

ALASKA STATE LEGISLATURE
JOINT MEETING
SENATE JUDICIARY STANDING COMMITTEE
HOUSE FINANCE SUBCOMMITTEE ON
PERCENTAGE OF MARKET VALUE PAYOUT

Fairbanks
June 26, 2003
6:10 p.m.

MEMBERS PRESENT

SENATE JUDICIARY

Senator Ralph Seekins, Chair
Senator Gene Therriault
Senator Hollis French

HOUSE FINANCE SUBCOMMITTEE ON PERCENTAGE OF MARKET VALUE PAYOUT

Representative Jim Whitaker
Representative Reggie Joule

MEMBERS ABSENT

SENATE JUDICIARY

Senator Scott Ogan, Vice Chair
Senator Johnny Ellis

HOUSE FINANCE SUBCOMMITTEE ON PERCENTAGE OF MARKET VALUE PAYOUT

Representative Kevin Meyer
Representative Mike Chenault
Representative Mike Hawker
Representative Eric Croft

COMMITTEE CALENDAR

Percent of Market Value Briefing by Bob Storer, Executive Director, and Bob Bartholomew, Chief Operating Officer, Alaska Permanent Fund Corporation

WITNESS REGISTER

Professor Rich Seifert
University of Alaska Fairbanks

475 Panorama Drive
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Mr. Eleazar Baker
Fairbanks, AK 99701

Mr. Jerry Macbeth
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Fairbanks, AK 99701

Ms. Mary Nordale
Private Attorney
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Mr. Cary Dewit
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Fairbanks, AK 99701

Ms. Mary Bishop
1555 Gus's Grind
Fairbanks, AK 99701

Mr. Dan Revero
2709 Park Way
North Pole AK 99705

ACTION NARRATIVE

TAPE 03-54, SIDE A

CHAIR RALPH SEEKINS called the joint meeting of the Senate Judiciary Committee and the House Finance Subcommittee on Percent of Market Value Payout to order at 6:10 p.m. Present were Senators Therriault and Seekins and Representatives Joule and Whitaker. The Chair announced that Bob Storer, Executive Director, and Bob Bartholomew, Chief Operating Officer, Alaska Permanent Fund Corporation (APFC), would testify.

MR. BOB STORER, Executive Director, APFC, said he would speak from a handout called "The Need For Change" and that Mr. Bartholomew would speak to the actual language of the proposed amendment, which is to memorialize inflation proofing in the constitution. He said it has been a time-honored tradition of the Permanent Fund Board of Trustees to insure that the fund is inflation-proofed so that all generations are treated equally.

What we propose to do in this change is protect the entire fund against inflation. The key issue here is an option on an annual fund payout and it should be assured in the amount that should be more stable and not only are we memorializing, or suggesting memorializing, inflation proofing in the constitution, it increases the stability of the payout from year to year and we'll show a slide to emphasize that a bit later. We're doing this by limiting the amount that can be distributed to the real earnings of the fund over time. The solution is what we call the Percentage of Market Value Payout.

If I could ask everyone to go to slide three. What is the percentage of market value payout? It is actually a formula that most of the endowment funds have adopted in terms of methodology for payout. It's a limit to the amount of funds that can be appropriated at any given time to the real earnings of the fund. The proposal to do this would be to limit the fund to no more than 5 percent payout, based on a five-year moving average of the fund.

When the stakeholders depend on the fund today, the proposal that the permanent fund trustees are suggesting is the entire fund is not protected from inflation as it is now structured and the change would adjust that. We also believe that this methodology is consistent with the fund's long-term investment strategies.

Currently, we use a realized income methodology to compute distribution. That was fine 26 years ago when the fund was created; and most public funds were invested only in fixed income where virtually all the earnings were the realized income or the interest payments based on those investments.

Modern funds - public, private, etcetera - are far more mature and have a substantial weighting towards the equity market and most of the appreciation in equities is not based on current income - dividends, in fact, are quite small, but on the appreciation of the asset and may be turned over or may be sold in the near term. Or it may be held for the very long term and the income would not necessarily be realized but,

in fact, the fund and the citizens of Alaska and the state would have benefited from that appreciation.

