
TAKING RESPONSIBILITY TODAY FOR ALASKA'S TOMORROW

JOBS, HOPE, AND ACCOUNTABILITY

For years Alaskans have heard about the state's "fiscal gap," which is the result of recurring expenses exceeding recurring revenues (if you were a family, you would describe it as "living beyond your means.") The state has been "living beyond its means" for 11 of the last 13 years.

This gap has been filled by spending from the Constitutional Budget Reserve (CBR), a savings account created by voters in 1990 that consists of one-time settlements from disputed oil and gas royalties and taxes. Over the years, \$7.9 billion has gone into the fund; today only \$1.9 billion remains. In spite of high oil prices in this current fiscal year that ends June 30, 2004, about \$277 million will be drawn from the CBR to prop up spending.

In developing the FY 05 budget, the challenge was to continue the process of ratcheting down spending and generating new revenues. The effort began with the Governor's proposed FY 04 budget guidelines and subsequent veto of Legislative authorizations. The Governor gave OMB the same parameters for developing the FY 05 budget:

- Limit using our savings from the CBR to \$400 million to prolong its usefulness as a buffer to oil price volatility.
- Spend less than this fiscal year while still paying for \$145 million in built-in cost increases, including:
 - \$34 million in employer costs for increases in retirement system contributions, unemployment insurance, and Workers Compensation;
 - \$7 million in merit increases for employees;
 - \$62 million in formula-driven increases, primarily for health and social services programs; and
 - \$45 million for increases in debt costs, primarily the result of bonds approved by voters in 2002 and to reimburse school districts for locally approved school construction bonds.

To limit the amount drawn from our savings, the Administration will also propose several additional sources of user-pay based revenues. The following proposals are estimated to raise about \$78 million in new revenues:

- Transient accommodation (bed) tax, which will generate \$32 million in annual revenue;
- Increase the tobacco tax by \$1/pack, estimated to generate \$36 million;
- Tax on cruise ship gambling, estimated to generate \$3 million;
- Pull tab tax reform, to provide \$2 million; and
- Tax on shore-side guided tour activities, which will raise \$5 million.

For the longer term, the Administration is committed to growing recurring revenues by developing Alaska's resources to pay for appropriate state responsibilities, such as public safety, transportation, and education.

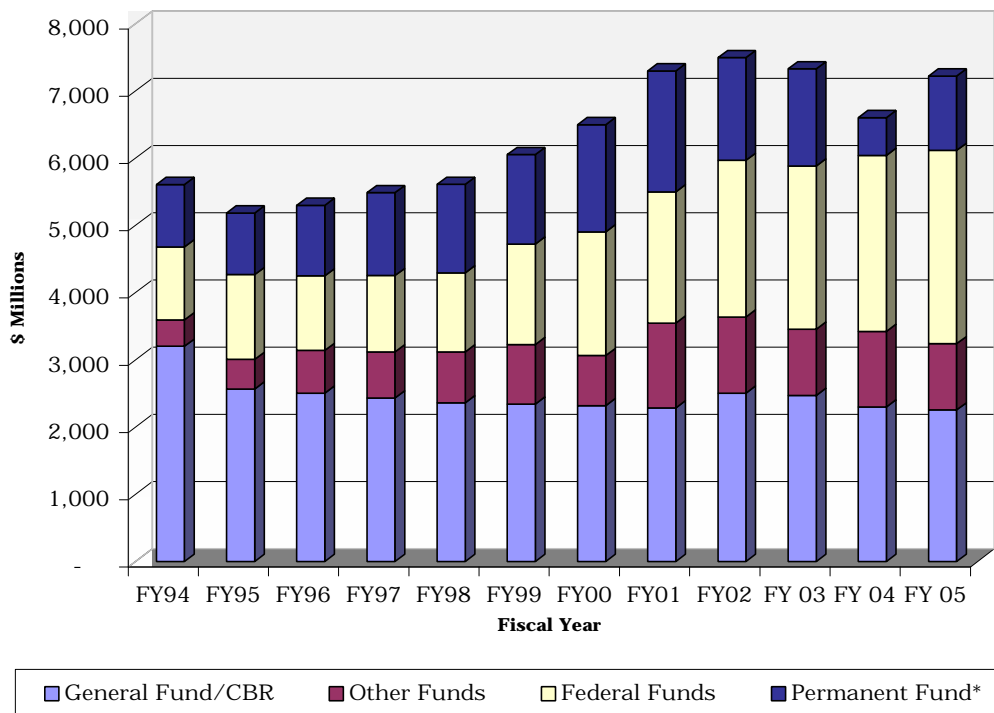
The following information provides background about state spending, revenues, and the context for developing the Fiscal Year 2005 budget.

FISCAL ISSUES

Historical Background

Chart 1 below shows appropriations by fund source for the FY 05 proposed budget compared to annual budgets in the past decade. What it demonstrates is that the main areas of growth by far in the total state budget have been federal funds and Permanent Fund payments for dividends and inflation proofing.

Chart 1
Appropriations by Revenue Source
Operating and Capital Budgets
FY 1994 - FY 2005 Proposed



Source: Legislative Finance Budget History File

*Permanent Fund includes appropriations for dividends and inflation proofing.

Federal funds have restrictions on how they may be spent and are largely devoted to transportation and health and social service programs. For the most part, the Legislature and Governor do not exercise much control over federal spending. Federal programs also often require a state general fund match (\$282 million in the FY 05 operating budget) or have maintenance of effort requirements. For the past several years, federal match requirements have

made up about half of the general fund portion of the state capital budget. For FY 05 the match portion of the capital budget is \$16 million out of \$40 million general fund total.

The “other funds” category in the budget includes such sources as university tuition and Alaska Housing Finance Corporation (AHFC) receipts and has grown as well, mainly to supplement and supplant declining general fund revenue. Beginning in 1992, there has been a concerted effort to separate out services that are fee supported from those that compete for general fund revenues. “Other funds” do not affect the fiscal gap or increase the draw on the CBR. Many fee-supported and self-funding programs have been reclassified from general fund to other state funds, which accounts for some of the growth in the other funds portion of the budget in recent years. The other funds portion of the FY 2005 budget is \$121 million lower than the FY 2004 authorized budget.

Chart 2 focuses on state-controlled funding sources (excluding Permanent Fund earnings discussed in detail in a later section) and shows the relationship between general fund revenue, draws from the constitutional budget reserve (CBR) and other funds during the past decade.

General Fund Revenues

The “fiscal gap” between revenues and expenditures is defined solely in terms of state general funds and is the focal point of the FY 05 proposed budget, because reductions in general fund spending help close the gap. Petroleum royalties and taxes comprise about 83% of general fund revenues.

The state currently produces about half of the 2 million barrels per day of oil that it did at its peak in 1988. The long term decline in production is exacerbated by the fact that new production from smaller fields is taxed at a much lower rate than the declining super-giant Prudhoe Bay and Kuparuk fields. Chart 3 shows historical and projected general fund revenue and demonstrates how the long-term underlying decline in petroleum revenue is affected by periodic spikes and troughs caused by oil price volatility.

