

## **The Crude Oil Blues: Alaska's 2017 Budget Process**

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### **Introduction**

Between 1980 and 2014, Alaska's state government was supported almost entirely through a combination of federal receipts and tax revenues from oil and gas production. In 1980, shortly after oil started flowing through the Trans Alaska Pipeline System, the state legislature repealed Alaska's state income tax. Since then, the state has relied on oil for around 90 percent of its own revenues.

Although Alaskan oil production has been in gradual decline since 1988, oil prices began rising in 2002 and, with the exception of a dramatic though short-lived drop in 2009, remained at historically high levels until 2014. High oil prices kept state tax revenues high and made additional revenues unnecessary—for example, from a state sales, income, or property tax. In August 2014, however, global oil prices began a dramatic decline, which led to dramatic deficits in fiscal years 2015 and 2016. Fortunately, Alaska began 2014 with significant savings.

With no dramatic increase in oil prices on the horizon, however, Alaskan politicians began to realize that the state's reliance on petroleum revenues was unsustainable. In previous budget cycles, the governor and legislature implemented meaningful budget cuts, amounting to around 30 percent of the state budget after accounting for inflation and population growth (D. Cole 2016), but the need for new revenues became ever more obvious as time went on. In 2016, the legislature finally began to seriously contemplate new sources of revenues.

During the 2016 legislative session, the Alaska State Legislature considered several approaches to generating new revenues, including a sales tax, income tax, and using earnings from the Alaska Permanent Fund. The legislature also made significant progress on passing a budget with substantial additional reductions compared to the last several years. Although it seems unlikely that the Fiscal Year (FY) 2017 budget will completely close the state's deficit, it seems possible, for the first time in decades, that it will include historic changes to the state's approach to generating revenues. The political unpopularity of every possible option the state faces, however, makes every approach controversial—cuts, taxes, and use of the state's savings are all opposed by key constituencies. Ultimately, the key question the legislature faced was what approach will be least politically harmful. Unfortunately, given Alaska's conservative political climate, it seems that the most likely outcome to the state's political/fiscal crisis is a combination of measures that will prove to be highly regressive, including reduction or elimination of Alaska's Permanent Fund Dividend and the implementation of some type of sales tax.

## Alaska's Economy in 2016

Despite low oil prices and predictions that Alaska would fall into a recession in 2015 or 2016, the Alaskan economy remained resilient into 2016, despite significant tailwinds. However, Alaska's resilient economy does little for the state government budget, due to the state's high reliance on oil for tax revenues.

### Oil

Although oil production in Alaska began as early as the 1950s in Cook Inlet (south of Anchorage), Alaskan oil became globally important in the early 1980s, as the Trans Alaska Pipeline System (TAPS) began to move Alaskan light, sweet crude from Prudhoe Bay on the Arctic Ocean to the port of Valdez in South Central Alaska. Oil revenues quickly became the most important source of revenue for the state of Alaska, in most years nearing 90 percent of the state's revenues, after excluding federal transfers. Because of the state's reliance on oil for its tax revenues, Alaska's budget expands when oil prices and oil production are high, and when production and prices are low, the state government's revenues and expenditures contract.

Alaska has experienced two notable contractions since oil became an important driver of the state's economy. The first (and by far the most dramatic) of these was in the late 1980s, and the second was in the 1990s, both concurrent with global increases in oil supplies and subsequent price declines. Between 1985 and 1988, low global prices for crude oil led to dramatic declines in state government revenues, widespread layoffs, and a decline in median family income of nearly \$10,000.<sup>1</sup> In the late 1990s, a similar drop in the price of oil led to a much softer landing for Alaska's economy, as low oil prices were buffered by relatively high and stable state government spending. In effect, the state used its savings to keep low oil prices from impacting the state's economy.

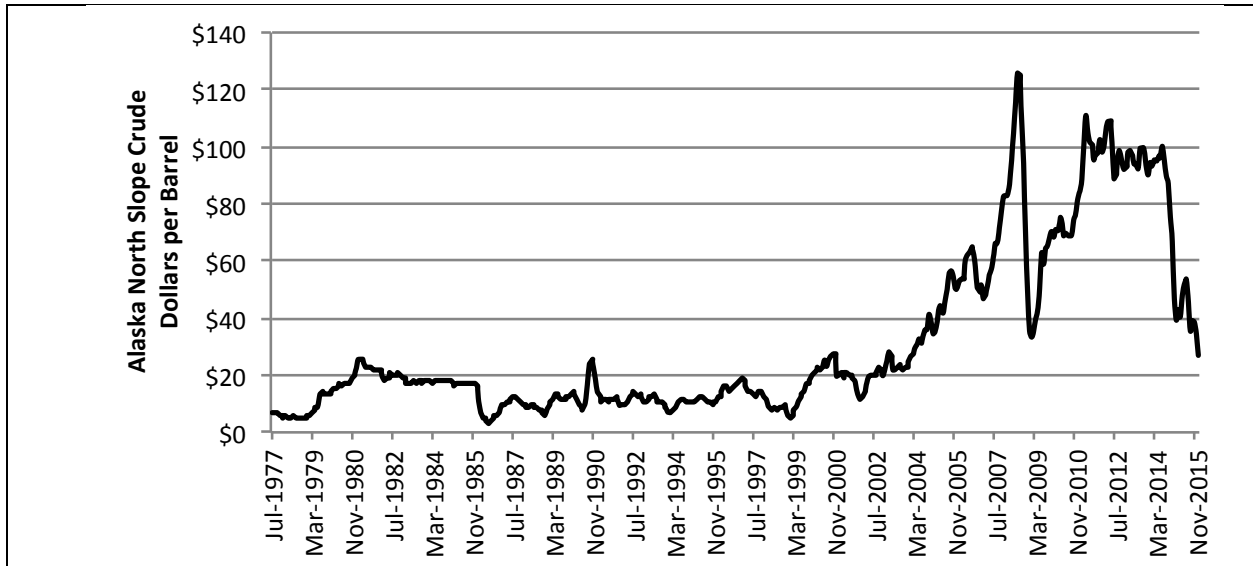
Beginning in the summer of 2014, global oil prices began a steady and sustained decline, driven by increased tight oil production (shale oil and fracking) in the United States and elsewhere, increased pumping in the Middle East (most notably Saudi Arabia), and decreased demand for energy due to a slow global economy and lower prices for so-called "green" energy (solar, wind, and small-scale hydropower, for example). With the exception of a dramatic but short-lived price decline in 2008–2009, this sustained price decline was the largest dollar decrease in the price of Alaska's oil since TAPS came online in the early 1980s (see Figure 1).