The fund currently cannot assure that the annual payments are available. If we were having this meeting about early October of last year, we would have told you there's about a 10 percent probability that there would be no dividend payout and that's because of what had happened in the market over the last few years. If we'd have had this meeting last March, I would have told you the same thing. There's about a 10 percent chance there would be no payout. That's because our income of dividends and interest was being dwarfed by losses in the securities that were held. It's not just the permanent fund, every fund in the country and individuals were suffering as well. I can tell you now over the last three or four months that there will be a full dividend payout. I noted as of last night for the fiscal year with only a few days to go, the fund has earned a positive 4.5 percent real rate of return. So, we've had a dramatic rebound in the stock market over the last few months.

The size of the payouts in the current methodology is far more unpredictable and less stable from year to year than if we would move to the percentage of market value payout.

MR. BARTHOLOMEW, Chief Operating Officer, APFC, said he wanted to make sure that they understood that this proposal does not directly affect the dividend or compute how big it should be. Before they get to the question of how big the dividend check should be, they should answer how much money should come out of the permanent fund each year.

The proposal for a percent of market value - its whole purpose is to say the rules we have today for determining how big the pie is and how much money should come out or should be available isn't the right way to do it and there's a better way...

CHAIR SEEKINS clarified that is not what they are considering under SJR 18. They are considering a maximum of 5 percent, but that is not a fixed number.

MR. SHORER said that the question was asked which formula best protects the fund against inflation. His answer is that the current formula is in statute and is discretionary.

While the fund has been fully inflation-proofed in the past that is not to suggest that it will be inflation-proofed in the future. We're suggesting that it be done constitutionally although it's implicit. It's implicit because the amount of inflation, the residual remains in the fund and only the real earnings are paid out. That's the 5 percent.

The current formula inflation-proofs principal only. There's a formula in the statutes that follows the dividend, that instructs how you compute the inflation and then you inflation-proof the principal every year. The proposed methodology would inflation-proof the entire fund over some long period of time. Granted, with a 5 percent payout, some years you're paying out more and some years you're paying out less. I like to call it a disciplined approach. People think about can you achieve it in a bear market. What I think is important is it provides the discipline in the bull market to stay the course. There are many people, if you went back a couple of years ago, that would say that 5 percent was way too conservative. Now, in the throes of a bear market that we hope has just ended, you'll hear 5 percent is way to optimistic.

This formula can best assure an annual payout. The current realized earnings base formula can vary in size from - I've got a slide later on that will show you that one year we had \$2.5 billion in realized earnings. The potential, somewhat limited, but the potential exists that there could be zero realized earnings in a given year. The 5 percent of the moving average assures that every year we have this known payout...

I didn't say this is a limit - up to 5 percent, but that would be available from year to year. So, the amount of funds that would be available would be far more predictable than the current methodology.

The earnings reserve, the realized earnings reserve has varied from as much as \$3 billion to several times

your special appropriations and that will include this July 1 of \$100 million - as I noted, a spending limit in the good years, but it assures spending in the bad years as well...

A realized earning base really absorbs all the market volatility from year to year and the principal is intractable. But the 5 percent limit, while it's smooth, the payout would vary from the market value of the fund over time. Markets are volatile; anytime it's volatile; it's been more volatile of late; but in recent years realized earnings in a given year - I said \$2.5 billion. It was as high as \$2.7 billion; a year ago we were about \$257 million in realized income for that year. I think we saw this morning about \$350 million this year. The percentage of market value smoothed out the volatility; it's far less volatile than realized income and does provide the stability.

MR. SHORER used a graph to accentuate the point on page 8. He noted that slide 9 shows the current statutory payout to date, which has been dividends only. There has been a high of \$1.2 billion, but there was as much as \$3 billion that could have been available for appropriations [in the realized earnings reserve - it was not used].

MR. BARTHOLOMEW explained that the slide shows under the current rules what happens in bull and bear markets. The \$3 billion that was not used - one of the problems with that is that the permanent fund was invested in long-term assets and if they know that money is available, maybe they should invest it differently.

Historically, they haven't taken out as much as is available. The flip side is in the low markets, which is where we're headed right now, what we are headed into in the next few years, we're showing - and we're using a model that we used to project into the future if you had continued low markets - there would only be \$175 million to \$300 million available for the dividends. That's a much smaller number. If you had extremely low markets, after you paid out the dividends, there wouldn't be anything else left. There would be zero available for other appropriations...

