

Alaska: Are We the Waiting?

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Abstract

In the wake of 2014's global collapse in oil prices, Alaska continues to struggle with a huge deficit. Fortunately, the state has over \$60 billion in savings to finance its fiscal gap, but Alaskans continue to fight over the need for spending cuts and new taxes. Outside of state government revenue, Alaska's economy remains relatively unaffected by low oil prices, and the state's reserve funds are growing. So far, though, Alaska's legislature has not generated a coherent solution to the state's unbalanced budget for the long term.

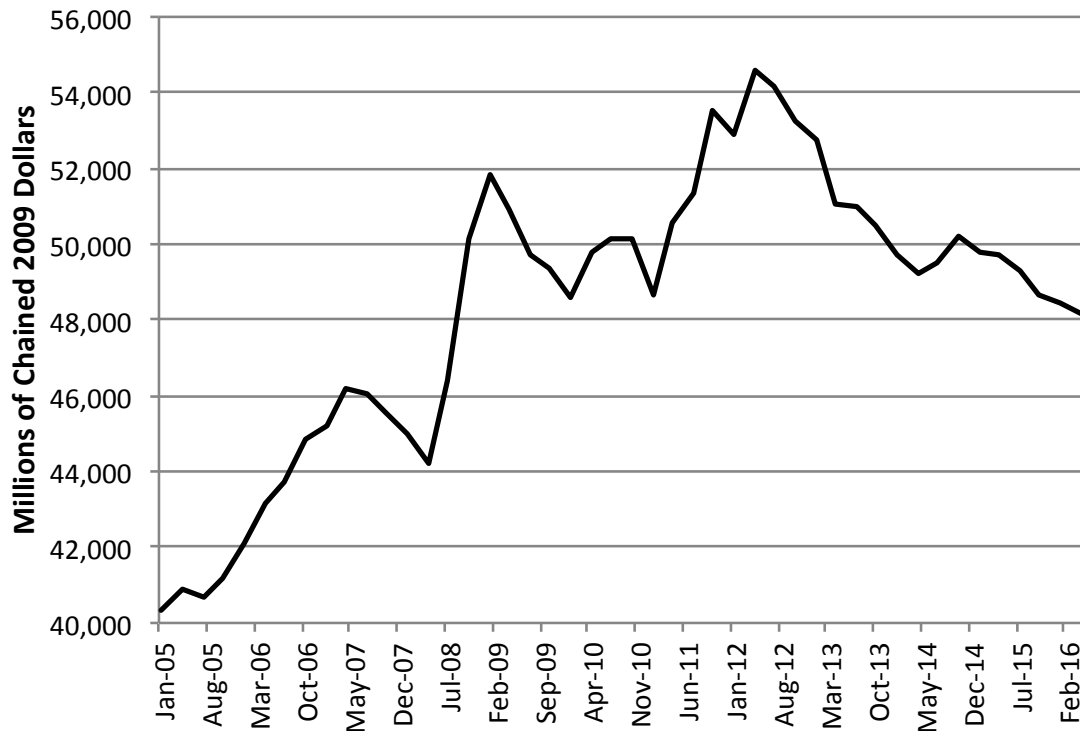
Introduction

Alaska relies on oil taxes for nearly 90 percent of the state's tax revenue, and Alaskan oil production has been falling since the 1980s. Although oil production from Alaska's North Slope oil fields is today around 25 percent of peak oil production in 1988, high oil prices from 2006 to 2014 cushioned Alaskan state government from the need to choose between higher taxes and cuts to services in the face of this production decline. In 2014, however, oil prices collapsed, dropping from about \$110 per barrel to a low of about \$20 per barrel in summer 2015. Since then Alaska's government spending has declined around 40 percent, and even with these large spending cuts, the state has been spending heavily in deficit. These large deficits (around 75 percent of the state's budget) have been funded by relying on the state's substantial reserve accounts. The last of Alaska's easily accessible reserves, however, will soon be gone, requiring some new source of revenue, or massive cuts to services. During Alaska's 2017 annual legislative session, the largest debates were about the nature of those revenues, and how large accompanying cuts would be.

