

MINUTES
SENATE FINANCE COMMITTEE
March 15, 2004
9:02 AM

TAPES

SFC-04 # 37, Side A
SFC 04 # 37, Side B
SFC 04 # 38, Side A
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CALL TO ORDER

Co-Chair Gary Wilken convened the meeting at approximately 9:02 AM.

PRESENT

Senator Lyda Green, Co-Chair
Senator Gary Wilken, Co-Chair
Senator Con Bunde, Vice Chair
Senator Fred Dyson
Senator Ben Stevens
Senator Donny Olson

Also Attending: GOVERNOR FRANK MURKOWSKI; SENATOR GENE THERRIAULT; SENATOR RALPH SEEKINS; SENATOR JOHN COWDERY; SENATOR TOM WAGONER; SENATOR BERT STEDMAN; SENATOR GARY STEVENS; SENATOR KIM ELTON; REPRESENTATIVE MIKE HAWKER; REPRESENTATIVE BRUCE WEYRAUCH; CHERYL FRASCA, Director, Office of Management and Budget; BILL CORBUS, Commissioner, Department of Revenue; DAN DICKENSON, Director, Tax Division, Department of Revenue; MIKE BURNS, Chair, Conference of Alaskans

Attending via Teleconference: There were no teleconference participants.

SUMMARY INFORMATION

State's Fiscal Picture - Looking Forward

The Committee heard from Governor Frank Murkowski, the Office of Management and Budget, and the Department of Revenue. No action was taken.

Conference of Alaskans

The Committee heard from the chairman of the Conference of Alaskans. No action was taken.

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State's Fiscal Picture - Looking Forward

Co-Chair Wilken stated that the purpose of this meeting is to begin consideration of the Resolutions adopted by the 55-delegates of the Conference of Alaskans, which occurred at the University of Alaska campus in Fairbanks February 10 through 12, 2004.

GOVERNOR FRANK MURKOWSKI addressed the Committee.

In my January State of the State message, I noted that Alaskans when confronted with challenges have shown the heartwarming ability and firm resolve to balance individual and shared needs. And I think we would all agree that we have that challenge today, and we obviously need resolve. Now we have the recommendations of the Conference of Alaskans that address the fiscal gap and I think it's time for us collectively to act. Your responsiveness, to date, has been, I think, most noteworthy and I want to thank you for agreeing to take up the recommendations of the Conference of Alaskans, beginning today, and work to resolve the issues by the end of the month. And I am pleased that a special session was not necessary. We all agree that the State needs a resolution this Session to address the long-term fiscal gap. It is a matter in which we all share a responsibility not to pass on to future Legislators, or future governors, the fiscal gap, which I was confronted with when I came into office in 2002.

The previous budget showed a deficit of some \$800 million. Now, the fiscal solution that we need must cover the period between now and the time when revenue from gas pipelines and other natural resource development starts to fill our treasury. In short, what we really need is a fiscal bridge, if you will. With regard to the distance, which the financial bride would have to span, I can report that we are continuing to make significant progress on the gas-line, which is a major pier, if you will, on the side of the shore. I have of course, the continued interest in the petroleum reserve and I want to highlight a little bit on the gas line.

We, as you know, have met and are continuing to meet with producers who have lease rights to the gas and TransCanada,

which has pipeline rights in Canada and proposes to build a 1,000 mile pipeline from the Alaska-Yukon border into Alberta. MidAmerica Company is working on a plan to construct the line in Alaska from Prudhoe Bay to the Canadian border. Now this Administration intends to have a firm commitment if at all possible, and to get the line committed before the end of this year. These proposals will be referred to you for approval.

Collectively of course, they will help solve our budget shortfall. A good deal of deliberation will focus on the risk that the State may have to take as we evaluate the various proposals. A prompt fiscal solution is necessary so that we can avoid the harms which would otherwise come to our citizens from a loss of public services between now and when we receive our revenues from the line and other resource development. I think we would all agree that we have done pretty well in FY 04 due to the high price of oil and by keeping our commitment to follow our plan to keep government spending below the previous year. And by limiting the CBR draw to less than \$400 million. Again, of course, we've been blessed by an increase in oil prices. But we cannot bet our children's future, their education, our families, our public safety, or our social obligations on the continuing high price of oil. It is our obligation to act now. Nor can we continue to count on the CBR to bail Alaska out each and every year. One can only suggest, what might happen were the price of oil to drop significantly over the next couple of years.

If it dropped, this would result in a major draw on the CBR. And as you know, I will not allow the CBR to go below a billion dollars. This minimum balance is absolutely necessary to provide a cushion against dramatic disruptions in State revenues. The CBR is not a permanent crutch for the State.

Now on the revenue side, we must look for some new revenue. On February second we provided the Senate and House with a list with \$212 million in potential and new revenues of which we need approximately \$150 million for FY 05. Among other items we've been discussing a one-dollar pack increase in the tobacco tax, which would raise some \$36 million. You know I've have been traveling around the State a great deal, and been meeting with some of the groups that are concerned with the social welfare of those less fortunate in our State and spent a little time with those service folks. Spent a little time with those who are committed with fetal alcohol syndrome, which is prevalent in our State, and I cannot help but reflect on the scourge of alcohol in Alaska. The cost of alcohol treatment in our State is \$453 million dollars, more than half

of what we spend in this State on education. Education is approximately \$722 million in the general fund or a total of \$755 million. But we spend \$453 million on alcohol treatment. State revenue raised from alcohol tax is only \$25 million. We average the highest alcohol consumption in the nation an average of 513 drinks per year for every man, woman and child. A lot of people don't drink at all. I was looking at some statistics the other day. Over 126 Alaska births per year are affected by pre-natal exposure to alcohol, representing the highest documented rate in the United States. I think these statistics speak for themselves. I think we have to do more than think about it. It begs for a solution. We must continue to increase State government efficiency and reduce waste. While we've cut spending by \$245 million, our Missions and Measures process continues to allow us to identify lower priorities and less effective programs that can be eliminated. We have nearly completed our review of the various State Departments. It is my understanding that this is the first time this has been done in some 27-years.

