

ALASKA

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OVERVIEW

Alaska began the 2004 fiscal year in better shape economically than the other western states, because the state Constitutional Budget Reserve (CBR) had not yet run dry. The first (2003) session of the 23rd Legislature failed to adopt a long-term fiscal plan, continuing uncertainty about the state's economic future, which has been an issue in state politics for more than a decade. It also allocated more funds than the new Republican Governor, Frank Murkowski, proposed, prompting him to use line-item veto powers to eliminate the Longevity Bonus for seniors and cut funding for local governments.

Alaska ended the FY2004 budget period in a context of the highest oil prices of 25 years. This made it unnecessary for the Legislature to consider seriously any proposals to fund state government from sources other than current oil revenues (and the Constitutional Budget Reserve). This was the background for deliberations in the FY2005 budget process, which concluded with an increase in state spending.

In this report on the Alaska FY05 budget process, we consider eight topics: the Alaska economy, federal issues, state issues, the 2004 U.S. Senate election, the budget process, executive budget actions, legislative actions, and the final 2005 budget.

THE ALASKA ECONOMY IN 2003-04

Alaska's population is small, about 652,000 in 2004, but it inhabits a vast landmass, roughly one-fifth the size of the continental United States. The state population is somewhat younger than the US average, with a small senior cohort. Although the gender imbalance in America's northern frontier has narrowed, men still outnumber women in the state population. Alaska Natives comprise 16 percent of the state population, the largest proportion in any American state. Other minorities—African-Americans, Latinos, Asians—are smaller in number than in most of the other western states.

In economic terms, the population is near the median in per capita income among the US states. In fact, since the oil boom years of the early 1980s, the gap between rich and poor in Alaska has narrowed. This is largely the consequence of the loss of high-paying oil industry jobs, and the increase in low-end, largely retail job opportunities.

The state economy has two pivots—the oil/gas industry and the state's Permanent Fund (PF). In both (as in 2002-03) most 2003-04 developments were equivocal.

The Alaska Oil Economy. Alaska's huge North Slope oil province, centering on Prudhoe Bay, has experienced production declines since 1989. Nevertheless, enhanced oil recovery methods as well as the discovery of new oil fields have reduced the rate of decline so that, by 2004, nearly 1 million barrels/day still passed through the Trans-Alaska Pipeline System (TAPS). Royalties, property taxes, and state severance taxes on oil and gas development produce the lion's share of state revenue (about 85 percent of General Fund revenue). The federal lease and state grant for the TAPS and its right-of-way terminated in 2004. Both government agencies conducted an elaborate scoping process and full environmental impact statement review in 2002-2003. Notwithstanding strong environmental protest to the extension of the grant and lease for 30-years (the preferred alternative for the federal Bureau of Land Management [BLM] and state Department of Natural Resources [DNR]), they were renewed, indicating continued federal/state confidence in the environmental security of the pipeline and the likelihood that it will be in use for the indefinite future.

The Alaska North Slope oil properties are dominated by British Petroleum (BP) and, since 1999, ConocoPhillips Petroleum. As in 2002, during 2003-04 BP indicated some hesitation about future exploration work in Alaska. It boosted its Gas-to-Liquids (GTL) project on the North Slope, but indicated little interest in exploring for new fields (FDNM, 12/4/03), after its closure of Badami in 2002 and decision to terminate the EIS review for the off-shore Liberty project in 2001. ConocoPhillips, however, was optimistic. Developer of the state's most recent and third largest field, Alpine, the corporation touted prospects for further development in the National Petroleum Reserve-Alaska (NPR-A), to the west of Prudhoe Bay and Kuparuk (the state's first and second largest oil fields). The federal Interior Department cooperated in these aspirations by proposing the opening of more tracts for development in NPR-A (FDNM 10/21/03; 1/24/04).

Oil and gas jobs remained at a low ebb in 2003-04 (FDNM, 9/14/03). Alyeska, the pipeline consortium, announced a 40 percent reduction to its workforce (ADN, 3/5/04), but there was positive news on the petroleum front. BP announced its intention to focus on heavy oil production, which might bring into production the West Sak fields with high estimated yields (FDNM, 11/8/03). Of greatest importance, oil prices remained high throughout the year, and by early July, 2004 were \$41 a barrel, nearly \$20 higher per barrel than the historical average; during the FY 2004 fiscal year they averaged \$31.13. (However, when adjusted for inflation, oil prices were at the mid-range as compared to the early 1980s and in 1990, before the onset of the first Gulf War. To reach the 1990 level, 2004 prices would need to reach \$57/barrel; to reach the early 1980s highs, they would have to attain \$80/barrel). Several factors accounted for higher oil prices than state petroleum economists had predicted: a cooler late fall and winter, increased discipline among OPEC states, the war in Iraq, and terrorist attacks on oil production workers and facilities in Saudi Arabia. High oil prices made it unnecessary for the state to draw from the CBR, and FY 2004 ended with \$40-50 million in the black instead of \$380 million in the red, as predicted the previous year.

