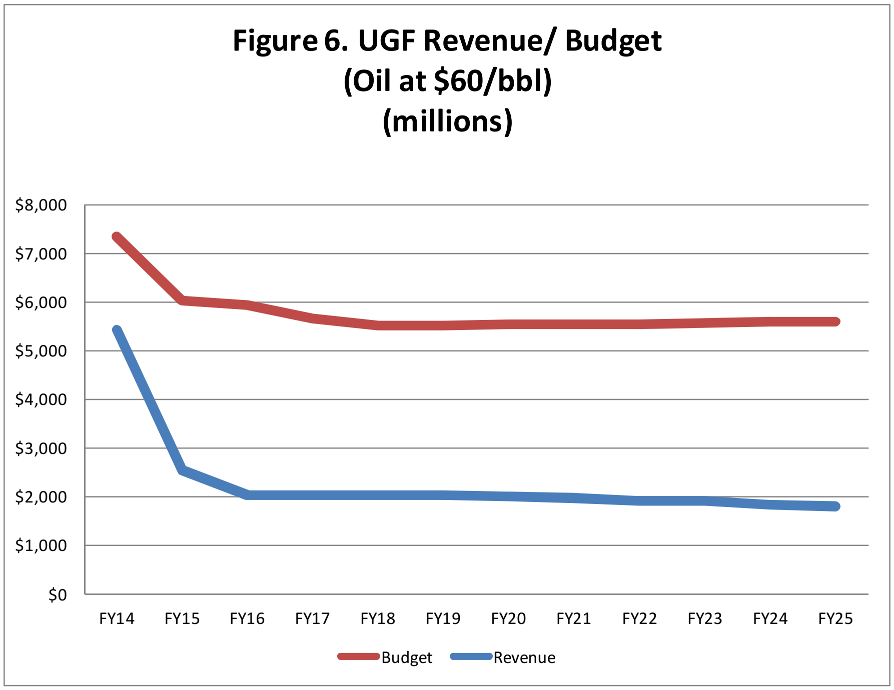
Figures 4 and 5 show that reserves would last until FY22 under this scenario. Some might argue that this scenario provides little reason to deviate from the current fiscal path—that six years is plenty of time to let events take care of themselves. But examine the risks of delaying action. Even under this arguably optimistic scenario, projected deficits exceed $1 billion annually after FY22.

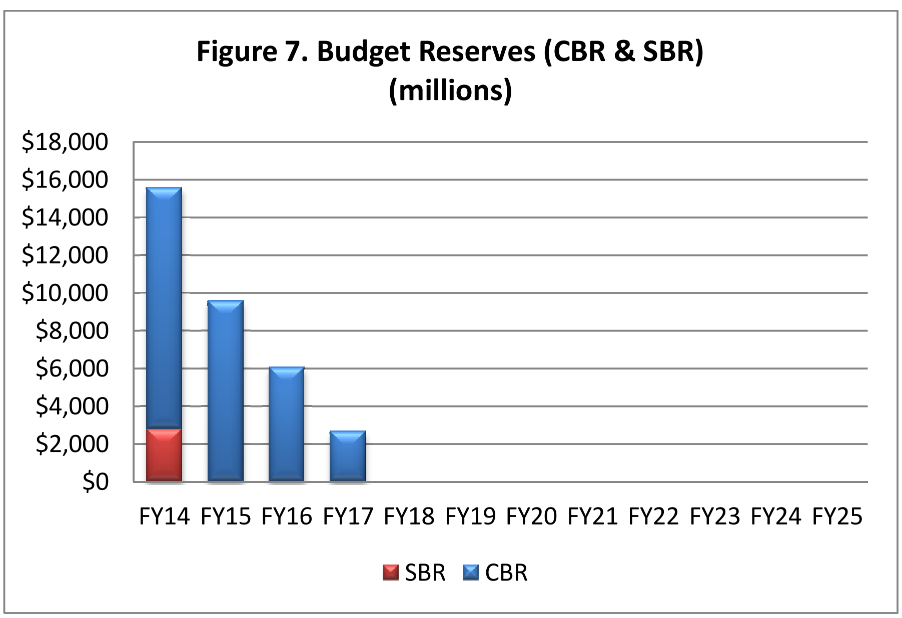
When there are no reserves to stabilize expenditures, the budget must be balanced every year. The volatility of oil revenue makes this a risky proposition. Under the DOR revenue forecast, the State would have to cut over $1 billion (over 20%) from the operating budget or enhance revenue in order to fill the fiscal gap. If revenue failed to meet projections, cuts or revenue enhancements would have to be immediate.