More important (and, for Alaskans, more worrying) than this dramatic, short-term price decline was the long-term production decline on Alaska's North Slope. Alaskan oil production peaked in 1988 and has declined by about 75 percent from peak production (see Figure 2). Since the 1980s, Alaska has repeatedly changed its oil tax regime to generate maximum revenue, to promote new investment in oil extraction, and to protect itself from declining production and fluctuating prices, most recently in 2014. In October 2016, Caelus Energy made additional discoveries of oil on the North Slope, roughly six million barrels, but pulling it out of the ground and moving it to a pipeline still prove difficult. However, declining oil production and low prices have led to a substantial deficit—around 75 percent of the state's FY 2016 budget was deficit spending (about \$3.5 billion of a \$4.5 billion deficit). The gradual depletion of Alaska's conventional oil deposits inevitably will require the state to return to a more conventional system to gen-

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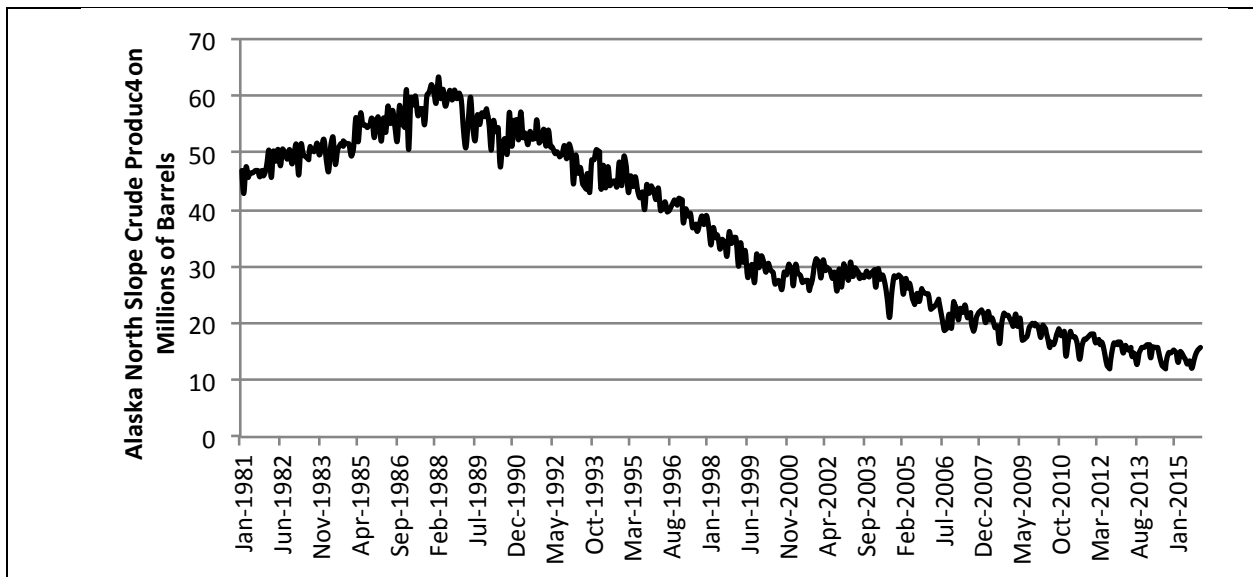
<sup>1</sup> Federal Reserve Economic Data.

**Figure 1. Alaska North Slope Crude Oil Price per Barrel.**



Between 2002 and 2014, rising and high oil prices masked Alaska’s oil production decline. However, since 2014, dramatic declines in Alaska North Slope Crude (and global oil prices) have cut deeply into Alaska’s tax revenues. Monthly first purchase price.<sup>2</sup>

**Figure 2. Alaska North Slope Monthly Oil Production.**



Alaskan oil production has been in decline since the late 1980s, although fluctuations in prices have often masked the fiscal effects of this decline.<sup>3</sup>

<sup>2</sup> U.S. Energy Information Administration. <http://tonto.eia.gov>. Retrieved March 3, 2016.

<sup>3</sup> US Energy Information Administration. <http://tonto.eia.gov>. Retrieved March 3, 2016.

erate revenue—mostly likely a sales tax, income tax, or both. Over the last several years, though, Alaska has funded its deficit by drawing down the principal of Alaska’s Constitutional Budget Reserve (CBR), the second-largest of the state’s sovereign wealth funds (discussed below, under “Alaska’s Reserve Funds”).

## Employment

Despite these worrying trends in oil prices and production, the Alaskan economy, so far, appears to be largely unaffected. Employment remains relatively high, and although there is some evidence that economic growth has slowed, there is little evidence for a state recession.

In the wake of the 2008 financial crisis, unemployment in Alaska increased slightly, to about eight percent—less than a two percentage point increase from precrisis levels. This compared favorably with the dramatic increases in unemployment nationwide (see Figure 3). Starting in 2014, economists predicted a recession—possibly a deep recession—as a result of relatively low oil prices, which would lead to lower oil and gas sector employment and lower state government revenues (DeMarban 2016a). Such predictions may come true in time, but the Alaskan economy has proven resilient so far, with no notable increase in unemployment since 2014. Were the state to generate significant revenue from sources other than taxes on the oil industry—for example, if Alaska had a sales tax or income tax—it appears likely that those revenues would have been largely unaffected by the decrease in the price of oil in 2014, 2015, and the first quarter of 2016. Two factors have likely driven the resilience of the Alaskan economy. First, although oil and gas is by far the largest contributor to state coffers (over 90 percent of the state’s nonfederal revenues in many years), a relatively small number of people are employed by Alaska’s oil and gas sector (only four percent as of December 2015).<sup>4</sup> Second, state expenditures have been relatively unaffected by the state’s declining revenues, because the state has been able to fund deficit spending with savings.

## Fisheries

In general, Alaska’s commercial and sport-fishing industries are healthier than at any time since statehood. Although there are important exceptions, Alaska’s fisheries are generally healthy, and yields are at near-record levels, with Alaska’s commercial fishery landings bringing in \$1.7 billion in revenues in 2014.<sup>5</sup> The revenue total for 2015 increased slightly to \$1.76 billion, and although the economic benefit of fisheries may have been lower than in 2014 due to a glut of salmon on global markets, Alaska’s fishing industry—including both commercial and sport-fishing industries—is healthy. Unfortunately, fishing contributes little to state government revenues—Alaska generates around six percent of its revenue from taxes on fisheries,<sup>6</sup> although some municipalities are substantially supported through taxes and fees on commercial fishing. In addition,