Now, going back to the Conference of Alaskans in Fairbanks, we received some good direction from that group. Among their recommendations were: passed a POMV, or Percent of Market Value, which would limit to five-percent the amount of money which the Legislature can use from the Permanent Fund earnings; second, maintain a prudent level in the CBR; third, protect the Dividend; fourth, use some of the Permanent Fund earnings to maintain essential public services; and lastly consider broad-based taxation. Now, I do not intent to propose a specific package for the Legislature or for the Finance Committee today. You will want to consider the results of the hearings that you have undertaken through the balance of this week, and I am going to be working with you and watching closely as you have witnesses come in from around Alaska to indicate their attitudes towards our budget shortfall. As you put your fiscal package together, I would suggest you be guided by the following criteria, which may help you. One, will it raise the revenue needed to meet the State fiscal needs during the budgeting period. Secondly, while it might fall short of any individuals or group's maximum desires, is it better than the adverse impacts of the loss of essential public services if there is no solution. Thirdly, would it have bipartisan support both in the Legislature and with the public. Fourth, is it consistent with the spirit of the resolutions adopted by the Conference of Alaskans. Is it basically fair to all Alaskans, will it unreasonably impact Alaskans current reasonable expectations for the amount of s Permanent Fund Dividend. Will the Permanent Fund and the

dividend be protected? How will it affect Alaska's economy, with special emphasis on the Rural part of our State. Is it good for Alaska, not only for today but in the future? Does it provide Alaskans the opportunity to have their say to vote on the matter? I know that members of the Legislature have a number of proposals and ideas of their own on how best to proceed and I respect that. And I look forward to working with you in reviewing the package that you develop and build a consensus, which meets, hopefully, these criteria. Each step in this year's long process to secure Alaska's future is of critical importance, and that first step was the Conference of Alaskans last month. The 55 men and women from across the State did well. Now it's our turn, the Legislature and the Governor's Office, to consider their recommendations and put our State on a sound fiscal footing. As you may have observed, I have been reading a little philosophy from Yogi Berra, of late, and Yogi Berra explained that, "tragedy lies in paralysis, not in choice." Doing nothing is not a solution.

Governor Murkowski concluded his comments and noted that Cheryl Frasca would further explain the reasons that the State must resolve its fiscal dilemma this year.

Co-Chair Wilken commented that this is a special occasion as the Governor's attendance at a Senate Committee meeting is rare. His attendance underscores the importance of resolving this issue.

Co-Chair Wilken reviewed the week's agenda. Today's schedule would include a presentation from the Office of Management and Budget, titled "Looking Forward;" testimony from the Department of Revenue; and a report on the Conference of Alaskans from its Chairperson, Mike Burns. Additionally, Senator Kim Elton, who also attended the Conference, would share, as a Conference observer, some remarks from the Senate's standpoint. The weeklong schedule should be viewed as a guideline in that it would be flexible and could be altered to allow discussions to be extended as necessary. While the focus of the week would be to discuss the five resolutions adopted by the Conference of Alaskans, time would be provided for Senators' comments and concepts as well as for public testimony. He detailed the protocol for visiting Senators' and others' participation in the discussions.

CHERYL FRASCA, Director, Office of Management and Budget, Office of the Governor, informed that the goal of today's presentation is to provide several fiscal scenarios, which might occur were the present fiscal situation to continue without relief from the development of a new fiscal structure that would provide more "certainty" to the State. It is important to realize "that this is

more than a math problem", it is a problem in regards to whether Alaskans could count on the State to meet its education and public safety responsibilities as well as being able to provide dependable assistance to those most in need. In addition, the establishment of an adequate financial structure would provide the economic stability needed to allow private industry "to invest with confidence" and provide jobs. While oil prices are currently elevated, four month earlier, when the State's budget was being developed, "it was a dramatically different revenue picture." The fact that revenues were approximately 25-percent lower than what was required to balance the budget, severely impacted budget decisions. While the Administration understands that it is part of their "job to cope with this uncertainty," the ultimate unfairness is to those Alaskans who count on the State to meet these traditional responsibilities and to our State employees who deliver valued services everyday. "It's time to get off the rollercoaster of looking to the Spring forecast and either breathing a sigh of relief or going to the end of session scurrying around to find one-time fund sources to cover spending and to further draw down the balance in the CBR." As the Governor stated, this problem should not be left to future Legislatures or Alaskans. Therefore, the purpose of today's presentation would be to provide the framework of how to address this situation.

BILL CORBUS, Commissioner, Department of Revenue, utilized a power-point presentation to convey three aspects of State revenues: one, "why the State hasn't fallen off the cliff yet, financially; two, the outlook of oil production; and three the revenue outlook."

Commissioner Corbus commented that the State "has not fallen off the cliff" due to higher than expected oil prices combined with spending reductions that have extended the life of the Constitutional Budget Reserve Fund (CBR) beyond the December 2005 depletion date identified in the Department's Fall 2000 Forecast. As a result, the Fall 2003 Forecast projects that the CBR would not be depleted until May 2007.

Commissioner Corbus noted that oil production projections "have been quite accurate," reflecting a slight falloff. Referencing the power point slide titled "Possible Increases to ANS Production," He noted that "known identified oil reserves" in FY 05 are projected to be 996,000 barrels per day with a gradual decline to 941,000 in the year 2012. That year, approximately 25-percent of oil produced would be gleamed from reserves that have been identified, but of which no development work has yet to begin. The graph also depicts other new oil sources that might occur in the National Petroleum Reserve-Alaska (NPRA), the Arctic National Wildlife Refuge (ANWR), Bristol Bay, Beaufort Sea, and Central Satellites of the Prudhoe

Bay field.

Commissioner Corbus referred to the chart titled "General Fund Unrestricted Revenue" which identifies the oil revenue projected in the Fall 2003 forecast. Non-oil Revenue and potential revenues based on the futures market, as projected by the financial market today, are also depicted on the chart. Beginning in the year 2006, the price is projected to be \$22 per barrel. This might raise questions, being that the most recent price has been \$35 per barrel. However, this is the projection going forward from 2006, as, based on historical records, the average price between 1982 and 2003 was \$20.50 per barrel.