The Permanent Fund and the Dividend. Voters through a constitutional amendment in 1976 established the Alaska Permanent Fund (PF) (see McBeath & Morehouse, 1994, 127-28). The Fund receives 25 percent of oil and gas severance taxes and royalties, which

otherwise would be directed to the state's General Fund. In 1980, the Legislature created the Permanent Fund Dividend (PFD), as a means to share oil wealth with the citizenry and create a constituency to support the PF politically. From 1982 to the present, the state has given each resident an annual dividend, based on the returns (computed as a rolling five-year average) on the investments of the PF. The October 2003 dividend was \$1108, more than \$400 lower than the previous year because of stock market declines. In fact, stock market losses eroded more than \$2 billion in the value of the PF, which stood at little more than \$22 billion in early 2003. By mid-2004, however, recovery in the market had returned the Fund's value (principal and retained earnings) to approximately \$27.4 billion.

The stock market correction threatened to endanger the dividend itself. Lack of fund earnings jeopardized the ability of the state to inflation-proof the PF and appeared toward the end of the 2003 fiscal year to be insufficient to afford any dividend at all. This led state policy-makers to consider both legal and constitutional changes to the PF and/or a restructuring of it to insure the flow of dividends, the single most prized product of government in the history of Alaska. The board of directors of the Permanent Fund Corporation publicized recommendations on a constitutional fix, which legislative committees began to hold hearings on statewide in summer, 2003. The proposal would amend the state constitution by making up to 5 percent of the PF's total market value each June 30th available for appropriation (called the percent-of-Market-Value [or POMV] proposal; see Alaska Permanent Fund Corporation, 2004). Its effect would be to inflation-proof the fund over time (by joining the earnings-reserve, now outside the corpus of the PF, with the Fund principal) and stabilize the payouts by reducing the impact of market swings in any given year. This proposal was one of several before the second session of the 23rd Legislature in January 2004.

The most radical proposal on the PF came from Fairbanks Republican House member Jim Holm. Noting the reluctance of state policy-makers to allocate earnings of the Fund toward state government operations because of the popularity of the PFD, Holm proposed that one-half the principal and earnings of the Fund be distributed among Alaska residents and the other half allocated to government support. This would deed each eligible Alaskan a one-time payment of \$20,000 (and also throw some Alaskans off welfare and send about \$2 billion to the IRS; see FDNM, 11/8/03 and 1/24/04).

Other Economic Sectors. News was mixed for the state's other resource industries. The salmon fishery, once the state's largest revenue producer, remained in a slump, and news of a spreading parasite infection in Yukon River salmon occasioned dismay. Tourism prospects for the 2004 season dampened when animal rights' groups started boycotts in opposition to wolf control policies (discussed below). However, gold prices soared, over \$400/ounce and more than double the 2001-02 rate (FDNM, 11/20/03). Finally, the USDA Forest Service announced its agreement to increase logging in the Tongass National Forest, which brightened prospects for the state's wood products industry (FDNM, 12/24/03).

The state jobless rate held steady at 8.9 percent (seasonally adjusted to 7.4 percent [ADN, 3/20/04]), and one report suggested that Alaska had the third highest rate of job growth in the nation (FDNM, 4/19/04).

Still, economic futures in the state remained poor for the younger generation, and the state lost a larger percentage of its high school graduates in 2003 than any other state (FDNM, 1/8/04). The brain and youth drain is a powerful symbol for those who seek booms in economic development.

Constitutional Budget Reserve (CBR). The state has a second reserve fund, established by a constitutional amendment in 1990 (McBeath & Morehouse, 1994, 128). The fund has been the depository for proceeds from tax cases the state has won against oil companies, and reached a high of nearly \$7 billion in the early 1990s. By the start of FY04 the fund had declined to \$2.1 billion and is expected to fall to \$1.8 billion by the end of FY05. In all but 3 of the last 14 years, the CBR has been used to balance the General Fund budget. The depletion of the CBR, which the state's revenue department now predicts will occur in 2008, is the single most important factor prompting serious interest in a long-range fiscal plan. Governor Murkowski drew a line in the sand when he argued for holding the CBR at \$1 billion, as a perennial rainy day account (FDNM 1/11/04).

Notwithstanding some bleak areas in the state's economy, Alaska is in the enviable position among the American states of having little general obligation bonded indebtedness, and its bond rating is quite good (FDNM, 7/28/03). It also has the greatest tax capacity of any American state, because of the lack of statewide taxes on income, sales, and personal property. Overall, the current health of the state economy in 2003-04 was good.

Federal Issues. Alaska remains a dependent province of the federal government with respect to its resources, as 60 percent of its lands are federal public domain. This strongly influences state economic development opportunities. Federal issues in 2003-04 were the state's congressional delegation, Alaska pork, and energy legislation.

The Alaska Delegation. Since 1980, Alaska's three members of the Congress have been Republicans. Two, Senator Ted Stevens and Representative Don Young, have advanced to positions of considerable power in national government: Stevens in 2003-04 finishes his last year as chair of the Senate Appropriations Committee; Young finished his third year as chair of the House Transportation Committee. The least senior member of the delegation is also its most controversial, Senator Lisa Murkowski, who gained her position as a gift from her father, who left the Senate to become Governor of the state after the November, 2002 elections.