Figures 6 and 7 show what would happen under the same expenditure scenario, but with oil prices at $60/bbl in FY16 and increasing by inflation thereafter. Reserves are fully consumed in FY18 under this scenario. Furthermore, deficits would continue at $3.5 billion or more without expenditure reductions or revenue enhancements.





Corrective Action

As discussed above, it is virtually impossible to cut our way out of a $3.5 billion structural deficit. It is also virtually impossible to cut our way out of a $1 billion structural deficit. That does not imply that cuts are useless tools to help close the fiscal gap. It simply means that cuts alone are unlikely to be sufficient.

That places revenue enhancements firmly on the discussion table. The list of potential actions includes:

1. Implementing a personal income tax.
2. Implementing a statewide sales tax.
3. Implementing a statewide property tax.
4. Increasing other taxes (such as motor fuels, corporate income or health care provider taxes).
5. Increasing fees.
6. Reducing or eliminating tax credits and other indirect expenditures.
7. Using Permanent Fund earnings.
8. Adopting financial strategies such as collateralization and securitization.

Revenue enhancements have several elements in common. They:

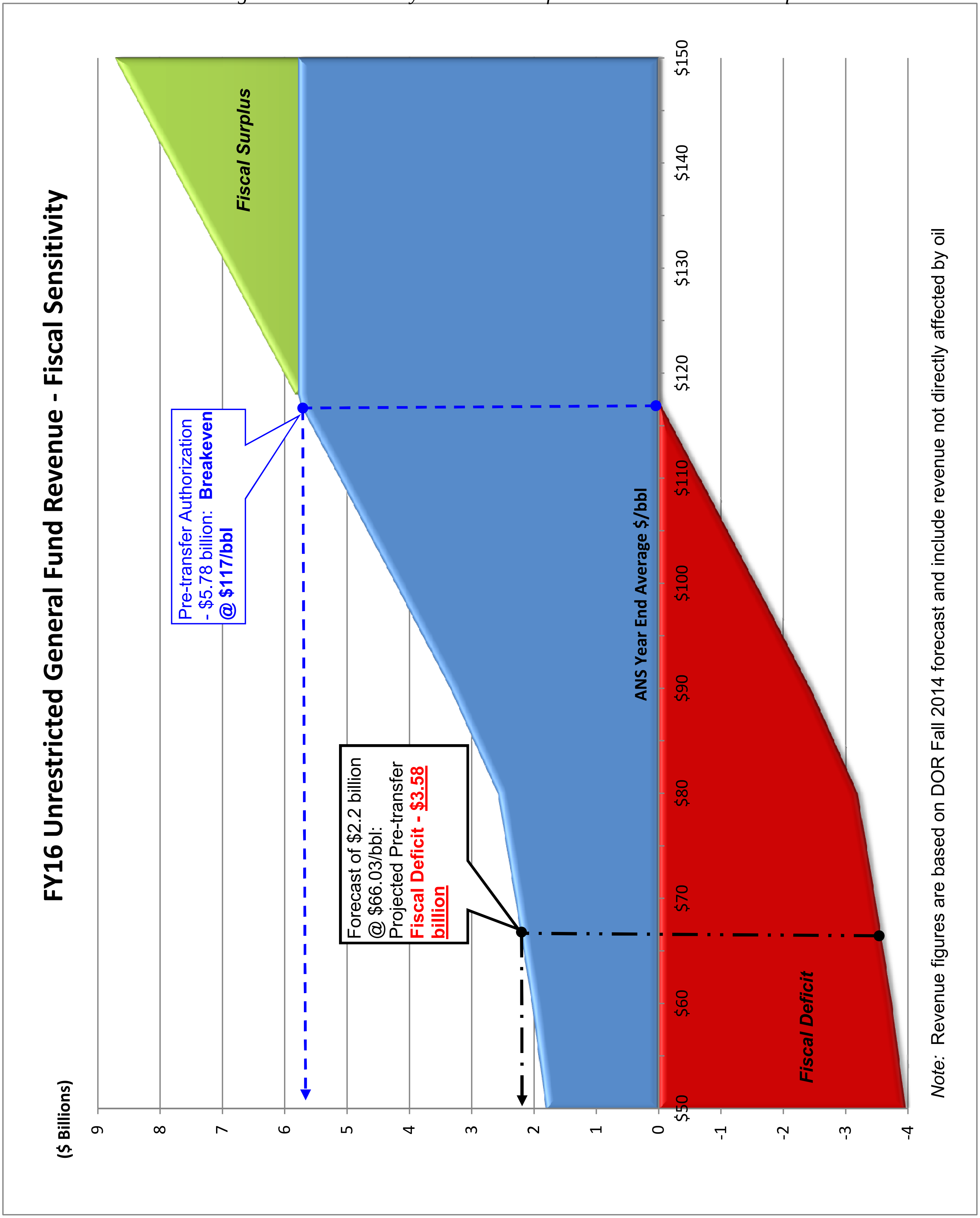
1. Typically require legislation, so they cannot be accomplished solely through the appropriation process.
2. May take substantial time to go from adoption to generation of revenue.
3. Are almost universally unpopular with citizens, who often have an entitlement mentality with regard to government services and to their (lack of) responsibility to pay for those services.
4. Are topics that legislators are reluctant to propose, which is understandable given the prevalent attitude of citizens.