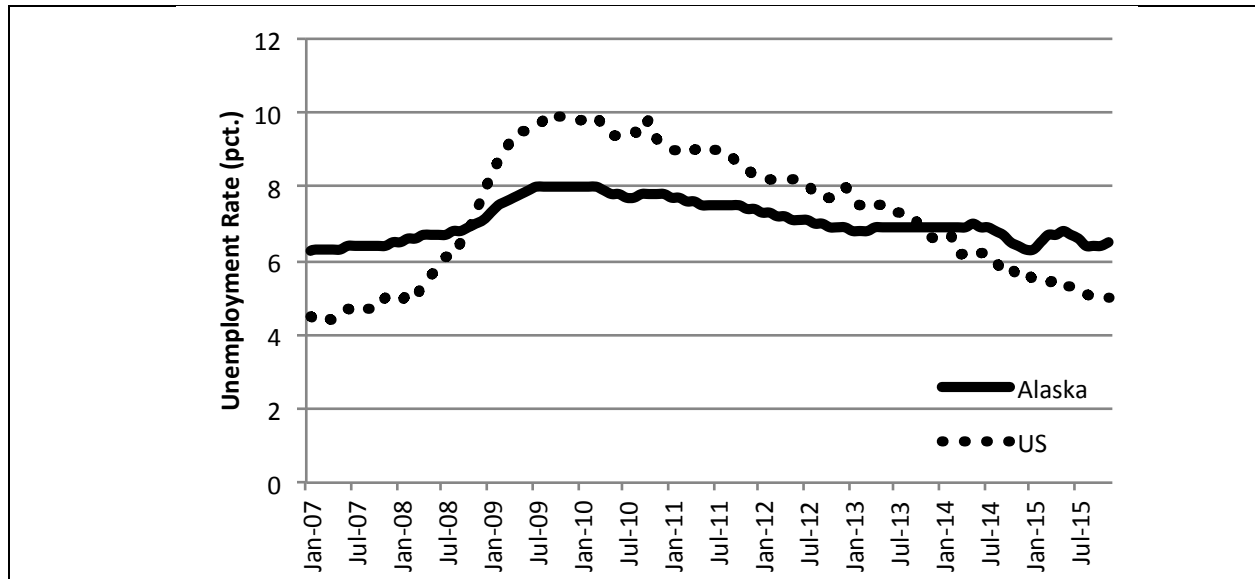
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<sup>4</sup> Federal Reserve Economic Data

<sup>5</sup> National Marine Fisheries Service Commercial Landings data. <https://www.st.nmfs.noaa.gov>. Retrieved November 25, 2016.

<sup>6</sup> Here, “fisheries” is defined broadly, to include most taxes on the seafood industry and commercial and sport fishery taxes and fees. Data from <http://www.tax.alaska.gov/programs/programs/reports/AnnualReport.aspx?Year=2015>

**Figure 3. Unemployment in Alaska.**



Alaska was relatively unaffected by the 2008 economic crisis, and although relatively high structural unemployment in Alaska has led to long-term unemployment rates higher than those of the United States as a whole, Alaska’s unemployment rate has, so far, been relatively unaffected by low prices for Alaskan oil. Seasonally adjusted monthly unemployment rate (Alaska) and seasonally adjusted monthly civilian unemployment rate (U.S.).<sup>7</sup>

fishing licenses and other fees related to sport fishing provide some support for state government conservation efforts and fish and game regulation enforcement.

### **Timber**

As recently as the 1990s, timber harvest was a mainstay of Alaska’s economy, although large-scale forestry was largely limited to the southeast panhandle. Several factors—including declining prices for lumber and paper due to increased global supplies, stricter Forest Service regulation, aging infrastructure, and the too-rapid harvest of old-growth timber in the ’60s, ’70s and ’80s—led to the rapid decline of southeast Alaska’s forestry industry. Today, timber is no longer a significant employer in any part of the state, and does not contribute in a meaningful way to state revenues. Although the U.S. Forest Service has recently begun to discuss a gradual increase in timber harvest on federal lands in southeast Alaska—a so-called “transition to second growth harvest”—forest harvest will not contribute significantly to state revenues for the foreseeable future.

<sup>7</sup> Federal Reserve Economic Data. <https://research.stlouisfed.org/fred2>. Retrieved March 3, 2016.

## **Tourism**

The tourism industry remains an important part of the Alaskan economy, although it contributes little to state government revenues. Tourism visits were up about seven percent between 2014 and 2015, with the largest increases in arrivals by air, which ushered more than two million tourists into the state during the 2015 tourist season. Cruise ship visits for the 2016 season surpassed one million and are expected to increase by another 35,000 for the 2017 season with the Princess, Holland America, and Norwegian cruise lines increasing capacity for their Alaskan voyages before 2018. These increases in cruise ship visitors translate directly into revenue for the state as the state of Alaska imposes a head tax of around \$32 per person on commercial passenger ships with more than 250 berths, and around 33 percent on income from gambling aboard passenger vessels. Municipalities, however, are allowed to siphon off the great majority of head tax revenues, and consequently, the state of Alaska only generated about \$2.2 million from head taxes in 2015.

## **Mining**

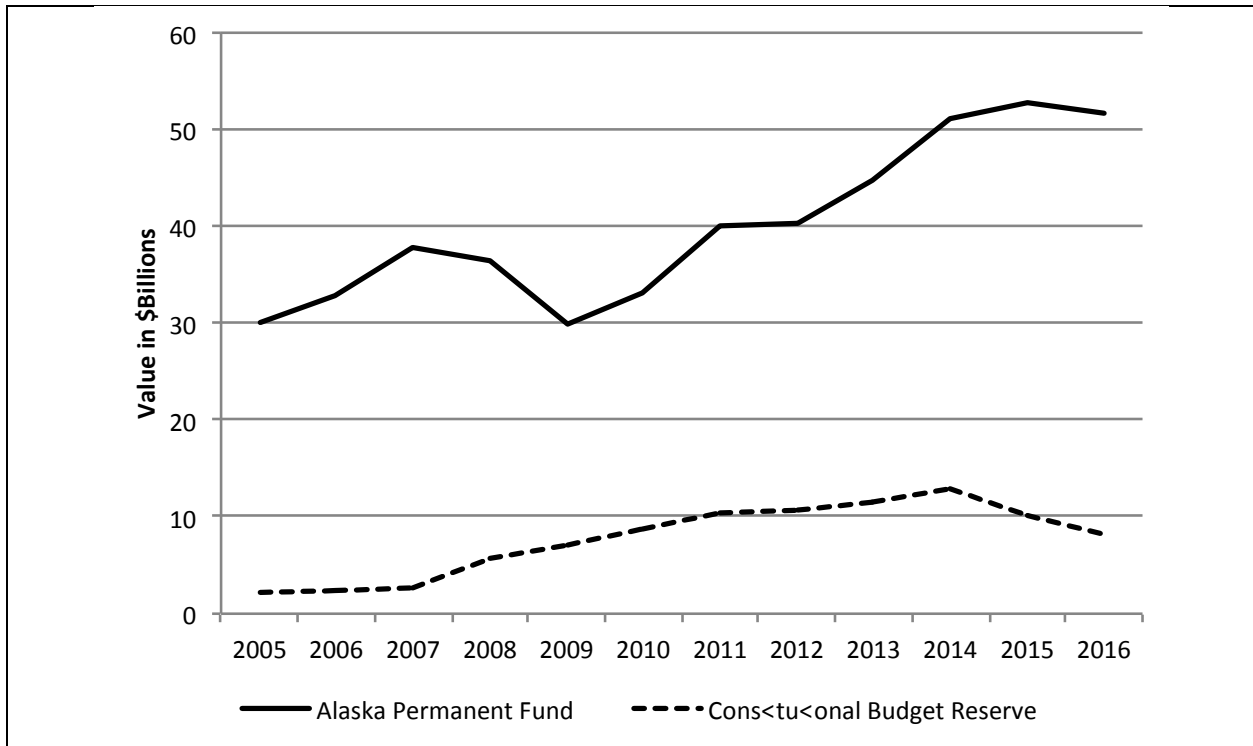
Mining also generates revenue for the state of Alaska; Alaska has a “mining license tax,” which is, in effect, a progressive tax on mining firms which increases from zero to seven percent depending on each individual firm’s net income (Alaska Department of Revenue 2010). There are a number of large, hard-rock and open pit mines in Alaska, including copper, zinc, silver, and gold mines. While the State Department of Revenue reports that mining revenue is likely to fall for 2016, as a result of falling commodity prices (Tax Division 2015), for less than \$15 million in operating and capital expenses, the state receives more than six times that in revenues: \$96.4 million from the mining industry (Loeffler and Colt 2016).

