

HOUSE FINANCE COMMITTEE
February 10, 2017
1:32 p.m.

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CALL TO ORDER

Co-Chair Foster called the House Finance Committee meeting to order at 1:32 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 Cathy Tilton
Representative Tammie Wilson

MEMBERS ABSENT

Representative Steve Thompson

ALSO PRESENT

Jonathan King, M.S, Vice President and Senior Economist, Northern Economics; Dr. Ralph Townsend, Director, Institute of Social and Economic Research, University of Alaska.

SUMMARY

PRESENTATION: FORECASTING ALASKA'S ECONOMY: 2016-2017
NORTHERN ECONOMICS

PRESENTATION: ALASKA'S ECONOMY
INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH

Co-Chair Foster addressed the meeting agenda.

^PRESENTATION: FORECASTING ALASKA'S ECONOMY: 2016-2017

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JONATHAN KING, M.S, VICE PRESIDENT AND SENIOR ECONOMIST, NORTHERN ECONOMICS, provided a PowerPoint presentation titled "Forecasting Alaska's Economy: 2017 - 2026" dated February 10, 2017 (copy on file). He believed that the state's economy was in recession. He noted that the presentation would focus on how the recession developed and where the state was heading. He addressed an overview of the presentation on slide 2:

Overview

We're in a Recession

We just completed Phase 1 lead by the oil industry and allied sectors.

The Timing of How We Got Here

Where We are Headed

What does Phase 2 look like?

How much does the State of Alaska and the consumer sector pull back?

Mr. King spoke to predicting recessions in Alaska (slide 3):

Predicting Recessions in Alaska

Layperson's definition is two quarters of negative gross domestic or state product (GDP/GSP).

Gross State Product in Alaska is not a great measure:
The value of all of the goods and services produced in AK...

Largely tied to the value of oil exports...

Highly variable from quarter-to-quarter because of oil production maintenance schedules...

Highly variable from year-to-year because of the price of oil.

If we used GSP to measure recessions we'd have to acknowledge that we're entering our fifth full year of recession.

Mr. King relayed that gross state product (GSP) was not a great measure in Alaska.

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Mr. King moved to slide 4, titled: "The Value of Our Economy." He relayed that the value of the state's economy had peaked in 2012 at \$50.6 billion, combining both the public and private sectors, and had been in decline for the past five years (slide 4). He detailed that the decline was due to a combination of oil production declines and oil price collapse. He turned to slide 5 and addressed a chart "Looking for Consistent Year-over-Year Job Losses." He reported that sustained multi-year job losses was an indicator of recession in the state. He pointed out that for most of the 2000s the state's employment change had been above the gold line on the chart (represented at zero percent) except for a short period in 2009 to 2010 when unemployment dropped sharply (1 percent) and quickly rose back above the gold line due to a rebound in oil prices. The economy had started slowing down while still growing in 2011. He highlighted two reasons for the slow down: the federal sequester removed a lot of money from the Alaskan economy and slowing investment in the oil industry. He summarized that the Alaskan economy began slowing down in 2011 but did not stop growing until 2015.

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Mr. King spoke to quarterly wages paid to Alaskans on slide 6. The slide included a chart titled "Wage Growth Trend Broken." He delineated that the chart depicted wage growth; each year the high had been a bit higher and the low was a bit higher (the fluctuations were due to seasonal employment) indicating a growing economy. However, beginning in 2015 the trend was broken and a fundamental shift in wages being earned in the economy occurred. He turned to slide 7, titled "Household Confidence." The chart reflected the household confidence index since 2010. The gold line represented the entire index, which increased over time and peaked to above 60 [third quarter of 2014]. Subsequent to a vote on SB 21 (Oil and Gas Production Tax) [CHAPTER 10 SLA 13 - 05/21/2013] and the general election in the fourth quarter of 2014, it became apparent that oil prices were in decline and the household and consumer confidence began to drop. The dark bars rising from the x axis for each quarter year represented individuals' expectations from their state and local economy. He elaborated that expectations had peaked in 2014, but then oil prices had collapsed and expectations declined to under

30 points in 2016. He stated that a decline under 30 was very mathematically difficult to "push" any lower. He noted a slight recovery in the expectation levels. He remarked that the country's consumer confidence rose by 20 points in the last quarter of 2016 and wages increased in the second half of 2016. The "Trump effect" recently increased consumer confidence due to a switch in the U.S. administration.