Alaska's Economy in Fiscal Year 2017

Although lower oil prices seem to have had only moderate impacts on unemployment in Alaska, the state has been in an increasingly deep recession since 2014 (Guettabi 2017). For an illustration, see Figure 1, showing declining Alaskan GDP over the last several years. Economists estimate that the recession will not end for several years, and when over, the state's economy will be permanently smaller—there will be no recovery (Wohlforth 2017). Even so, impacts on individual Alaskans appear to have been modest so far, and there are some bright spots in the Alaskan economy, including tourism, which is growing, and fisheries, which are stable.

Figure 1. Alaska's GDP



Since 2012, and increasingly since 2014, Alaska's economy has been in decline, driven by lowered oil prices and production.¹

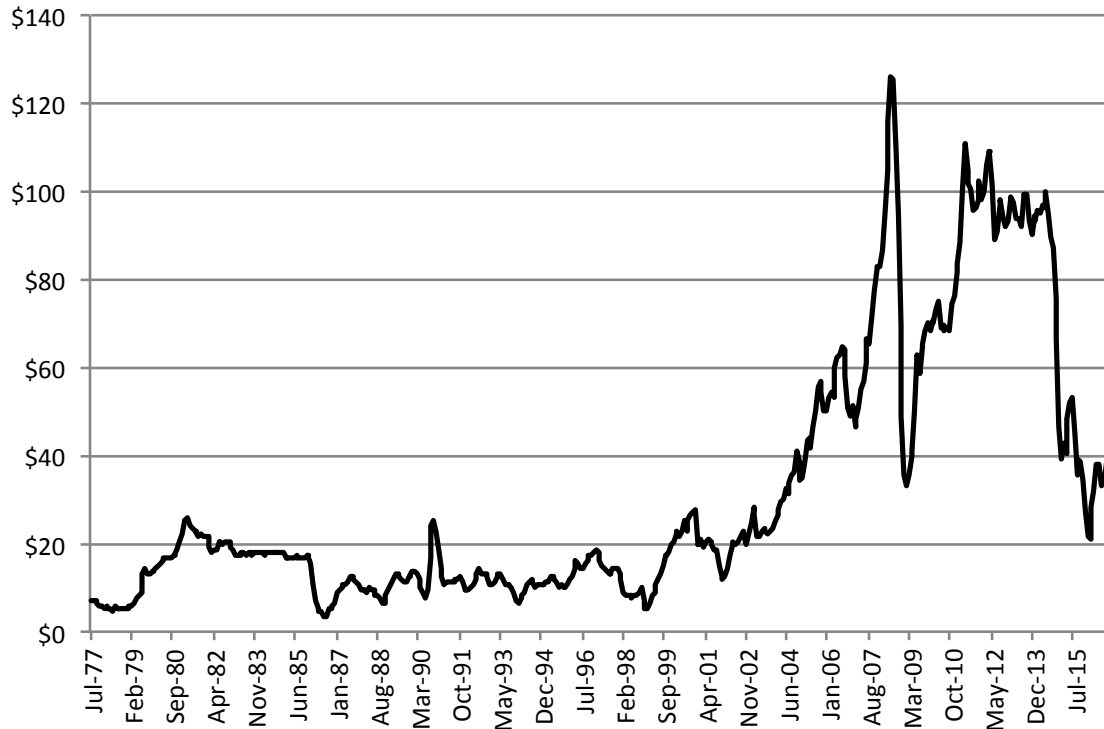
Oil

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 resulting from global increases in oil supplies and subsequent global price declines. Between 1985 and 1988, low prices for crude oil led to dramatic declines

¹ Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/> Retrieved April 6, 2017.

Figure 2. Alaska North Slope Crude Oil First Purchase 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. Although global oil prices have recovered somewhat since their low in 2015, these price increases have been insufficient to balance Alaska’s budget.²