## **Alaska’s Reserve Funds**

Although Alaska is not unique among the U.S. states in its ownership of sovereign wealth funds, Alaska’s investment funds are uniquely large; the most well-known of Alaska’s several investment funds, the Alaska Permanent Fund, is currently valued at over \$50 billion. The second-largest of Alaska’s funds, the Constitutional Budget Reserve is also quite large—currently over eight billion dollars (down from about \$12 billion two years ago). The Alaska Permanent Fund

Just as oil production from Alaska’s North Slope has declined, the size of the Alaska Permanent Fund has grown, and earnings from Alaska’s financial investments have, for the last several years, been greater than earnings from taxes on oil. However, earnings from the Permanent Fund have not typically been used to fund government operations, and instead are primarily reinvested in the fund and are used to pay out Alaska’s famous (or infamous) Permanent Fund Dividend. In 2015, Alaska’s Permanent Fund Dividend (PFD) was \$2,072 dollars, which means that almost every Alaska resident received a \$2,072 payment in early October (Klint and Doogan 2015). The value of the permanent fund increased in 2015, to \$52.8 billion, though the size of the fund declined somewhat into 2016 to \$51.5 billion in March. The 2016 PFDs were slated to be slightly smaller than the 2015 dividend, at \$2,042, but were halved by Governor Bill Walker in an effort to prolong the life of PFD program. This led to a lawsuit filing on behalf of a few current and former legislators to return the other half to Alaskans, declaring this veto beyond the governor’s

**Figure 4. Alaska’s Reserve Funds.**



While budgets have drawn on and continue to reduce the size of Alaska’s easily accessible Constitutional Budget Reserve fund, the Alaska Permanent Fund continues to experience healthy long-term growth. Reserves currently total nearly \$60 billion.<sup>8</sup>

authority (Herz 2016b). It didn’t take long for a Superior Court judge to side with Governor Walker in his interpretation of the Alaska State Constitution (*Alaska Dispatch News* 2016).

As the size of the permanent fund has grown, and as Alaska’s oil revenues have declined over the last few years, a number of commentators and politicians have proposed using the earnings of the permanent fund to close our fiscal gap (McGuire 2016, Walker and Mallott 2016). Such an approach is attractive to many legislators, because politicians can shrink or eliminate Alaska’s deficit, at least for several years, by using permanent fund earnings without implementing a sales tax or an income tax. Although the principal of the fund is protected in Alaska’s Constitution, there is no restriction on the legislature’s ability to use fund earnings. However, 35 years after it was created, the permanent fund dividend is very popular and is viewed as an entitlement by many Alaskans. Arguably, this is consistent with the goals of the dividend program—some have argued that the dividend was primarily a tool to create a constituency that would fight to protect the permanent fund (Hammond 2012). Certainly, the permanent fund dividend has been fabulously successful in protecting the permanent fund. Although the fund is under-researched, there is also some evidence that it has a stimulatory effect on Alaska’s economy and

<sup>8</sup> Alaska Permanent Fund Corporation and Alaska Department of Revenue. <http://www.apfc.org/> and <http://treasury.dor.alaska.gov/Investments>. Retrieved March 12, 2016.

is an important factor in reducing economic inequality in Alaska, which is currently the lowest of any U.S. state (Goldsmith 2012). Consequently, many state politicians fear the political and macroeconomic consequences of reducing or eliminating the dividend by spending fund earnings.

## **Alaska Constitutional and Statutory Budget Reserves**

Historically, Alaska has managed several other sovereign wealth funds. The third of these—the Statutory Budget Reserve (SBR)—was worth about \$3.7 billion in 2014, but could be relatively easily accessed by the legislature, requiring only a majority vote, and was liquidated in 2015 in order to fund a portion of Alaska’s deficit.

The second-largest of Alaska’s funds is the Constitutional Budget Reserve (CBR), which was a receptacle for surplus revenues from multistate lawsuits against U.S. Tobacco firms and Alaska’s lawsuit against Exxon-Mobil in the wake of the Exxon Valdez oil spill. The fund was created in 1990, and was depleted in the late 1990s, when oil prices declined and the state ran large deficits. However, when oil prices rose again in the mid-2000s, the CBR was replenished, and Alaska has used CBR funds to balance its budget in the last several years. In 2014, the value of the fund peaked, at around \$12.8 billion. Today, the fund is worth approximately \$8.2 billion. If Alaska’s deficits are not reduced through some combination of budget cuts and new revenues, the remainder of the CBR will be spent in two to three years.

One important point about the Constitutional Budget Reserve is that it can only be spent with the approval of three quarters of the members of both chambers of the state legislature. This has given the minority party in the legislature disproportionate power when the legislature hopes to tap the CBR. In the Senate in 2016, Republicans have been able to entice two rural Democrats into a majority coalition, giving the coalition a three-quarters supermajority. In the House, however, a minority coalition of Democrats and one Independent currently controls 13 of 40 seats, making it likely that they will be able to impact the shape of the FY 2017 budget in a meaningful way.