SENATOR THERRIAULT asked if that is one reason the trustees feel moving to the percentage of market value payout (POMV) is beneficial - you always keep up with inflation, never letting the value of the principal be eroded.

MR. SHORER replied that word "guarantee" might be too strong, because in the short term there might be some down markets where you don't earn enough to fully cover inflation in the short term (a year or two). The trustee's proposal over the long term will earn enough in the good years to make up for inflation that may not have gotten covered when you had one or two down years. Over the long term, inflation has a higher priority because you're going to limit the spending to earnings after inflation over time.

MR. BARTHOLOMEW added that it's important to know that the fund will grow under this scenario for two reasons, because it would retain enough of the earnings to cover the effects of inflation so the fund will grow at the rate of inflation. It also grows because you get \$250 to \$300 million a year in deposits from oil revenues.

MR. SHORER explained that the proposal limits the payout of real rate of return over time and on a realized income base, there are times when it will be very low, but there are times when there has been over \$3 billion in realized income and all of that money could be appropriated well beyond inflation-proofing, if deemed appropriate. The POMV does insure over time that the fund is inflation-proofed.

He reminded them that the existing formula is 26 years old and while it has served the fund well, the reality is that a 15-year bull market masked what is a very serious issue - changing the payout methodology. The National Association of College and Universities Business Offices (NACUBO) conducts a study every year. They surveyed 574 foundations and found that 85 percent of the members use some form of payout methodology based on a POMV. Some use three years, others use more or less. Larger funds tend to have a bit of a smaller payout. He guessed that was because they tend to have a lot more new donors coming in every year so they can be a bit more conservative, but it's going to grow and grow.

SENATOR THERRIAULT asked if they computed a scenario based on the history of the fund if a POMV methodology had been in place and how that would affect the current value of the fund.

MR. SHORER replied that they had, but it is difficult to compare, because the payouts have been less than the 5 percent moving average of the fund. Because it's always been less and because the Legislature has always inflation-proofed, the problem becomes a compounding issue. If you started paying out the entire 5 percent way back in 1983, then the fund would be smaller simply because there would have been greater payouts.

MR. BARTHOLOMEW added that when the fund was invested 100 percent in bonds 20 years ago, there was a year when the formula for payout of the dividend exceeded 5 percent of the total value of the fund. Since the fund has been invested in equities, in 1983 the earnings of the fund have grown faster than they did under the fixed income bonds. Since 1983, the amount paid out for the dividend has actually been quite a bit less than 5 percent. For the most part it's been around 3 percent. The fund would probably be the same size today if the POMV had been in place. If you split the dividends as proposed, they would have been smaller than under the existing formula.

One of the reasons we are proposing this is that it keeps the dividend or any distribution from the fund from going really high in the good years and going really low in the bad years...

REPRESENTATIVE WHITAKER asked what they expect the dividend to be this year under the current methodology.

MR. SHORER replied that he thought it would be below 3 percent of the fund value, about \$690 million.

REPRESENTATIVE WHITAKER said his question was about the individual check.

MR. SHORER replied that it would be about \$1,100.

REPRESENTATIVE WHITAKER asked what it would be under the proposed POMV methodology.

MR. SHORER replied that he really couldn't answer, because if you take 5 percent of the five-year average of the market value, you would have roughly \$1.2 billion available to spend. It would be up to the Legislature to decide how much of the \$1.2 billion would go to the dividend as opposed to other purposes. If he knew what percentage of the pie he was going to use, he could

estimate a rough dividend. The amount available for distribution would be about 2.5 percent. They project about \$690 million to \$700 million would be available, divided by 620,000 people.

REPRESENTATIVE WHITAKER asked how they transition from one formula to another.

MR. SHORER replied:

If we went to the payout methodology and stayed with the 2.5 percent for dividends, what would happen is over the next few years, if you went to the POMV approach, it would actually be slightly higher than what we're projecting under the existing formula.

REPRESENTATIVE WHITAKER asked if it would be fair to say there would be adequate funding to pay an equivalent dividend to what is paid out today.

MR. SHORER replied yes.

REPRESENTATIVE JOULE asked if the Legislature had ever chosen to not inflation-proof the fund and how much is it in terms of dollars.

MR. BARTHOLOMEW replied by giving them a perspective on how they do inflation-proofing today. They look at the change in the national consumer price index from one year to the next. They take that amount and multiply it by the size of the permanent fund's principal. Last year it took \$600 million; this year it will take \$350 million. They will move that amount from the earnings pool to the principal where it can no longer be spent.

