

HOUSE FINANCE COMMITTEE
January 25, 2017
1:31 p.m.

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CALL TO ORDER

Co-Chair Seaton called the House Finance Committee meeting to order at 1:31 p.m.

MEMBERS PRESENT

Representative Neal Foster, Co-Chair
Representative Paul Seaton, Co-Chair
Representative Les Gara, Vice-Chair
Representative Jason Grenn
Representative David Guttenberg
Representative Scott Kawasaki
Representative Dan Ortiz
Representative Lance Pruitt
Representative Steve Thompson
Representative Cathy Tilton
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

David Teal, Director, Legislative Finance Division; Pat Pitney, Director, Office of Management and Budget, Office of the Governor; Gunnar Knapp, Professor Emeritus of Economics, University of Alaska Anchorage Institute of Social and Economic Research (ISER).

PRESENT VIA TELECONFERENCE

None

SUMMARY

HB 57 APPROP: OPERATING BUDGET/LOANS/FUNDS

HB 59 APPROP: MENTAL HEALTH BUDGET

PRESENTATION: MODELING ALASKA FISCAL PROPOSALS:
IMPLICATIONS OF DIFFERENT FISCAL ASSUMPTIONS AND CHOICES
OVER TIME BY GUNNAR KNAPP, PROFESSOR EMERITUS OF ECONOMICS,
UNIVERSITY OF ALASKA ANCHORAGE INSTITUTE OF SOCIAL AND
ECONOMIC RESEARCH (ISER)

Co-Chair Seaton reviewed the agenda for the meeting.

#hb57

#hb59

HOUSE BILL NO. 57

"An Act making appropriations for the operating and loan program expenses of state government and for certain programs; capitalizing funds; amending appropriations; repealing appropriations; making supplemental appropriations and reappropriations, and making appropriations under art. IX, sec. 17(c), Constitution of the State of Alaska, from the constitutional budget reserve fund; and providing for an effective date."

HOUSE BILL NO. 59

"An Act making appropriations for the operating and capital expenses of the state's integrated comprehensive mental health program; and providing for an effective date."

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Co-Chair Seaton conveyed that the committee substitute was strictly a version with technical corrections.

Co-Chair Foster MOVED to ADOPT the proposed committee substitute for HB 57, Work Draft (30-GH1855\J).

There being NO OBJECTION, it was so ordered.

Co-Chair Seaton invited Mr. Teal to the table to explain the technical corrections in the bill.

DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, pointed to the document comparison (copy on file). He explained that the document comparison was derived after working with Legal Services and the chairman's office. He reported there

was nothing significantly different from the governor's version of the bill. He would not be going through every change, but confirmed there were no transaction changes. He noted there were a few date corrections and editing changes. Essentially, the governor's bill was in a Legal Services format, providing a clean start. The committee substitute would become the basis for amendments.

Co-Chair Seaton asked Mr. Teal to remain at the table and invited Pat Pitney to verify that there were no substantial changes other than wording, technical, and date changes from the Office of Management and Budget's perspective.

PAT PITNEY, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, OFFICE OF THE GOVERNOR, confirmed that she agreed that the bill represented the governor's intent of the original version. There were no material changes, only clean-up changes.

Co-Chair Foster MOVED to ADOPT the proposed committee substitute for HB 59, Work Draft (30-GH1856\D).

There being NO OBJECTION, it was so ordered.

Co-Chair Seaton asked Mr. Teal to address the process related to the changes in the committee substitute.

Mr. Teal reported that the process regarding the bill was identical to the one used for the operating budget. House Bill 59 was the mental health bill. There were only a few changes to the bill most of which were noted in the margins of the document and had to do with formatting. He would have liked to have tracked the changes to make it easier to see the ones that were more significant. He encouraged members to review the changes that were made. He commented that items may have been reordered.

Co-Chair Seaton asked Ms. Pitney if the committee substitute was the bill submitted by the governor with technical realignment. Ms. Pitney responded affirmatively.

Vice-Chair Gara understood the need for a separate mental health budget and that it started based on a court order. He wondered how certain items ended up in the mental health budget rather than in the operating budget. He mentioned that in the prior year there was a disabilities item that was funded with undesignated general funds (UGF) in the

mental health budget. He recognized that things funded by the Alaska Mental Health Trust ended up in the mental health budget. He also was aware of how it related to mental health issues. He asked about the dividing line between what mental health items ended up in the mental health budget versus the operating budget. He provided an example from the previous year's budget. Ms. Pitney responded that there had been a tradition built up. She spoke of base plus increments and decrements. Over time a distinction had been made. She thought discretion was used but she deferred to Mr. Teal as to the boundaries. She noted that the priorities of the Alaska Mental Health Trust Authority Board were represented in the distinctions. She did not believe there were any hard and fast rules.

Vice-Chair Gara would take her answer, as the administration did not know. He commented that he knew priorities were not the only part of the equation.

Mr. Teal remarked that the reason he did not know was because it was all done by computer. [members could be heard laughing in the background].

Vice-Chair Gara made a humorous remark.

Mr. Teal answered that the budget was divided by fund codes related to mental health. He mentioned mental health trust receipts. He confirmed that there were UGF in the mental health bill that were coded with gf/mh. He surmised that if the item in question was part of a mental health group it would automatically switch over to the mental health bill which explained why there were mental health allocations. He suggested that the same allocations would appear in the regular operating budget and the mental health bill. It took the mental health fund group from the regular operating budget placing it into the mental health bill. He relayed that with capital the dividing line was less certain because there might be different fund sources. However, the projects were proposed by the Alaska Mental Health Trust Board. The governor was required to forward them to the Legislature or provide a letter to the AMHTA explaining why he did not forward them. At the end of session, the legislature had to write a letter for the chairman's signature describing what was left out of the AMHTA request and the reasoning behind that decision. It was a requirement in statute that the bills had to be separated, although they were taken up together, amended

simultaneously, and were heard together in a conference committee. He was certain that if there was not a statute requiring separate bills there would only be one bill.

Representative Wilson referred to page 2 and asked if the collective bargaining of the state's unions was in the mental health budget. Mr. Teal responded affirmatively. He furthered that anytime members of the bargaining association were funded with mental health dollars, the same language that appeared in the regular operating bill was repeated in the mental health bill. Since it was not always clear where the bargaining units appeared, the legislature has repeated all the bargaining units even if it was irrelevant to the mental health fund group.