Commissioner Corbus stated that the State has been fortunate in experiencing four years in which the price of oil exceeded revenue expectations. Yet, the State was still required to withdraw more than one billion dollars from the CBR. Other revenues would be necessary to compliment oil revenues. The natural resource development projects being furthered by the Governor would not be expected to generate revenue until the years 2011 and 2012. In addition, a "'Pendulum Swing' might occur in which commodity prices may decline before new resource revenues appear ... It's time to prepare for lower oil prices now." In the short run, the State could not support its financial obligations on oil revenue. "This way out is not available to us."

Co-Chair Wilken asked whether the Commissioner had received a copy of a chart [copy not provided] developed by the Division of Legislative Finance that depicts the price of oil on an axis. Being that the Commissioner was unfamiliar with the chart, Co-Chair Wilken stated that it would be provided. It reflects the sensitivity of the State's budget as the price of oil alters.

Senator Bunde understood that the addition of an income tax, alone, could not balance the budget shortfall, "without some serious negative impacts to our economy."

Commissioner Corbus agreed that "an income tax would have certain adverse impacts" on the State's economy.

Senator Bunde stated that an income tax would be required to remove \$500 million from the economy in order to balance the budget. This would have "a serious negative impact on the economy."

Commissioner Corbus agreed.

Senator Dyson asked whether it would be prudent to consider the impacts that might occur were a State income tax or other user tax

implemented, as there is a sensitivity tolerance to taxes. For instance, taxing cruise ship passengers at one level might be tolerated but at another level might tend to drive passengers or ships elsewhere.

Commissioner Corbus responded that the Governor has proposed five or six revenue generating options that are based on some type of user fee or tax. These options could be enacted without adverse impact on the economy.

Senator Dyson understood therefore that were a report developed, it would depict zero or negative impacts.

Commissioner Corbus responded that while he is unsure in that regard, the State would fare better were the taxes implemented.

Ms. Frasca pointed out that were the tobacco tax increased, it might change behavior in addition to producing revenue. The Department of Revenue's Tax Division could more appropriately address discussion regarding any tax impact.

Senator Dyson reiterated that national historical patterns reflect that when taxes are raised, the tendency is to attempt to avoid paying the tax. He asked whether information is available which would estimate the length of time required before the State would benefit from any behavioral changes associated with an increased alcohol or tobacco tax.

Ms Frasca responded that this information might be available from the Department of Health and Social Services.

Senator Olson asked regarding the types of impacts that might result from increased taxes.

Commissioner Corbus responded that while he could not speak to what tax level would be viewed as intolerable, one negative impact would be that a tax would remove money from people's pockets.

Senator Olson asked whether an example could be provided; specifically in regards to adverse affects on constituents.

Commissioner Corbus could not provide a specific example. He concluded his presentation.

Senator Bunde shared that states whose primary revenue source is an income tax, claim that when an economic downturn occurs, they are more adversely affected, as this revenue source is more volatile than a sales tax.

Co-Chair Wilken asked that debating the benefits of a sales tax verses an income tax be refrained, as the purpose of this hearing is to focus on the presentations.

DAN DICKENSON, Director, Tax Division, Department of Revenue, verified that an income tax is more volatile than a sales tax. When plotted against income from a severance tax, the two taxes would be reflected as flat lines that "wiggle while the severance tax goes up and down." This is the scenario that Alaska is familiar with.

Ms. Frasca noted that Commissioner Corbus' presentation reflected the revenue picture of the State whereas her power-point presentation, titled "The Fiscal Gap & State Spending" [copy on file] would focus on the State's spending situation, which is the other side of the equation.

Ms. Frasca noted that the graph titled, "The Gap: Looking Forward," depicts actual State spending and revenue comparisons for 1984 through 2004, and projections for 2005 through 2010. The CBR was established in 1991, and "coincidentally" the chart depicts a number of times in which there existed a gap between spending and revenue. This underscores the extent to which the State is dependent on the CBR. The State did not require money from the CBR in 1997 and 2001 even though a \$400 million draw was projected for 1997 and approximately a \$250 million draw was projected for 2001. This illustrates the volatility and unpredictability of budgets. However, a billion dollar draw was required in subsequent years. Attempting to develop a balanced budget is difficult. The assumptions going forward are based on a flat spending level as determined by the Fall 2003 forecast utilizing \$22 per barrel as the revenue base. "A fiscal gap continues to exist."

Ms. Frasca stated that the chart titled, "CBR has Propped Up Spending" "illustrates the structural nature of the gap."

Ms. Frasca stated that the chart titled, "Impact on CBR Balance" which is based on the Governor's proposed FY 05 budget, depicts July 2006 as being the date when the CBR balance would lower to one billion dollars. However, were an increase in education funding factored in, as is being discussed, the CBR would hit that mark in April 2006.

Ms. Frasca noted that the chart titled, "FY2005 Governor's Proposed Operating Budget" is a pie chart that depicts the services provided to Alaskans: K-12 Budget is the largest at 35-percent of the FY 05 budget; the Department of Health and Social Services would 24-percent; the University of Alaska would be ten-percent; the

Department of Transportation and Public Facilities would be four-percent; and all other departments including the Legislature, the Governor's Office, the Department of Administration, the Department of Law, the Department of Environmental Conservation, the Department of Public Safety, the Court system, and the Department of Natural Resources would total 16-percent or \$325 million. The budget for these other departments could be eliminated and the State would still experience a budget shortfall.

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Ms. Frasca stated that the chart titled, "K-12 Funding * FY 94-05 Gov. Amended" depicts fund sources for K-12 education which is the largest State funded operating budget program. To keep pace with inflation, the funding for K-12 should reflect a 17-percent increase between 1994 and 2004; however the chart depicts that the general fund funding has increased 16-percent which is below the rate of inflation. With all funds included, the program has increased approximately 12-percent.