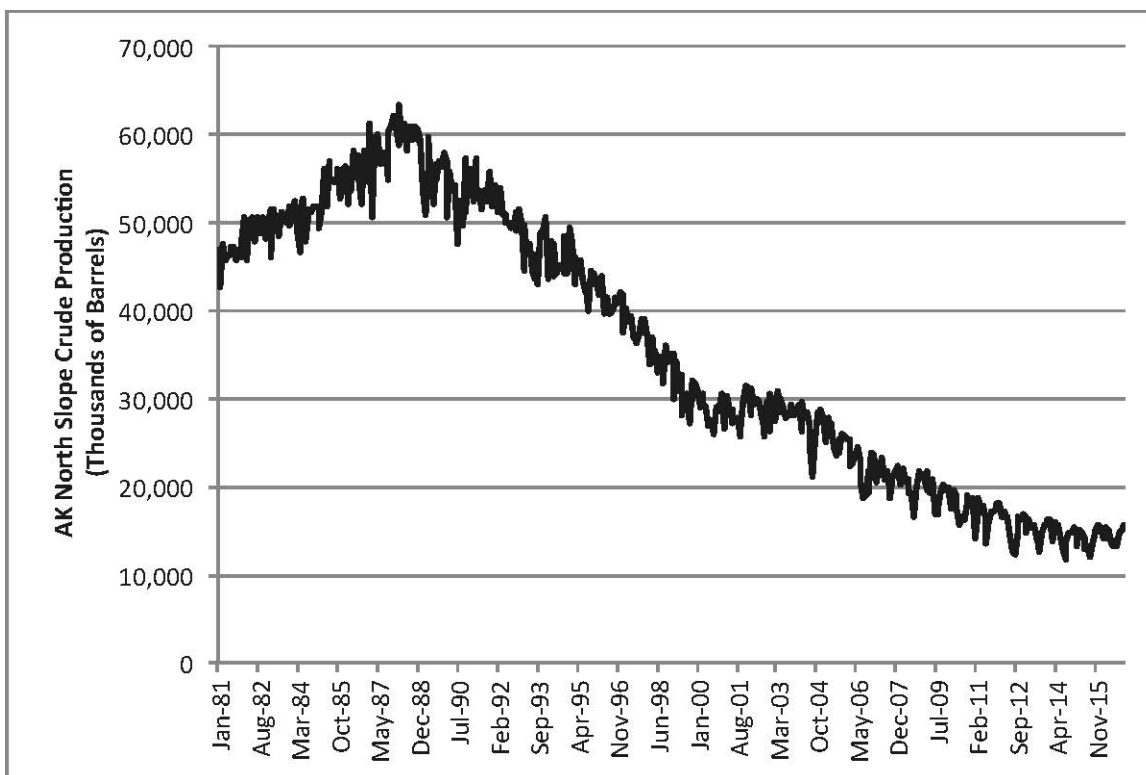
in state government revenues, widespread layoffs and a nearly \$10,000 decline in median family income.³ In the late 1990s, a similar drop in the price of oil led to a much softer landing for Alaska’s economy, as low oil prices were buffered by relatively high and stable state government spending. In 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 2).

² US Energy Information Administration. <https://www.eia.gov/> Retrieved March 20, 2017.

³ Federal Reserve Economic Data. <https://research.stlouisfed.org/fred2> Retrieved April 1, 2016.