Further Analysis

Although the fiscal summary (on page 10) provides a concise statement (and comparison) of projected revenue, appropriations and the size of the anticipated surplus or deficit, it has the limitation of being short on explanation. This *Overview* contains more detailed discussions of the Governor's FY16 budget submitted on December 15:

- Agency summaries (operating budget on pages 15 and capital budget beginning on page 75) provide a quick comparison of the Governor's proposed budget with FY15 spending.
- Narratives on individual agency operating budgets begin on page 87. Although the December 15 budget is a work-in-progress, many of the budget adjustments are expected to remain, and the issue analysis will remain valid.
- Language sections of both operating and capital bills (with analysis) begin on pages 29 and 84, respectively.

"Subcommittee Books" with more detail on each agency will be available in the Finance Committee rooms soon after the Governor submits amendments.


FY16 Unrestricted General Fund Revenue - Fiscal Sensitivity
($ Billions)
9
8
7
6
5
4
3
2
1
0
-1
-2
-3
-4
$50
$60
$70
$80
$90
$100
$110
$120
$130
$140
$150
ANS Year End Average $/bbl
Fiscal Surplus
Fiscal Deficit
Pre-transfer Authorization - $5.78 billion: Breakeven @ $117/bbl
Forecast of $2.2 billion @ $66.03/bbl: Projected Pre-transfer Fiscal Deficit - $3.58 billion
Note: Revenue figures are based on DOR Fall 2014 forecast and include revenue not directly affected by oil

State of Alaska Fiscal Summary-- FY15 and FY16 (Part 2)

($ millions)

Approximate Balances of Reserve Accounts

	FY15				FY16			
	BoY Balance	In	Out	EoY Balance	BoY Balance	In	Out	EoY Balance
Permanent Fund Principal -- Market Value (no appropriations allowed)	**45,002.0**	**1,688.0**	**0.0**	**46,690.0**	**46,690.0**	**1,681.0**	**0.0**	**48,371.0**
Undesignated Reserves	**21,858.2**	**2,986.5**	**8,823.7**	**16,021.0**	**16,021.0**	**3,191.0**	**5,981.5**	**13,230.5**
Total Excluding Permanent Fund	**15,647.1**	**270.5**	**6,593.7**	**9,323.9**	**9,323.9**	**357.0**	**3,662.5**	**6,018.4**
Constitutional Budget Reserve Fund (cash)	12,806.2	270.5	3,739.6	9,337.1	9,337.1	357.0	3,662.5	6,031.6
Statutory Budget Reserve Fund	2,791.0	-	2,791.0	0.0	0.0	-	-	0.0
Alaska Housing Capital Corporation Fund	49.9	-	63.1	(13.2)	(13.2)	-	-	(13.2)
Permanent Fund Earnings Reserve Account	**6,211.1**	**2,716.0**	**2,230.0**	**6,697.1**	**6,697.1**	**2,834.0**	**2,319.0**	**7,212.1**
Designated Reserves	**2,897.0**	**1,485.0**	**1,435.7**	**2,946.3**	**2,946.3**	**1,466.1**	**1,372.3**	**3,040.0**
Alaska Capital Income Fund	**75.8**	23.0	72.7	**26.1**	**26.1**	23.0	-	**49.1**
Alaska Higher Education Investment Fund	**460.6**	28.8	16.6	**472.8**	**472.8**	29.5	17.3	**485.0**
Public Education Fund	**1,202.7**	1,303.0	1,244.6	**1,261.1**	**1,261.1**	1,272.4	1,256.0	**1,277.5**
Revenue Sharing Fund	**180.0**	52.0	60.0	**172.0**	**172.0**	60.0	57.3	**174.7**
Power Cost Equalization Endowment	**977.8**	78.2	41.7	**1,014.4**	**1,014.4**	81.1	41.7	**1,053.8**
Reserves (Excluding Permanent Fund Principal)	**24,755.1**	**4,471.5**	**10,259.4**	**18,967.3**	**18,967.3**	**4,657.1**	**7,353.8**	**16,270.5**
Unrestricted General Fund Appropriations				6,105.6				5,859.2
Years of Reserves (Reserves/UGF Appropriations)				3.11				2.78