Chart 2
State Funding Sources and CBR Draw
Operating and Capital Budgets
FY 1994 - FY 2005 Proposed

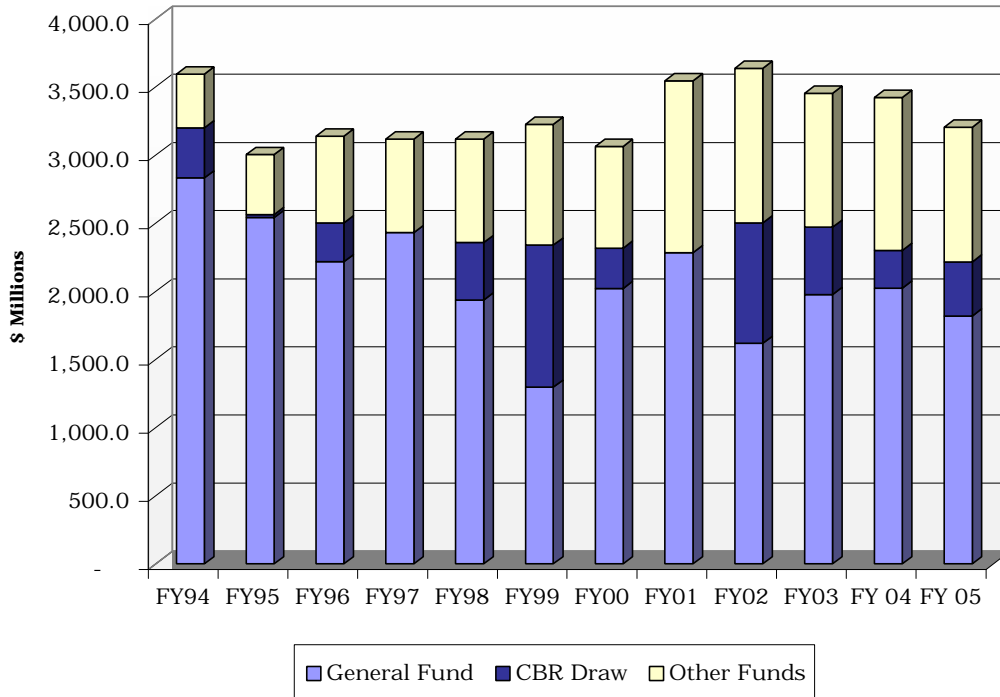
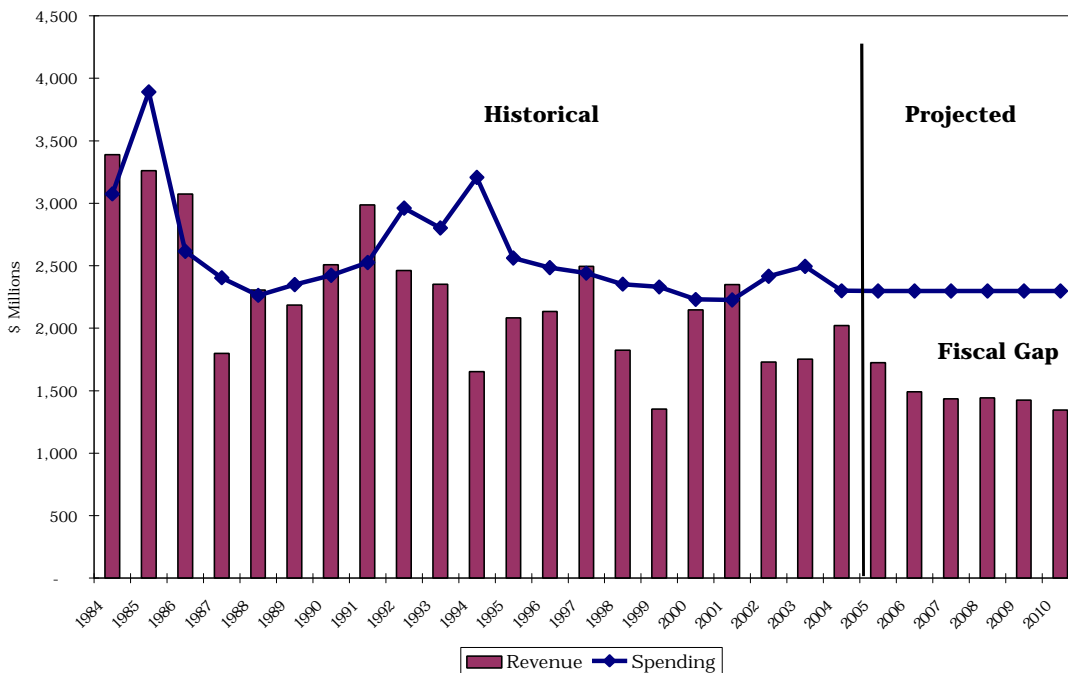


Chart 3
The Gap: Looking Forward
Historical and Projected General Fund Revenues vs.
Expenditures: FY 1984 - FY 2010



New oil developments in NPRA and elsewhere on the North Slope will undoubtedly improve the long-term revenue picture but are at least a few years off. Likewise the Governor's proposals for industrial roads to mining and other natural resource development prospects will take some time to bring revenue returns to the state treasury. While the Administration is very focused on getting the infrastructure in place to support development, it is premature to build anticipated revenues into the forecast. For this reason it is important to preserve the balance in the CBR so that it can help bridge the fiscal gap until revenues from new development are available.