MR. SHORER explained that the Legislature always inflation-proofed in the past and excess earnings were appropriated to the principal as well.

CHAIR SEEKINS asked if those appropriations amounted to about \$7 billion.

MR. SHORER replied that is correct and added that the fund is divided equally between mineral contributions, inflation proofing and special appropriations. The principal of the fund is about \$22.2 billion today.

SENATOR THERRIAULT confirmed that the inflation proofing is done as an appropriation by the Legislature.

MR. SHORER agreed.

SENATOR THERRIAULT asked if it was true then of the \$22.2 billion that the Legislature put two-thirds of it there.

MR. SHORER replied that is correct.

SENATOR THERRIAULT noted that under the proposal, the 5 percent is all that's available for appropriations and dividends and asked if the only change they are making is not to the calculation, but to the amount that is available for distribution.

MR. SHORER replied that is correct and they have always said it is the prerogative of the Legislature to determine how the money is used. They recognize there is a benefit to creating a dividend payout formula that is also based on the POMV approach, but they are proposing to memorialize inflation proofing by limiting the amount of money that can be appropriated in any single year.

SENATOR FRENCH asked how many years the other funds have been using a POMV formula according to the NACUBO study.

MR. SHORER said it is a phenomenon over the last 20 years, but he would have to do research for a precise answer.

SENATOR FRENCH asked to what extent our vision is skewed by the recent bull market and what would happen if a long period of stagnant returns were to occur.

MR. SHORER replied the permanent fund decision is independent of any market, including the recent bull market. One of the benefits of the 5 percent limit is that you don't get caught up in the bull market. The permanent fund has not achieved a 5 percent real rate of return over the last 3 to 5 years. Over the last 15 years, they benefited in excess of the 5 percent. "Our look forward is naïve. It doesn't have a bull market and it doesn't have bear market scenario, but it recognizes that both will probably occur in our expectation."

SENATOR FRENCH asked which funds were using the POMV market prior to 1983, before the long bull run and what payout were they using based on the models they formulated before it began.

MR. SHORER replied he would have to research that question.

CHAIR SEEKINS said he didn't think the permanent fund took advantage of that bull market starting in 1983. They started increasing the asset allocation in the early 1990s to take advantage of the equities market.

MR. SHORER said that is right. There was a strong bias at the time to be conservative to maintain the confidence of the citizens of Alaska. "But from 1983 to 1993, it didn't matter whether you held stocks or bonds; you were going to earn about 13.5 percent with either one. So, it was actually a fortuitous period to own bonds."

REPRESENTATIVE MEYER asked what would happen if they said the payout would be 5.5 percent.

MR. SHORER replied that to achieve that goal, the permanent fund would have to have a more aggressive asset allocation. They might even have to change the current constraints on what it must invest in to allow it to exceed its existing limits in terms of equities. A 5.5 percent payout under the current scenario is spending 5 percent of the real income and .5 percent of the inflation proofing. Ultimately, it would erode the principal.

REPRESENTATIVE MEYER said he had been asked why they inflation-proof, because the stock market will inflation-proof itself over time. Stock values go up with inflation.

MR. SHORER replied if they change the legislation to POMV, he would agree with that statement. However, they are not double inflation-proofing as the stock market appreciates over time, because assets must be converted into realized income and be appropriated by the Legislature. Using the POMV would allow them to make purely investment decisions based on asset allocation.

REPRESENTATIVE MEYER said in 1999 the House passed a bill to use the permanent fund earnings in some sort of fashion and asked him how the two plans differ.

TAPE 03-54, SIDE B

[Indiscernible answer because tape was turned over manually.]

MR. BARTHOLOMEW said there was a handout with an analysis of SJR 18 setting forth six bullets. He wanted to make sure they understood what changes to the constitution were being proposed.

Page 1, line 10 adds a second paragraph, (b), to the constitutional provision on the permanent fund.

Page, line 11 removes the word "principal" from the constitution. That leaves the earnings reserve, which had different rules. Under the POMV proposal, "principal" would be deleted and the fund would be one pool of money. Today they are all invested as one; it's simply an accounting mechanism that they do. This is a significant policy question, as it's become known that the principal is off-limits and is protected. The protection that is being proposed by the POMV is the spending limit of 5 percent a year of the total fund value. What it means today is if there are a couple more down years, the earnings reserve could spike down for a short term when the markets do. That's what leads to the possibility of a zero payout being available in any one year.