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Representative Wilson asked about whether the wording was the same in each budget including reducing proportionately the amount for the bargaining agreements if an agreement had not been reached.

Mr. Teal answered, "That's correct."

Co-Chair Seaton thanked the presenters for coming forward.

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AT EASE

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RECONVENED

Co-Chair Seaton indicated that the meeting would end at 3:30 PM.

^PRESENTATION: MODELING ALASKA FISCAL PROPOSALS:
IMPLICATIONS OF DIFFERENT FISCAL ASSUMPTIONS AND CHOICES
OVER TIME BY GUNNAR KNAPP, PROFESSOR EMERITUS OF ECONOMICS,
UNIVERSITY OF ALASKA ANCHORAGE INSTITUTE OF SOCIAL AND
ECONOMIC RESEARCH (ISER)

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GUNNAR KNAPP, PROFESSOR EMERITUS OF ECONOMICS, UNIVERSITY OF ALASKA ANCHORAGE INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH (ISER), introduced himself. He wanted to continue to be useful. He spoke of his work currently being voluntary in retirement as listed on slide 2: "About Me...":

- Former Director and Professor of Economics at ISER
- Studied Alaska fiscal issues
- Retired end of June 2016
- Now a "Professor Emeritus"
- All of my work on fiscal issues is voluntary
- Not being paid by anyone
- My attempt at public service
- All opinions are my own

Mr. Knapp reported being a Professor Emeritus because he retired at the end of June. He was in Juneau due to his interest in the fiscal issue and because he had done a significant amount of work over the previous several years. He wanted to remain involved in studying the issue and to be helpful if possible. He stressed that his work was completely voluntary, he was not receiving payment from anyone, and all his opinions were his own.

Mr. Knapp turned to slide 3: "My main goal is to illustrate a way of comparing fiscal proposals." His main objective was to come up with a way he could compare different fiscal proposals under discussion. He made a model to do so. He had several legislators approach him to assist them in modeling their proposals. As a result, he came up with a complicated model and was invited to the legislature to discuss it.

Mr. Knapp advanced to slide 4 highlighting that he was not advocating for or against a fiscal proposal. There was a wide range of things people were talking about. He was interested in running numbers and looking at what would happen.

Mr. Knapp discussed slide 5: "My focus is on: Unrestricted General Fund (UGF) revenues and spending Permanent Fund earnings and draws." His focus was primarily on unrestricted general fund (UGF) spending and the potential use of Permanent Fund (PF) earnings.

Mr. Knapp turned to slide 6: "I will not talk about oil credits or oil taxes." He clarified that he would not be addressing other parts of the budget or talk about oil credits or oil taxes. He explained that his models handled those items such that if oil credits were changed, the

model would reflect a change in spending. If oil taxes were changed, the model would reflect a change in revenues.

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Mr. Knapp turned to the graph on slide 6: "A long-term look at our UGF revenues and spending . . .". The graph showed what the state's revenues and spending have been on a per capita basis adjusted for inflation since oil began flowing. He noted that the revenue part was reflected by the blue and red lines at the bottom. The blue lines represented non-oil revenues and the red line represented oil revenues. It was clear there had been two huge oil booms: one in the early 80s and one in 2008-2013. They were similar in terms of the value per Alaskan. There had been periods where the state had a significant amount of money and then periods where it had much less money.

Mr. Knapp drew the committee's attention to two lines. First, the yellow line showed the agency spending per capita. Second, the purple line denoted the total spending per capita. The difference between the two lines was the capital budget and statewide operations. Alaska's fiscal policy over the historical period noted on the chart was that when the state had more money it spent more. The state would typically grow both the operating and the capital budgets, but particularly the capital budget. He continued that when the state had less money it cut back on both budgets, but particularly the capital budget. Over a long period of time the agency budgets were squeezed down, and capital spending was reduced. At a certain point, the state went from running surpluses to running deficits. Everyone was panicking in the late 90s and early 2000s because the state had been running progressive deficits and drawing down savings. He added that the cycle repeated itself bringing the state to its present circumstance. In terms of the difference, the state's revenues had fallen to a much lower level with less of a prospect of coming back. The state was left with the question of what to do. He thought it would be impossible to squeeze the spending down to the expected level of revenues.

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Mr. Knapp reviewed slides 8 and 9. He reported that the state had been paying the deficits by drawing down its savings. Alaska's Permanent Fund had been growing

substantially and generating money. Historically, the savings had been used to pay dividends, to inflation-proof the fund, and to build up the earnings reserve account (ERA). Clearly, the state was not using all its earnings which accounted for why the PF had been growing so quickly. Presently, the question was whether it was time for Alaska to start using the PF earnings to address the deficit issue.

Mr. Knapp spoke to slide 12: "Key issues in the current fiscal situation." He continued that part of the state's fiscal debate had to do with how much of the state's spending should be cut or how many taxes should be raised. Another question he presented was to what extent could or should the state solve the fiscal problem by using the PF earnings. He wondered what way the funds should be used if the state decided to use them. Several proposals were being developed to look at the issue.

Mr. Knapp advanced to slide 13: "My model is only a starting point for thinking about fiscal proposals." He reported developing a model that would allow him to compare them. He emphasized that there was nothing magical about his model, as it was a large Excel spreadsheet containing several formulas that tracked specific things. He designed the model, so he could quickly change a number or a variable to look at the effects of tweaking it a certain way or another.

Mr. Knapp detailed slide 14: "My model is only a starting point for thinking about fiscal proposals." He thought his model was simplistic. The way the budget worked was very complicated. He suggested that his model was good for a first start, big picture comparison of different proposals. However, he emphasized that it was not a substitute for the detailed models put together by organizations with that responsibility and expertise. It was not a substitute for what the Legislative Finance Division (LFD) was able to model. He would always differ to LFD for specifics.

Mr. Knapp scrolled to slide 15: "All the model projections are in millions of dollars" He clarified that his numbers were reflected in millions of dollars.

Mr. Knapp turned to slide 16: "My model is work in progress." His model was a work in progress and might contain errors.

Mr. Knapp explained slide 17: "My model's projections, like any fiscal projections, depend critically on assumptions." He illuminated that anytime projections were made, assumptions were critical. In the state's model, the assumptions had to do with what would happen to oil revenues and what would happen to PF rates of return. If the state had a model that included what the state's finances would look like, the assumptions the state took on about oil revenues and its return on investment were critical to the type of results the state would get.