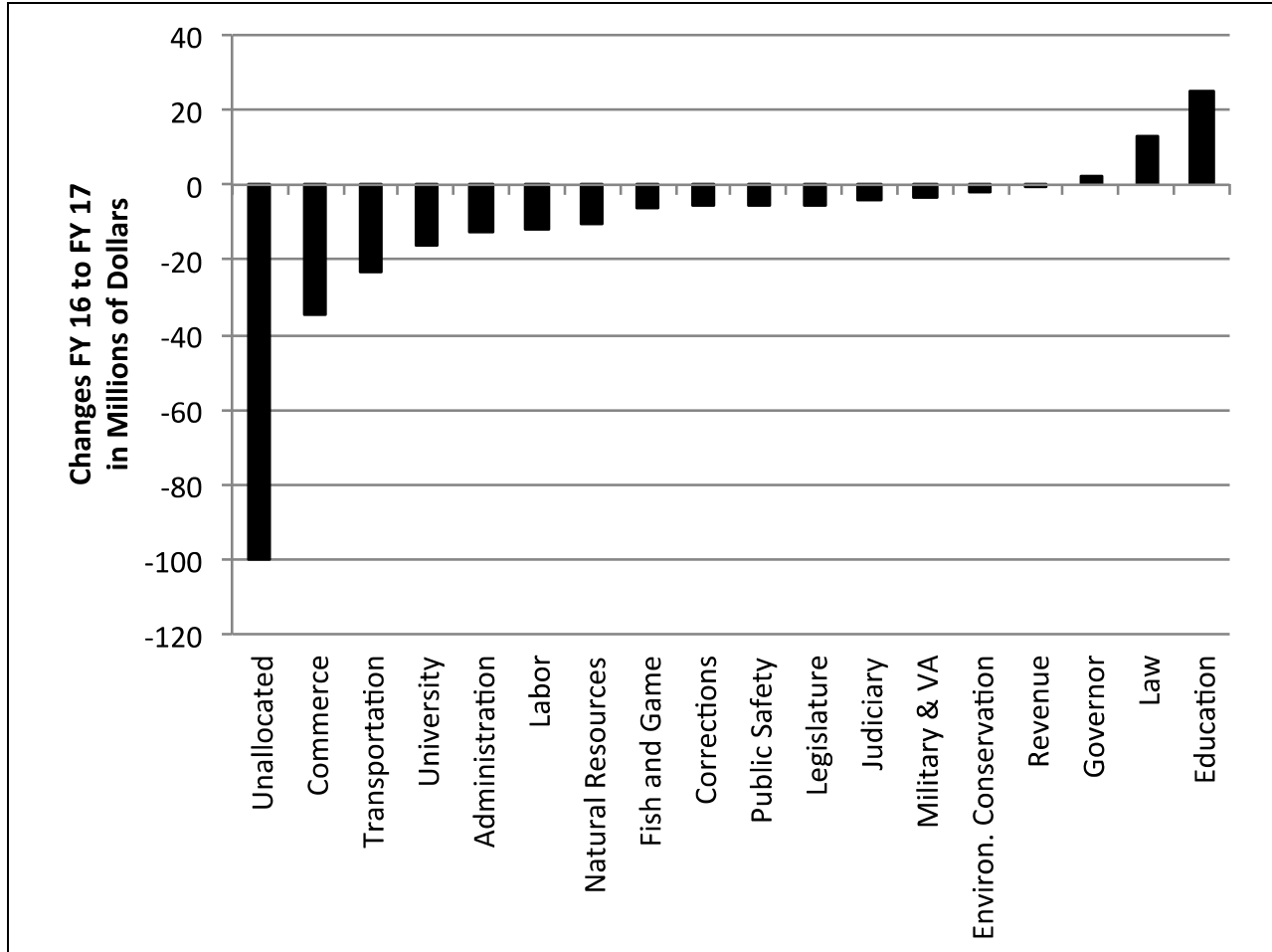
## **Budget Reductions**

Because of Alaska’s significantly reduced revenues, the state government has continued to reduce expenditures for the FY 2017 budget. Unrestricted general fund use for agency operation budgets were decreased by 5.7 percent from FY 2016, and general funds by 3.1 percent. FY 2016’s capital budget was already \$2.5 billion smaller than in FY 2015, and was pared down by another 18.3 percent for the next fiscal year. The governor himself vetoed nearly \$1.3 billion across 11 departments, the University of Alaska system, and debt service (DeMarban and Rosen 2016).

## **Capital Budget**

Like the FY 2016 budget, Alaska’s FY 2017 capital budget remained small. Governor Walker’s budget request was for just over \$1.2 billion, with \$957 million of that in federal receipts. The state’s capital outlay under the governor’s budget request will be around \$300 million, which is only a hair larger than 2016’s capital outlay of about \$235 million. The striking thing

**Figure 5. Winners and Losers, by Dollar Amount.**



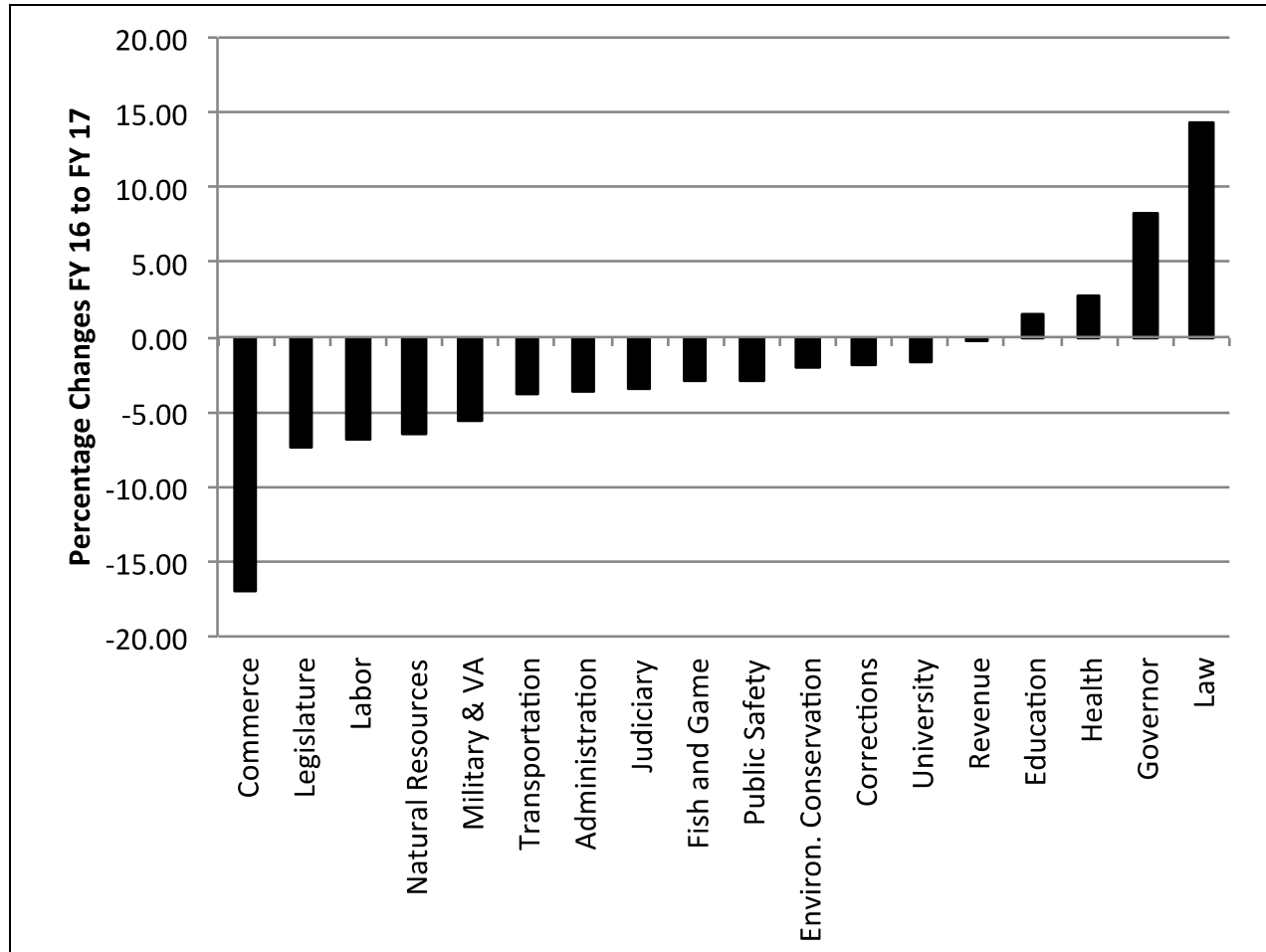
By far the largest proposed budget reduction for FY 2017 is an “executive branchwide unallocated reduction.” The Department of Commerce, Transportation, and the University System also received significant reductions. Meanwhile, the Governor’s office, Department of Law, and Department of Education received increases.<sup>9</sup>

