

How Vulnerable Is Alaska’s Economy to Reduced Federal Spending?

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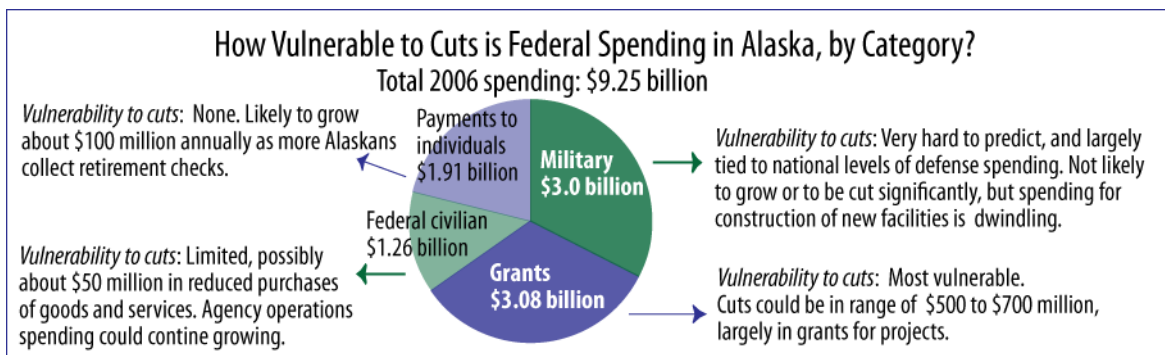
About a third of all jobs in Alaska can be traced to federal spending here—and over the past decade the rapid increase in federal spending drove much of the economic growth. Federal spending in Alaska more than doubled between 1995 and 2005, and in 2006 it was \$9.25 billion.

But now federal spending here has stopped growing, and many Alaskans are worried that the economy is vulnerable to spending cuts as the federal budget tightens. This analysis estimates that Alaska could be vulnerable to federal spending cuts in the range of \$450 million to \$1.25 billion—which could cost the economy anywhere from about 7,000 to 20,000 jobs in the future.

We estimate potential vulnerability as a range, because it’s impossible to predict with any precision how federal spending will actually change. The best we can do is estimate the likely magnitude of reductions, given federal budget problems. Any cuts will likely be made gradually, over time, and recent strength in the petroleum and mining sectors will help cushion the effects. Also, keep in mind that even if spending is reduced, the federal government will still be a major contributor to the economy. We used two methods to bracket the potential range of reductions.

(1) **Undo the Past Decade of Expansion in Spending:** This method analyzes how much federal spending would fall, if the extraordinary growth of the past decade were erased. Until 1996, per capita federal spending in Alaska was about 38% above the national average. Today it is 71% higher. If per capita spending dropped back to its historical level, federal spending would decline \$1.25 billion, or 14%, from current spending. Such spending cuts would most likely be spaced over years and be concentrated in grants and military spending. Alaska per capita spending would gradually move back to its historical differential from the national average.

(2) **Analyze by Category of Spending:** This method estimates the vulnerability of specific categories of federal spending, given recent growth and factors that could affect future levels. These cuts could total roughly \$450 million to \$650 million, or 5% to 7% of current spending. As the figure below shows, grants are most vulnerable, military spending is hardest to forecast, and transfers to individual Alaskans (mostly retirement checks) will keep growing.



This analysis is part of a new ISER research initiative, *Investing for Alaska’s Future*, funded by a grant from Northrim Bank. The initiative will help Alaskans better understand their economy and the importance of investment for building a strong economy.

In the rest of this note we first describe the historical importance of federal money to Alaska's economy and the recent growth in federal spending, before presenting our estimates of potential federal spending cuts in more detail.

Importance of Federal Spending

About one third of the jobs and personal income in Alaska can be traced, directly and indirectly, to all types of federal spending.¹ The \$9.25 billion in federal spending in Alaska in 2006 consisted of more than \$3 billion for defense and \$6.25 billion for activities not related to defense.² Non-defense spending was divided among federal agencies, which spent \$1.26 billion on wages and procurement (construction of new facilities as well as supplies and equipment); grants to state and local governments (as well as nonprofits and tribal governments) totaling \$3.08 billion, and transfers—payments to individuals and others under programs like Social Security and federal retirement—of \$1.91 billion.