Ms. Frasca declared that challenges in developing a budget based on the revenue forecast would include such things as determining how to control spending in the larger component or whether to decrease funding in the smaller budgets.

Ms. Frasca continued that the Chart for the "University Funding FY 94-05 Gov. Amended" depicts that over time the GF funding of the University has increased from 1994 to 2005 by 24 percent. Its All Funds, which includes such things as tuition and federal funding, has increased 68 percent.

Ms. Frasca noted that the proposed FY 05 GF budget for the Department of Public Safety is approximately the same as it had been in FY 94. Other Funds have increased 21-percent in that timeframe. Any further GF funding reduction in this program would be detrimental.

Ms. Frasca informed that the Department of Corrections' prison facilities are at capacity. The "Corrections Funding FY 94-05 Gov. Amended" proposed budget is 31 percent higher than the FY 94 budget and all other funds have increased 53-percent in that timeframe. This is "a population driven" program.

Ms. Frasca pointed out that as depicted on the "DOT M&O Funding FY 94-05 Gov. Amended" chart, FY 05 budget would be seven percent higher than the FY 94 budget, and All Funds have increased 21

percent in that time period. While not many new roads have been constructed, lane miles have been added. This budget has not kept in line with inflation.

Ms. Frasca characterized the "Medicaid Funding FY 94-05 Gov. Amended" FY 05 budget as one of the most interesting as there has been a 95 percent GF increase and an All Funds increase of 461-percent since FY 94. The FY 05 Medicaid services budget would total approximately one billion dollars.

Ms. Frasca noted that the chart titled "FY 05 Spending: \$5,058.00 Per Capita*" depicts the Governor's proposed FY 05 budget in a per-program per-capita basis. She noted that at one time the State's budget was presented in a by program rather than a by department basis. The highest per capita budget general fund amount is the Education program at \$1,116 per resident, followed by \$738 per capita general funds for the Health/Human Services program. Were the alternate "B" budget that was discussed at the Conference of Alaskans implemented, it would lower the total per capita amount by \$483. A reduction of this amount would be challenging.

Senator Bunde, noting that the FY 05 budget would amount to \$5,058 per capita, shared the understanding that the State expends \$6,000 in services per capita for each new resident, but only receives \$5,000 in income per capita. This is referred to as the "Alaska Disconnect."

Ms. Frasca responded that she was unfamiliar with this equation but would further analyze the per capita component.

Senator Bunde asked for confirmation that the per capita amount depicted in the chart would double were federal funds included.

Ms. Frasca affirmed.

Senator Dyson, commenting that charts are helpful, asked whether prior years' funding could be depicted in the per capita format, as he understood that while Alaska still spends, per capita, more than other state, the amount has decreased over time.

Ms. Frasca affirmed that Alaska's per capita amount is different from other states, particularly were the Permanent Fund Dividend and inflation proofing included.

Senator Bunde asked for confirmation that the Permanent Fund Dividend is included in the \$5,058 per capita amount.

Senator Bunde commented that the largest component of the \$5,058

total per capita amount is the Permanent Fund Dividend and inflation proofing.

Ms. Frasca affirmed that to be true.

Senator Bunde stated that were the POMV methodology enacted, it would be interesting to see whether the Permanent Fund component would continue to be the largest per capita expenditure.

Senator B. Stevens suggested that royalty deposits be calculated into the Permanent Fund earnings and inflation-proofing component, as "they are an expenditure."

Ms. Frasca replied that royalty deposits were excluded from the chart, as the focus of it was to reflect monies that are included in the budget process. Royalty deposits are dedicated funds that are deposited directly into the Permanent Fund, rather than being an appropriation.

Senator B. Stevens countered that it is still an expenditure.

Co-Chair Wilken stated that while it might not be an appropriate item to include in the chart, knowing the royalty deposit amount would be a helpful tool.

Ms. Frasca continued that department processes are being reviewed to determine the best way to conduct business "so that we can save some dollars internally." The goal is to minimize budgetary reduction impacts on direct services to residents. Some of the internal measures in this regard include "the consolidation of the Human Resources function in the Department of Administration which will save approximately \$600,000 in FY 05;" implementation of Information Technology (IT) standards and coordination by sharing information and services within the departments; eliminating middle management; reviewing the usage and coordination of the State's equipment fleet; planning and control of commodities' purchases such as office supplies; better management of overtime with the goal of reducing it from 16 or 18-percent to four percent; better management of travel and reducing travel expenses by increased utilization of such things as teleconferencing; renegotiation of leases to lower expenses; and furthering departments' missions and measures in order to increase efficiency and provide the appropriate service.

Ms. Frasca stated that looking forward, the chart titled "Building a Fiscal Bridge to New Resource Revenues, Scenario: No Use of PF Earning to Support Essential Services" depicts two future fiscal scenarios: one based on the Governor's FY 05 Proposed flat-spending

budget; and the second being that budget plus an increase in education spending and a one-point-four percent inflation adjustment. Even were the flat spending scenario adopted there would be a \$4.3 billion gap in spending verses revenue, absent new revenue sources. There would be approximately \$1.6 billion in the CBR.

Ms. Frasca stated that the spending/revenue gap would amount to \$6.5 billion even were the spending limit that is currently being considered to accompany the increased education funding and the inflation adjustment proposed in scenario two.

Ms. Frasca stated that the final chart in the presentation titled, "Building a Fiscal Bridge to New Resource Revenues, Scenario: 50% PF Earnings to Dividends; 50% to Fund Essential Services" depicts the same revenue forecast for the two budget scenarios with the exception being that 50-percent of the Permanent Fund earnings, after Permanent Fund Dividends were paid, would be allocated to support the budget. This scenario would serve to reduce the spending gap. Under this scenario, the budget providing for increased education spending and an inflation adjustment would experience a \$1.9 billion rather than a \$6.5 billion gap.

Senator Bunde surmised from this chart that new resource revenues would be online in approximately 2011 and would, at that time, close the fiscal gap.

Ms. Frasca concurred that, under a flat spending scenario, this would be correct.

Co-Chair Wilken asked whether all states are experiencing "sharp" Medicaid expense increases.