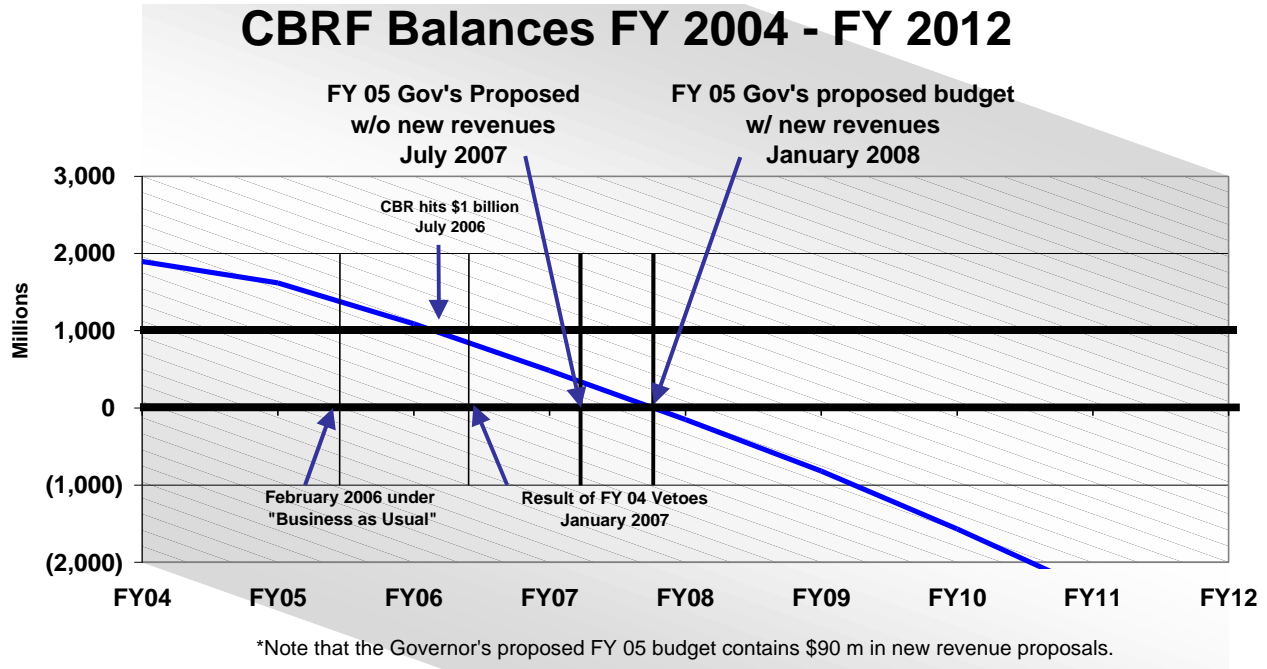
General Fund Revenues and the CBR Draw

The CBR was established by a constitutional amendment authorized in a statewide vote in the 1990 general election. It was capitalized by oil and gas royalty and tax settlements with petroleum companies and was designed as a buffer to insulate the state general fund from oil price swings that devastated the state economy in the mid '80s. At current production level, every \$1 change in the average price of oil over the fiscal year results in a little less than \$65 million change in revenues. (In the mid-'80s every \$1 change in the price of oil generated \$150 million due to high production in high tax fields.)

Virtually all of the large tax and royalty cases have been settled, which means there are no more big deposits to replenish the CBR. During the past decade the CBR has served as a buffer to oil price volatility and been used to address the state's structural deficit.

For 11 of the past 13 fiscal years, the state has balanced its budget by drawing money from the CBR. Even assuming flat general fund budgets at the Governor's proposed FY 05 level and continued extraordinarily high oil prices, without additional new revenue sources, the CBR will be depleted in July 2007. Chart 4 is a graphical depiction of the Department of Revenue (DOR) projection of the CBR balance at the FY 05 Governor's proposed spending level.

The Alaska Department of Revenue recommends a minimum CBR balance of \$1 billion to cushion oil price volatility. Additionally the state needs about \$400 million per year for cash flow. Cash flow draws on the CBR occur when incoming revenues do not match expenditures. Petroleum revenues are greater in winter months when North Slope gas handling facilities work most efficiently, while payments going out are at their highest at the change in fiscal year (June 30) and during the summer construction season. The ability to use the CBR for cash flow has saved the state millions in financing charges (without this type of cushion governments have to borrow money using revenue or tax anticipation notes, which incur interest costs).



To give some idea of the sensitivity of the fiscal gap to new revenue sources, the Governor's proposed new revenues would extend the CBR expiration date from July 2007 to January 2008. If the Governor's target of \$400 million annual draws on the CBR was maintained indefinitely, the expiration date is extended to December 2010. Such a scenario would entail additional general fund budget cuts or revenue increases of \$270 million in FY 06 (plus further cuts or revenue increases in subsequent years) to maintain the CBR draw target.

The immediate goal expressed in the budget is to slow the rate of CBR decline with a combination of budget cuts, leveraging funds available with bonds, and new user-pay based revenue sources. Longer-term, the goal is to close the fiscal gap by balancing expenditures with recurring revenues. The changes embodied in the Governor's proposed FY 05 budget reflect the Administration's policy priorities to increase support for public safety, resource development and education. Reductions to agency budgets are focused on taking administrative savings first and direct services last.

The fiscal summary (Table 1) provides a broad outline of the FY 2005 enacted budget compared to FY 2004.

State of Alaska Fiscal 2004 Authorized/FY2005 Governor Fiscal Summary Comparison

(dollars shown in millions)

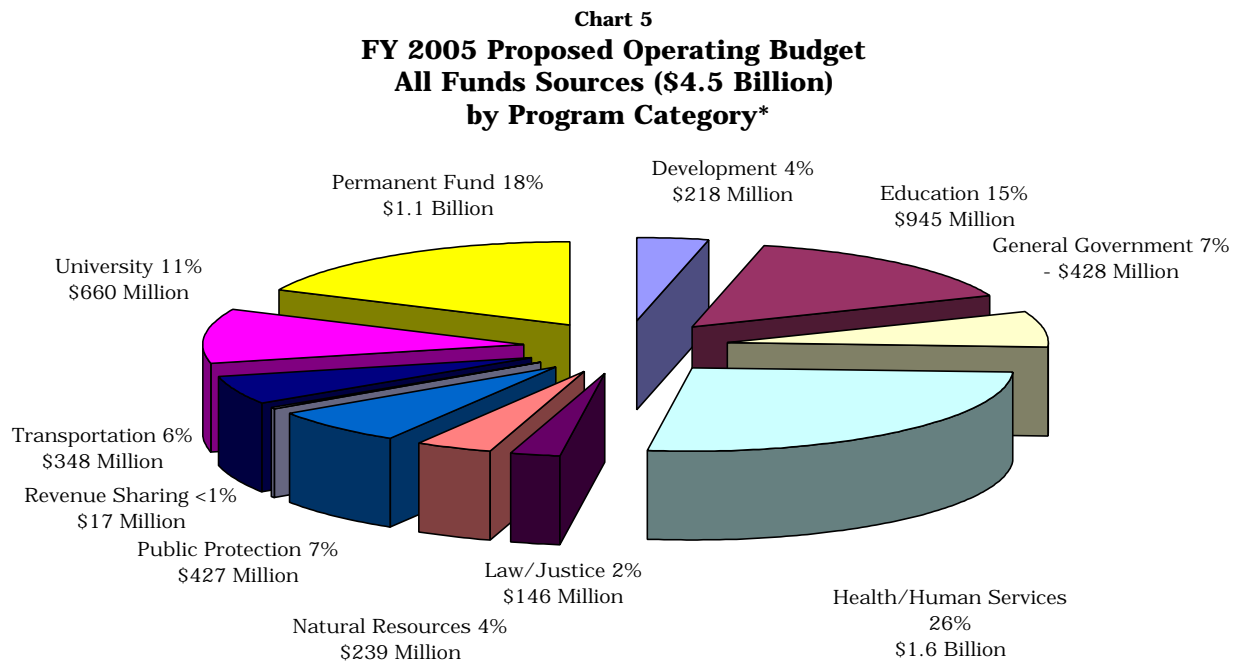
	FY2004 Authorized				FY2005 Governor			
	General Fund	Federal Funds	Other Funds	Total Funds	General Fund	Federal Funds	Other Funds	Total Funds
1 Revenues								
2 Unrestricted General Fund Revenues (A)	2,022.9			2,022.9	1,724.3			1,724.3
3 Proposed New Revenues				0.0	12.5			12.5
4 Corporate Proceeds(B)				0.0	40.0			140.0
5 Corporate Dividends (C)			67.5	67.5			100.0	76.7
6 Federal and Other Funds		2,609.5	1,055.3	3,664.8		2,861.1	825.4	3,686.5
7 Total Revenues	2,022.9	2,609.5	1,122.9	5,755.2	1,776.8	2,861.1	1,002.1	5,640.0
8 Authorization to Spend								
9 Operating	2,147.3	1,533.6	810.2	4,491.2	2,142.9	1,521.2	821.4	4,485.5
10 Agency Operations (non-formula)	1,086.8	803.2	1,262.6	3,152.7	1,076.1	750.1	1,277.4	3,103.6
11 Formula Programs	1,060.5	730.4	140.5	1,931.5	1,066.7	771.2	135.0	1,972.9
12 Duplicated Authorizations (D)			(593.0)	(593.0)			(591.1)	(591.1)
13 Capital	84.6	1,030.4	160.3	1,275.3	40.0	1,300.9	58.4	1,399.3
14 Project Appropriations & Revised Programs	84.6	1,030.4	291.3	1,406.3	40.0	1,300.9	164.2	1,505.1
15 Duplicated Authorizations (D)			(131.0)	(131.0)			(105.7)	(105.7)
16 Debt and Other Statewide	68.7	45.4	152.4	266.5	68.8	39.0	122.3	230.1
17 Debt Service	3.6	0.0	131.9	135.6	2.7	0.0	177.0	179.7
18 Loan and Debt Fund Capitalization	50.0	45.4	99.8	195.3	48.6	39.0	85.4	173.0
19 Supplemental Appropriations (down from \$25.6)	15.0			15.0	12.5			12.5
20 New Legislation				0.0	5.0			5.0
21 Duplicated Authorizations (D)			(79.4)	(79.4)			(140.1)	(140.1)
22 Total Authorization to Spend	2,300.6	2,609.5	1,122.9	6,032.9	2,251.7	2,861.1	1,002.1	6,114.9
23 PF Dividends (and PFD division operations)			560.0	560.0			490.0	490.0
24 PF Inflation Proofing and Transfers (E)		2.4	0.0	2.4			613.0	613.0
25 Total AK Permanent Fund		2.4	560.0	562.4			1,103.0	1,103.0
26 Totals with Permanent Fund	2,300.6	2,611.9	1,682.9	6,595.3	2,251.7	2,861.1	2,105.1	7,217.9
27 Draw from CBR to Balance Fiscal Year	277.7				474.9			
28 Adjustment for Deposit of ASTF Endowment	(95.0)							
29 New Revenue through Legislation					(77.5)			
30 Adjusted CBR Draw	182.7				397.4			