Mr. Knapp continued to slide 18: "What should we assume for comparing different fiscal proposals?" He argued that if the state made optimistic assumptions, it would not have a problem. Conversely, if the state made its assumptions pessimistic enough, it would have a huge problem. He wondered how a state planned when it did not know what its revenues would be.

Mr. Knapp reviewed slide 19: "Most analyses of fiscal proposals rely on a single set of assumptions." He pointed out that the most convenient assumptions for the state to use (the most recent DOR projections and the current PF assumptions from advisor recommendations) were magic numbers to use for planning. The state would plan everything based on those numbers. However, historically, neither of the assumptions were likely to come true or remotely true.

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Mr. Knapp pointed to slide 20: "Historically, we have done very poorly at projecting future oil prices, particularly over the longer term." He reported that most analyses of fiscal proposals relied on a single set of assumptions. The state had done a poor job of projecting future oil prices. He noted the bars on the chart showed what came true and the different lines showed what had been projected in different years about the state's future revenues. His objective was not to criticize the people that made the projects, but rather to show how difficult it was to predict future oil prices. He posed the question about why the state would do better currently. Two or Three years out the price assumptions would probably be way off from the official ones.

Mr. Knapp explained slide 21: "We have also not done very well at projecting North Slope oil production over the longer term." He opined that it was also difficult to project future oil production for more than a few years out. Historically, there had been periods where the state had been overly optimistic and times where it had been the opposite.

Mr. Knapp advanced to slide 22: "Because we have not done well at projecting oil prices or production, we have not done well at projecting state revenues, particularly over the longer term." He suggested that if the state's inability to guess future prices was combined with its inability to predict future production, the state would have a difficult time accurately projecting its future revenues.

Mr. Knapp advanced to slide 23: "Historically, after a few years, our actual revenues have usually been much higher or lower than the revenues which we projected a few years earlier." He indicated that in looking at projected unrestricted general fund (UGF) revenues, typically, the projections were off by about 30-40 percent one way or the other.

Mr. Knapp scrolled to slide 24:

"In modeling fiscal proposals, we should look at a range of assumptions about future oil revenues and make sure that we're comfortable with the implications of those assumptions given the likelihood that they might come true."

Mr. Knapp encouraged members to look at a range of assumptions rather than relying on one.

Mr. Knapp discussed slide 25: "What range of oil revenue assumptions should we be looking at?" He wondered what the range of assumptions should be. He did not know the correct range. He suggested going beyond the point estimate. He could tweak his model in several different ways to show the effect of different oil prices. However, it was already known that if oil prices were higher, the state received more money.

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Mr. Knapp pointed to slide 26: "For today's presentation, I only show projections based on the most recent DOR Fall 2017 revenue projections, because..." He relayed that it was unlikely for oil prices to go high enough to generate a significantly larger amount of money to get the state out of its fiscal problems.

Mr. Knapp turned to slide 27: "Historically, Permanent Fund rates of return have fluctuated widely. Projections assuming a constant rate of return may be very wrong." He noted that it was also true that, historically, the state had seen real changes over time in 10-year averages.

Mr. Knapp advanced to slide 28: "Historically, Permanent Fund average earnings over longer periods of time have also fluctuated widely. Assumptions about future rates of return won't necessarily come true." He argued that the state could not assume that the projection of the PF earnings was going to come true on a year-to-year basis or in earnings. In terms of what the state could do, he suggested that as legislators thought about different fiscal proposals, they should consider how they would play out if the PF returns were lower or if they varied significantly.

Mr. Knapp turned to slide 29: "I use three sets of modeling assumptions for future Permanent Fund rates of return." He used 3 sets of assumptions. First, he used what the Permanent Fund Corporation was projecting for returns. Second, he showed the effect if the return was 1 percent less than the projection. Third, he used an arbitrary 10-year period in history from FY 06 to FY 16 using the rates of return for those years.

Co-Chair Seaton interjected with a question regarding slide 28. He was confused about the colors on the chart. He commented that the colors did show up. He mentioned fund total revenues, real return, and inflation.

Mr. Knapp detailed slide 30: "If we don't inflation proof or draw any PF earnings..." He mentioned a few basics about the PF. He indicated the information was important in terms of thinking about any proposal that involved the use of PF earnings. He asked what would happen if nothing were taken from the PF. Assuming the projections were correct, the fund would grow to \$113 billion by FY 27. That would be the maximum size of the PF if the state did not draw from it at all. On the other hand, the more the state drew from it for

dividends and for government, the less the fund would grow. He pointed to the graph on the right of the slide. The realized earnings were shown in blue. He had not included inflation proofing in the example. He ran the model with the assumptions that all earnings were accumulated in the realized earnings where the grow would appear.

Mr. Knapp highlighted slide 31: "Effect of 1% lower earnings..." He continued that if the rate of return was lowered by 1 percent, the state would end up with \$13 billion less in the fund in FY 27. Every percent of the rate of return on average made a significant difference.

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Mr. Knapp continued to slide 32: "Effect of the same rates of return as for FY 06-FY 17..." He spoke to the effect of a varying rate of return like in FY 06 - FY 16. The amount still grew but was significantly more varied.

Mr. Knapp turned to slide 33: "If we fully inflation-proof but don't draw any PF earnings." He explained that in the graph he showed what happened if the state inflation-proofed. He continued that inflation proofing was taking money from one part of the PF and placing into another part of the PF. Money was taken from the earnings reserve account (ERA) from which the legislature could spend, and placed into the principal account from which the legislature was not allowed to spend. It did not change how much the PF earned or the fund value, but it kept it safer. He posed the question as to how much money the state wanted to take off the table to ensure that the principle was safe from being spent. By inflation proofing the fund it did not make the PF any larger, it just moved money to a part of the fund the legislature could not get at as easily. In the remainder of his presentation assumed that the state would not inflation proof the fund.

Mr. Knapp advanced to slide 34: "If we don't inflation-proof and draw only dividends based on the current formula." He reported that if the fund was not inflation proofed, there were no government draws, and the dividend formula was kept the same the PF would only grow to \$82 billion by FY 27. His point was that dividends were not using the entire PF earnings. There was extra money the state could potentially use and still have a very large PF.