about these numbers is how dramatically they differ from the FY 2014 or FY 2015 capital budgets, both of which totaled about \$2.1 billion, with around \$1 billion in state expenditures; the state has reduced its capital expenditures by around 70 percent between FY 2015 and FY 2017.

Conspicuous by their absence from the capital budget are several large, controversial projects that were in their early stages when oil prices began to drop in 2014. These include the enormous Susitna-Watana hydroelectric project, the “Juneau Access Project,” a road and ferry system that would have given improved access to the capital, a road to the Ambler mining dis-

<sup>9</sup> State of Alaska Legislative Finance Division. <http://www.legfin.akleg.gov/BudgetReports>. Retrieved March 20, 2016.

**Figure 6. Winners and Losers, by Percentage Change.**



With over a 17 percent reduction for FY 2017, the Department of Commerce, Community and Economic Development took by far the largest cut. The legislature, and departments of Labor, Natural Resources, and Military and Veterans Affairs also took large cuts. State of Alaska Legislative Finance Division. <http://www.legfin.akleg.gov/BudgetReports>. Retrieved March 20, 2016.

tract in the Brooks Range, and a bridge across Knik arm just north of downtown Anchorage. Those projects that remain involve deferred maintenance, the continued retrofitting of the Capitol, and a statewide mobile radio system.

### **Operating Budget**

The Alaska FY 2017 operating budget, like the capital budget, includes significant cuts from prior years. The governor’s budget request called for a \$4.5 billion expenditure from unrestricted revenues, compared to roughly \$5.1 billion in FY 2016, and the state House of Representatives and Senate called for even deeper cuts.

By far the largest cut proposed by the legislature is a \$100 million unallocated cut that the Senate refers to as a “place holder” for future reductions (Herz 2016b). The significance of this placeholder is unclear—one possibility is that the legislature will attempt to use this unallocated cut as a way to force the executive to make the difficult choices about budget reductions, thereby attempting to avoid the political costs of budget reductions. A second possibility is that additional cuts will be made in the conference committee process, as the Senate reconciles their somewhat more generous budget bill with the House’s more austere proposal.

The largest agency cut for FY 2017 is an approximately \$15.3 million, 50.1 percent, reduction to the department of Commerce, Community and Economic Development. Cuts to this department were made in the tourism marketing sector and to the Alaska Gasline Development Corporation.

The second-largest operating budget reduction, by percentage, was a roughly 16.2 percent reduction in funding for Environmental Conservation. This was a relatively small reduction in dollar terms (\$3.2 million) that was mostly paid for through staff furloughs. Other departments have decreased their own costs through furloughs; the Alaska Court System began closing its doors early on Fridays to cut its own budget saving the state roughly \$2 million annually.

An additional set of reductions was proposed by reducing the rent paid for the legislature’s Anchorage office building—part of a debate on whether Alaska’s Anchorage-based senators and representatives should occupy a controversial new office building viewed as wasteful in the current fiscal climate.

The enacted FY 2017 budget also includes a 14.7 percent reduction to the Department of Fish and Game (about \$9.5 million). This reduction includes cuts to administrative budgets and most significantly to the Commercial Fish Entry Commission.

In an opinion letter to the Alaska Dispatch News in September 2016, Governor Bill Walker wrote: “We could close every school and every prison, and we still wouldn’t have enough money to pay for state services” (Walker 2016). With such a large deficit and low revenues, it is very unlikely Alaska will be able to cut its way to a balanced budget and state lawmakers will continue to debate increases in revenue.