Although acerbic and confrontational, Senator Stevens' integrity had not been challenged until 2003. First a watchdog group criticized his support of the Air Force plan to lease Boeing planes, attributing the support to his spouse's lobbying on behalf of the aircraft manufacturer. Shortly after these charges were cleared, the Los Angeles Times published a full page attack on Stevens, questioning the enormous growth of his recent investments in projects over which he has exercised influence (ADN, 12/18/03; FDNM 12/19/03; 12/20/03).

Alaska Pork. Alaska continued to draw significantly more dollars from the federal government than its residents paid in federal taxes (FDNM, 8/14/03). Senator Stevens again

larded the FY05 federal budget with funds for rural sanitation and safety, research projects at the University, airports, Native health clinics, military installation housing and infrastructure construction and other improvements, new rural and urban education initiatives, and accelerated funding for National Missile Defense construction in Delta and the Aleutians. Congressman Young brought more funding for Alaska bridges, roads, the marine highway system, and airports (FDNM 1/22/04). The House's version of the renewal of the Transportation Equity Act had some \$500 million of Alaska earmarks. One project alone would cost \$135 million, "the Gravina Island Access Bridge," labeled a "bridge to nowhere" by Taxpayers for Common Sense, which gave it the Golden Fleece Award (FDNM 4/11/04; 7/26/04). (The bridge would join the southeast town Ketchikan to its airport on the island.) Even Senator Lisa Murkowski added money for rural education projects. Indeed, the level of federal funding exceeded state General Fund revenue by \$1 billion, as we shall see in detailed analysis of the FY05 budget.

Alaska and Energy Legislation. The Alaska delegation and lobbyists for state energy resources had hopes that the Bush energy bill would spur oil and gas development in the state. Initially, the Bush administration included development of the Arctic National Wildlife Refuge (ANWR) in the legislation, but by late 2003 the administration had dropped this support in an attempt to enlarge the coalition of supporters (FDNM, 9/19/03). Given lack of support in the first session of the 108th Congress for opening ANWR, this issue is likely to remain dead until the 109th Congress. The Bush administration signaled its continued interest in the opening of ANWR by inserting \$2.6 billion in revenue from this oil field in the federal FY 2005 budget proposal.

A second attempt of the state delegation was to include large incentives for owners of North Slope gas to build an in-state natural gas pipeline from Prudhoe Bay to tidewater in Valdez. The desired incentive was a price guarantee for natural gas, with federal tax credits if gas prices dropped below the specified level. However, the energy department spoke against tax credits consistently, as no other natural gas producers in the United States had obtained them (FDNM, 9/11/03). Too, Fed chair Alan Greenspan opposed tax credits. The legislation entering the House- Senate conference in September contained only loan guarantees, but no tax credits for producers (FDNM, 9/5/03, 10/5/03, 11/7/03, and 11/15/03). Although both Stevens and Murkowski voted with the Republican majority to support the energy compromise, neither considered the incentives sufficient to spur production. They added incentives to the federal Jobs Bill in April, and the U.S. Senate did pass modest tax credits in May (ADN, 5/12/04). It seemed unlikely, however, that the Congress would enact the package before the end of the session.

STATE ISSUES

Two issues with budget ramifications occupied state leaders during 2003-04—the natural gas pipeline and wolf control. A number of other smaller issues revealed tensions in state development policy.

The Gas Pipeline. The Alaska North Slope has 35 trillion cubic feet of proven natural gas (almost twice current annual US consumption, or 20 percent of known US reserves).

Development of an Alaska natural gas line has been a perennial issue in state politics since the late 1980s; it became a large discussion item in 2000 and 2001, when gas prices rose. However, declining prices in 2002 diminished the interest of the oil/gas industry in construction of a new gas pipeline in Alaska. Three oil companies are the lessors of North Slope gas—BP and Phillips have a 30 percent interest each, with Exxon holding a 40 percent interest.

Governor Murkowski had promised action on a gas pipeline during his 2002 campaign, and once inaugurated met with producers to stimulate construction. He ventured to Yukon Territory to attract support of Canadians for movement of North Slope gas south (FDNM, 12/2/03). He proposed extending the Alaska railroad to move natural gas (1/13/04). But the most significant breakthrough occurred when MidAmerica Pipeline Company, owned by billionaire investor/financier Warren Buffet, proposed construction of a gas line from the North Slope to the Interior, and then following the AlCan Highway through Canada to the Mid-West (FDNM, 1/23/04).

The MidAmerica proposal stimulated the owner companies to make a counter proposal to the state (ADN, 1/24/04). Too, the Murkowski administration had been less than subtle in suggesting that owner companies might lose their leases to the gas if they did not transport it to market. A third consortium, TransCanada, also proposed a Yukon line after the gas reached the Interior. Yet moving Alaska natural gas through Canada to market is less attractive to Alaska policy-makers than an all-Alaska route, which would allow in-state use of gas as well as higher revenues from transportation charges.