The more the state dipped into that extra money, the less the PF would generate in earnings in the future.

Mr. Knapp detailed slide 35: "I'll show the model projections for 5 "fiscal proposals" (2 hypothetical, 3 approximations of actual proposals)". He would walk the committee through 5 fiscal proposals reflecting combinations of things that could be applied to spending, revenues, drawing money from the ERA, and dividends. The first 2 proposals were completely hypothetical for purposes of illustration. The last 3 were his attempts to model Sen. Dunleavy's proposals, the proposal in HB 365 [Legislation introduced in 2016 - Short Title: INCOME TAX; PERMANENT FUND TAX CREDIT], and the Governor's proposal. He emphasized that his attempt to model the last 3 proposals represented his understanding, which might not be correct, of how these proposals worked. His objective was to illustrate in contrast the approaches that the different proposals took.

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Representative Wilson asked for clarification about HB 365. Mr. Knapp indicated it was Co-Chair Seaton's proposal. Co-Chair Seaton clarified that HB 365 was a proposal from the previous year presented in House Finance. Representative Wilson wanted clarification for the public.

Mr. Knapp reviewed his first hypothetical proposal on slide 36: "Cut and Tax Only Projections." The parameters of the proposal included eliminating the deficit immediately and leaving the Permanent Fund earnings intact. The proposal involved cutting spending and raising taxes in a 50/50 proportion. In other words, he would take the current deficit compared with current revenue sources and split the difference. He would get rid of half of the deficit by cutting spending and half of it by raising taxes. He explained that the model was depicted in the upper left-hand graph. It showed what the state was spending and how it was funded. The top [dark] green line in the graph represented what the state was spending. The yellow [horizontal] line in the middle represented the current incoming revenues. Current oil revenues were depicted in black at the bottom of the graph. He highlighted the blue portion which represented the current non-oil revenues. These two sources at the bottom represented the Department of Revenue's (DOR) projections of the state's current

revenue sources. In the model he would slash the green spending line by half the amount of the deficit and he would add a large amount of new taxes. His point was that without dipping into the PF earnings the legislature would either have to implement very large spending reductions or substantial taxes or a combination of both. The fiscal issue was a large problem and was difficult to solve with just by implementing a combination of cutting, spending, or new revenues. On the other hand, with this approach the PF would be growing rapidly because it would not be touched. Hence, the fund would be earning more, and the dividend payouts would increase. In summation, spending would be reduced, taxes would be increased, the PF would go untouched, and the dividends would increase. Presumably it was why there was a significant amount of discussion about "Cut and Tax Only" being too harsh and about the possibility of using the earnings.

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Mr. Knapp stated that slide 37 showed the "Do Nothing" projections. He reemphasized that it was a totally hypothetical scenario. He suggested that if the state were to leave spending as it was and avoid implementing any new revenues, the state would first draw down the use the Constitutional Budget Reserve (CBR) fund. He noted the graph on the bottom left showed the state's 3 savings accounts including the CBR, the Permanent Fund Earnings Reserve account (ERA), and other funds (the miscellaneous funds with a balance). The constitutional budget reserve would quickly be depleted to fund the deficit. Once the CBR was gone the state would have to turn to the only other source of money to pay for it, which was the ERA. The state would be doing so without a plan.

Mr. Knapp continued that there was no plan in place such as Senator Dunleavy's, Co-Chair Seaton's, or the governor's plans. He called the circumstance a "forced draw" denoted in a dashed red [vertical] line. A forced draw meant drawing from the PF ERA and was shown at the middle graph at the top of the slide. It showed how much the PF would earn in realized earnings and what kinds of money would the state be taking out of the account. He pointed to the middle graph at the top. The money taken from the account would be spent to pay for dividends (shown in blue generated from the same formula that had been used previously) and for the deficit. By taking more money out

every year than what the account was earning, the ERA would begin to be depleted. He pointed to the next graph over [top right] that showed the total amount of dividends being paid shown in blue. The yellow line showed the dividend amount. The dividend would continue to rise because the total value of the PF would still be growing slowly. Two things would be added including royalty deposits and unrealized earnings. The interesting thing about doing nothing was not a total disaster scenario from a fiscal viewpoint. Projecting out 10 years, the PF ERA would be going down, but Alaska would not immediately run out of money. However, the state would be spending more than it was taking. The "do nothing" plan could result in going to the ERA. However, he emphasized that the PF was earning so much money that it was a way of having a large draw from the fund. He thought this approach was a dangerous way because unlike any of the other plans people were proposing, it was an uncontrolled way in which to do so. He thought the scenario was a default way of having access to another source of cash.

Representative Ortiz asked what would happen to the PFD amount and the distribution to Alaskans in the "do nothing" plan. Mr. Knapp responded that he had left the dividend formula intact. The state's current formula was based on what the PF earned. He suggested that because the PF grew a little, the dividend also grew a little over time.

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Mr. Knapp turned to slide 38: "Do Nothing Projections". He relayed that the slide showed the same thing except he assumed that the PF earned 1 percent less. Therefore, the funds would be earning less and drawing down the fund more rapidly. The dividends would no longer increase, and the PF would become flat - not growing at all.

Mr. Knapp reviewed slide 39: "Do Nothing Projections". He indicated that the slide showed the same "do nothing" scenario but with varying rates of returns (he referred to the scenario as the FY 06-16 scenario). He suggested that if the hypothetical rates of return came true, there would be widely varying rates of return. He continued that the state would be drawing the same amount from the Permanent Fund that was earning widely different amounts every year. Therefore, the ERA balance would go up and down. Under certain scenarios the state would never fully deplete the

account. There was a chance the account would be fully depleted if the state encountered enough bad years. He also noted that the dividends would fluctuate widely just like they had in the past under the historic formula.

Representative Wilson asked if he was assuming a rate of return based on historical data. She wondered if he was assuming that the state would make a minimum of 3, 4, or 5 percent. Mr. Knapp responded that he had no clue of the rate of return. There would be some variation. His point with his model was to illustrate what would happen if the returns varied. If the returns varied, the dividend would vary, and the ERA would bounce around. He claimed there was nothing magical about his numbers, as he was only using them as an illustration.