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Mr. King addressed "High Earning Sectors" on slide 8. He explained that oil and gas, construction, and professional and business services were three economic sectors that contained highly skilled, high demand jobs for a highly educated workforce. The three sectors were closely aligned to oil prices. He expounded that the first sector depicted on the graph was the oil and gas sector. He noted that the area above the red dotted line on the chart (zero percent) was positive and below was negative. There had been continued growth and periods of record high growth (2014 to 2015) in oil and gas employment, but a decline began in 2015 and dipped well below the red dotted line in 2016. There were still declines in the oil and gas sector, but the line had turned upward, meaning losses were slowing but would not stabilize until the line rose to the red dotted line. He pointed to a construction sector line in gold. The construction sector was volatile and seasonal. The sector peaked in 2014 due to large capital budgets. The line declined in 2015 and was closely aligned with the oil and gas sector. The construction sector line rose above the red dotted line in the latter half of 2016 for unknown reasons. He pointed to the professional and business sector represented by the purple line on slide 8. The sector was stagnant since 2013. He related that many businesses had not been adding staff at the time because they knew the state's spending was unsustainable. The sector negatively declined in mid-2015 and losses continued. The sector was expected to remain in contraction to an unknown point in time.

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Vice-Chair Gara pointed to slide 5 and slide 8 related to year-over-year statistics. He wondered why the graph lines were so jagged over time. Mr. King clarified the information was represented monthly year-over-year.

Representative Ortiz spoke to the construction and manufacturing sector that had jumped back above the zero line. He wondered why. Mr. King replied the reason was not yet known but noted the line was a "U" shape under the red dotted line and had been rising. He continued that federal spending had increased but since the 2017 presidential inauguration came to a halt. He deduced that most likely, the largest outside driver was the stationing of the F-35 fighter jet and associated construction that was "helping to insulate" Fairbanks.

Vice-Chair Gara surmised that job numbers would be easier to follow. He pointed to the construction numbers and asked whether the numbers on the graph represented percentages compared to the year's prior. Mr. King replied in the affirmative. He stated that the graph did not depict total jobs in the economy; the data was compared to "12 points prior." His goal was to show the evolution of the recession. He referred to a recent article in the Alaska Dispatch News (ADN) that declared 9000 jobs were lost in the third quarter. He contended that the interpretation of the data was incorrect. He conveyed that the correct interpretation was "compared to the 3rd quarter in 2015 there were 9,000 fewer jobs in the Alaskan economy in the 3rd quarter of 2016." His graphs were "watching the relative health of the sectors" versus total job numbers. He would switch to the total number of jobs data in later slides.

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Mr. King addressed slide 9, titled "State Employment and Retail." He noted that the red circle on the graphic portrayed where the high earning sectors transitioned into recession. He explained that retail had grown in late 2015 through 2016 and had begun to decline in late 2016. He had recently spoken with the head of a major retailer in the state who stated that the first quarter of 2017 was the first time in 160 quarters (16 years) that the company lost money in the state. The retail sector was not a "primary sector" of the economy and did not bring money into the state, but it signified what people did with their money after earning it from a sector that brought money into the economy. Therefore, the retail sector represented a secondary effect of the economy. He reported that "the contagion was starting to spread" from the primary sectors to the secondary sectors. A gray line represented state

government as well as a green circle. The state started to contract right after Governor Walker's inauguration in 2014. The contraction was slower and more measured due to yearly accounting periods. The line depicted that state government was losing jobs at the equivalent of 5 percent per year.

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Representative Wilson asked for clarification about the slide. She asked whether the slide depicted state government and retail jobs. Mr. King replied in the affirmative. He elucidated that the graph represented jobs not positions. He emphasized that Department of Labor and Workforce Development (DLWD) statistics only counted the actual number of jobs. The count was based on employed individuals as measured through unemployment insurance. The data represented "real people losing real jobs."

Mr. King moved to slide 10 titled "Our Biggest Growth Sector." He noted that the red dot reflected the high earning sectors, the green was retail and the blue reflected state employment. The green line represented healthcare which was the one growth sector in the economy along with a slight increase in tourism in 2016. He reported that tourism was a lower earning sector and not driven by the state's economy. He offered that healthcare was the largest wage and salary sector in the state's economy with 50 thousand employees. He detailed that other than commercial fishing, which was not a wage and salary sector, healthcare was the largest employer in the Alaskan economy. Towards the end of 2016 the line flattened and "kicked up" to the right, indicative of the governor's Medicaid expansion decision.

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Mr. King advanced to slide 11 titled "Where are we Headed?"

Basic Things Determine Economic Robustness:

Money coming in...

Money going out...

Rich economies bring money in and hold onto it.

Right now we're doing neither.

Mr. King noted that the state had difficulty retaining money inside Alaska because of the lack of manufacturing in the state. He elaborated that when a bush resident bought something in their community's store, \$.80 cents of every \$1.00 spent immediately left the state's economy. A good multiplier in the Lower 48 was that a dollar would circulate 2 to 2.5 times, whereas in Alaska the multiplier was \$1.20; higher in the urban areas at \$1.60 to \$1.70. He remarked that the state "leaked money like a sieve." He concluded that when the state lost revenue from oil, it was felt very quickly in the economy.

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Mr. King addressed the, "Three Legged Stool" on slide 12:

Federal Government:
Education and Health Care
Direct Employment
Constructions

Oil:
Industry Direct Investment
State Revenues

Everything Else:
Fishing
Tourism
Air Transport
Mining

Mr. King turned to slide 13 titled "Budget Context."