By late March, MidAmerica had withdrawn its application, because the state declined to give it exclusive development rights. In late June, the state approved TransCanada Corporation's application, yet risk-sharing issues remained unresolved (ADN, 6/8/04). The chief impediment to starting development remained the lessor companies, who sought either federal or state guarantees before they agreed to sell the gas. As consultant Pedrovan Meurs told the Legislature: "This is the largest project in the world, and large projects take time" (FDNM, 4/11/04).

Wolf Control. Running for office, Frank Murkowski said he wanted to base predator control on the "best science" and not on politics. He opposed the policy of the Knowles administration, which had been reluctant to limit the state's growing wolf population, particularly in areas of interest to hunters of moose. One of the first actions of the Murkowski-appointed Board of Game was to approve a plan of predator control in the McGrath and adjoining interior regions of the state.

Under protest of animal rights' groups, such as People for the Ethical Treatment of Animals (PETA), which threatened a tourism boycott of Alaska (a similar threat caused a change in wolf control policy of the Hickel administration), the administration opposed use of low-flying aircraft and state personnel in controlling wolves. The first session of the 23rd Legislature joined the conflict, and a legislative compromise made land-and-shoot predator control, including wolf killing by permitted civilians, legal, which effectively overturned previous citizens' initiatives that had banned such methods.

PETA contested this approach and organized boycotts in December 2003; before the New Year demonstrators had hit the streets in several cities, urging potential tourists to boycott Alaska until the administration changed its policy (FDNM, 12/3/03; 12/10/03; 12/29/03). The Governor held firm, however, and the first batch of wolves was terminated in late January. It seems unlikely that the boycotts will have more than a marginal impact on tourism revenue for the state in the 2004 season.

Rural-Urban Tensions. Throughout the year, tensions flared between Alaska's rural areas, most of whose residents are Alaska Natives, and Alaska's cities, where nearly 80 percent of the state's population lives. The FY04 budget approved by the Governor redirected some rural funds to cities (FDNM, 7/10/03), and rekindled charges of racism against the Republican Governor and Legislature. The administration declined to revive attempts to amend the state's constitution to provide a subsistence provision for Native or rural residents. The Governor angered Alaska Natives by urging that the Federal Subsistence Board have a state representative (FDNM, 11/10/03). Then, in the legislative session, Fairbanks Senator Gary Wilken (R) continued his efforts to organize rural Alaska into borough governments. Roughly two-thirds of rural areas lack boroughs, and thus residents pay no property taxes, a condition they wish to continue.

THE 2004 ALASKA SENATE ELECTIONS

The 2004 U.S. Senate election seems likely to be the most closely contested and expensive in state history. By mid-2004, the candidate field had narrowed to one Democrat and two Republicans. Former two-term Governor Tony Knowles announced his candidacy by mid-2003, and by early 2004 had visited Washington, DC three times to raise funds. His treasury had nearly \$1 million by the end of January (ADN, 1/29/04). Although tainted by the nepotism issue, the incumbent Republican Senator, Lisa Murkowski, had been successful in limiting competition. First, Teamsters' boss Jerry Hood declined to run against her in the August Republican primary (FDNM 7/31/03). Then, former legislator, chair of the Alaska Railroad Corporation, and owner of Riverboat Discovery John Binkley, announced he would support Murkowski (FDNM, 9/19/03).

Lisa Murkowski draws little support from the dominant socially conservative wing of the state Republican Party. Sarah Pailin, former Mayor of Wasilla who ran a close second in the 2002 lieutenant gubernatorial primary, considered a primary bid but decided against filing. Opposition in the primary will come from Mike Miller, veteran legislator (with service both in the House and Senate), who left the Legislature in 2002 as Senate President. Governor Murkowski had appointed Miller Commissioner of Administration. He resigned this post in early April and within two weeks had filed for the U.S. Senate primary race. Almost immediately, Alaska Right-to-Life endorsed him. Shortly thereafter, surprisingly, Lt. Governor Loren Leman also endorsed his primary race. Miller is far behind Murkowski in the polls and lacks financing to stage a statewide contest. The question is whether he will adhere to the pre-primary pact and strongly support Murkowski when she wins the primary. In addition to the nepotism issue and the large national interest in the race, there will be a

third party candidate in the general election—Green Party activist Jim Sykes—who may draw some votes from Knowles.

Lisa Murkowski had raised nearly twice the amount of the Knowles' campaign by early 2004, but the difference quickly narrowed as the national parties focused on this and the other four highly competitive races, on the results of which leadership of the U.S. Senate hinges.

THE BUDGET PROCESS

The typical budget process in Alaska follows the calendars of the executive, House and Senate. The executive begins the process with the executive budget request for operating and capital funds, issued by December 15th, one month prior to the start of the legislative session. Usually the House, after holding some hearings on the executive requests, adopts ceilings through the majority caucus; in recent years, it has voted on a budget by late March. The Senate makes some changes in House priorities before it adopts its version of the budget, requiring conference committee action. The Legislature is limited by constitutional amendment to a session of 121 days, which means it must conclude by mid-May. During those years when the Legislature faces a deficit (11 of the last 14), it must requisition funds from the CBR. To spring funds from the CBR requires a three-fourths vote of each house of the Legislature, and thus, with the exception of the FY04 budget, the minority has been involved and some of its preferences have been honored, which has had the effect of increasing the size of the budget over what the Republican majority would have preferred.