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Co-Chair Seaton asked about the rate of return from 2006 to 2017. He wondered if Mr. Knapp was using a 10-year average. Mr. Knapp responded in the negative. He wanted to use something that he could use to illustrate the point about what would happen if the state got variable returns. He randomly chose a past historical period. The scenario was completely hypothetical.

Co-Chair Seaton asked if Representative Wilson had her question answered. Representative Wilson responded that she was still confused. She asked for clarification about the PF rate or return assumptions. Mr. Knapp would show her 3 slides [slide 37, 38, and 39] and suggested that she look in the upper right-hand corner. He explained that he illustrated the proposals with 3 different sets of assumptions for each scenario. He indicated that when he used APFC (Alaska Permanent Fund Corporation) [slide 37] it meant he used the assumptions provided by the advisors of APFC. He turned to slide 38 which used the numbers from the previous slide less 1 percent. He used the third slide, slide 39, for the purposes of illustration applying historical numbers to the model.

Co-Chair Seaton asked about the projected levelized rate of return for the APFC proposals. Mr. Knapp thought the rate was a 6.9 percent total.

Co-Chair Seaton asked if, in that situation, an average rate of return was being applied every year. The same

average rate of return minus 1 percent was applied to the other slide. The third slide applied the actual rate of return over a 10-year period which Mr. Knapp happened to choose FY 06 - FY 17. Mr. Knapp added that the average for the FY 06 - FY 17 was about half a percent lower than the average for APFC. The average was in between the others.

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Mr. Knapp advanced to slide 40: "Dunleavy Proposal Projections." He reviewed Senator Dunleavy's proposal. He proposed a very significant spending cut. He modeled an \$800 million cut over three years. He pointed to the green line on the upper left-hand chart which went down. He suggested that cuts of \$300 million per year for two years and \$200 million for one year would be applied to the budget, cutting it by \$800 million. The reductions were a significant part of his proposal. The senator's plan reflected no new revenues but left the oil revenues and the non-oil revenues intact. There was also a draw from the PF. Basically, the same amount would be drawn for dividends calculated in the same way. Historically, the state used a formula to determine what to draw from the ERA. The formula took the average of the earnings over the previous 5 years and spend half the amount. In the Dunleavy proposal it took all the earnings, keeping half for dividends and used the other half for state government. That was his understanding of the general concept of the proposal. There was also a planned draw down of the CBR and a draw down from some other state funds. He pointed to the upper left-hand corner drawing attention to the red portion of the chart indicating the revenues from the draw from the PF equal to the dividend amount. The money was added to the general fund to be used to fund government. Those revenues combined with the suggested spending cuts would provide enough money to eliminate the deficit and begin to run a surplus because of rising oil revenues. The surplus would then be used to build up the CBR shown in the bottom left-hand graph.

Representative Pruitt noticed that the planned draw was more than the spending based on the formula being applied. Mr. Knapp checked the senator's projections and they showed a surplus close to Mr. Knapp's projections.

Representative Pruitt wanted to confirm that Mr. Knapp's plan placed the surplus in the CBR. Mr. Knapp thought that

was the senator's intention. The CBR grew to about the amount listed on the slide.

Mr. Knapp explained that the surplus was a result of an \$800 million spending cut and a draw amount equal to the dividends from the ERA. He suggested that because, so much was drawn from the ERA, the ERA would not grow as rapidly. He directed the committee's attention to the graph on the bottom right which showed the components of the PF. He pointed to shaded parts which represented unrealized gains. The state was only allowed to spend the realized gains. He explained that if a person bought stocks which grew to twice the value, the earnings would not be realized until the stock was sold. In all his models, growth occurred partly because every year the state was getting unrealized gains.

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Representative Pruitt understood that it was a matter of shifting some of the state's money from the ERA to the CBR. Simply put, it was a fund transfer. He asked if it was an advisable move. He estimated that if the funds were left within the PF the power of being a part of the PF would be better.

Mr. Knapp relayed that the state was not taking it out and placing it into the CBR. The money was being taken out and used to pay for government and some of the funding would be left over and placed in the CBR. He agreed that it did not make much sense to take more money out than needed and putting into a fund that did not earn as much money. He thought it was important to consider. He added that an interesting feature of the plan was that it was simple. The state would only use money that was acquired as realized earnings.

Vice-Chair Gara spoke to realized earnings of the Permanent Fund that were arbitrary. He reasoned that if government was being run on volatile earnings, revenue would go up and down as well. Mr. Knapp concurred with Vice-Chair Gara.

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Vice-Chair Gara suggested that realized earnings of the PF were not 6.9 percent per year. He provided an example of unrealized earnings. He relayed that the realized earnings

were somewhat arbitrary in terms of when they were cashed out. He wondered, if the government and the PF dividends were based on the realized earnings that were radically going up and down, whether the government and dividends would also go radically up and down under the plan.

Mr. Knapp offered to skip ahead 2 slides [slide 42]. The slide showed the same plan but also showed the FY 06 - FY 16 rate of return assumptions. He indicated that both the dividend formula and the general fund draw were based on earnings that were changing. They both went up and down frequently. There was a significant variation in the money available. He thought Vice-Chair Gara was correct.

Vice-Chair Gara spoke to another issue. The Alaska Permanent Fund Corporation would be forced to sell its stock to create realized earnings if the state wanted to ensure a \$3000 dividend every year. He thought the PF would be unable to maximize its return. If the dividend was set high, the APFC would have to cash out investments that it would otherwise keep. Over the long term it would start earning less. He wondered if it was a possibility.

Mr. Knapp would modify slightly what Vice-Chair Gara stated. He relayed that in the past there had been a certain dividend formula with a significant amount of variation over the years, which Alaskans had grown to accept. He thought Alaskans would be much less willing to have a variable budget than a flexible dividend. The state was currently faced with a complicated issue for people managing Alaska's incredibly valuable asset. If the state needed access to more cash, it would change the way investments were made. He questioned what it would do to investment strategy and whether earnings would be reduced over time. He thought the legislature would have to grapple with the complex issue. He conveyed that for reasons he did not quite understand there was supposed to be less of a concern if a Percent of Market Value (POMV) type of payout was used.

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Representative Ortiz thought that none of the models assessed the impact on the overall economy. Mr. Knapp responded that his models only looked at the financial feasibility of each of the scenarios. They said nothing about how any of the different proposals would affect the

economy or the demographics of the state. He encouraged members to use his models as a starting point to check to see if a plan really worked financially. He also suggested that as legislators debated they would need to get into larger philosophical questions such as what role the dividend would play. In other words, what kind of dividends did Alaskans want versus government spending or keeping taxes low. Anyone looking at the plans could determine which would help the economy or certain demographics more. He remarked that his presentation just contained boring numbers.

