SUSTAINABLE BUDGET PROPOSAL
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My proposal is built around Scott Goldsmith's sustainable budget model. That approach takes a long-term view, treats all generations equitably by providing both current and future generations with the same share of the state's resources, and offers Alaskans significant predictability. (The model and a series of papers are available at www.iser.uaa.alaska.edu.)

Based on the assumptions in the model's supplemental sheet, the long-term sustainable spending number is in the range of $4.5 billion annually, adjusted thereafter for inflation and population growth. Consistent with the intent of the founders of the Permanent Fund, the sustainable budget approach includes as part of government revenues the income earned from the Permanent Fund remaining after deductions for paying Permanent Fund dividends and inflation-proofing the principal of the fund. If any of the significant assumptions fail to materialize, the sustainable number is less.

This proposal reduces spending to $4.5 billion by FY 2018. All spending is affected, but the largest share of reductions (36% of the total) falls on reimbursable oil tax credits, which are reduced and capped at the levels projected in fall 2014. Once reduced to $4.5 billion, all spending categories adjust with inflation beginning in FY 2019, except that additional funds are shifted from oil tax credits to capital spending, in significant part to help pay state costs for the planned LNG project.

Consistent with the sustainable budget approach, this proposal pays for current spending by combining oil revenues with income earned from the Permanent Fund in excess of the amounts required for the PFD and inflation proofing, supplemented by borrowings from the Constitutional Budget Reserve and accumulated past excess earnings from the Permanent Fund (held in the earnings reserve). Draws from the CBR and earnings reserve are repaid beginning in 2025, when revenues exceed the sustainable spending level because of LNG and growing financial earnings. Because long-term revenues are sufficient to fund spending, the proposal does not cap or reduce the PFD or rely on broad-based taxes.

A key to the proposal is continued monitoring and fiscal discipline. If any of the long-range assumptions change—for example, if the LNG project no longer appears likely, oil prices don't achieve anticipated levels, or financial returns are less than projected—then spending must be reduced further or supplemental revenues enacted. For the present, however, this approach responsibly reflects what we see ahead.

Graphs prepared by Gunnar Knapp to compare state finances for FY16 (this year) with projections under this proposal for FY17-FY21, if oil prices average $70/barrel.
SUPPLEMENT TO SUSTAINABLE BUDGET PROPOSAL
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Alaska’s overriding fiscal challenge is its cyclical nature—it goes through cycles of high revenues, followed by lower revenues, then followed again by higher revenues. Alaska historically has dealt with these cycles through a short-term lens, by raising spending significantly when prices are high and reducing spending significantly when prices are low. This cyclical approach leads to serious economic dislocations and uncertainty. More importantly, it also leads to serious intergenerational issues, with some generations of Alaskans benefitting from the state’s wealth more than others, solely depending on where they happen to fall in the cycles.

While some have suggested we have entered a permanent condition of lower revenues, it is more likely we simply have entered another—although possibly extended—low cycle. As the graph on the left indicates (Figure 1), given rising financial returns on the state’s fiscal nest egg and assuming the success of an LNG project, one can foresee coming out the low cycle sometime in the early to mid-2020’s.

The question this challenge raises is how to develop a fair fiscal policy that creates a stable and reliable economic environment through both types of cycles and as importantly, treats all Alaskans fairly regardless of where they happen to fall in the cycles.

Dr. Scott Goldsmith has done considerable work on an approach that identifies a middle ground through the cycles by developing a long term, sustainable budget number that if followed, enables consistent spending at equal levels, adjusted for inflation and population growth through both types of cycles. The approach contemplates putting revenues in excess of the sustainable level into reserve accounts during periods of high revenues and drawing on those reserves to maintain the same level of spending (again, adjusted for inflation and population growth) during periods of low revenues. His series of papers on the subject can be found at http://goo.gl/3qvkD.

The approach not only reduces dislocations and uncertainty, it also assures citizens, businesses and investors who are otherwise concerned about the potential of reduced PFD payments or increased taxes during periods of challenging economic conditions, the very time they are least prepared for them. It was the approach that Governor Walker had in mind when he said this during the campaign: “I will make the hard choices necessary for a sounder fiscal future, including putting in place a sustainable budget. I will work to make sure the investment climate in Alaska supports those goals, which includes creating a favorable fiscal climate for citizens and companies investing in our economy.”

In his most recent paper (http://goo.gl/fs7INX) Dr. Goldsmith calculates the sustainable budget number at $4.5 billion (the solid black line in Figure 2, next page). While current oil prices have dipped since the preparation of that paper, the sustainable budget number is based on long-term price forecasts, includes a portion of the return from Alaska’s fiscal assets, which have become and will continue to grow in significance, and also includes an estimate of the returns from the LNG project. As a result of those multiple inputs, and looking beyond current price levels which reflect more of an excess supply overhang than long term trends, the sustainable number remains largely in the same range.
As usual in low-revenue cycles, the challenge is how to supplement current revenues to maintain sustainable spending levels through the cycle. As the graph on the left indicates (Figure 2), the proposal I have submitted funds the spending level through draws from two sources: (1) the Constitutional Budget Reserve and (2) the use of accumulated past income from the Permanent Fund remaining after deductions for the PFD and inflation proofing. The size of the draws over the term of the 10-year cycle total roughly $14.5 billion, well within the combined capacity of the two accounts.

**There are two keys to the approach.** The first is that, once a high revenue cycle returns, the state exercises the fiscal discipline necessary to limit state spending to the sustainable spending level and excess revenues are used to refill the state's reserves (which surely will be needed again when the next low cycle occurs). If the state fails to do that (as occurred from roughly 2010 through 2014), the long term sustainable number (which is based in part on earnings from the reserves) drops and the state is much less prepared to weather the following low cycle than otherwise would be the case. As the above graph (Figure 2) indicates, the state should reenter a high revenue cycle in the mid-2020s. If the state maintains fiscal discipline once it does, the excess revenues will refill the draws made during the current low cycle by the mid-2030s and then begin to build again to help provide funds in subsequent years to offset forecasted oil and LNG declines.

The second key is constant monitoring. As is clear from both Figures 1 and 2, anticipated revenues from Alaska LNG ("Natural Gas") are a significant part of the anticipated future revenue stream. As the graph on the left indicates (Figure 3), without it the targeted $4.5 billion spending level is no longer supportable. Instead, the sustainable number resets to roughly $3.8 billion and future fiscal strategies must start from there.

There are some who currently believe the Alaska LNG project is a non-starter and future fiscal policy should be shaped without it. Having spent a large part of my career advising and working on large-scale oil and LNG projects, I disagree. Based on current information I believe the Alaska LNG project remains on track and, if it continues to do so, that there is a place for it in the global environment. Based on that, I believe that the various steps others have suggested, such as cutting government spending dramatically below $4.5 billion or at the other end, enacting taxes, or cutting the PFD to support current spending levels, is an overreaction with potentially severe consequences to the overall Alaska economy. But I admit it is important to closely monitor the situation and if, as with any other significant inputs into the calculation, future events show a change in direction, the state's fiscal targets will need to be modified.