Alaska's budget staff is large for a sparsely populated state. In the executive Office of Management and Budget, about one dozen analysts work on fiscal planning issues. The Legislative Finance Division of the Alaska Legislature has six analysts. Each of the co-chairs of finance committees in the House and Senate has two to three budget staff members. Thus, nearly 30 staff members have highly specialized knowledge of budget data.

During the 22nd Legislature, Democrats and Republicans in the House formed a bipartisan fiscal policy caucus to develop a long-range fiscal plan. The caucus held several town meetings, but did not succeed in attracting support from the leadership of the House. In the first session of the 23rd Legislature, new leadership in the House formalized the caucus as a Ways & Means Committee. Speaker Pete Kott charged the committee with finding ways to bridge the state's fiscal gap by increasing revenue and curbing spending. During the inter-session, this committee held several hearings statewide, but during the second session of the 23rd Legislature, its work was overshadowed by proposals from the Conference of Alaskans.

EXECUTIVE BUDGET PROPOSALS

Executive Budget Request. On December 15, 2003, Governor Murkowski unveiled his budget plan for FY05. He proposed a reduction of \$4 million in the General Fund budget, which would equal \$2.14 billion. Because of fixed cost increases and inflation, the actual

reductions in state General Fund spending would total \$170 million, spread among state departments but with proportionately greater reductions in the state Department of Education and Early Development. The Governor also proposed about \$75 million in increased taxes and fees, targeting tourists, smokers, and all workers who would pay an employment tax. Significantly, the Governor proposed no new general tax, such as a sales tax. He intimated that he would later make proposals concerning the earnings reserve of the Permanent Fund (FDNM, 12/16/03).

The Governor's largest increase in funding benefited the University of Alaska, which he'd promised a 5 percent increase each year of his term. The Governor kept this pledge but put the University increase of \$10.6 million in the Capital Budget (FDNM, 12/16/03). The state's contribution to the \$1.4 billion Capital Budget would be \$40 million, a reduction from the \$84.6 million spent in FY04. All would come from sale of state property to the Alaska Housing Finance Corporation (FDNM, 12/19/03). Federal revenues and fund public works projects would pay for the remaining \$1.3 million statewide.

The Governor's most controversial proposal was to call a conference on the purpose of the Permanent Fund and possible uses of fund revenues to fund state government, for mid-February in Fairbanks. The choice of Fairbanks was deliberate, as the state constitutional convention was held there in 1955-56. The Governor proposed selection of 55 representatives of the public, the exact number of delegates to the state constitutional convention (modeled on the U.S. Constitutional Convention). The Governor selected Randall Burns, Chair of the Permanent Fund Corporation, as convenor, to be assisted by former legislator and President of the Board of Regents, Brian Rogers (FDNM 1/15/04). The Governor said he did not want the conferees to propose new state taxes, and restricted them to a discussion on the Permanent Fund, with the intent of forging a consensus that could be used to nudge the Legislature to develop ballot propositions for the 2004 general election.

Conference of Alaskans. Hundreds of Alaskans applied for seats on the panel, and when selected in late January it included former legislators, businesspersons, Alaska Natives, and local government officials. The panel's activities were being carefully scripted to rein in discussion, but the Governor relented when some representatives insisted on the need to consider new revenue sources.

The panel met in mid-February and generally followed the outline recommended. They adopted four proposals:

1. To imbed the Permanent Fund Dividend in the state constitution;
2. To consider the reinstatement of the state income tax;
3. To seek voter approval of the percent-of-Market (POMV) proposal to stabilize dividends; and
4. To maintain a minimum amount (\$1 billion) in the CBR as a state rainy day fund (FDNM, 2/13/04).

However, indicating the suspect nature of the proceedings, within two weeks, a populist response formed to the panel, calling itself the "People's Conference." Organizers particularly objected to the unrepresentative nature of the Conference of Alaskans. They

pointed out that three-fourths of the panelists made more than \$100,000/year, and their high income blinded them to the effects of proposals such as an income tax on Alaska's poor and middle classes. Another group, the "Alaskans Just Say No" committee reiterated its complaints and objected again to the Governor's attempt to focus discussion on using part of PF earnings to fund state government.

As we shall see below, none of the panelists' proposals was adopted by the Legislature, showing that it was following an independent path and unresponsive to executive leadership at a time of high oil prices.

LEGISLATIVE ACTIONS

The first day in the second session of the 23rd Legislature, Democrats led an attempt to override the Governor's 2003 line-item veto of the Longevity Bonus. The attempt failed, but was supported by one Republican legislator, Robert Lynn from Anchorage. The Republican caucus in the House then censured him and stripped him of his chairmanship of two committees. This was an effective test of caucus rules on budgeting, which had been exercised just once since Republicans gained control of the Legislature in 1995.