Co-Chair Seaton commented that the first part was modeling \$800 million cut over 3 years resulting in a surplus in the out years. He suggested that if the state were to cut \$2 billion over 3 years then the state would have a bigger surplus. He concluded that the committee could review the financial effect on a system, but it did not show whether it was feasible within a vibrant Alaskan economy.

Mr. Knapp suggested that one person might like the \$800 million in cuts. Another person might disagree with certain cuts. It was not just an exercise in changing the numbers drawing the green line lower. The argument was about another subject.

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Representative Wilson repeated the plan. She indicated that half of the earnings would be used to pay dividends, the other half would be used for government. She noted the lack of a set dividend and the five-year average used to calculate the dividend amount. She asked about having more funding coming out of the ERA than what was needed for government and whether it would be better to invest any surplus into something like the CBR. The earnings would be lower, but the funds would be more accessible. Alternately, leaving the unused surplus in the ERA would generate more profit.

Mr. Knapp thought that 5 or 6 years down the road when the deficit was fixed, and the legislature realized that money was being taken out of a high income earning account and being placed into a low income earning account, it would want to take less out of the account. He did not believe the plan would work exactly in the manner suggested.

Mr. Knapp detailed slide 43: "HB 365 Projections". He Noted that HB 365 was a bill Representative Seaton introduced in 2016. He highlighted that in the model there was an increase in spending equal to \$4.65 billion. The increase was due to an assumption about the need to increase payments to pay off oil tax credits that were due.

Mr. Knapp posed the question about how to pay for spending. The model was built on having a budget increase. He reported that without a budget increase the state would have less of a deficit. He pondered how the state would pay for spending. The plan had a feature that none of the other plans had - it introduced a new source of revenue - an income tax providing \$650 million in revenue every year. In addition, there would be a 2.3 Percent of Market Value (POMV) draw from the Permanent Fund. The model kept a dividend program but cut it in half. The same formula would be used to calculate the dividend, but a smaller percentage of the earnings would be paid out.

Mr. Knapp continued to explain that the Percent of Market Value approach, the average market value of the PF over the proceeding 5 years, would be used to calculate the government draw (shown in red on the charts). He pointed to the upper left chart on slide 43. In combination, the \$650 million from new revenues from an income tax and the POMV draw would fill a significant portion of the budget deficit. However, it would be necessary to draw some extra money from the PF. He suggested that because the amount being drawn would be less relative to what it was earning, the ERA would increase in the model.

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Mr. Knapp pointed to slide 44: "HB 365 Projections." The slide showed different assumptions about the PF earnings - they dropped by 1 percent. The dividends would be less over time. However, the draw for government would not go down as much because it was based on the market value. He suggested that if earnings went down by 1 percent, the market value would not go down by 1 percent and there would be less of an immediate effect on the size of the draw. The state would be able to draw a similar amount for government.

Mr. Knapp continued to slide 45: "HB 365 Projections." The third version of his model had a variable rate of return. The dividend would be variable and half the size. He

thought that because the PF draw for government was determined by a POMV model, there would be a more stable draw for government. However, the value of the ERA would fluctuate significantly. He was aware the Legislative Finance Division had conducted some detailed analysis of the proposal. He recommended that members defer to the division's numbers.

Co-Chair Seaton added that the assumption was out of character for where the proposal was because the budget had not been increased to \$4.6 billion. He asserted that when the budget did not increase, the draws would not take place and the CBR would be maintained over time. It would be discussed at a different time.

Mr. Knapp did not mean to characterize that Representative Seaton was advocating a large budget increase. He had seen a model version run by LFD. A larger problem would arise if the state spent more money.

Co-Chair Seaton suggested that he had been one of the strongest proponents of reducing the oil tax credits instead of extending them indefinitely and paying them off annually.

Mr. Knapp did not treat the proposal fairly. He used a higher level of spending. He suggested that it was a hybrid way of calculating dividends and the Permanent Fund draw for government in different ways. The dividend went up and down like it always had, though it was a smaller amount. However, the draw for government was more stabilized because of the POMV concept.

Mr. Knapp highlighted slide 46: "Governor's Proposal Projections." He indicated that the governor's proposal was the most complex of all of them because it changed more things. He modeled it as if spending was held at \$4.3 billion. He clarified that he was not making any statement about what the governor was proposing for spending.

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Vice-Chair Gara wondered if Mr. Knapp was talking about the governor's proposal in the current year or in the previous year. Mr. Knapp responded that he was talking about the proposal the governor put forward in December at the time he announced the budget for the current year. His general

understanding was that the governor's proposal had some similarities to things that were talked about at the end of session in the previous year. He read the language introduced in the present year.

Representative Wilson asked if the increase on the motor fuel tax was included. Mr. Knapp understood that the governor proposed an increase in the motor fuel tax which would add millions of dollars. However, he did not include it in the model. He suggested that if the increase in the motor fuel tax was added it would be reflected in the green bar showing new revenues. He reemphasized that in his model was not an exact characterization of what the governor proposed. He thought the governor had suggested that the motor fuel tax would be a start, but additional revenues would be necessary. He clarified that if new revenues were added, the deficit would be smaller.

Representative Wilson responded that it was already in the budget for the current year. Items had been moved from undesignated funds to designated funds as if legislation had already passed increasing the motor fuel tax. The monies were reflected in the budget. She suggested that an additional \$80 million would have to be added to \$4.3 billion. It was already in the budget.

Mr. Knapp reported that the projections he used did not include the tax. He could add the numbers to his model and show what would change if there was more time. His goal was to demonstrate a general concept. He wanted to emphasize how the governor's proposal would use the PFD. It reflected more of a change of how the earnings would be used.