Ms. Frasca stated that a national survey has been conducted in this regard. That information would be provided.

Co-Chair Wilken expressed that the chart depicting Medicaid expenses is "amazing."

Senator Olson understood that, in addition to the 7,000 vehicles in the State fleet, the Department of Public Safety would be, with the assistance of federal funds, purchasing helicopters. He inquired as to the maintenance plans for these craft.

Ms. Frasca voiced being unaware of this purchase. The Administration is working with the Department of Fish and Game and Department of Public Safety to determine the most efficient use of vehicles with cooperation and coordination of vehicles being a

consideration. Consideration is also being given to disposing vehicles that are expensive or dangerous to maintain and operate. Were helicopters purchased, their maintenance needs must be addressed. This matter would be investigated.

Senator Olson asked how, as a means to control spending and close the budget gap, a uniform percentage reduction across all departments would affect State operations.

Ms. Frasca stated that the Administration seeks to avoid across the board reductions as "that suggests that everything is equal in terms of the services that we deliver." Determining which programs required more funding influenced the FY 04 budget. Education is an example of a program that requires more funding, and were that not a consideration, the results would be devastating.

Ms. Frasca informed the Committee that due to the fact that a presenter from the Department of Labor and Workforce Development was unavailable today, the impact of stable revenue funding on the private sector economy component could not be presented.

Co-Chair Wilken stated that that presentation would be rescheduled.

Senator Olson commented that while the Committee has been informed of the negative affects of a state income tax, what are the negative affects of not having one.

Commissioner Corbus responded that the negative affects of not having additional revenue sources would be a reduction of State services. He reiterated that the Administration does not support the implementation of a State income tax. Other revenue sources would be more desirable.

Senator Olson opined that one of negative outcomes of not having a state income tax is that its absence is a draw that attracts "less desirables" to the State.

Ms. Frasca commented that Governor Murkowski's view of an income tax is that there "are a number of tools in the tool box," and the question is in what priority order should they be utilized. The income tax would be the last resort.

Co-Chair Wilken thanked Ms. Frasca and Commissioner Corbus for the presentations.

AT EASE: 10:14 AM / 10:15 AM

Co-Chair Wilken announced that the aforementioned Division of

Legislative Finance "fiscal gap sensitivity chart titled "Projected Fiscal Gap/Surplus at Various Year-End Average ANS Crude Prices Given \$2.3 Billion FY 04 General Fund Budget" has been provided [copy on file].

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Presentation by the Conference of Alaskans

Co-Chair Wilken announced that Mike Burns, a retired banker and the Chair of the Conference of Alaskans, would be presenting a synopsis of the Conference.

MIKE BURNS, Chair, Conference of Alaskans, explained that the Conference's 55-delegates conducted the Conference in an unofficial and un-attributed discussion and debate that led to a series of final votes. The delegates were not required to negotiate with the Administration or the Legislature. They "were simply an advisory group to the Administration" and were a fair representative of the people of the State and Legislators' constituents. They were charged with discussing, debating, and answering four questions regarding their view of Alaska's future.

Mr. Burns shared that the goal of the seven conveners who were charged with selecting the 55 Delegates was to provide balance on the premises of geography, gender, rural/urban, ethnicity, age, and bi-partisanship. During the selection process, no one was asked their position on any of the four questions. Early in the discussions, it was determined that rather than selecting the "usual" individuals, the goal was to select "the undiscovered." A difficult undertaking, it took more than 25 hours to select the final 55 delegates from a list exceeding 1,000 applicants. It was a fair process that strived to select a re-assuring and refreshing group with a history of public policy experience in these types of issues and "new undiscovered faces." The conveners "were pleased with the make-up of the group."

Mr. Burns shared that the 55 Alaskans could have provided a multitude of solutions. In order to complete "the breadth and depth" of the Conference's agenda in a three-day period, the Conference utilized consensus technology which allowed votes to be "un-attributed to a delegate" and thereby assisted in keeping the discussion moving by allowing for a support or non-support consensus of an issue "or simply the desire to move on with the discussion." The voting options kept the Delegates on track.

Mr. Burns shared that rather than "the wide variations in

solutions" catching his attention, it was "the two over-riding factors that united the delegates": the sense of frustration relating to what was happening to State services such as education; and the sense of anxiety as the result of non-resolution of the State's fiscal situation and its effect on the economy, the job market, and the investment climate. In addition, there was anxiety resulting from the realization that currently favorable interest rates could change, that revenue from crude oil could diminish due to lowering prices, and that federal aid to the State is unsustainable. "Time is not our friend."

1. Should the use of income for the Permanent Fund be limited by the Constitution to 5% of the Fund's value, as the Permanent Fund Trustees have proposed?

Mr. Burns stated that the first question posed to the group received an "overwhelming" yes response. Referring to the letter [copy on file] dated February 12, 2004 from the delegates to Fellow Alaskans, he read as follows.

We must inflation-proof the Permanent Fund in order to keep it and the Permanent Fund Dividends (PFDs) from evaporating away in the future. The "percent of market value" (POMV), as suggested by the trustees will put inflation proofing into the Constitution, instead of leaving it to the Legislature's discretion. POMV is a technical change in determining how much money from the Fund is available, but it has nothing directly to do with the choice of using it for Dividends or spending it on anything else. That's the next question.

Mr. Burns shared the second question posed to the group and the group's response as follows.

2. Should a portion of the income of the Permanent Fund be used for essential state services, such as education?

Our answer here is "yes, but..." There are two conditions to our endorsement. One, dividends must be paid out first under POMV. Only what's left over could be used for essential state services. Two, the delegates to the Conference of Alaskans recommend that the governor and legislature take action to balance the state's revenues and expenditures, including but not limited to, consideration of a personal income tax, other broad-based taxes and other alternative sources of income.

Mr. Burns informed that the response to question number two passed with only two "no" votes.

3. Should the state maintain a minimum balance in the Constitutional Budget Reserve to stabilize state finances against fluctuations in oil production or prices?