Notes

- A FY2004 Unrestricted Revenues are based on an oil price of \$27.70 per barrel and estimated production of 0.996 million barrels per day. FY2005: \$24.65 and 0.985 mbd
- B Bonds Proceeds are projected proceeds from sales of Alaska Housing Finance Corporation (AHFC) bonds of \$25 million and Alaska Student Loan Corporation (ASLC) bonds of \$75 million, and potential purchase of state assets by AHFC (\$40 million).
- C Corporate Dividends include funds made available to the State by the boards of the Alaska Industrial Development and Export Authority (AIDEA), Alaska Housing Finance Corporation and Alaska Student Loan Corporation. The AIDEA dividend for FY2004 is \$18.2 million and for FY2005 \$22 million. The total AHFC transfer for dividend, capital projects, loan programs and debt service is \$103 million for FY2004, and \$103 million for FY2005. Since AHFC's debt payments for general government purpose bonds do not require appropriation, the net transfers appropriated here are \$47 million for FY2004 and \$49.1 million for FY2005. The ASLC Dividend is \$5 million in FY2004 and \$5.6 million for FY2005.
- D Duplicated authorizations are in the budget twice, such as when funds flow in and out of a holding account or one agency pays another for services provided.
- E \$354 million of FY2004's projected inflation proofing of \$540 million was prefunded in FY2003. Currently, there is no appropriation for the remaining \$186 million estimated for full inflation proofing in FY2004.

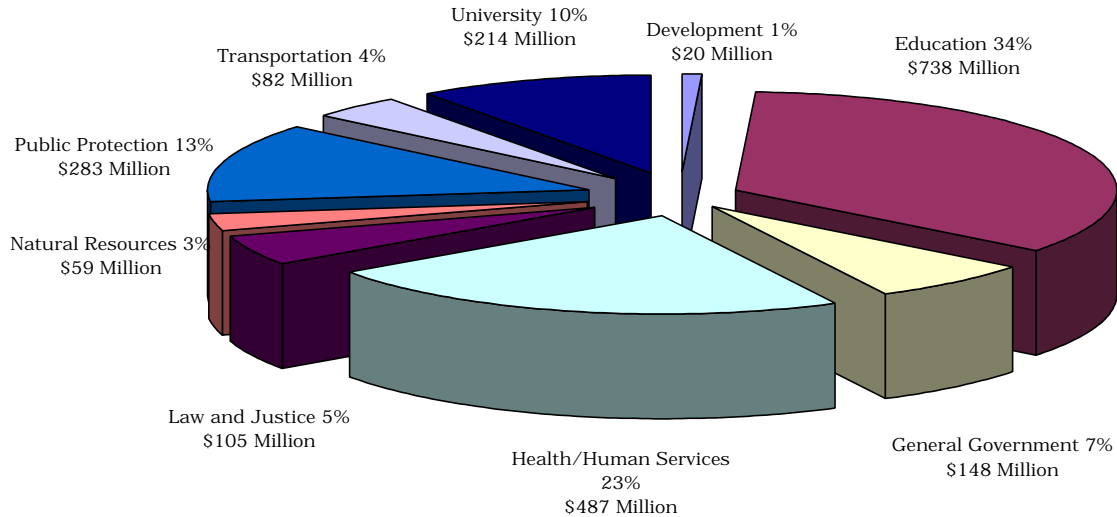
The pie charts (charts 5 and 6) provide a sense of the relative share of spending by program area in the FY 05 Governor's proposed operating budget in terms of total funds and general funds. Policy priorities expressed in the operating budget include:

- Public Safety
 - 20 new troopers, 5 new court service officers
 - 6 new criminal prosecutors
 - 9 civil attorneys, of which three are for Child in Need of Aid case, one for Juvenile Delinquency cases, and one for human services case work
 - 14 social workers and 7 associate social workers
- Education
 - K-12 classroom support, school debt reimbursement and pupil transportation funded as provided by law
 - 5% (\$10.6 million) increase for the University of Alaska
- Resource Development
 - 13 new positions in DNR's Division of Oil and Gas to work on oil and gas initiatives such as the Alaska Peninsula oil and gas lease sale and the gas line project
 - Coastal management "Permit Portal" created to further streamline permit issuance
 - DEC will assume primacy for issuance of permits under the Clean Water Act (instead of the Federal government), which will expedite the permit process