Figure 3. Alaska North Slope Monthly Oil Production

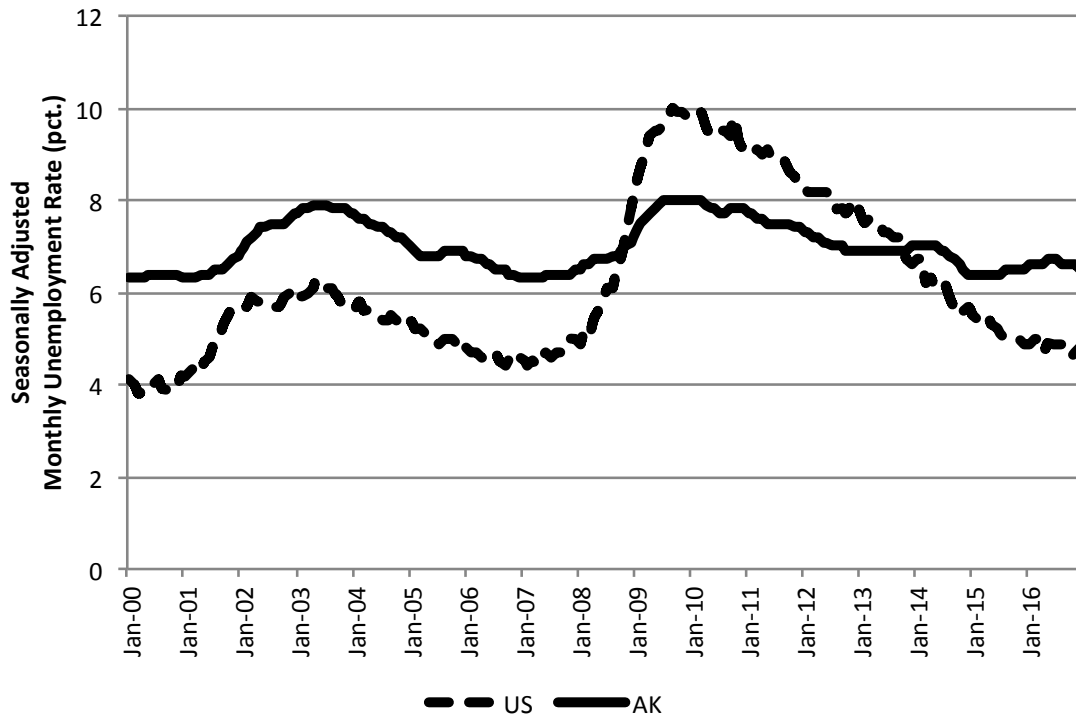


Alaskan oil production has been in decline since the late 1980s, although fluctuations in prices have often masked the fiscal effects of this decline.⁴

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. Oil producers have made several large discoveries recently, including a very large discovery by Spanish firm Repsol, which may eventually produce over 100,000 barrels of oil daily, increasing flow through the Alaska pipeline by around 25 percent (Harball 2017). Despite this find, however, oil production will remain far below the 1988 peak in production (see Figure 3). Consequently, 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 will eventually require the state to return to a more conventional system to generate revenue—most 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”).

⁴ US Energy Information Administration. <https://www.eia.gov/> Retrieved March 20, 2017.

Figure 4. 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 (US).⁵

Employment

Despite declining GDP, impacts on unemployment and underemployment have been modest; the state has been able to buffer the impacts of oil price and production declines by relying on its substantial savings. Though Alaskan unemployment is higher than the national average, Alaska's relatively high unemployment figures seem to be mostly associated with high structural unemployment, especially poor employment prospects in often-impoorished rural Alaska. The most recent unemployment figures available show unemployment essentially unchanged from summer 2014 (see Figure 4). Measures of underemployment are up modestly, and there is some indication of declines in construction spending and other economic leading indicators. However, Alaska seems to have weathered the economic storm of low oil prices relatively well so far, despite dire predictions.

⁵ Federal Reserve Economic Data. <https://research.stlouisfed.org/fred2>. Retrieved March 20, 2017.

Fisheries

In general, Alaska's commercial and sport-fishing industries are healthier than at any time since statehood. Although there are important exceptions, including halibut and king salmon fisheries in several areas, yields are at near-record levels, with Alaska's commercial fishery landings bringing in \$1.76 billion in revenues in 2015, up slightly from 2014 levels.⁶ However, fishing contributes little to state government revenues—Alaska generates around six percent of its revenue from taxes on fisheries,⁷ although some municipalities are substantially supported through taxes and fees on commercial fishing. In addition, 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 (Beier 2011; Beier, Lovcraft, and Chapin 2009). 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 US 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 (Kheiry 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. Other revenues were larger, with tourism bringing in around \$105 million in state government revenues, through the Alaska Railroad Corporation, the Alaska Marine Highway System, vehicle rental taxes, and other taxes (McDowell Group 2016). Even so, total state revenues from tourism are not a significant proportion of Alaska's state government budget.

⁶ National Marine Fisheries Service Commercial Landings data. <https://www.st.nmfs.noaa.gov>. Retrieved April 8, 2017

⁷ 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/>. Retrieved April 8, 2017.

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 that increases from zero to seven percent depending on each individual firm’s net income (Alaska Department of Revenue 2010). The mining license tax falls primarily on a number of large hard-rock and open-pit mines in Alaska, including copper, zinc, silver, and gold mines. Relative to oil revenues, mining tax revenues have been relatively small, and due to falling commodity prices worldwide, mining license revenues have declined significantly in recent years, from \$46.7 million in 2013 to around \$11.7 million in 2016 (Alaska Department of Revenue 2017).