Yes, a prudent amount should be in reserve at all times, for two reasons. We can't afford to send home all the police, firefighters, teachers or other critical personnel because the state treasure is empty due to something unforeseen. It is critical that a prudent amount be retained in the Constitutional Budget Reserve (CBR) to stabilize state finances against fluctuations in oil production or prices. This is necessary to maintain the state's very good credit-rating which will save millions of dollars in the future. Therefore, if oil production is interrupted or prices fall, so that we need to draw the CBR below the prudent balance, the state needs a plan to refill it back to that level as soon as possible.

Mr. Burns noted that this resolution passed unanimously. In addition, it should be noted that the balance in the CBR was a primary focus of the Standard & Poors (S&P) financial rating company presentation to the Delegates. S&P conducts its credit rating analysis on a two-year basis, this being the interim year. The State currently has a favorable credit rating, which is "heavily reliant on the CBR balance. A depletion of the CBR would be a negative trend" for S&P.

4. Should the use of the income of the Permanent Fund for dividends and possibly for other purposes be determined annually by the Legislature, as is currently the case? Or should be it be dedicated in the Constitution?

A reasonable percentage of the Permanent Fund money available under POMV should be constitutionally dedicated to PFDs in order to make them "permanent" like the Fund itself. All other uses of the remaining Permanent Fund money should be left for the Legislature to appropriate, since it is impossible for this generation to predict what the needs will be for the next.

Mr. Burns stated that this was the most contentious issue and had the most discussion. It passed with 37 "yes" votes. "The Dividend is viewed as a unique Alaskan economic and social factor." Delegate Byron Mallott recounted to the group a conversation he had had with Elmer Rasmussen, when Mr. Mallott replaced Mr. Rasmussen as a member of the Permanent Fund Board of Trustees. Mr. Rasmussen told him that on the day the PFD is distributed, all Alaskans anywhere in the State are "treated exactly equal," and that this "created a

real dignity for the dividend." This is important to the State, its individuals, and the Fund.

Mr. Burns agreed with that concept. He noted that one Conference discussion involved the creation of a needs-based dividend. It received very little support, as it would be contrary to the concept regarding the dignity of the dividend.

Mr. Burns voiced that discussions on the dividend should be kept in economic perspective. He stated that line seven of the federal income tax form asks one's annual total wages, salaries and tips. This is the line that reflects how we live, raise our families, and build our future. Line 20 of the form asks the total of miscellaneous or other income. This is the line where the PFD is noted. While public policy is driven by line seven, as it is a reflection of the job market, investment climate, and the economy. "Line 20 is treasured for its uniqueness and dignity."

Mr. Burns commented that "Alaska is blessed with an abundance of" natural, human, and financial human resources. We "have the ability to deal with this challenge;" however, the Legislature must be the State's "champions." He supported the comment of one delegate who expressed that the goal of the Conference was to, "Do good for all, not the best for anyone."

Senator Bunde thanked Mr. Burns. Continuing, he shared that it is assumed by the public, that "some of the earnings if not all" of the POMV would be used to support State services. Therefore, the question is whether the Delegates approached the POMV from being separate from the spending support of State services or whether their view mirrored the public's.

Mr. Burns responded that, "if there was a big winner, it was the POMV concept." After "a lot of discussion and education, it was able to separate itself from the spending" and the allocations. It is a confusing issue. The Delegates spent a lot of time discussing this and required a lot of education; however that separation did occur and it was recognized as "a management tool."

Senator Bunde stated that the public's confusion is of concern.

Senator Bunde noted that, from reading letters to the editor and other communication, there is a general sense that the public perceives that "the State spends too much money." However, he understood that this was not the view of the Delegates.

Mr. Burns responded that the three-consenser responses were akin to "Yes, I agree, No, I don't agree, or let's just move the discussion

along." These "straw votes" were helpful in moving discussion forward and when a "straw vote" was conducted, concern over State spending did not rate "too high." This was supported by discussions pertaining to the level of education funding which is of concern. He contrasted non-support of education to equipment's deferred maintenance needs in that when a child's education is inadequate, it is hard to regain that lost ground, whereas a piece of equipment could be rebuilt.

Senator Bunde asked whether discussion occurred about the amount of dividend money that leaves the State in the form of federal income tax.

Mr. Burns shared that this "leakage factor," as referenced by economists, did not garner as much discussion as anticipated. "There is no question that the federal treasury is the biggest beneficiary" of the PFD. He "had hoped that the S&P presentation would be the springboard" for discussions regarding investing in the State; however, this was not delved into.

Senator Dyson stated that while education is important, he disagreed that the negative affects of low funding could not be recoverable. Continuing, he asked for assurance that no effort was made to stack the group based on higher than the norm income or by those who might benefit from government spending, as was seemingly the case presented by the media, who "wanted to impeach the process." His assumption was that the individuals who applied for a delegate position were those who were interested in the State's process and were educated. In addition, the fact that government dominates our State is another issue that cannot be denied.

Mr. Burns reiterated that income was not a consideration. Some of the Delegates might have been chosen because their success lead to name recognition and experience. People in Rural areas might have been selected due to their being leaders in health care or education fields which might be some of the better paying jobs in Rural Alaska. He assured that, in his perspective, monetary and government connections were not an issue. He himself was surprised at the statistics of the group, but avowed that these issues probably would not have changed the make-up of the group, of which he is not embarrassed.

Co-Chair Green voiced surprise regarding the Delegates' position on a State income tax, particularly in light of the financial make-up of the group. This exonerated the conveners' actions in regards as to whether the delegate's income was a factor.

Co-Chair Green asked for further explanation in regards to

characterizing POMV as a management tool.

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Co-Chair Green specifically asked whether the Department or the Legislature or the Permanent Fund Board of Trustees would utilize POMV as a management tool.

Mr. Burns responded that POMV would be a management tool for the Permanent Fund Board and the money managers they hire. Money managers have different specialties; including such things as managing trust accounts or investment accounts and POMV would be used as a common management guide.

Co-Chair Green asked how POMV would differ from what is currently provided in this regard.