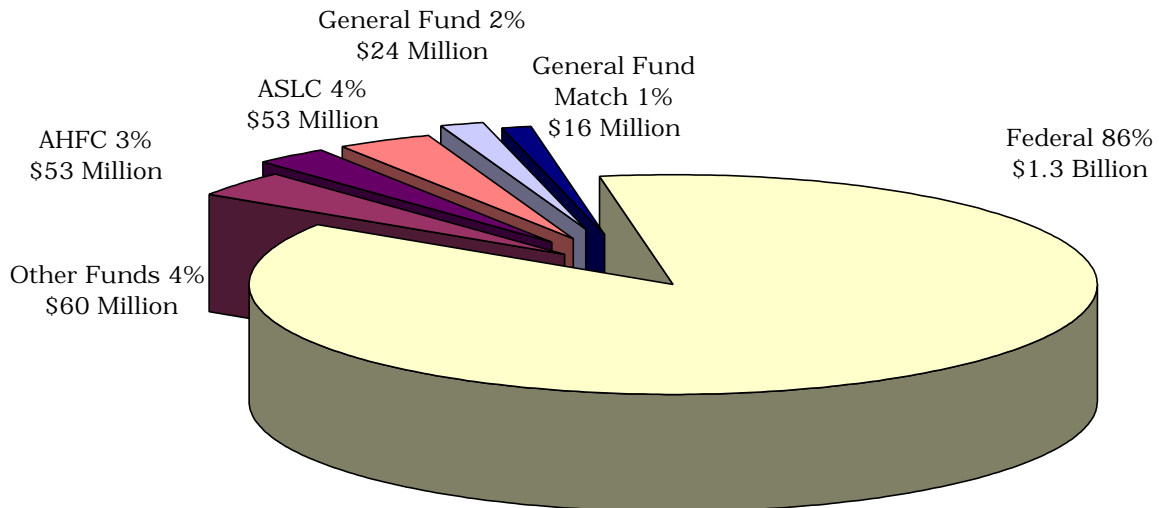
*Permanent Fund earnings appropriations are for dividends and inflation proofing.

Chart 6
FY2005 Proposed Operating Budget
General Fund (\$2.1 Billion)
by Program Category



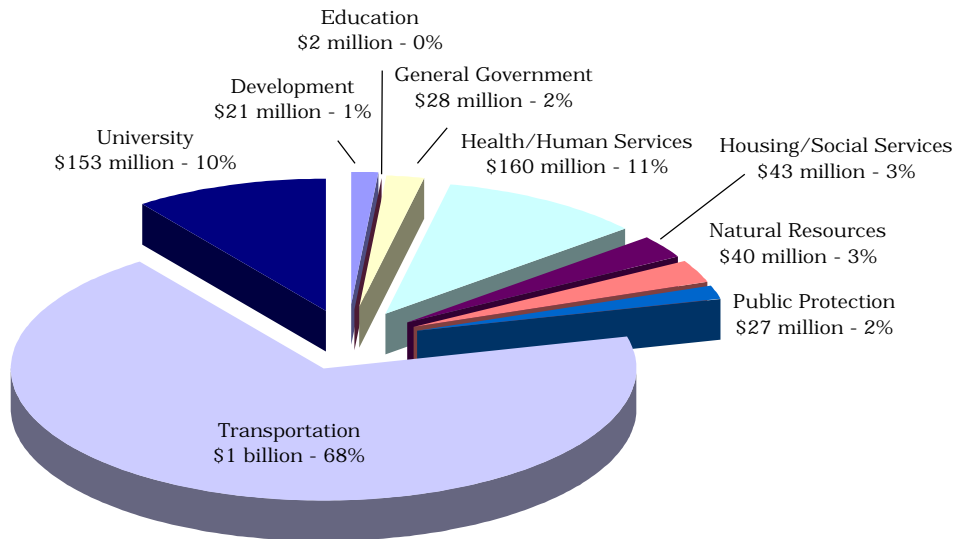
The Governor's proposed FY 05 capital budget is shown in charts 7 and 8 by major funding source and program category. As in years past, the capital budget is driven primarily by federal funding. Bond proceeds from the Alaska Student Loan Corporation (ASLC) and the Alaska Housing Finance Corporation (AHFC) are used to help limit the draw on the CBR to the Governor's \$400 million target.

Chart 7
FY 2005 Proposed Capital Budget
All Fund Sources (\$1.4 Billion)



*Slices add to more than total due to duplications, (i.e., when funds flow from one account to another or when one agency makes a purchase from another.)

Chart 8
FY 05 Governor's Proposed Capital Budget
by Category: \$1.4 Billion



*Slices add to more than total due to duplications, (i.e., when funds flow from one account to another or when one agency makes a purchase from another.)

Spending

In recent years, formula programs and debt service have been primary driving forces in state spending increases. To be successful, any long-term fiscal plan needs to come to grips with these areas of systemic budget growth.

Formula Program Growth

Charts 9 and 10 show formula program growth by fund source and provide some perspective on how their growth affects the state operating budget. Even though the focus here is on *state* spending, it is important to show the growth in federal funding, particularly for Medicaid, because of state match requirements (\$282 million of the \$2.1 billion in general funds for the FY05 operating budget).

Formula program growth has been largely controlled in FY 04 and FY 05 by reorganizing and refinancing efforts undertaken in the Department of Health and Social Services (DHSS). About \$64 million in general funds were added to pay for increases in caseload driven programs such as, Medicaid, Adult Public Assistance, and the Subsidized Adoption and Guardianship programs. These increases were covered by refinancing \$19 million in various programs (getting federal funds in place of state funds to cover costs), \$23 million in administrative efficiencies, and \$24 million in cost containment initiatives. Overall DHSS funding in FY 05 is less than FY 04, which has not happened in many years.

Chart 9
Formula Program Growth
by Fund Source
FY 1999 - FY 2005

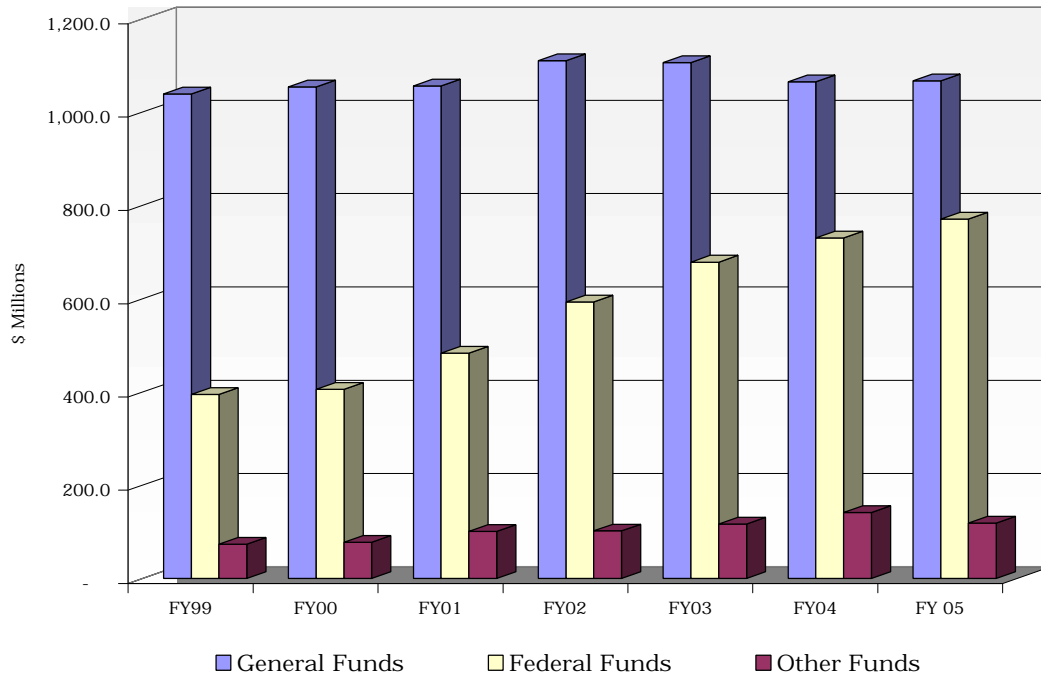


Chart 10
Operating Budgets vs. Formula Programs
General Funds
FY 1994 - FY 2005 Proposed