Alaska’s Reserve Funds

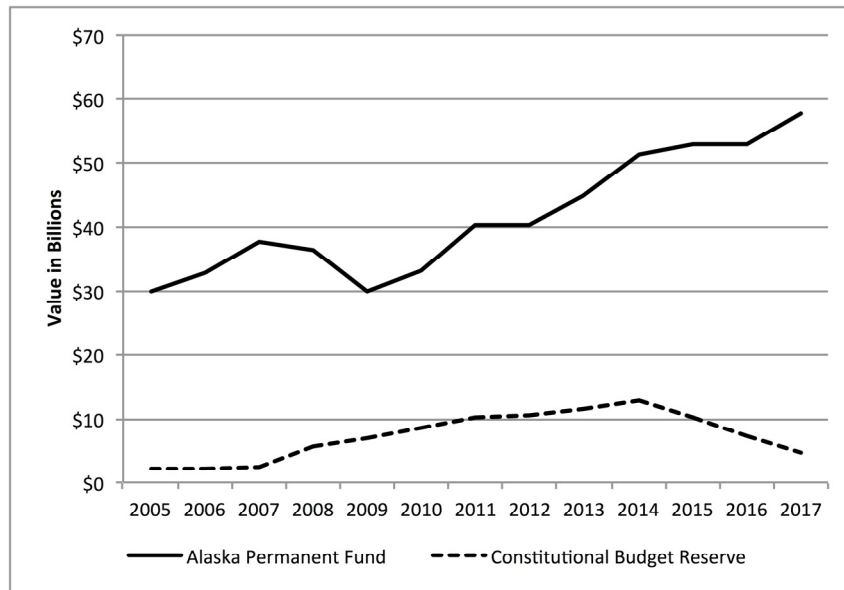
Although Alaska is not unique among the US states in its ownership of sovereign wealth funds, Alaska’s investment funds are uniquely large; the most well-known of Alaska’s several investment funds, the Alaska Permanent Fund, is currently valued at over \$61 billion. The second-largest of Alaska’s funds, the Constitutional Budget Reserve is also quite large—currently about \$3.5 billion dollars—though spending has depleted the fund’s balance, from around \$12 billion in 2013.

The Alaska Permanent Fund

For the last several years, earnings from Alaska’s investments, including the Permanent Fund and Constitutional Budget Reserve, have 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 2016, Alaska’s Permanent Fund Dividend (PFD) was \$1,022 dollars, which means that almost every Alaska resident received a \$1,022 payment in early October (Herz 2016). The value of the permanent fund increased in 2016, to \$61.2 billion in Fall 2017. Controversially, 2016 PFDs were slated to be only 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.

As the size of the permanent fund has grown and Alaska’s oil revenues have declined, commentators and politicians have proposed using the earnings of the permanent fund to close Alaska’s fiscal gap (McGuire 2016; Walker & 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 broadly based taxes. 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 underresearched, there is also some evidence that it has a stimulatory effect on Alaska’s economy and is an important factor in reducing economic inequality in Alaska, which is currently the lowest of any US state (Goldsmith 2012). Recent work also strongly suggests that the PFD has significantly reduced poverty in Alaska (Berman and Reamey

Figure 5. 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.⁸

2016). Consequently, many state politicians fear the political and macroeconomic consequences of reducing or eliminating the dividend by spending fund earnings.

Nevertheless, in 2017, legislators in both parties and in both the state House and Senate have proposed using revenues from the Alaska Permanent Fund to fund government. These plans are discussed below, under “Policy Issues.”