Mr. Knapp turned to slide 47: "Governor's Proposal Projections." He explained that there were several parts to using the Permanent Fund earnings in the governor's proposal. First, there would be a large single draw from the PF based on a POMV concept of 5.25 percent. He continued that 20 percent of the draw would be used to pay dividends. The other 80 percent would be used to help fund government. In addition, the share of oil royalties that got deposited into the PF would be reduced from about 31 percent to the constitutionally mandated 25 percent. Thus, more oil royalties would go to government and oil revenues would be higher. Also, 25 percent of the unrestricted oil royalties the state received would be used to add to dividends. He pointed to the upper right-hand graph which

showed that the dividend payout for Alaskans would be a combination of 20 percent of the 5.25 percent POMV draw plus 20 percent of the unrestricted oil royalties. If either the draw or the oil royalties changed, the dividend would change. The model resulted in a smaller dividend, roughly about \$1000. There were some other features that he did not think he modeled right which proposed a minimum dividend at start up. He relayed that the draw from the PF was based on a POMV. The Percent of Markey Value was driving part of the dividend. The other portion of the dividend was coming from royalties. Under the plan the PF earnings were not all being spent because the PF was earning approximately 6.9 percent. The Permanent Fund would still be growing in value.

Mr. Knapp detailed slide 48: "Governor's Proposal Projection". He discussed a variable earnings scenario. The Permanent Fund earnings would vary, but the use of them would be driven by the 5.25 percent draw. There were other complicated features that were important. The draw from the PF would be reduced if the oil revenues rose by a certain amount. The state would not take as much out if there was another oil boom. Another feature would be if a certain amount was accumulated in the ERA, then some of it would automatically be placed into the principle. He reiterated the inaccurate characterization and referred committee members to consult with LFD or the Office Management and Budget. He was only presenting a general concept.

Mr. Knapp moved to slide 49: "What is a 'Sustainable' level of state spending?". He wanted to address the question of a sustainable level of state spending. He thought the issue was subtler and did not have a specific answer. His answer to the questions about a sustainable level of spending was that it depended on several assumptions.

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Mr. Knapp addressed slide 50: "What is a 'Sustainable' level of state spending?":

- The time period we are planning for
- What we assume about future oil revenues and investment returns
- How much we want to preserve or grow our assets
- How much we want to pay in dividends

- How much we're willing to raise in new revenues
- Whether we want to keep the same buying power of our spending and savings by adjusting for inflation
- Whether we want to keep the same per-capita buying power of our spending and savings by adjusting for population growth

Mr. Knapp posed the question about the length of sustainability. Assumptions around future oil revenues and investment returns were critical. He provided a hypothetical scenario. He did not believe the question about what was sustainable could be answered without addressing how much money the state would have. The state did not have the answers about how much oil revenue it would have or what the returns would be. All that could be provided were estimates. The fact was that no one knew the truth. He used the example of getting ready to retire and looking at a sustainable level of spending based on investments. It depended on how certain the state wanted to be.

Representative Guttenberg thought Mr. Knapp could answer a few of the questions listed on the slide regarding planning. He asked about an appropriate timeframe and a relevant equation.

Mr. Knapp would go through his bullet list quickly. He thought the state should consider a 10-year time horizon. A longer time horizon would be difficult. He had no clue as to what the state should assume about its future oil revenues and investment returns. He would trust the experts at DOR and APFC to provide reasonable estimates of averages. He suggested coming up with something that worked in a low case scenario. He believed a critical question had to do with preserving and growing the state's assets and deciding what the state wanted to leave for future generations. An individual that was retiring would consider what they wanted to leave for their kids. He thought the minimum standard should be to leave future generations with the same real buying power as the state's current assets.

Mr. Knapp addressed the question about whether to keep the money the same or keeping it the same per capita. He suggested that if Alaska's population grew 50 percent over the following 10 years and the state needed to be as rich per capita, it would have to save more. He offered that the state should be striving for a level of spending that would

leave the inflation adjusted value of the state's assets the same after 10 years. It meant that the state needed to spend no more than what it was taking in in terms of real value. He thought the issue could be debated for a long time.

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Vice-Chair Gara asked about budget cuts and job losses. He wondered if Mr. Knapp had updated his studies on the impacts of spending cuts on jobs and the impact of other revenue measures on jobs. He wondered if someone had further refined his reports by someone who was currently working at the Institute of Social and Economic Research (ISER).

Mr. Knapp reported that he had worked on a study in the prior year that tried to look at the different ways of reducing the deficit and their economic implications. He reported that after having finished his report he had not done any more work on the subject. He noted that he had not been following what others at ISER were doing. He was not aware of any changes to it and did not have anything new to say about it.

Vice-Chair Gara understood there was someone else at ISER who had a projection concerning how many jobs were lost for every \$100 million in budget cuts.

Mr. Knapp relayed that his former colleague, Dr. Mouhcine Guettabi, was one of the co-authors of the study he had worked on. He believed that when Mr. Guettabi said something about economic effects associated with doing various things he would have been referring to the same study rather than a new work. He had not talked with Mr. Guettabi about it.

Mr. Knapp reviewed slides 51 and 52. He suggested that if the state reached sustainability, it faced the question coming up about sustaining the value of its assets. The question as to which assets needed to be sustained would need to be answered. He posed the question whether the state should sustain its value of spendable assets such as the CBR and the ERA, or if it should sustain the value of all its financial assets such as the PF principle amount. The state was adding 25 percent of the royalties to the principle of the PF to save for future Alaskans. It could

be argued that the state should sustain even more. His questions spoke to the point of sustainability.

Mr. Knapp scrolled to slide 53: "What the nominal value of our assets would need to be at the end of FY 27 to sustain their nominal value of as of the beginning of FY 18." He explained that the chart showed the nominal value of the state's assets measured in different ways. He suggested that if the committee followed his standard, not depleting the assets, he would look at the third column. He emphasized that the chart showed the nominal value without adjusting for inflation. He thought the numbers were too low. He recommended projecting inflation and expanding the numbers. The money the state could spend depended on oil revenues.

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Mr. Knapp proceeded to slide 54: "Sustainable on paper isn't necessarily the same as sustainable in practice." He pointed out that sustainable on paper was not necessarily the same as sustainable in practice. He argued that a plan was not sustainable unless discipline was used to stick to the plan. He suggested there were two things for a plan to be sustainable not just on paper but in practice. First, discipline to not over project future average revenues was necessary. Second, the temptation to spend a little bit more had to be avoided. The state's plan had to be built on average revenues coming in. He referred to slide 7 reflecting Alaska's history. He commented that the state had never had the discipline to watch spending in the good years. He reported that on two occasions Alaska had spent a significant amount of money and built many things. As a result, Alaska had to go through a long and agonizing period of reducing spending because the level was not sustainable in practice. He suggested the state consider building in ways that would allow the state to stick to the plan.