Mr. Burns expressed that one major difference, and this is "the key thing," is that when the Fund was created "it was entirely in fixed income." The "concept of paying out dividends from only realized gains made a great deal of sense." Today, however, 60-percent of the Fund is comprised of equity investments. Unrealized gains are as important or more important in an equity portfolio as realized gains. The POMV includes both unrealized gains and losses and realized gains and losses in the Fund's return. The concept of isolating the two is "not compatible with the way the Fund is structured today."

Co-Chair Green understood therefore that five percent of the total, as proposed in the POMV, would consider both unrealized and realized gains.

Mr. Burns concurred.

Co-Chair Green asked for clarification regarding whether the POMV approach would affect how the Fund is managed.

Mr. Burns stated that it could affect how the Fund is managed. He could not recall a time when gains were used to support the Permanent Fund Dividend, but noted that this could occur.

In response to a question from Co-Chair Green, Mr. Burns stated that there could be a time when the decision might be made to sell an investment to support the payment of the Permanent Fund Dividend (PFD). While he could not recall it ever occurring, he explained that under the current system, a bad investment decision could be

made were the decision made to sell, for example, a stock that was purchased at \$20 at \$120 in order to have a realized gain to fund PFDs. The stock might be sold even were the Fund's analysts to predict that the stock's price would continue to increase. Under the POMV program, this unrealized gain would be factored in, at market value, without having to sell the stock.

Senator Bunde asked whether a representative from the Permanent Fund Corporation (PFC) would be presenting to the Committee.

Co-Chair Wilken answered in the affirmative; the PFC would be presenting at the next Committee meeting.

Mr. Burns stated that another difference imposed by "Pure POMV", is that the valuation of the Fund would be determined on a year-to-year basis and the corpus, or principal, "would go away," as the Fund would be recognized as a whole.

Co-Chair Green asked whether the ability to spend up to five percent of the Fund's value would create the assumption or "pressure to spend the entire five percent." She noted that while the Legislature has the ability to utilize the Earnings Reserve account, it has not opted to do so.

Mr. Burns replied that, "only time will tell." He agreed "that this same option is available to this body today."

Co-Chair Green shared that when the State is in a budget deficit situation, all available sources of funds, including the Earnings Reserve Account and the CBR are considered as possible funding sources. Therefore, she questioned whether this POMV method might be utilized to address budget shortfalls.

Mr. Burns reiterated that "time and history" would provide that answer. What people originally thought about the language and purpose of the Permanent Fund and how it is viewed today "are quite different."

Co-Chair Wilken agreed that, "it's definitely a change."

Senator Bunde declared that, "we do spend the earnings. We spend it for hold harmless every year." Money is spent on such things as processing PFD applications. It has not been used to the level required to balance the budget.

Senator Olson asked for further information regarding the Delegates' position pertaining to whether State spending was at a sufficient level, specifically in regards to education.

Mr. Burns recalled that the wording of the question was akin to whether State services could be reduced further. He opined that education funding should be increased, especially as federal standards have placed additional demands on it.

Co-Chair Wilken interjected that this is a topic that should be discussed as a separate issue.

SENATOR TOM WAGONER voiced concern about constitutionalizing the POMV and the payout of the PFD in light of projected decreases in oil revenues; specifically how it would affect State services.

Mr. Burns, speaking for himself, remarked that this is an "excellent point." He opined that constitutionalizing the payment of a PFD "could tie our hands" for future generations. "Untying Constitutional dividends would be very difficult." However, the State is in a difficult situation today and something must be done in the interim. If constitutionalizing the dividend is what it would take to politically move the State forward then it should be done for a period of time, perhaps for six or eight years. He suggested incorporating a termination date into the amendment. This concept was discussed with the Department of Law and the Attorney General prior to the Conference and there is no reason that a specific timeframe could not be specified. This should be considered in order to move the State in a direction that would allow it to balance its budgetary needs.

In response to a comment from Senator Wagoner, Mr. Burns responded that incorporating termination language into the amendment is "doable" and should be considered.

SENATOR RALPH SEEKINS voiced the understanding that the income information attributable to the Delegates was based on the family rather than the individual's income.

Mr. Burns concurred.

Senator Seekins, a former member of the Permanent Fund Board of Trustees, spoke to the comment that under the POMV plan, the principal of the Permanent Fund would become "irrelevant." Currently, the principal is approximately \$23 billion and the market value is \$28 billion. Therefore, there is an approximate five billion difference between the two. He asked whether there was concern at the Conference that the principal of the account might be breached.

Mr. Burns responded that this issue was discussed. However, it was

determined that, while there might be some invasion of the principal from time to time, in the long-term, "it would not undermine the health of the Fund."

Senator Seekins reiterated that there is an approximate "\$5 billion cushion between market value and principal under the old rule."

Mr. Burns stated that POMV would utilize market value.

Senator Seekins stated that, under the POMV proposal, inflation proofing would be intrinsic to the Fund rather than being "an annual re-calculation."

Mr. Burns responded that the inflation proofing being proposed in POMV "is the difference between the five percent and" the long-term rate, which is approximately 7.9 percent.

Senator Seekins interjected that it is "roughly eight percent."

Mr. Burns stated that this would equate to long term realizable returns in the market place." The concept of inflation proofing was very important to the Fund when it was first created because it was all fixed income. Asset allocation "is a hedge against inflation."

Senator Seekins understood therefore, that the State is currently inflation-proofing "appreciating assets."

Mr. Burns concurred. This could be likened to the State having "a belt and suspenders policy with the inflation proofing and asset allocation." We are basically double inflation proofing the Fund.

Senator Seekins concluded that the State is more than inflation proofing the Fund.

Mr. Burns concurred.

SENATOR GENE THERRIAULT asked regarding the Delegates' discussion in regards to implementing a needs test in regards to the Dividend.

Mr. Burns replied that the discussion pertained to a proposal to double the amount of the PFD and then "claw it back." This would in effect create a needs based dividend or "a negative income tax." This was considered to being an affront to the dignity of the Dividend.