Most Republicans were supportive of the Governor's General Fund and Capital Budget requests, while Democrats said they shorted the poor, Alaska Natives, and statewide education. Legislators were luke-warm about the Governor's permanent fund panel. Several leaders, for example Senate President Gene Therriault, said there was no consensus on using the PF earnings reserve to fund state government expenses. It is clear, however, that the Governor's actions focused more attention on the Legislature than it was comfortable with in an election year. The Legislature responded by 1) reaching agreement on corrections to the Governor's budget request, and 2) failing to agree on any proposed change to status quo fiscal policy.

Agreeing on the Details. For much of the session, legislators held routine hearings on the Governor's operating budget request. They gave no serious attention to reducing the budget. For example, after proposing to cut \$89 million in Medicaid reimbursements (FDNM, 2/20/04), they restored it in response to protests (FDNM, 3/31/04). They also restored committee cuts to parks and public TV/radio (ADN, 4/6/04).

Education funding became the vehicle for releasing sufficient monies from the CBR to balance the operating budget. The Governor's budget funded the foundation formula in full, but this was at a flat funding level. It did not cover increases in direct costs, such as salary increases, or inflation. School districts statewide complained that flat funding would force them to layoff non-tenured teachers, cut special reading and math programs needed to prepare students for state assessments, and reduce or eliminate popular extra-curricular activities such as sports. In response, the House adopted a bipartisan proposal that increased K-12 education funding by \$82 million, University of Alaska funding by \$15.8 million, and, to satisfy Democrats, added over \$10 million in public works projects. The Senate agreed to the education funding increase but objected to the pork (for Democrats).

Disagreeing on a Plan. Both Houses held lively discussions and debates on the elements of a long-range fiscal plan. The House heard an income tax bill early in the session, and the Senate considered a 4 percent sales tax proposal. Yet all tax proposals died—income, sales, cruise ship head tax, unemployment head tax, tourism marketing tax, and changes in corporate income and oil industry taxes (ADN, 5/15/04). Several bills proposed a constitutional amendment to protect PFDs, but neither House had sufficient votes (a two-thirds majority is required in each House to place a proposed constitutional amendment on the ballot).

Many legislative leaders believed a constitutional spending cap would be needed before voters would approve using earnings of the PF to fund state government. The House passed such a measure (FDNM, 4/23/04), but in the Senate Democrats declined to support the measure unless education (K-12 and University) was exempt from the cap. As a result, the Legislature did not enact a new spending limit.

Measures to stabilize the PFD through taking 5 percent of the capital plus earnings annually for dividends passed the House on a partisan, 27-13 vote; the Senate, however, rejected the proposal on a 5-15 vote. Finally a variety of proposals advanced in both Houses to allocate part of the PF's earnings for state government. The proposal receiving most support was HB 298, which would allocate half of PF earnings to dividends and, if more than \$1,000 per capita were available, would distribute 45 percent to education and 5 percent to communities (ADN, 4/29/04). This bill passed by a vote of 22 to 17, still insufficient to move to the November General Election ballot; and the proposal did not even reach a vote in the Senate. Said Senator Gary Wilken in mid-May, when oil prices hit \$40/barrel, "Every year we can get by without asking the working people of Alaska to contribute to government is a good thing" (FDNM, 5/15/04).

Legislative failure to act on a long-range fiscal plan is largely explained by high oil prices and continued access to the CBR. Partisanship also played an important role in 2004. Democrats favor an income tax; Republicans prefer a sales tax, notwithstanding its impacts on communities, which already have sales taxes in place. This year, the Democratic caucuses in House and Senate also opposed use of the PF earnings to support state government. They saw political advantage in appearing as champions of the PFD and picturing Republicans and particularly the Governor as waffling on campaign pledges to protect the dividend. Democrats hold 12 of 40 seats in the House and 8 of 20 seats in the Senate, which means that proposing any constitutional amendment to voters required unity of Republicans. Yet several Republicans, and especially those in the Senate, objected to any perceived tampering with the PF.

Special Session. Before the Legislature met, Governor Murkowski said he would call a special session on March 1st to address the long-range fiscal plan. He backed off this call when House and Senate leaders agreed to hear proposals in mid-March. Then, when no constitutional amendment proposals had passed either House 10 days before the mandated end of session, the Governor again threatened to call a special session (ADN, 5/1/04).

After legislators left Juneau in mid-May, the Governor called a special session for late June, and limited the agenda to fiscal issues concerning use of PF earnings for state government. However, legislators were disinclined to revisit issues they had already acted on. The only tax to emerge from the session was a \$33 million increase in cigarette taxes, advertised as a health and not a revenue issue. After the three-year phase in, Alaska's tobacco taxes will be the second highest in the nation (FDNM, 6/24/04).

Legislators and Governor traded blame for lack of success in the special session. Clearly most legislators welcomed an election season without measures on the ballot that might affect voters' PF dividends. This means, however, that the next opportunity to ask voters will be November 2006, also a gubernatorial election year.