By eliminating it and replacing it with a spending limit, you will be able to have money each year and the policy question is balancing the benefit of having a controlled limited distribution every year against the risk of having no distribution.

Page 1, lines 13 - 14 say that all the income from the permanent fund shall be deposited into the general fund unless otherwise provided by law and for the last 21 years the Legislature has provided that all the earnings of the permanent fund will remain there until it's appropriated. It has not been going automatically into the general fund. This language is being removed, because under POMV there will one pool of money and all the earnings of the permanent fund will stay in until it's appropriated. The legal guidance they have says they don't have to refer to the "income" of the permanent fund anymore, because it will stay there.

Page 2, lines 2 - 6, adds a long sentence that says they are going to protect the permanent fund from inflation and assure that the real value of it will be preserved over the long term. Lines 4 - 5 describe how that will be accomplished. Line 5 says,

"of the average market values of the fund on June 30 for the first five of the six fiscal years immediately preceding the fiscal year."

MR. BARTHOLOMEW explained:

There is a reason we had to put that wording in there. If we just said - take the average market value of the last five years - that includes the year that you're in. So, the Legislature just completed their work and they've appropriated next year's budget, but they still don't know how much will be available from the permanent fund until we get to June 30. So, they start their work in January and we're doing the budget, but we don't know what's available. That's why we're saying go back one more year - going back six years so that we know a year early. So, a year ahead of time the Legislature and the administration would know what's going to be available from the permanent fund in the future. It's to give a whole level of surety and not have to do all these projections.

Page 2, lines 9 - 12, is a transitional provision. It says that right now the permanent fund is two pools of money, the principal and earnings reserve. Attorneys wanted to make it perfectly clear that the earnings of the permanent fund at the time people vote on this becomes part of the permanent fund and is subject the constitutional protection.

The last change is on page 2, line 13, that says since this is a constitutional amendment, it will go before the voters of the state of Alaska at the next general election which is in November 2004.

REPRESENTATIVE WHITAKER said he was comparing SJR 18 and HJR 26 and the only difference he could see is on page 2, line 2 and asked if that is the only one.

MR. BARTHOLOMEW replied that is exactly right. Lines 2 - 3 are a policy statement and the House version doesn't have that.

MR. RICH SEIFERT, Professor at UAF, endorsed the POMV idea as a sound approach. About a year ago, he brought up his concerns about corporate crime and the erosion of the permanent fund to the board and he didn't think it had been adequately dealt with at the national level.

If our equity is 50 percent in the stock market, it's all right to have the prudent investor rule hold sway, but it's only a prudent investment if you're not being defrauded.

He said that people voted to protect the fund's principal originally. One of the best ways they could protect it is to invoke an income tax. "What would be the incentive to inflation-proof the fund if the Legislature has available to it a fixed well known amount of money, maybe half of the 5 percent, every year?"

He also wondered if changing to this formula would change the IRS status.

CHAIR SEEKINS said he likes the predictability of the POMV regardless of what other sources of revenue there might be out there.

MR. ELEAZAR BAKER, Fairbanks resident since territorial time, said he will be retiring soon and will need to depend on the dividend as part of his fixed income.

SENATOR THERRIAULT asked him if he took the long-term view that inflation proofing should always be assured or the shorter-term view of a higher dividend.

MR. BAKER replied he doesn't care about a higher dividend, but he does care about the stability of the fund.

SENATOR THERRIAULT asked if he would like to see a more predictable payout as opposed to widely divergent amounts.

MR. BAKER replied that the more they can put the formula in the constitution, the safer it will be from attack.

MR. JERRY MACBETH, Fairbanks resident, said he works at the University and looked at the financial spreadsheet projection comparison of the status quo versus POMV. The projection from 2003 to 2012 under the status quo has the fund growing from \$24 billion to \$40 billion; and under the POMV, the fund would grow from \$24 billion to \$33 billion - \$7 billion less. He wanted to know where that \$7 billion is.

MR. BARTHOLOMEW explained that this particular scenario shows that the Legislature appropriated for usage of the dividend.

