Fitch Ratings: Governor's Proposals Would Reduce Credit Quality of Alaska Municipalities

Fitch Ratings believes Alaska Gov. Mike Dunleavy's proposed budget and related changes in property tax laws Alaska could have significant negative impacts on local municipalities' credit quality throughout the state if enacted. Fitch does not anticipate immediate rating changes due to the legislation because prospects for passage are highly uncertain. Fitch will monitor progress of the legislation and may take rating action if the likelihood of passage increases.

The budget proposal introduces broad cuts throughout the state budget in an attempt to realign the state's spending with revenues, which have dwindled since oil prices plummeted in 2014. The governor proposed a deep reduction in general fund spending, including elimination of the state's school bond debt reimbursement program for local governments, a 24% cut in unrestricted general fund spending for schools, a 31% reduction in the Department of Health and Social Services, and a 45% cut for the University of Alaska.

Cuts in state school funding could stress the budgets of Fitch-rated boroughs. Reductions in formulaic school funding could put the onus on borough policymakers to partially backfill some district revenue losses and could crowd out spending on other services, creating budget stress for borough governments. Boroughs levy property taxes on behalf of school districts in the state and share operating tax caps with them. The loss of school bond reimbursement would prompt immediate increases in debt service property tax rates that support schools' unlimited tax general obligation (GO) bonds. Higher debt service tax rates could make it more difficult to garner public support for tax increases that would be needed to offset losses in operating revenues and could decrease public appetite for school bonds to meet ongoing capital needs. Cuts in overall state and local government spending could also have negative impacts on employment and economic activity. Government is the first or second largest employer in many Alaska boroughs.

A second, related proposal would shift property tax levies on oil and gas infrastructure from the local coffers to the state. The change would be of particular concern for the North Slope Borough ('AA'/Stable), which relies almost entirely on an energy-dominated property tax levy. Approximately $440 million in revenue would be shifted to the state from local government budgets under the proposal.

The North Slope Borough could lose about $372.1 million, or 93% of its 2018 property tax revenues and 86% of total revenues, under the proposal with exact percentages depending on which assets are classified as oil infrastructure. The vast and scarcely borough covers the state's Arctic coast and Prudhoe Bay oil fields. Outside of the energy sector, the borough's small, remote indigenous communities have very limited tax bases and economies. The borough itself is the primary employer in the villages, and few significant private enterprises exist. State-assessed energy infrastructure accounted for 91% of the borough's $20.5 billion taxable assessed value in 2018. Fitch believes the borough is unlikely to be able to reduce spending to match revenues available under the governor's plan, and earnings on its large permanent fund (which equalled $708 million at the end of fiscal 2018) would be insufficient to replace the lost revenues on an ongoing basis.

The borough's rating incorporates the narrow, highly concentrated tax base as an asymmetric risk factor. Fitch has long expected a gradual decline in the tax base as oil reserves are depleted over many years and recognized the risk of technological change to oil production. The borough keeps debt maturities very short, providing meaningful bondholder protections against gradual declines in the tax base. However, the rating does not incorporate the risk of a sudden change in state tax law of the sort proposed by the governor. If passed, the change in tax law would likely prompt a significant downgrade in the rating, absent offsetting policy actions to provide alternative revenues to the borough. The borough had about $162.7 million of GO bonds outstanding at the end of fiscal 2018.

The impact of the change in the property tax regime would be notable but much less dire for other local governments in the state. For instance, the Fairbanks North Star Borough (IDR 'AA'/Stable), which has the second-highest exposure among rated entities, collected about $11.2 million in oil infrastructure property taxes in fiscal 2018, approximately 10.3% of its overall general fund revenue. Anchorage ('AA+'/Stable), the state's largest city, has a much more diverse tax base with less than 0.5% of revenues derived from property taxes on energy infrastructure.

Fitch has not yet taken rating action in response to the proposals because they appear to have very uncertain legislative prospects in both the Alaska House and Senate. The proposals were met with immediate opposition from local government leaders across the state, many of whom have joined the North Slope Borough in lobbying to kill the property tax legislation. Borough management believes the bill is unlikely to pass and would pursue litigation to block the law if passed. Fitch will monitor the legislative progress of the proposals, and if passage begins to appear more likely, Fitch would reconsider the ratings of local governments in the state.

Analysis of the impact of the governor's budget proposal on the state's budget will be covered in a separate publication. The governor has also proposed new protections for permanent fund dividends to the state's citizenry. For details, see "Fitch Ratings: Alaska Proposals to Limit Budget Flexibility Could Pressure Rating", published Feb. 5, 2019.

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