Governor's Vetoes. Some legislators expected the Governor to retaliate with line-item vetoes or reductions after the special session adjourned. However, the Governor vetoed few appropriations in the 2004 election year budget (see "Summary of Vetoes," July 20, 2004). He left the Capital Budget untouched and cut only \$4.5 million from Operating Funds. He struck an appropriation to capitalize the Alaska Marine Highway Stabilization Fund, and then reduced funds appropriated for travel, equipment, un-ratified labor agreements, and other expenses. Altogether, the vetoes reduced the GF Operating Budget by less than 1 percent.

FINAL BUDGET

The FY05 budget bears a close resemblance to the budget of the previous year. It balanced the books with a smaller draw from the CBR than in FY04, and it increased spending slightly over the FY04 plan, as noted below.

Revenues. Alaska's FY2005 total, all-source, budget (including capital funding) is \$7.569 billion. 1 indicates the sources of revenue.

TABLE 1.
Revenue Sources, FY 2005 Budget
(Millions)

<u>Revenue Source</u>	<u>Amount</u>
Unrestricted General Fund Revenue	\$1,971.9
Constitutional Budget Reserve	360.6
Federal Funds	3,011.5
Other Funds	1,094.0
Permanent Fund Earnings	<u>1,131.0</u>
Total	\$7,569.0

The primary sources of unrestricted state revenues are royalties, property and severance taxes assessed on North Slope oil and gas production. This amount is \$150 million greater than in the previous year, notwithstanding lack of change in oil production (averaging 0.985

million barrels/day in FY04). Higher oil prices throughout FY04 led to estimates of continued higher prices into FY05. Correspondingly, the draw on the CBR is less, by about \$120 million, than predicted for the FY04 budget. (As noted above, the predicted deficit in FY04 had been erased by the close of the state 2004 fiscal year.) Federal funds projected to support the FY05 budget, the largest single category of funding, are \$540 million higher than for FY04. Other funds—including agency program receipts, license fees, and tuition at the University of Alaska, among other sources—are slightly lower (by \$60 million) than in the previous year. Finally, PF earnings are more than \$600 million greater, requiring an explanation.

The state constitution requires a three-fourth's majority of each House in order to draw funds from the CBR, which has required Republicans to seek support of minority Democrats since Republicans gained majority control in 1995. Such support has been costly and distasteful for Republicans, who object to increases in social welfare spending. In the first (2003) session of the 23rd Legislature, Republicans were able to take advantage of an exception to the three-fourth's requirement: when available revenues are less than those of the previous fiscal year, the extraordinary majority is not required. (See 2004 Alaska report)

Typically, PF earnings to be allocated to dividends and the PF earnings reserve are counted as revenue sources for state government. But in 2003, Republicans transferred the earnings reserve to FY2003 revenues, instead of to FY2004. This lowered the total revenues to an amount significantly lower than in FY2003, allowing a draw from the CBR without participation of the Democrats. This option was not available for FY2004, and the PF earnings reflect both PF dividends and earnings reserve amounts.

Capital Budget. The total Capital Budget of the state for FY2005 will be \$1.563 billion, about \$350 million larger than in the previous year. The state's share is tiny, less than \$9 million and nearly \$80 million less than in FY2004. The lion's share of the state Capital Budget—92 percent or \$1.445 billion (an increase of nearly one-half billion over the previous year)—is federal funding.

Operating Budget. Table 2 compares the FY2005 operating budget with that of FY2004 by agency, pointing out the percentage increase (or decrease):

TABLE 2.
Operating Budget, FY 04/05, and Changes
(In thousands)

Agency	FY 2004	FY 2005	Change in Percent
Administration	\$70,587.9	\$66,230.5	-6.2
Community & Economic Development	10,583.7	7,646.5	-27.8
Corrections	149,444.8	154,564.1	3.4
Education & Early Development	743,560.1	829,155.5	11.5
Environmental Conservation	11,341.1	11,778.5	3.9
Fish & Game	27,087.6	26,167.0	-3.4
Office of the Governor	14,330.1	17,337.8	21.0
Health & Social Services	527,126.3	527,018.6	0.0
Labor & Workforce Development	10,662.0	10,880.9	2.1
Law	26,425.7	29,603.2	12.0
Military & Veterans Affairs	8,611.1	8,982.8	4.3
Natural Resources	47,130.2	51,900.9	10.1
Public Safety	78,346.4	84,344.0	7.7
Revenue	8,214.8	9,361.7	14.0
Transportation & Public Facilities	96,345.0	97,185.2	0.9
University of Alaska	212,716.0	228,266.0	7.3
Alaska Court System	54,845.5	58,974.9	7.5
Legislature	37,193.7	38,527.9	3.6
Debt Service/Special Appropriations	53,374.0	54,396.1	1.9
Total-Operating Budget	\$2,187,924.8	\$2,312,322.1	5.7

Source: Alaska Legislative Finance Division, Fund Group: General Funds, June 18, 2003, August 8, 2004

The overall budget increase from FY2004 to FY2005 is \$124 million or 5.7 percent. Only three departments saw a reduction in funding. The Department of Fish & Game budget dropped 3 percent, and Administration's budget was reduced by 6.2 percent. Most significant was a reduction of 28 percent to the Department of Community and Economic Development. Most of this is accounted for by an increase in the Governor's Office budget. The Alaska Trade Office was transferred from Community and Economic Development to give it more visibility in the Office of the Governor.