So, the top half just shows each year how much we earned, payment of dividend and then we go to the next year. Under POMV, we assumed the entire 5 percent that's available - we wanted to show that scenario. It's not an apples and apples.

MR. MACBETH said he is undecided about whether it is wise to amend the constitution to provide the POMV payout. He doesn't see the need based on the Legislature's performance of inflation-proofing it since it was established. He was concerned about predictability and volatility of the fund. If you decrease the volatility, you also increase the culture of dependence on the permanent fund dividend, which he thinks is unhealthy for the state's development over the long term.

MS. MARY NORDALE, private attorney, said she was the Commissioner of the Department of Revenue from 1984 - 1986 and was a member of the Permanent Fund Board of Trustees. She commented:

In 1986 what we had anticipated within the department during 1985 happened and that was the big crash in the price of oil. And we had to scramble around and try to figure out how to dig about \$800 million out of the budget for FY87. That faced legislators when they came to Juneau in 1987 and it was a very, very, painful period, as you well know. At the time, in 1984, as has been noted earlier, the constraints on investment opportunities for the fund were very severe. As a consequence, inflation proofing as an element that needed to be taken into account was extremely important because the bulk of the fund was invested in fixed income. The effects of inflation were more severe at that time on those investments than it would be in the equity market - this would be over time. So, I am very much supportive of the Senate Resolution. I hope if it does pass, that it incorporates the language of the policy statement because that is both a pledge to the people and a constraint on the investment technique opportunities available to the trustees. It's a joint effort to retain the fund - permanently retain its integrity and keep it growing.

When you are considering, however, opportunities to fund our state, I hope you will not dismiss lightly an income tax. I served on a long-range financial planning commission in 1995, which recommended an array of spending cuts and revenues to avoid the crash that we predicted in 2005. That is when we figured the state would hit the wall if no changes were made in both spending and in revenues. The problem is not that the permanent fund earnings are not available; the problem is that most of the programs that absorb a lot of the state's revenues are population driven - schools, welfare payments, support of Medicaid - whatever. But, you will see that most of the large items in the budget are population driven and the only income source available to the state at this time is an income tax. If you go to a sales tax, all you're doing is taking out of the pockets of smaller communities and putting it in the hands of the state which is not a fair exchange at all, because in the long run, it's a benefit to the state to strengthen local government. Getting back to the original point, I firmly support the resolution and I hope the Legislature will adopt it...

SENATOR THERRIAULT said an income tax sort of supercharges the redistribution of wealth by, for instance, taxing his and his wife's \$2,000 worth of dividends at their tax rate and not necessarily taxing his neighbor who might not be in a taxable category at all and who has access to all the different sorts of welfare available.

MS. NORDALE replied that might be true, but if you own a share of stock in General Motors and she owns a share, you will pay federal income tax at a different rates because the incomes are different. That is part of the whole system.

I don't see how we can make an adjustment in terms of the dividend to affect some sort of super equality, a negative income tax, just to protect the person who might, because of a higher income, pay more income tax. I think one of things you need to realize is that the dividend is taxable by the federal government. If it were taxable as income here in the state, it would be money that would stay in the state and not go to the federal government.

CHAIR SEEKINS said that only the portion that came to the state couldn't be taxed by the federal government.

MS. NORDALE responded that under the old system of taxation, 16 percent of federal tax went to the state treasury and that is better than nothing, basically.

MR. CARY DEWIT said he thinks the POMV makes sense particularly the part that allows the Legislature to predict how much money is coming in ahead of time. However, he is concerned if this is in the form of a constitutional amendment. He suggested that the 5 percent figure not be fixed there, but be made to reflect the actual market growth. He also read something in the Fairbanks paper about including a cap on government spending.

CHAIR SEEKINS said that is in a separate bill that Senator Dyson had introduced.

MR. DEWIT said he also supports an income tax. It is the fairest and most sensible way of providing a long-range source of revenue for the state.

SENATOR THERRIAULT remarked that it's acceptable public sport in America to distrust anyone who has anything to do with spending a public dollar. He asked why an income tax would magically transform that.

MR. DEWIT replied when a person sees a solid connection between money going out of their pocket into government revenue, they are going to be much more interested in how that money is spent.

TAPE 03-55, SIDE A

SENATOR THERRIAULT commented there isn't that dynamic when he and thousands of other people write their property tax check.

MR. DEWIT said maybe there is a public apathy problem.