¹ See "What Does \$7.6 Billion in Federal Money Mean to Alaska?" by Scott Goldsmith and Eric Larson, UA Research Summary No. 2, Institute of Social and Economic Research, November 2003.

² Data for this report comes primarily from the Consolidated Federal Funds Report of the US Department of Commerce.

Largest Civilian Federal Programs in Alaska in 2006 (Million \$)

Transfers		Grants--Formula		Grants--Project		Civilian Agency	
Total	\$1,910	Total	\$1,850	Total	\$1,230	Total	\$1,260
6 Largest	\$1,622	6 Largest	\$1,457	6 Largest	\$707	6 Largest	\$1,030
Social Security	\$722	Medicaid	\$733	Indian Health Service	\$365	Interior	\$230
Federal Retirement (Civilian and Military)	\$342	Highway Construction	\$427	Airport Improvement Program	\$214	Homeland Security	\$255
Medicare	\$269	Impact Aid to Education	\$84	EPA Special Purpose Grants	\$43	Postal Service	\$187
Unemploy Insurance	\$104	Indian Housing Block Grants (NAHASDA)	\$121	Alaska Native Education Programs	\$33	Transportation	\$165
Veterans' Compensation	\$114	TANF (Temporary Assistance for Needy Families)	\$60	Salmon Recovery	\$27	Agriculture	\$110
Tribal Self Governance	\$71	Special Education	\$32	Section 8 Housing	\$25	Commerce	\$83

Source: Consolidated Federal Funds Report and author's estimate

Recent Growth

When Alaska became a state in 1959, about 80% of jobs in Alaska depended, directly and indirectly, on federal spending. Development of the private economy and a decline in the military presence gradually reduced federal importance to the economy. But starting in the mid-1990s, federal spending in Alaska began growing at a much faster pace, and the economic contribution of federal spending increased.

Between 1995 and 2005 spending increased by \$5 billion—118 percent. Adjusted for inflation, that represented an increase of \$4 billion in the annual contribution of federal spending over that interval (see Figure 1). A large share of the economic growth during this period can be attributed to this infusion of purchasing power. No other sector of the economy was generating that kind of economic punch.

Figure 1.



This period of accelerated growth of federal spending in Alaska is now drawing to a close. Spending was virtually unchanged between 2005 and 2006, and if we adjust for inflation it was down 3%. The slowdown is due both to tightening of the federal budget and cutbacks that are bringing federal spending in Alaska back towards the position it was in a decade ago—between 30 and 40 percent per capita above the national average.

Vulnerability Analysis: Undo the Last Decade of Expansion

Any further slowdown or decline in federal spending is impossible to predict, but either would hurt an economy grown accustomed to the rapid increases of the last decade. Fortunately the recent strength in the petroleum and mining sectors would partially offset any adverse effects. As we noted on page 1, one method of estimating potential cuts in spending is looking at how federal spending would change, if per capita spending fell back to the level where it was in 1996, before the extremely fast growth started.

In 2006, per capita federal spending in Alaska was \$13,805, the highest in the nation and 71% above the national average of \$8,058. That compares with an Alaska differential of 38% a decade earlier—and which was a level also consistent with at least the decade before that. If Alaska were to immediately fall back to the 1996 differential, federal spending in 2006 would have been \$1.25 billion, or 14%, less than it actually was. Such a drop could cause a 5% decline in the economy. That may not sound like much, but it represents about 20,000 jobs.

Table 1 Federal Spending in Alaska: Undo the Last Decade of Expansion

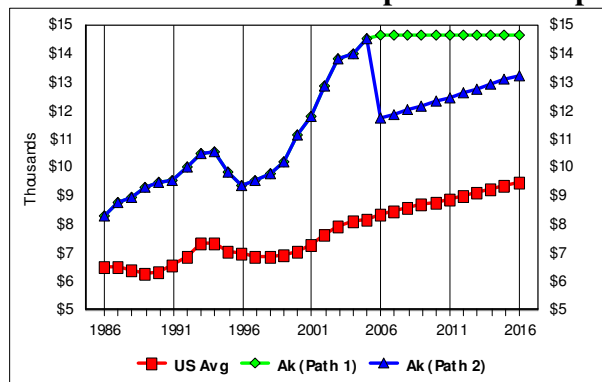
	Actual 2006	2006 with 1996 Differential	Reduction
TOTAL (Billion \$)	\$9.251	\$7.996	\$1.255
Transfers*	\$1.910	\$1.910	\$ 0
Military	\$3.001	\$2.692	\$.309
Grants	\$3.080	\$2.179	\$.901
Civilian Departments	\$1.260	\$1.216	\$.044