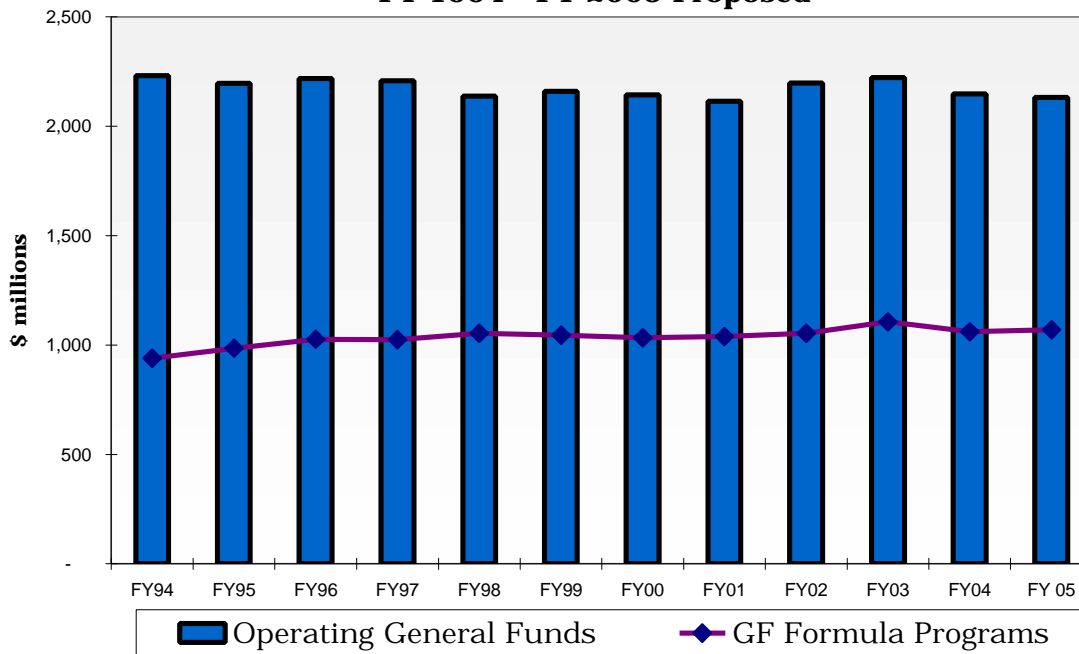


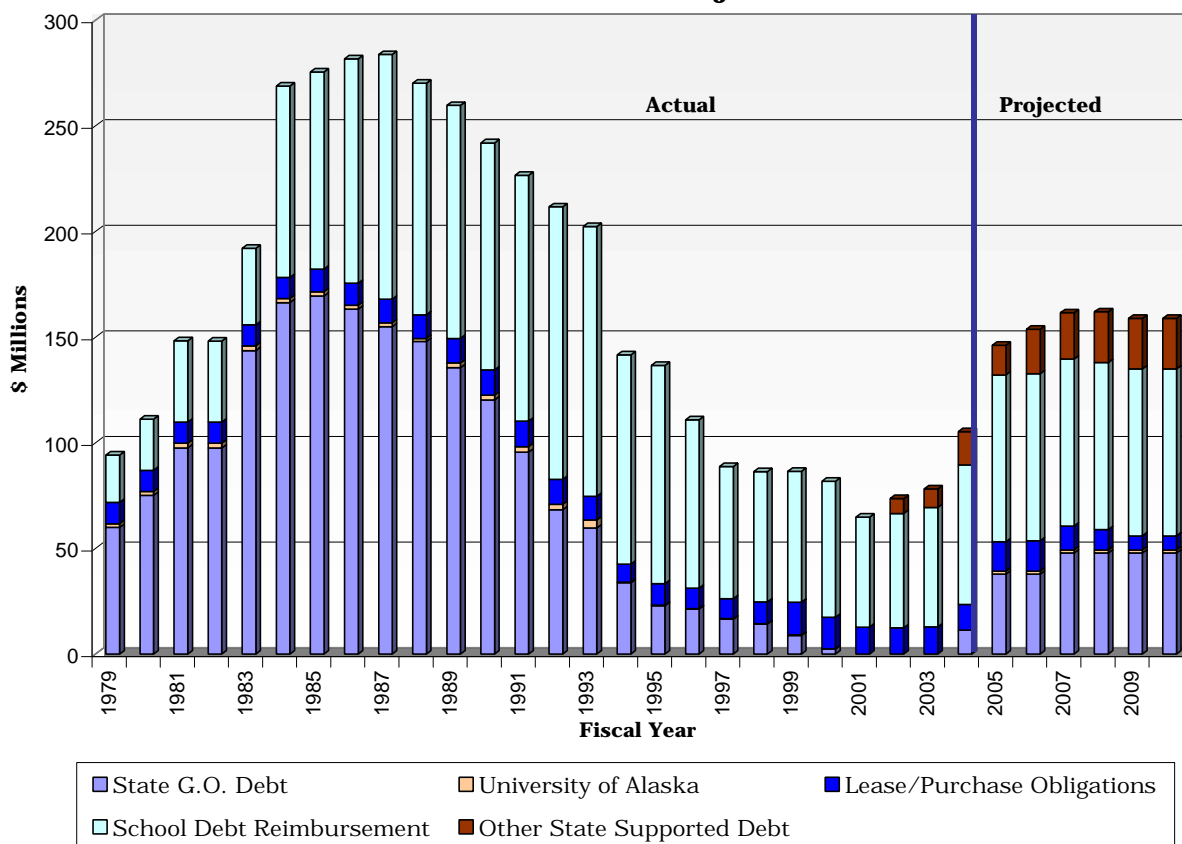
Table 2 is a list of formula programs that highlights changes in the FY 05 budget compared to FY 04.