Mr. Knapp highlighted slide 55: "It's useful to compare fiscal proposals." He assumed that the goal was to get to a solution. There were wildly varying opinions in the legislature about the right solution and about what should be done to solve Alaska's fiscal problem. The state had to get past an impasse. He suggested looking at all the proposals running the same graphs and using the same

terminology to determine how each played out. It would make it easier to have a discussion.

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Mr. Knapp discussed slide 56: "You can't debate the merits of a fiscal proposal by only talking about that proposal." He thought the state needed to be comparing different ways of doing things. All the proposals involved a change. They all involved doing something painful such as cutting spending, adding taxes, or cutting dividends. He argued that although none of the options were appealing, something had to be done to fix the state's deficit. The question was which alternative or mix of things should the state choose. He thought the conversation had to be about comparing alternatives. He thought people needed to move away from complaining about a proposal to offering suggestions.

Mr. Knapp pointed to slide 57: "There are many potential ways to address Alaska's fiscal challenge and end unsustainable draws on our savings." He explained that there were several ways to approach the issue, but they all involved a combination of the unpleasant options of reducing spending, increasing revenues, cutting dividends, or saving less of the PF earnings. He thought it was important to understand that if one option was off the table then more of the other options would have to be imposed. He thought a combination needed to be considered rather than talking about an option by itself. He thought finding the best combination should be the focus. If someone did not want to do option A, of options A, B, C, and D, then more of options B, C, and D would have to be exercised.

Mr. Knapp moved to slide 58: "Fiscal projections can't tell us which proposals are 'best'":

- They can tell us whether proposals are feasible and/or sustainable
- They can't tell us about other things that matter:
 - Short-run economic effects
 - Long-run economic effects
 - Effects on government services
 - Relative effects on different income groups
 - Relative effects on different regions

Mr. Knapp reported that none of the projections determined which proposal was best. They indicated whether the proposals penciled out. He thought the issues listed at the bottom of the slide were what really mattered. Alaskans had widely varying opinions about the items. He believed that showing the numbers was a starting point for beginning the rest of the conversation about how to associate the proposals with the things that mattered. He thanked members for the opportunity to appear before the committee.

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Representative Wilson agreed with Mr. Knapp about the math. She wondered where to get the data for each plan showing how Alaskans would be affected. She listed the financially challenged and large corporations. She noted hearing about people having to go on public assistance or having to seek other means to make up the difference when the dividend was cut. She was uncertain where to get the data showing which solution was best.

Mr. Knapp thought that all the hearings, discussions, and testimony gathered from different groups provided feedback to lawmakers. He thought much of the information was being gathered in the legislative process. He suggested there were certain studies that could be conducted. He reported ISER having done a study regarding short-run economic impacts. The study determined that if dividends were reduced or if taxes were raised it had certain effects on jobs and income. In terms of data regarding the effects on government services of cutting the budget, it was the sum of a million different options of how the budget could be cut and how reductions would play out on schools, troopers, and other services. Collecting the data could take years. He suggested that legislators pay attention to constituent feedback to decide on the right balance of services and how much Alaskans were willing to give up in taxes or dividends to pay for them. He thought it would be useful to study certain kinds of things such as the affects on rural and urban Alaska. He provided a hypothetical scenario. He thought that listening to constituents was a way to get more accurate input.

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Representative Wilson asked if he would suggest trying several different things to balance the budget or trying only a couple of things to see how it affected the economy before doing more things. She indicated that in the previous year there had been several suggestions. She thought that it would have been difficult to know what did not work with implementing several things at once.

Mr. Knapp thought the state was running out of time and stated that the legislature had been adjusting to the "financial problem" for 4 or 5 years. He acknowledged that the legislature had done many things to reduce spending. However, the savings had been depleting at a rate of about \$10 million per day. He voiced that some legislators might not want to "go into the water too fast" but cautioned that some action had to be taken quickly. He emphasized that the longer the legislature failed to act, the less money would be available, the lower the future earnings, the more the state would be at risk, and the more Alaskans would be left uncertain about the future. He continued that ideally it would be good to move slowly and carefully. However, time was running out.

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Representative Kawasaki referred to when Mr. Knapp mentioned spending differently, preventing the state from spending in high years and saving in lower year. He remembered when he started in 2007 the state owed the CBR billions of dollars because it had been spent down. After 2009 there were changes to oil taxes and in the price of oil. The state had huge surpluses which were used to pay back the CBR. Some money was spent on things that might not have been necessary. He mentioned the legislature having replaced Ryan Middle School in his neighborhood because it was going to fall in an earthquake. He thought some items were necessary to fund after years of lean budgets. He mentioned that there had been talk about adding a spending limit. He wondered if it was a viable option.

Mr. Knapp was not an expert on spending limits. He thought it was well worth having the discussion. However, he did not know that it was the only way. There were real operational problems with spending limits. He provided a hypothetical scenario. He thought a spending limit was a blunt tool. He would not assume it was the best option.

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Vice-Chair Gara asked Mr. Knapp his opinion. There had been several job losses. He asked if he would now do as much as possible to fix the deficit rather than waiting.

Mr. Knapp responded that the state was currently in a fix. He agreed that the state was in a troubling recession and that legislators needed to be concerned with not aggravating the circumstances based on the current fiscal situation. He noted that the money was running out and the legislature needed to think about the future and to come up with a stable way of dealing with the state's finances. He stressed that the legislature had to live with the state's fiscal reality. Alaska was not the federal government. In a recession the federal government could print money to keep the economy going, but Alaska did not have that option. He indicated that he could not advise the legislature on the correct approach but maintained that cutting government, cutting dividends, or adding taxes would all cost jobs. Some people argued that certain things would cost fewer jobs. He stated that reducing government cut real jobs in an obvious way. He claimed that a lack of investment in the state would also cost jobs. He suggested that if people did not see a future in Alaska they might leave. People might leave if they felt schools were not up to par, which might result in more lost jobs in ways that were not as obvious. The state was in a fix and he did not know the answer.

Co-Chair Seaton hoped the legislature would find a fix to the problem. He reviewed the agenda for the day.

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ADJOURNMENT

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The meeting was adjourned at 3:32 p.m.