* Alaska per capita transfers are less than the national average

Source: Institute of Social and Economic Research

A cut that big (shown in path 2 in Figure 2) would be unlikely to occur in a single year. More likely, program cuts would be spaced out over several years and be offset by normal growth in other programs driven by formulas. The result could be a scenario as shown in path 1 of Figure 2, where per capita federal spending in Alaska stays at the current level for a number of years while the U.S. average trends upward. Over time the Alaska differential would fall back to its historical value of about 40%.

Figure 2. Possible Future Paths for Per Capita Federal Spending in Alaska

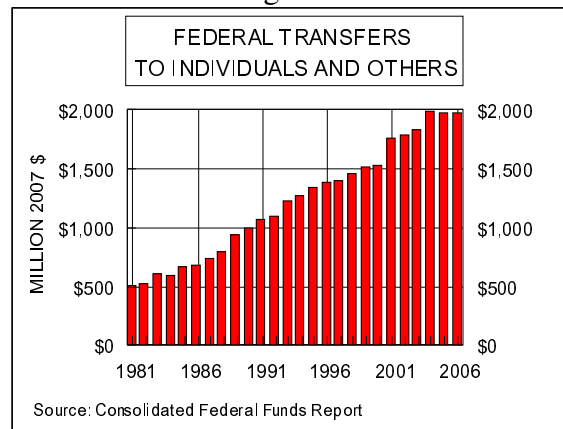


Vulnerability Analysis by Category of Spending

A second way of estimating the magnitude and composition of Alaska's vulnerability to spending cuts is looking at the main categories of federal spending individually.

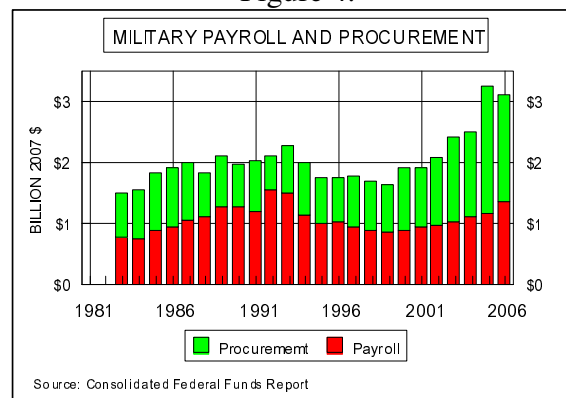
Transfers make up 20% of federal spending, and their growth depends on the number of people eligible for programs like Social Security and federal retirement benefits, as well as on the benefit levels for these programs. Consequently, transfers can be expected to increase at about the same rate as in the past and add about \$100 million more each year to the economy. (A small part of this category of federal spending consists of payments to tribal governments, which have fallen off in recent years, and this helps explain why growth has stalled in the last two years.)

Figure 3.



Military spending consists of both wages for military personnel and procurement (construction and purchases of services), which together totaled more than \$3 billion in 2006. The future of military spending is the most difficult to predict. A decrease in the military procurement budget from the 2005 peak of \$1.9 billion occurred as expected in 2006, but growth in the wage bill was nearly large enough to prevent an overall decline (Figure 4).

Figure 4.