Table 2 Formula Programs FY 04 Authorized vs. FY 05 Proposed				
Agency	Program	FY 04 Authorized	FY 05 Proposed	Change
DOA	Elected Public Officers Retirement System Benefits	1,493.9	1,493.9	0.0
	Unlicensed Vessel Participant Annuity Retirement Plan	75.0	75.0	0.0
	Subtotal	1,568.9	1,568.9	0.0
Education	Foundation Program	701,768.9	693,344.9	(8,424.0)
	Pupil Transportation	53,933.8	54,433.8	500.0
	Boarding Home Grants	185.9	185.9	0.0
	Youth in Detention	1,100.0	1,100.0	0.0
	Schools for the Handicapped	6,297.2	0.0	(6,297.2)
	Special Schools	0.0	6,425.2	6,425.2
	Subtotal	763,285.8	755,489.8	(7,796.0)
DHSS	Alaska Temporary Assistance Program	47,653.7	43,896.9	(3,756.8)
	General Relief Assistance	1,499.0	1,499.0	0.0
	Adult Public Assistance	57,820.2	57,161.4	(658.8)
	Old Age Assistance-Alaska Longevity Bonus (ALB) Hold Harmless	519.5	0.0	(519.5)
	Permanent Fund Dividend Hold Harmless	15,405.5	15,949.9	544.4
	Child Care Benefits	47,725.0	46,013.2	(1,711.8)
	Tribal Assistance Programs	8,612.5	8,381.4	(231.1)
	Behavioral Health Medicaid Services	104,292.6	118,328.6	14,036.0
	Medicaid Services	620,354.1	649,258.2	28,904.1
	Children's Health Eligibility	2,279.6	0.0	(2,279.6)
	Catastrophic and Chronic Illness Assistance (AS 47.08)	1,471.0	1,471.0	0.0
	Subsidized Adoptions & Guardianship	18,382.7	19,732.9	1,350.2
	Foster Care Base Rate	9,511.1	10,106.9	595.8
	Foster Care Augmented Rate	2,685.5	2,126.1	(559.4)
	Foster Care Special Need	4,712.3	4,662.0	(50.3)
Children's Medicaid Services	9,911.4	10,851.7	940.3	
Senior and Disabilities Medicaid Services	183,544.5	191,291.2	7,746.7	
Subtotal	1,136,380.2	1,180,730.4	44,350.2	
DCED	National Program Receipts	15,830.0	15,830.0	0.0
	Fisheries Business Tax	1,600.0	1,600.0	0.0
	Alaska Energy Authority Power Cost Equalization	15,700.0	15,700.0	0.0
Subtotal	33,130.0	33,130.0	0.0	
DMVA	Retirement Benefits	1,322.5	2,025.3	702.8
Total		1,935,687.4	1,972,944.4	37,257.0
	General Funds	1,064,709.2	1,066,749.0	
	Federal Funds	730,431.1	771,156.4	
	Other Funds	140,547.1	135,039.0	

Debt Service Growth

Another area of recent and future growth in the state budget is debt service. During the past decade, the state was able to leverage non-general fund revenue sources to finance capital projects, e.g., tobacco settlement receipts, and the Alaska Housing Finance Corporation (AHFC) annual dividend. However that all changed in 2002 when voters approved the first issuance of general obligation bonds since 1980 for transportation and school construction projects. The Legislature also approved a school debt reimbursement program for municipalities and capital project debt reimbursement for various university, harbor and power projects.

Chart 11
State Supported Debt Service
Historical and Projected



The Governor's FY 05 proposed budget uses \$140 million in bond and other proceeds to help fund the capital budget and pay debt service. Included in this total is:

- \$75 million from refinancing a portion of the Alaska Student Loan Corporation portfolio (this is year one of a three-year program);
- \$25 million for primarily Village Safe Water projects financed with Alaska Housing Finance Corporation (AHFC) corporate general obligation bonds
- \$40 million (net), which may come from the purchase and lease back of state facilities by AHFC (the Administration is currently evaluating an idea by which AHFC would manage (and own some) state facilities).

In total funds terms, debt service increased by \$45 million, for a total cost of \$177 million in Fiscal Year 2005 and it will continue to increase in the future as additional authorized bonds are sold as shown in Chart 11. Table 3 provides a detailed breakdown of the state's debt obligations and the revenue sources used to meet them.

Table 3
FY2005 Governor's Budget
Debt Obligations and Revenue Sources
(\$ thousands)

Debt	FY2004	FY2005	Inc/(Dec)
School Debt Reimbursement (estimated maximum per school districts)	66,024.1	79,032.7	13,008.6
Lease Finance			
DEC Seafood and Food Safety Lab		1,475.0	1,475.0
API Replacement	706.0	1,661.5	955.5
Palmer Airport Fire Facility	756.8	757.6	0.9
Spring Creek Correctional Facility	3,991.2	3,973.9	(17.3)
Anchorage Times Building	789.3		(789.3)
Soldotna DOT Maintenance Facility	639.3	640.3	1.0
Anchorage Health Lab	2,319.1	2,346.3	27.2
Fairbanks Courthouse	2,900.3	2,906.8	6.5
Trustee Fees	100.0	50.0	(50.0)
Total Lease Finance	12,201.9	13,811.3	1,609.4
Atwood Building	3,549.4	3,549.4	(0.0)
HB528- University	1,412.9	1,414.0	1.1
HB528- Harbors	709.0	130.0	(579.1)
HB528- Power Projects	696.8	1,192.0	495.2
General Obligation Bonds- Transportation, Education and Museum	15,192.6	32,315.5	17,122.9
General Obligation Bonds- GARVEE Transportation	4,194.5	14,090.6	9,896.1
Total Debt	103,981.2	145,535.5	41,554.2
Fund Sources			
School Fund (Cigarette Tax)	28,600.0	30,200.0	1,600.0
Debt Retirement Fund Balance (contingent on sweep reversal)	7,869.8	10,133.2	2,263.4
School Fund FY2004 excess appropriated back to DRF (FY2004 Supp)		5,372.1	5,372.1
Investment Loss Trust Fund	2,500.0	104.0	(2,396.0)
AHFC Dividend (DRF)	8,861.1	27,568.0	18,706.9
AHFC Dividend (Atwood Building Debt)		2,326.1	2,326.1
AIDEA Dividend (DRF)		11,000.0	11,000.0
ASLC Bonds (DRF)		24,815.0	24,815.0
GO Bond Premiums (Series 2003A)- Bond Premiums and Interest (DSF)	15,192.6	12,609.3	(2,583.3)
GO Bond Premiums (Series 2003A)- Capital Projects Interest (DRF)		2,473.1	2,473.1
GARVEE Transportation Bonds- Federal Revenue (DRF)	3,894.5	8,606.4	4,711.9
GARVEE Transportation Bonds- Bond Premiums and Interest (DSF)		5,045.6	5,045.6
GARVEE Transportation Bonds- AATP Match (DRF)	300.0	438.6	138.6
Chugach Grant interest earnings (DRF)	29,707.6	0.0	(29,707.6)
International Trade and Business Endowment balance	4,382.0	0.0	(4,382.0)
State Land Disposal Income Fund balance (contingent on sweep reversal)	2,500.0	0.0	(2,500.0)
Atwood Building miscellaneous earnings (tenant rent and interest)	2,718.5	1,223.3	(1,495.2)
Municipal Bond Bank interest on reserve account	775.0	775.0	0.0
Lease Retirement Account investment earnings (DRF)	461.3	109.8	(351.5)
General Funds Appropriated	6,352.0	2,735.9	(3,616.1)
Total Fund Sources	114,114.4	145,535.5	31,421.1
(roll forward in DRF to FY2005)	10,133.2		
General Fund Appropriations			
Appropriation to Debt Retirement Fund	2,702.4	0.0	(2,702.4)
Appropriation to Administration for Atwood Building Debt	830.9	0.0	(830.9)
Appropriation to University for HB528 Debt	1,412.9	1,414.0	1.1
Appropriation to Transportation and Public Facilities for HB528 Debt	709.0	130.0	(579.1)
Appropriation to Community and Economic Development for HB528 Debt	696.8	1,192.0	495.2
Subtotal General Fund Appropriations	6,352.0	2,735.9	(3,616.1)

In addition to the items listed above, the Alaska International Airport System and State corporations such as AHFC (including Northern Tobacco Securitization Corporation bonds) and AIDEA also issue and pay for debt for corporate purposes. Also, the Alaska Clean Water Fund and Alaska Drinking Water Fund are capitalized in part from debt that is paid from their respective fund earnings.