SENATOR KIM ELTON, a Conference observer, voiced being initially skeptical as to whether the make-up of the Delegates was truly representative of the State's citizens; however, as the Conference

concluded, he was "very, very impressed with how they dealt with the chore handed to them." He reviewed the Delegates responses to the four questions presented to them including: their support of the POMV plan; their position that earnings from the Permanent Fund should be used for essential State services such as education and public safety with the caveats being that the PFDs should be paid first and that the Administration and Legislature also implement a broad based and other taxes to accompany usage of the earnings; while the Delegates did not specify "how or at what amount," they did support a Constitutionally dedicated PFD; and that the State should stabilize the CBR to support State finances against the fluctuation of oil prices and production by specifying a minimal balance of approximately one billion dollars be maintained.

Senator Elton voiced surprise at the scope of the discussions conducted by the Delegates and highly praised the "straw vote" voting process as it proved to be "instructive" to the process. He read the following excerpt from the Letter to Alaskans that was written at the conclusion of the Conference by Delegates: "These were challenging discussions with no easy answers. We, the Conferees, sincerely believe these are the best answers for all Alaskans as a whole and we know they are superior to the easy answers."

Co-Chair Wilken stated that the Conference's straw poll tallies [copy on file] would be provided to the Committee.

Senator B. Stevens, the Senate Majority Leader who participated in the Conference as an Ex-Officio non-voting member, specified that at no point was there ever a roll call vote at the Conference. He found this interesting. Another interesting component was the answer options to votes, such as "Yes, No, Yes but, No but, or Maybe." He characterized the broad range of voting options as a confusing "phenomena." The entire process was confusing and it was difficult at times to understand the proceedings. He left the Conference feeling that the majority of the Conferees felt that State spending was insufficient. 76-percent of the Delegates were "directly affected by State spending either by their company or their organization or their personal income." He did not feel that this percentage was truly representative of the State's population. "There were only 13 Delegates who were independently business oriented." Some questions that were pertinent to education were not addressed; for instance, while education spending has kept up with the rate of inflation since 1994, had the enrollment rate of change since 1994 kept the same pace. He left the Conference still wondering if increased spending was the answer or would further efficiencies through improved management of State government be the answer. He felt that these questions were not approached and that

increased efficiencies rather than "the sky is falling mentality that was presented at the Conference" should be a consideration. While stating that a solution must be reached to address State spending, he declared that the State has been consistently able to make payroll and support its obligations.

Senator B. Stevens stated that the most important presentation at the Conference was that of Standard & Poors credit rating agency in which it was stated that, since 1990, the State has not experienced a downgraded credit rating. How the State manages its money, not how it conducts business is a consideration in the credit process. Hurdles that must be overcome are whether the State could access the Earnings Reserve Account or be able to utilize the State's assets or whether the State could attempt to get more money to spend more money.

Senator B. Stevens applauded the efforts of the Delegates but opined that whether it was a known goal or not, the outcome of the Conference was that the State should have more money to spend. Noting the words attributed to Elmer Rasmussen that the dividends were distributed equally to everyone in the State, he argued that was that the case then, contrary to the premise of the "claw back provision," it should be taken back equally. He avowed that Mr. Rasmussen would be disappointed that his words were utilized in that scenario. In summary, however the most positive outcome of the Conference was "that it got people engaged in that it got them talking about PMOV, the importance of the CBR, and it educated the general populace about the how State government operates." He stated that there would always be a difference of opinions in regards to whether State government is operating properly. One question that would always be debatable" is whether the State is spending too much or enough money. The question is whether we have enough money to spend. He opined that, "we do."

Senator Stedman reviewed the process in which the Permanent Fund evolved from originally being a 100-percent fixed income portfolio. He surmised that a bond portfolio would not experience a lot of capital gains as they are offset by capital losses. Therefore the dividend is extremely critical to the yield.

Mr. Burns agreed, however noted that a large bond portfolio would be the exception in that discounts under and over par are received and amortized premiums are a factor. While capital gains are realized in the bond market, "by and large it is interest rates." That is why the realized gains are an important indicator in a portfolio like that.

Senator Stedman understood that the inflation process currently

being utilized was based on the original structure of the fund.

Mr. Burns affirmed.

Senator Stedman recalled that the asset class of equities was selected for growth as well as their long-term offsetting of inflation impact.

Mr. Burns stated that this would be achieved due to their growth.

Senator Stedman understood that real estate holdings in a portfolio also serve to offset inflation.

Mr. Burns affirmed.

Senator Stedman understood therefore that the Fund's asset allocations have, over time, been changed to include real estate, equities, and other classes. The calculation that is currently used is a two-year average that does not consider what type of asset base, including cash, exists.

Mr. Burns voiced being uncertain as to whether classes are weighted differently. All asset bases are inflation proofed identically, provided their length of time in the system is similar.

Senator Stedman surmised therefore that there are "inequities" in how inflation proofing is calculated, as the length of time the asset is in the portfolio is not a consideration. Alaska's inflation proofing mechanism differs from the norm.

Mr. Burns responded that an energy-based economy as experienced by this State is substantially different than other state's economies.

Senator Stedman asked whether the public would more easily be able to explain the current Permanent Fund program or the proposed POMV plan.

Mr. Burns responded that, "contrary to absolute logic," the existing manner is easier to explain because it is incorrectly understood. POMV "would be infinitely easier to understand" were it explained to people who had no experience with the current plan.

Senator Stedman agreed.

Mr. Burns expressed that the current system has been altered over the years and as a result, the average citizen does not correctly understand how it works.

Senator Stedman declared therefore that were the goal to create something that is easily understood, that program would be the POMV.

Mr. Burns agreed. An educational process must occur in regards to the POMV program.

Mr. Stedman agreed.

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Senator Bunde asked whether a State spending limit mechanism was discussed at the Conference.

Mr. Burns stated that while a spending limit was not a component of the Conference agenda, it was "widely assumed" by the Delegates that some sort of spending limit would be imposed, as it is an issue currently being proposed in the Legislature.

Co-Chair Wilken thanked Mr. Burns for his presentation.

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ADJOURNMENT

Co-Chair Gary Wilken adjourned the meeting at 11:29 AM