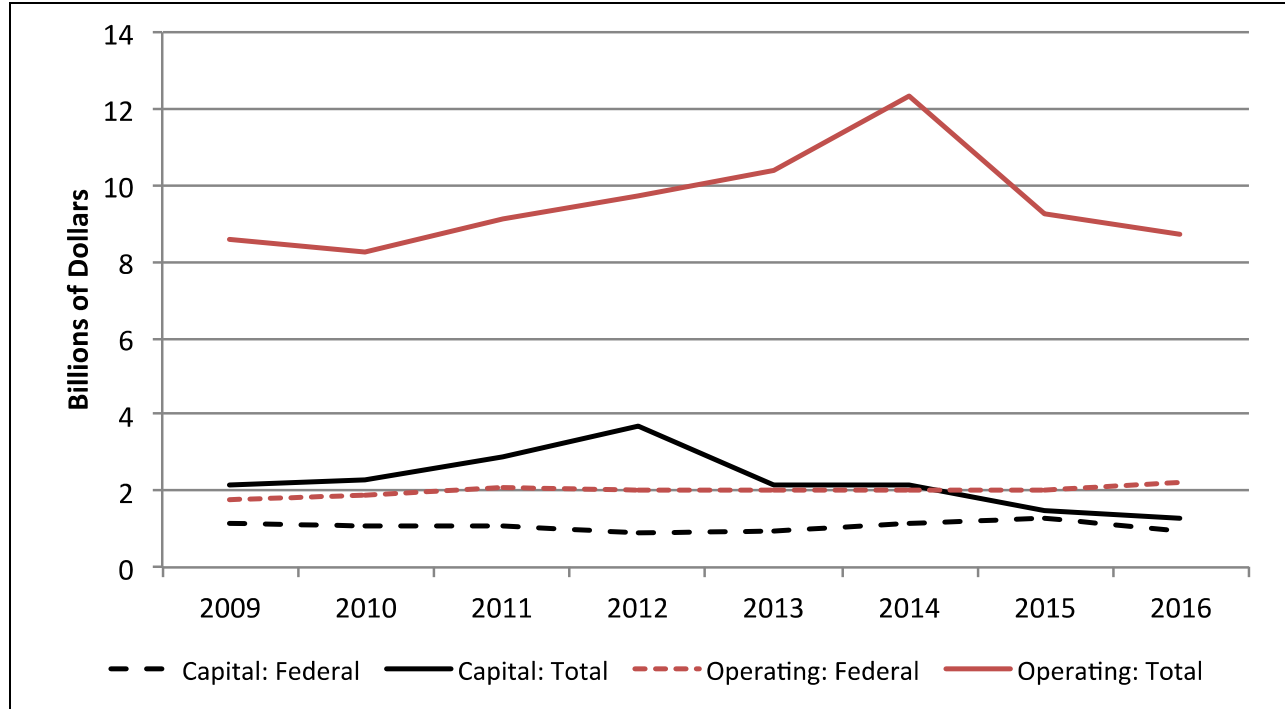
## **Policy Issues**

In addition to a generally difficult fiscal year with substantial budget cuts, Alaska faces a number of policy questions with clear fiscal implications. Potential declines in federal receipts, Medicaid expansion under the Affordable Care Act/Obamacare, criminal justice reform, Alaska’s North Slope natural gas pipeline, and a reform of oil and gas production tax credits are all on the agenda.

## **Federal Receipts**

Historically, the federal government has spent generously in Alaska. In the 1990s and early 2000s, Alaska’s congressional delegation—which enjoyed seniority and the powerful committee chairmanships that went along with it—was viewed as an open pipeline to Alaska-specific appropriations. When Senator Ted Stevens was defeated in 2008 in the wake of a corruption scandal, many Alaskans feared that Alaska’s high per-capita federal receipts would decline with the loss of Stevens’s political influence. These concerns were compounded by fears that expenditures would decline due to the congressional sequestration process, and general move away from

**Figure 7. Federal Receipts And Total Budget Expenditures over Time.**



While Alaska’s capital and operating budgets have changed over time, federal receipts have been relatively steady. <http://www.legfin.akleg.gov/BudgetReports>. Retrieved March 21, 2016.

earmarks in federal spending bills. Such fears appear to have been unfounded. While Alaska’s capital and operating budget expenditures have changed over time (typically following the price of oil and therefore, Alaska’s tax revenues), levels of federal spending in Alaska’s state budget have remained relatively constant over time and do not appear to have declined after 2008. Today, federal receipts make up about 76 percent of Alaska’s capital budget and around 25 percent of the operating budget—roughly \$1.2 billion and \$2.2 billion, respectively. Figure 7 shows the relative sizes of federal receipts and total budget sizes over the past several budget cycles.

### **Medicaid Expansion**

When Alaska’s current governor, independent Bill Walker, first ran for office in 2014, he campaigned hard on the issue of Medicaid expansion in Alaska under the Affordable Care Act (“Obamacare”). Walker twice attempted to gain legislative approval for his efforts to expand Medicaid, but was rebuffed by Republican opponents in the legislature. Subsequently, Walker chose to expand Medicaid without legislative approval, a process that continues to play out in the court system.

In Spring 2015, Walker submitted an operating budget to the legislature that included funding for Medicaid expansion. Republican leaders in the legislature, however, argued that Medicaid expansion was too significant a change to take place without substantial legislative vetting

and stripped Medicaid expansion from the budget (Moritz 2015). In response, the Walker Administration prepared and submitted a bill to the legislature that would have expanded Medicaid. However, that legislation stalled in committee (Forgey 2015).

After the end of the Spring 2015 legislative session, the Walker Administration sought legal advice from the Alaska Department of Law on the legality of expanding Medicaid in Alaska through executive fiat. Alaska's attorney general agreed with the Walker administration that, under existing Alaska law, it is legal for the executive to accept federal funds for Medicaid expansion without legislative approval and in June, the Walker Administration announced plans for expansion (Goodnough 2016). Quickly, the legislature responded by filing a lawsuit, attempting to stay and reverse the Walker administration's Medicaid expansion proposal (Herz 2016b), the lawsuit was dismissed by the court system in March, however (Andrews 2016).

Although the fiscal impacts of Medicaid expansion are uncertain, they are almost certainly small or negative over the short term. Over the longer term, the state will be required to bear some of the burden of Medicaid expenses, although it is possible that improved medical care for the otherwise uninsured will reduce the real fiscal impact of Medicaid expansion on the state of Alaska (Cole, Haught, Shen, and Cardick 2013).

The legislature also passed a health care reform bill in 2016. According to the bill's sponsor, through the expansion of tele-health, fraud prevention, and enforcement, a new waiver program, new community and social supports and other measures, the state is expected to save tens of thousands of dollars over the course of implementation (Sponsor Statement, SB74, Senator Pete Kelly).

## **Criminal Justice Reform**

Until relatively recently, criminal justice reform was a position typically associated with the Left. Recently, however, the Republican majority caucus in the Alaska State Senate raised the issue of reforming criminal justice—especially reducing prison populations—as a way to reduce the cost of Alaska's criminal justice and corrections system.

Alaska's Senate Majority Leader (and probably the most conservative legislator in the Senate) carried a criminal justice reform bill through the legislature's regular 2016 session that, will have significant fiscal implications in the years ahead. The criminal justice reform package seeks, in effect, to reduce Alaska's prison population by focusing incarceration on violent criminal offenders alone, reducing recidivism by improving reentry services for prisoners (effectively expanding Alaska's probation system), and reducing penalties for minor crimes. The bill's sponsor claims that the proposal will reduce Alaska's prison population by around 20 percent over a 10-year period, and will save around \$424 million in its first 10 years (Coghill 2016). The bill has been criticized as being soft on crime and for insufficiently protecting the rights of victims of crime (Buxton 2016, Shedlock 2016), but passed with co-sponsorship from both parties.

## **Natural Gas**

Along with an abundance of crude oil, Alaska has large deposits of natural gas. For decades, Alaskans have relied on in-state natural gas extraction for electricity (the Anchorage bowl, in particular, relies on natural gas from the Cook Inlet area as a power source), but Alaska's largest source of natural gas—the North Slope, where natural gas is deposited along with crude oil—remains untouched for commercial export. Alaskan politicians have long eyed North Slope natu-

ral gas as a source of revenue and jobs, but so far, efforts to encourage industry to commercialize natural gas have been unsuccessful (Hevesi 2010).