The cost to the state for financing future debt is dependent on the state's credit rating. Currently the state enjoys an excellent credit rating – Aa2 Moody's, AA for both Standard and Poors and Fitch. During the last Administration in August 2002, Moody's gave Alaska a "negative outlook" pending some positive action to address the long-term fiscal gap. All of the rating agencies are quite aware of Alaska's long term fiscal situation and are watching closely to see how it is addressed. The Governor has made it clear to them that he intends to control spending and maintain the viability of the CBR. While controlling spending is only a part of a long-term solution to the state's fiscal gap, the state's future credit rating will be tied to successful efforts to match recurring expenditures with recurring revenues.

Looking Forward: Long Term Fiscal Options

The Permanent Fund Trustees have proposed a mechanism for removing funds from the Permanent Fund that is an endowment-type concept called the Percent of Market Value, or POMV. This is the mechanism used by most major funds throughout the world. There is universal agreement among experts that this would be a better mechanism than that in current use. The funds removed (the payout) would be deposited into the General Fund and made available for appropriation by the Legislature for dividends and perhaps other purposes.

There is no consensus yet about how the payout should be spent by the Legislature. Some have proposed that 50% of the payout be spent on the dividend and 50% on government programs. The Governor is still considering the matter.

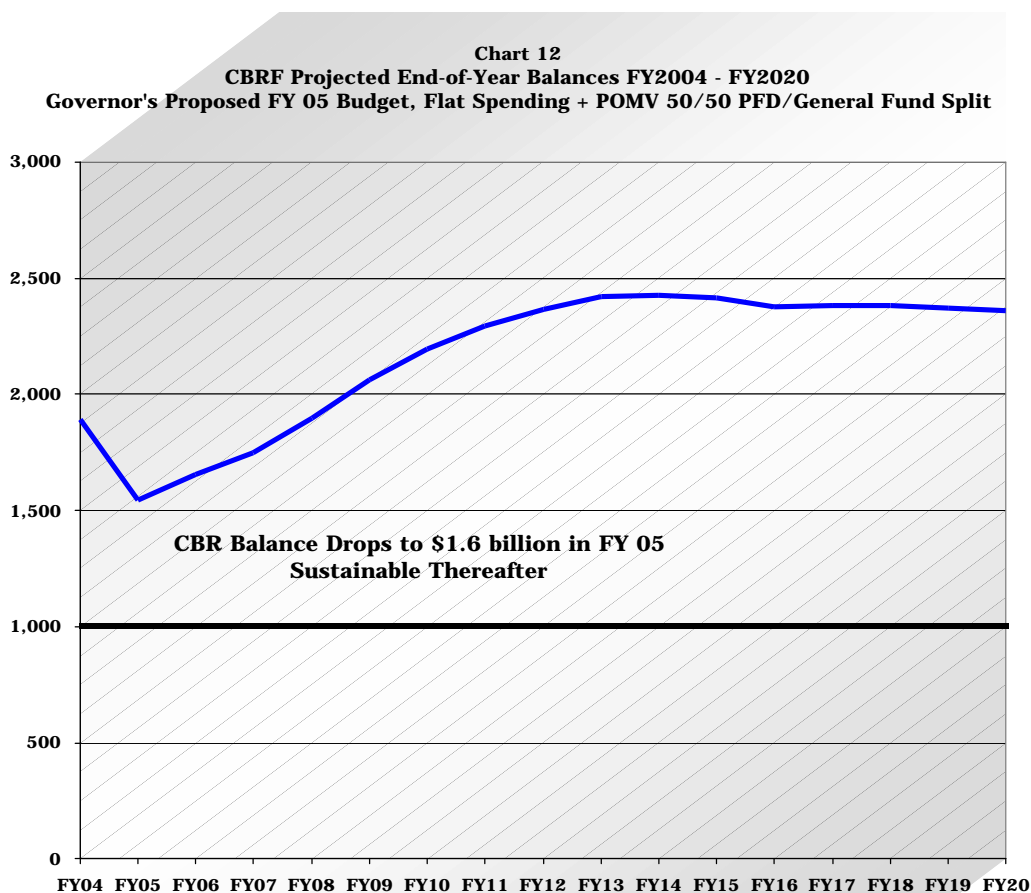
The basic elements of the Trustee's proposal are straightforward: Five percent of the market value of the Permanent Fund would be made available to the Legislature each year (about \$1.36 billion). On average, the Fund is expected to earn about 7.95% per year so the payout rule would add 3% each year to the value of the Fund to offset the effects of inflation and maintain its real value into the future. The Trustees have made no recommendation on how the payout is to be spent. The Governor supports the POMV model as proposed by the Trustees (but for modeling purposes as presented in Chart 12 we assume the POMV payout is split evenly between dividends and the general fund.)

Currently dividends are paid out of the Earnings Reserve Account (ERA) of the Permanent Fund. Because of market losses, the balance in the ERA in September 2002 was zero, prompting speculation that earnings might not be available to pay a 2003 dividend. However, the stock market turned around in April 2003 and allowed individual dividends of \$1,110 to be paid in October. A subsequent Attorney General's opinion clarified ERA accounting procedures.

The effect was to remove stock market volatility from the dividend calculation, which greatly reduced the possibility that the dividend could ever be zero.

Because changing to a POMV payout model requires a constitutional amendment, it must receive approval by two-thirds of each house of the Legislature and then be approved by voters in a statewide general election. If placed before and approved by voters in 2004 and it is decided to split the payout 50/50 between dividends and government services, \$682 million would be available for dividends and an equal amount to the general fund to support state services beginning in FY 06.

A POMV provision coupled with using some of the payout to fund government services is not a silver bullet but would extend the projected CBR depletion date beyond the foreseeable future. As Chart 12 illustrates, the CBR balance would fall to \$1.6 billion in FY 05 but would increase thereafter, providing the fiscal stability necessary for businesses to make investments in resource development projects such as the gas line and NPRA, which will bring in more recurring revenues that will increase with a growing and diversifying economy.



Summary

The initial focus of the Governor's proposed FY 2005 budget is on the fiscal gap between general fund revenues and expenditures. The first step is to slow the drawdown of the CBR balance to maintain its usefulness as a buffer to oil price volatility and for cash flow needs. The Governor's proposed budget cut \$145 million in built-in general fund cost increases to achieve \$49 million in overall savings compared to FY 2004. The operating budget is \$4 million less than FY 04. New revenue proposals totaling \$90 million will be needed to keep the FY 05 CBR draw to just under \$400 million.

For the longer-term, the Governor supports the Permanent Fund Trustees' POMV recommendation as the best means of protecting the Permanent Fund and provide a stable payout of the earnings to meet the highest and best use as determined by the Legislature and Alaskans.