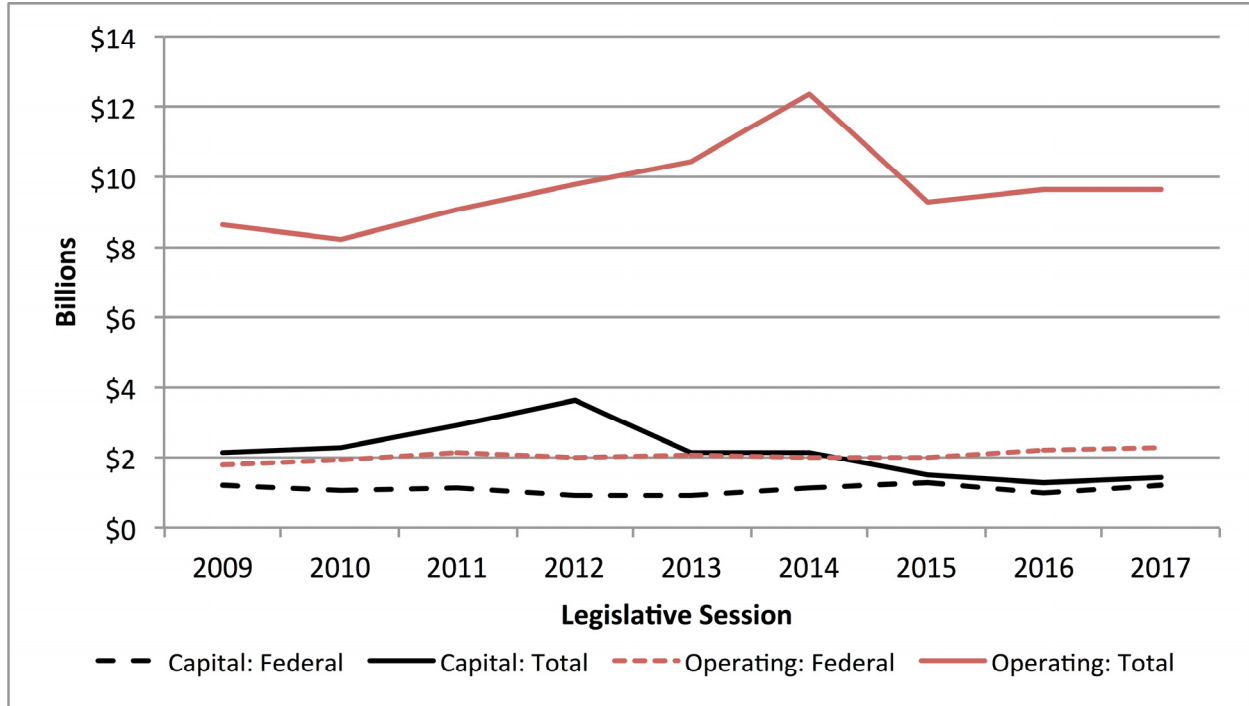
The Constitutional Budget Reserve

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 US 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

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

Figure 6. Federal Receipts and Total Budget Expenditures over Time



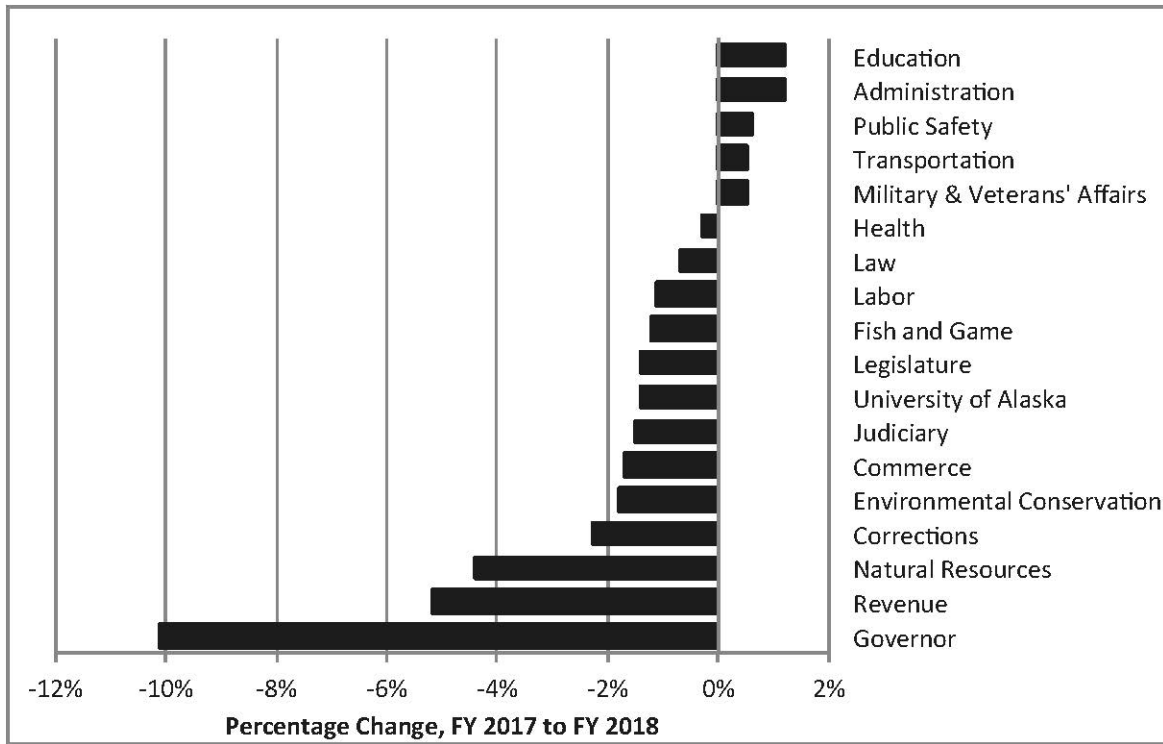
While Alaska’s capital and operating budgets have changed over time, with significant declines since 2014, federal receipts have held relatively steady.⁹

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 \$3.5 billion, down from \$8.2 billion last year. 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 less than two years.