The other departments (with the exception of the state's second largest, Health & Social Services, whose allocation did not change) received increases of from 1 to 14 percent. We have discussed increases in education funding, both K-12 and University of Alaska, which are the largest part of the overall dollar increase. However, there were increases to Natural Resources to expedite state oil/gas permitting and development, and to the Revenue department to pay for new oil/gas development staff. The Public Safety budget increased to allow hiring of 20 new state troopers, who are responsible for law enforcement outside Alaska's cities and boroughs. The Department of Law budget increase pays for hiring a dozen new state prosecutors. The court system initially was not slated for corresponding increases, but at the initiative of the state Senate, the court system received an unallocated increase in funding.

Thus budget increases reflect three themes: greater focus on development of Alaska’s oil and gas resources, increased support for K-12 and higher education, and increased funding for statewide law enforcement.

Table 3 presents agency totals from all sources. For details of agency appropriations, see: <<http://www.legfin.state.ak.us>. This shows that the total operating budget of \$6.1 billion relies less than 38 percent on state unrestricted General Fund appropriations. The federal share is \$1.5 billion (and the federal government contributes another \$1.445 billion to capital projects). The Department of Health & Social Services receives 60 percent of the federal funding. Both K-12 and university education also receive substantial federal support.

Program receipts such as user and license fees and tuition are large parts of the budgets of many state agencies. For example, they comprise 40 percent of the University of Alaska budget, 60 percent of the Transportation & Public Facilities budget and nearly 70 percent of the Revenue Department’s budget.

TABLE 3.

Agency Summary—FY 2005 Operating Budget
(In thousands)

Agency	General Fund	Federal	Other	Total
Administration	\$66,230.5	\$1,206.2	\$40,841.6	\$108,278.3
Community & Eco. Development	7,646.5	25,807.0	62,966.6	96,420.1
Corrections	154,564.1	4,397.4	8,737.8	167,699.3
Education & Early Development	829,155.5	171,776.8	23,476.7	1,024,409.0
Environmental Conservation	11,778.5	16,663.6	6,133.2	34,575.3
Fish & Game	26,167.0	56,971.2	42,572.1	125,710.3
Office of the Governor	17,337.8	155.3	801.8	18,294.9
Health & Social Services	527,018.6	935,222.7	112,048.5	1,574,289.8
Labor & Workforce Development	10,880.9	98,667.9	23,074.5	132,623.3
Law	29,603.2	761.0	3,634.8	33,999.0
Military & Veterans Affairs	8,982.8	18,825.7	596.8	28,405.3
Natural Resources	51,900.9	16,206.3	30,204.6	98,311.8
Public Safety	84,344.0	11,883.2	5,627.4	101,854.6
Revenue	9,361.7	37,504.9	106,678.2	153,544.8
Transportation & Public Facilities	97,185.2	3,664.6	150,706.7	251,556.5
University of Alaska	228,266.0	124,362.0	237,208.9	589,836.9
Alaska Court System	58,974.9	716.0	295.2	59,986.1
Legislature	38,527.9	0.0	0.0	38,527.9
Debt Service/Special Appropriations	54,396.1	41,253.2	1,373,249.3	1,468,898.6
Total	\$2,312,322.1	\$1,566,045.0	\$2,228,874.7	\$6,107,241.8

Source: Compiled from General Fund Group, Federal Receipts, and Other (non-duplicated), Legislative Finance Division, August 2, 2004.

CONCLUSIONS

There was little new in Alaska’s FY2005 budget process. The second-year Republican Governor did stress the need to develop a long-range fiscal plan and use of PF earnings to fund state government operations. His approach was indirect, as he empanelled a “conference

of Alaskans” to make the painful recommendations (much as former Governor Knowles had formed fiscal policy task forces, with similar results).

The Legislature under Republican leadership spurned the panel’s recommendations and did not reach consensus to send any proposal to voters. This left outstanding the issues of:

- Embedding the Permanent Fund dividends in the state constitution,
- Enacting a new state spending cap, and
- Using part of the PF earnings reserve to fund state government.

The Legislature also declined to adopt any new tax or increase existing taxes or fees with the single exception of the tobacco tax).

A \$2.1 billion balance in the CBR and high oil prices in 2004 made it unnecessary for any immediate change to state fiscal policy. Also, U.S. Senator Ted Stevens and Congressman Don Young continued their successful campaign to trap more federal dollars for Alaska (on a per capita basis) than any other state delegation was able to capture.

These factors enabled the Legislature and Governor to enact a FY2005 operating budget nearly 6 percent larger than the previous year’s. The state’s economy boomed in 2004 and prospects for 2005 looked good as well. Starting the 2004 election season, political leaders congratulated themselves for saving their constituents’ PF dividends and avoiding imposing income and/or sales taxes for yet another year.

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