MS. MARY BISHOP, Fairbanks resident, said she is on a fixed income and definitely supports inflation proofing. She also supports the Legislature and the administration knowing the amount available for appropriation one year in advance. She wondered if that would also mean knowing the amount of the dividend ahead of time as well.

MS. BISHOP said that this proposal seems to allow the state to use some of the money for their regular budget, which she doesn't think happened before.

CHAIR SEEKINS clarified that every year millions of dollars are spent out of the permanent fund on things like public safety and hold harmless agreements. This year it amounts to around \$40 million.

MS. BISHOP asked who decides how much of the 5 percent goes to pay dividends and how much will pay for government.

SENATOR THERRIAULT replied all that is under discussion. Current wording is just up to 5 percent and the Legislature could have a statutory scheme on how the dividend would be calculated. The current statutory computation of the rolling five-year average could be retained.

CHAIR SEEKINS added that currently the Permanent Fund Board of Trustees is able to determine the size of the dividend to a degree by deciding whether or not to sell or retain shares. Right now the size of the realized income is a function of what the board and the executives instruct the managers to do. "You can play god with the size of the earnings now."

MR. BARTHOLOMEW said their goal is to earn 5 percent over inflation. Their consultants estimate that going forward for the next five years they are going to do 8 percent or a little less and inflation is going to be 3 percent or a little less. If you leave 3 percent in the fund, you have 5 percent to spend and they don't know what the capital markets might do. Inflation might go up, which could affect how much interest you get from bonds.

SENATOR THERRIAULT commented that it would be very handy to be able to know how much money they are working with and the only thing that would give the Legislature surety would be if all state revenues went into the permanent fund and the percentage draw off limited every year. This was originally known as the Cremo Plan after the person who developed it years ago. Right now, corporate taxes, rents and royalties still need to be projected.

MR. DAN REVERO, North Pole resident, said he opposes a state income tax, but is inclined to favor a sales tax to spread the money to municipalities. He supports the POMV.

CHAIR SEEKINS asked further questions or further questions or comments.

SENATOR THERRIAULT said this year the Legislature used 17(b) of the constitution to get access to the constitutional budget reserve with a simple majority, but to do so, they had to make an advance appropriation for the next year's inflation-proofing, leaving \$100 million in the earnings reserve. At the time, it was projected to have \$360 million; the \$260 million was moved in advance. He asked Mr. Bartholomew what the advance deposit would be under the proposal. Currently, everything in excess of \$100 million is moved into the principal of the permanent fund.

MR. BARTHOLOMEW responded that one of the components in the letter of explanation is that the Legislature would take money out of the earnings reserve and move it into the principal, earmarking that for next year's inflation proofing. At the same time next year's inflation proofing appropriation is repealed and moved ahead one year.

To give you the perspective of inflation, last year it took \$600 million to fully inflation proof. This June 30 that will end here in less than one week, we're predicting it's going to take \$350 million to inflation proof. Looking forward to next year, I think we're looking at about \$550 million to fully inflation proof. All of these are projections. At the time that the Legislature made the decision, we projected the sweep to be \$250 million. So you would have paid a little less than half of next year's inflation ahead of time. The only change since then as the markets have changed and as our managers have made decisions, the amount of realized income has risen and we expect that transfer or sweep, now, to be roughly \$350 million. So, we're going to sweep more and we're going to - if you apply that to inflation proofing, then there will be less needed next year. And the only other comment is when we get to next year it is the balance that is in the earnings reserve, which will be the \$100 million that we're going to start with. What we will earn next year in realized earnings, when we get to the end of the year - that will determine how much is available for the Legislature for dividends or inflation proofing.

SENATOR THERRIAULT asked him to explain the inflation proofing at \$600 million, going down to \$350 and that they are projecting it to go back up to \$580 million. He questioned whether they overestimated what's going to be needed.

MR. BARTHOLOMEW answered that he could make a statement like that looking at just next month or next year, but they try to get away from one year windows. When the trustees talk to their consultants, they look at five years and over five years they are projecting inflation to be 2.6 percent. "So, when I estimate to you that it's going to cost \$550 million for inflation proofing, it's based on a five year average."

MR. SHORER added that the inflation number is based on a calendar year and we are six months through that for this year.

CHAIR SEEKINS thanked everyone for their comments and adjourned the meeting at approximately 8:00 p.m.