Under the Alaska State Constitution, the CBR can only be spent with the approval of three quarters of each legislative chamber. This has given legislative minorities greater leverage over the budget than they would otherwise hold; for the last several years, Democratic minorities have been able to effectively bargain with majorities in order to promote their own budgetary priorities. In the wake of November 2016 elections, which brought a Democratic-dominated coalition to power in the House, this means that the House majority will likely need to negotiate to pass a budget with the Republican minority. In the Senate, a Republican-dominated coalition controls 14 of 20 seats, making negotiations necessary with the Democratic minority, or with a single insurgent Republican Senator, Mike Dunleavy of Wasilla.

⁹ <http://www.legfin.akleg.gov/BudgetReports>. Retrieved March 29, 2017.

Figure 7. Winners and Losers, by Percentage Change, House Budget



In general, operating budget cuts proposed by the House are smaller for FY 18 than for the previous several years. The governor’s office was the only agency with significant cuts, but this was after relatively large budget increases in FY 17. State of Alaska Legislative Finance Division.¹⁰

Budgetary Changes by Agency

Between 2012 and 2016, the state of Alaska reduced its budget by over 40 percent (see Figure 6). In 2017, the Alaska House, dominated by Democratic representatives, and the Senate, dominated by conservative Republicans, generated only slightly different operating budgets.

Operating Budget

Under the House budget, only two agencies were slated for budgetary changes of five percent or more. The Department of Revenue was cut 5.2 percent (around \$20.7 million), mostly by cutting funding to the Alaska Retirement Management Board, the organization charged with overseeing retirement pension investments. The governor’s office was cut about 10 percent (about \$2.9 million), mostly to the Division of Elections, which will not be charged with overseeing statewide elections in 2017. The Senate generated a budget bill that included slightly larger cuts in some areas, notably to the University of Alaska. However, the Senate’s budget proposal, de-

¹⁰ <http://www.legfin.akleg.gov/BudgetReports>. Retrieved March 29, 2017.

spite rhetoric to the contrary, differed only slightly from the House budget bill, calling for a 5.6 percent cut to the Department of Revenue, and a small (\$1.8 million) executive branch-wide unallocated cut (Brooks 2017b).

Capital Budget

After several years of budget reductions, Alaska's capital budget has dwindled away to almost nothing. The current year's capital budget totals around \$1.43 billion, a roughly \$3.3 billion reduction from the most recent peak in capital spending, in 2012. Further, almost all of this year's capital projects spending is funded by the federal government—the governor's capital budget proposal included only \$147 million in state revenue spending. Although the capital budget is skeletal, it does include a few large items, including a \$240 million replacement for the F/V Tustumena, one of only a small number of open water-capable Alaska ferries. The Tustumena, once known colloquially as the “Trusty Tusty,” but now commonly referred to as the “Rusty Tusty” was recently mothballed after a long and storied career serving remote communities in Prince William Sound, the Gulf of Alaska, and the Aleutian Chain. Only \$22 million of the ferry's replacement will be funded with Alaska's own revenues. Other expenses in the capital budget include urban and rural airport upgrades, and significant expenditures for deferred maintenance.

Policy Issues

In addition to a generally challenging fiscal situation, Alaska faces a number of policy questions with clear fiscal implications. The biggest issue at hand in 2017 (as in 2016 and 2015) is how to generate new revenues. Legislators have considered two sources of new revenue, including spending some of the earnings from Alaska's Permanent Fund and implementing an income tax. Alaskan legislators also have discussed a spending cap and reducing Alaska's generous oil production incentive program.

New Revenues

In 2016, the governor's office and the legislature proposed complicated schemes that would “replumb” Alaska's permanent fund and oil tax systems as a way to generate new revenues for state government (McGuire 2016, Walker and Mallott, 2016). The details of those proposals are not important here, because they were broadly (and perhaps correctly) seen as a bait and switch scheme that would allow politicians to spend some of Alaska's Permanent Fund earnings without having to pay a significant electoral penalty. In 2017, the legislature has proposed a series of more straightforward measures, including two competing proposals to tap the Permanent Fund earnings, and a proposal to implement an income tax.