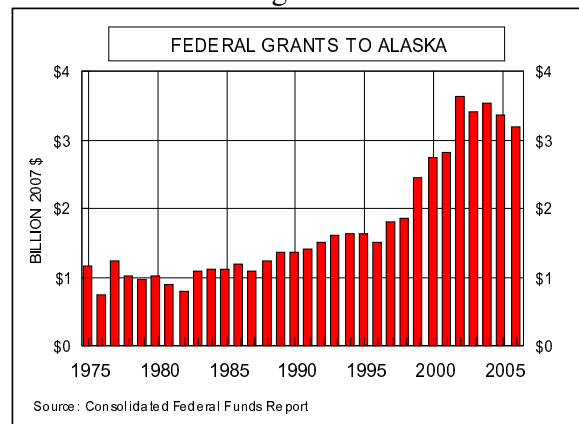
If Alaska defense spending were to fall back to the 1996 differential discussed above, it would only drop by \$300 million (because the per capita differential only increased modestly, from 234% above the national average to 273%). But Figure 4 makes it clear that growth in military spending in Alaska has primarily been the result of the Iraqi war rather than an increase in Alaska spending relative to the rest of the nation. If the total federal defense budget were to fall,

it would pull down military spending in Alaska, even if the Alaska differential remained at its current level. Right now it appears unlikely that the federal military budget will be cut significantly in the future, but military spending in Alaska is unlikely to increase from its current plateau, and is more likely to fall as money for construction of new facilities continues to dry up.

Grants (including both formula-driven and project grants) is the category of spending that has seen the largest growth in the past decade. Most of the increase occurred between 1999 and 2002, and since then the amount, adjusted for inflation, has been trending downward (Figure 5). Most of the overall effects of a reversion to the 1996 Alaska differential would be in grants, which would drop \$900 million.

Most formula grants flow to the state government and are based on either individual eligibility, for programs like Medicaid, or state eligibility, for programs like highway planning and construction. Some of the formulas (for example, the highway fund and Medicaid) contain special provisions that provide additional funds for Alaska and these might be eliminated in the face of budget cutbacks. Losing special provisions in a few of the largest formula grant programs could cost Alaska an amount in the range of \$100 to \$200 million annually.

Figure 5.



Project grants are either for specific capital projects or to provide program services. These were the fastest growing category of federal spending in Alaska for nearly a decade. Most go to state government and nonprofit agencies in Alaska, including tribal governments and Alaska Native nonprofit organizations. The largest are for airport construction and for Native health care.

Two figures representing the potential vulnerability of federal project grants are based on estimates of “pork” and “earmarks.” A large share, but not all, of the \$400 to \$600 million in Alaska “pork” identified each year by the Citizens Against Government Waste (a national nonprofit organization) consists of project grants.³ The U.S. Office of Budget and Management identified nearly \$700 million in “earmarks” for Alaska in the 2005 federal budget, and some of that was in project grants.⁴

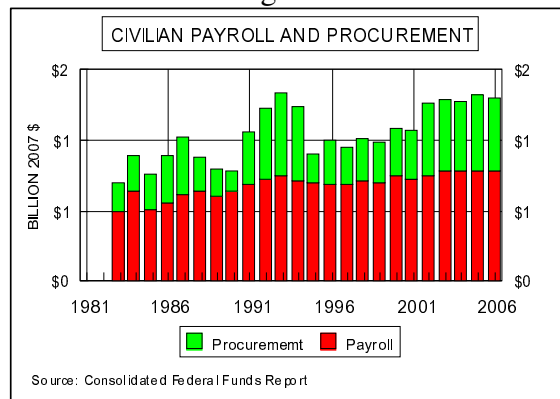
³ Most of the remainder was federal procurement—military and civilian.

⁴ Some earmarks in formula and project grant programs do not increase the total appropriation, but rather specify how a portion will be spent. Consequently the level of earmarks is not necessarily a good measure of federal spending in Alaska that is vulnerable.

On the other hand, some of the recent growth in project grant funding has been to support health care for Alaska Natives; that funding was formerly provided by federal agencies. Taking this into consideration and assuming the 1996 differential as a reasonable base, perhaps about \$400 million of project grants could be vulnerable.

Federal civilian spending is for both purchases of goods and services and wages of federal civilian employees in agencies. Growth in recent years has been concentrated in the purchase of goods and services, including construction services (procurement). The number of federal employees has not increased much. (The top five departments in 2005 were Interior, Homeland Security, U.S. Postal Service, Transportation, and Agriculture.) A reduction in procurement spending could take \$50 million out of the budgets of these agencies and return spending to the differential of 1996.

Figure 6.



For more information about this topic contact Scott Goldsmith at 786-7720 or afosg2@uaa.alaska.edu. Additional information about the Alaska economy is available on the ISER website www.iser.uaa.alaska.edu/