In 2015, Alaska was involved in two alternative natural gas commercialization projects. The smaller of these was shelved in November, and the larger project—referred to as AKLNG (Alaska Liquid Natural Gas)—is facing a rocky future (Raines 2015). AKLNG would consist of a natural gas treatment facility on Prudhoe Bay on the Arctic Ocean, a natural gas liquefaction plant located near Nikiski, south of Anchorage, and an 800-mile, 42” buried natural gas pipeline that would join the two (Alaska LNG Project 2016). The project would be extremely expensive—around \$65 billion dollars by some estimates—and the feasibility of the project is subject to fluctuations in natural gas prices (which, like oil prices, are currently quite low) (Brooks 2016c). In theory, however, the project would bring substantial new revenues into the state once the project goes online, though even the most optimistic estimates would place this no sooner than the mid-2020s (Alaska LNG Project 2016).

The pipeline project would be jointly owned by the major oil and gas producers on the North Slope and the state of Alaska. Alaska would own a 25 percent share in the project. Initially, the state’s 25 percent share was slated to be held jointly by the state of Alaska and Trans-Canada, the firm that would build and operate the pipeline and associated infrastructure, but in November, the state agreed to purchase Trans-Canada’s ownership share in the project after the firm decided that AKLNG would not be sufficiently profitable (Baird 2016).

Nevertheless, although the legislature has continued to debate appropriate levels of expenditure from the project—with the House finance committee eliminating funding for AKLNG in 2016 (Tuten 2016)—pre-engineering work for the project and negotiations with potential buyers have continued forward under Governor Walker ([peninsulaclarion.com](http://peninsulaclarion.com), n.d.). So although Alaska’s natural gas has the potential to generate large expenditures as well as large revenues for the state, the future for natural gas commercialization remains uncertain.

## **Oil and Gas Tax Credits**

Historically, Alaska has offered a generous set of tax incentives to promote the development of new oil and gas resources. As production from Alaska’s large deposits and major producers like Exxon-Mobil and Conoco-Phillips has declined, smaller scale production from relatively small producers has increased in importance to the state, and oil and gas production tax credits have become more important in promoting new oil patch development.

When oil prices were high, these tax credits—which take the form of cash payments to producers from the state—seemed reasonable. As oil prices have declined and the quantity of credits have increased, however, production credits, which are predicted to top \$850 million for FY 2017, may be larger than tax revenue from oil (predicted at only \$690 million) (Brooks, 2016b).

To remedy this situation, the Walker administration proposed legislation in January which would have reduced production credits by \$500 million annually, after capping production credit payouts to \$500 million total for FY 2016. In addition, Walker’s proposal would have increased the minimum tax rate paid on oil production from 4 percent to 5%. However, the House Resource committee substantially weakened the bill, reducing production credit payouts by \$65 million or less annually (DeMarban, 2016b).

## **New Revenues**

Alaska's current revenue situation is clearly unsustainable. For FY 2017, revenues may total less than 25 percent of state spending, and the state's deficit may be greater than \$4 billion (Troll, 2016). For each of the last two years, the legislature has sought to reduce expenditures, hoping that global oil prices will rebound. With Alaska oil production at 25 percent of its historical maximum, however, it seems very unlikely that oil prices will rise high enough before Alaska burns through its easily accessible reserves (Alaska's Constitutional Budget Reserve fund, currently valued at around \$8 billion). In order to resolve Alaska's relatively challenging fiscal situation, the state faces several options, which include implementing broad-based taxes such as income or sales taxes, or tapping the earnings of Alaska's Permanent Fund.

The Governor and individual legislators have proposed almost every possible combination of revenue alternatives, though it is currently unclear whether the legislature has the stomach for any fiscal changes other than continued budget cuts. Ostensibly, the Senate and House of Representatives have begun to discuss options for new revenues after completing their work on Alaska's operating budget. Both the Governor's Office and legislators themselves submitted bills for new sales and income taxes (Herz, 2016a), though none of these passed the Legislature in 2016.

Perhaps the most popular proposal has been to avoid new taxes by using the earnings from Alaska's Permanent Fund. The Permanent Fund earns significant revenues for the state. Indeed, Permanent Fund investments now earn more for the state than oil taxes do. Two proposals—one from the Governor's office and one forwarded by a senior Republican Senator—have suggested preserving Alaska's well-known dividend checks but paying dividends directly with oil royalty revenues (one of several types of revenues the state earns from oil) rather than the earnings of Alaska's Permanent Fund. This would leave the Permanent Fund earnings to fund some government operations, and would permit the continuation of the dividend program for some time (McGuire, 2016; Walker & Mallott, 2016). However, dividend checks would be smaller (around \$1000 compared to the approximately \$2000 checks in 2015) and would decline over time as oil production, and oil royalties, decrease. An alternative to this complicated plan would be to simply cap the size of the Permanent Fund Dividend or do away with the dividend entirely. All of these options, however, would be highly regressive, harming poor and especially rural Alaskans (who rely heavily on dividend payments) much more than wealthy Alaskans (Knapp, Guettabi, & Berman, 2016).

## **Muddling Through to a Soft Landing?**

In 2016, Alaska faces significant fiscal challenges, as low oil prices and declining production have led to ever-lower state revenues. However, Alaska also has resources not available to most other states, including almost \$60 billion in savings, and no broad-based taxes to speak of. If Alaska faces a fiscal crisis, it is certainly a crisis most other states would like to have. Although the state is quickly burning through its most accessible reserves—the Constitutional Budget Reserve fund—Alaska has plenty of options to plug its fiscal gap, and at current oil prices, nearly two years to do so.

Most likely, the state will need to spend some of its savings, continue to reduce spending and implement a sales or income tax (or both) in order to balance its budget.

Although the governor called for the legislature to balance the state's budget during the 2016 Legislative session, a complete resolution of the fiscal "crisis" will not happen in FY 2017, nor would that be desirable. A researcher at the University of Alaska Anchorage's Institute of Social and Economic Research remarked, in a presentation to the Legislature in February 2016, that "fully closing the deficit this year would have a very large impact on an already-weak economy. But delaying significant progress would also have large impacts" (Knapp, 2016).

During that session, the Legislature analyzed options for alleviating some of the fiscal stress, and while cuts were made, no new taxes were implemented, nor was the Alaska Permanent Fund altered. Bills modifying current corrections and healthcare programs should decrease costs in those areas, but the Legislature took no substantial action towards filling the budget gap. In the 2017 session, with new legislators elected on a platform of resolving the budget crisis, it is likely there will be additional cuts (not wholly unjustified, as Alaska's per-capita level of state government spending is the highest in the country) and possibly new revenues. The most likely source of revenue at the moment remains the earnings from Alaska's Permanent Fund investments. Of course, Alaska's state politicians hope that oil prices rebound and new taxes become unnecessary, though a return to \$120-per-barrel oil seems unlikely.

Ultimately, it may be in the best economic interest of the state to draw on reserves while gradually implementing a series of new taxes. Thus, the messy, contentious, frustrating, drawn-out political process of resolving the state's fiscal challenges may lead to something like the best case solution over the next several years.

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