Members of both the Republican-dominated Senate majority and Democratic-dominated House majority have proposed very similar plans for using Permanent Fund revenues to fund government. The Senate's proposal—SB 26—would take 5.25 percent (Percent of Market Value, or POMV) of the Permanent Fund for the first three years and use these funds to pay for state services and dividends. About a quarter of that funding would be used to pay \$1,000 dividends for each Alaskan, somewhat smaller than historical averages, after adjustment for inflation, with the remainder of the POMV take (around three quarters) used to fund state government. The 5.25 percent take would be reduced to 5 percent after three years, with 75 percent of that amount used

to pay for state government and the remainder to be used for dividends. The Percent of Market Value figure would be based on a rolling average of the fund's value in five of the past six years (as a way to smooth fluctuations in the Permanent Fund's value over time. In FY 2018, the Senate's proposal would generate around \$2.5 billion in revenue for the state, plugging most of the state's deficit. A final component of the Senate proposal is the inclusion of a statutory spending cap of \$4.1 billion. Though the proposed spending cap would, in theory reduce the state's budget if followed, because each year's budget is also statute, the spending cap would not, in reality, serve to bind future legislatures (Brooks 2017a, Kitchenman 2017b).

Initially, the House majority coalition introduced a competing revenue bill—House Bill 115—which would have used a somewhat smaller portion of the Permanent Fund (4.75 POMV) to fund government, and would have provided for slightly larger Permanent Fund Dividends (around \$1,100) (Tuten 2017). The House proposal also included an income tax, which would have taxed Alaskans at 15 percent of their federal income tax liability (Kitchenman 2017a). In response to some procedural concerns, and possibly as a result of negotiations with the Senate majority, the House removed the Permanent Fund component from the revenue bill and adopted a version of the Senate's proposal, which would have allowed for a slightly larger dividend for the next three years (\$1,250) and includes a “self destruct” clause that requires the legislature to adopt an income tax in order for the Permanent Fund draw to go into effect (Herz 2017b).

Oil Production Credits

One common critique of the Republican legislatures of 2016 and before was their unwillingness to reduce Alaska's oil production incentive payment system, even as most other areas of the state government budget were repeatedly and significantly cut. In 2017, as in past years, oil production credit reformers introduced legislation to reduce cash payments to oil producers, arguing that the state cannot afford substantial cash subsidies at a time when budgets are billions of dollars in the red. The House majority proposed to eliminate most cash subsidies for oil producers and eliminate some tax credits for oil exploration and development, while partially offsetting these changes by reducing some taxes on oil production (Tarr and Josephson 2017). Overall, the proposed changes would improve the state's fiscal position, reducing the deficit by about \$130 million in fiscal year 2018 (Herz 2017a).

Surprisingly, Senate Republicans introduced a similar measure late in the session, and the two chambers arrived at a compromise during a legislative special session in July. If anything, changes to statute may have been harder on the oil industry than the House's initial proposal; most future subsidies were eliminated, and the legislature agreed to appoint a panel to study oil taxes, but no tax reductions were made, saving the state around \$150 million annually. The legislature also appropriated around \$60 million to pay down existing subsidy obligations under pre-2017 law (Brehmer n.d.).

Will This Be the Year?

November 2016 elections led to significant changes in the Alaska Legislature. While the partisan balance of the relatively moderate state Senate was unchanged, the state House of Representatives flipped, when Democrats gained several seats and were able to form a coalition with three moderate Republicans and two Independents. This new House coalition favors both a state

income tax and the use of some investment revenues from Alaska's Permanent Fund sovereign wealth fund.

While the state Senate continues to oppose new taxes, the Republican majority in the Senate has long favored some use of earnings from Alaska's Permanent Fund sovereign wealth fund to pay for government services, making a partial solution to Alaska's fiscal challenges more likely in the past. Though the 2017 legislative session adjourned during the constitutionally mandated 120-day session limit and has run over several special sessions, we await a decision—possibly during a fall special legislative session or during the 2019 session—as to whether the state will use new taxes or earnings from the Permanent Fund earnings reserve account to fund state government operations.

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