FY2017 budget gap:\$ 3.0 billion
Approx. max sustainable flow from
Permanent Fund (incl. ER, CBR):

$4.5\% \times \$60 \text{ B} = \$ 2.7 \text{ billion}$
\$300 million

So the long run gap:

\$1000 PFD: \$300 M + \$700 M = \$1.0 billion
\$2000 PFD: \$300 M + 1.4 B = \$1.7 billion

Mr. King highlighted slide 14, titled "Dynamic Forecasting with the Alaska REMI Model:"

Comparable to ISER's Man in the Arctic Program (MAP)

Dynamic model which forecasts policy changes over time.

Best in medium to long term applications (5 -50 years)

Model at the State and Regional (12) level

Used by Northern Economics for larger projects with dynamic policy implications:

Shell Offshore

"Big Gas Pipeline"

Susitna Watana

Recession Policy Forecasting

JBER Force Reduction

Mr. King explained the firm had done some forecasting with the Alaska "REMI" (Regional Economic Model, Inc.) model. The model was a large mathematical model that represented all of the different linkages of the sectors in the Alaskan economy. The model was also linked to a demographic cohort model that defined the state by age, gender, and ethnicity. The model enabled his firm to enter different scenarios and determine the effect on the economy over time; up to fifty years.

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Mr. King moved to "2015 Fiscal Policy Forecasting" on slide 15. He elucidated that the slide depicted a scenario the firm ran with the REMI model. The "Y" axis represented the Total Employment Forecast that included the self-employed. He qualified that when DLWD and the Institute of Social and Economic Research (ISER) performed employment forecasting they only considered wage and salary employment. He noted that the total number of wage and salary jobs totaled approximately 365 thousand. The number of self-employed in the state was 100 thousand that included doctors, fishermen, carpenters, sole proprietors, etc. The model projected the recession to continue until around 2020, losing jobs from a high of 460 thousand in 2015 to the approximately 440 thousand job level; a loss of roughly 15,000 to 18,000 jobs. Subsequently, the economy would improve. He delineated that in order for a job increase an economic stimulus was necessary in the form of spending. In Alaska, typically the increase would represent federal spending or more oil revenue. In the model, the upswing was

associated with an assumption that the large gas pipeline would begin construction due to old forecasting. He related that in actuality, the Alaska economy had been more durable than forecasted in 2015. The prediction for 2016 (blue bar) and actuals (gold bar) difference was less than 1 percent.

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Mr. King moved to slide 16 titled "2017-2026 Budget and Revenue Scenarios:"

Status Quo
\$4.2B Unrestricted General Fund; Spending from reserves

Scenario 1
\$4.2B Unrestricted General Fund; Reduced dividend

Scenario 2
\$4.2B Unrestricted General Fund; Broad Based Tax

Scenario 3
\$3.2B Unrestricted General Fund; Full PFD; No Taxes; Step down over 2 years

Northern Economics does not advocate for any of these individual scenarios.

Our purpose is always to help society make better, more informed decisions.

Mr. King reported that Northern Economic prepared the four models for the legislature as "book ends." He added that the scenarios were not in support of specific policies, but as a forecast of the future under different scenarios. He spoke to the status quo and acknowledged that the spending was unsustainable and "endangered the corpus of the permanent fund" without a recovery.

Vice-Chair Gara asked if he was referring to the actual Permanent Fund Dividend (PFD) amount from the previous year. Mr. King clarified that he was referring to the actual \$1,000 PFD that was paid to residents and built into the model. He addressed scenario 1 that spent the reserves from the reduced PFD on government services. He mentioned

that Scenario 3 included unrestricted general funds of \$3.2 billion UGF; full PFD; no taxes; and \$500 million "step down over two years." He emphasized that he was not present to recommend a scenario, but to provide options.

Representative Wilson asked about the PFD amounts in scenarios 1 and 2 on the slide. Mr. King answered the status quo would be the normalized payout (a \$2,000 payout in 2016) and a reduced payout of \$1,000 under scenario 1. Representative Wilson asked about the PFD amount in scenario 2. Mr. King answered the scenario included a substantially reduced dividend to below the \$500 level.

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Mr. King underlined "Caveats and Assumptions" on slide 17.

USEIA Oil Price Forecast
No strong recovery

Nominal Dollars
Scenarios are in \$2016

Additional assumptions
No major positive economic movers such as pipelines or significant new oil production
Does not account for other potential black swans (healthcare)
Small amounts of continued deficit spending.

All Forecasts are Wrong
"Forecasts create the mirage that the future is knowable"
-Peter Bernstein

Mr. King moved to slide 18 and spoke to "Comparison to Other Forecasts"

What is a Job?
ISER and ADOLWD forecast wage and salary jobs
NEI uses wage and salary + self employed

Convergence
All three organizations predict similar losses for 2017
ISER forecasts are equivalent to NEI's status quo forecast

Divergence

NEI scenarios adapt the status quo to reasonably likely scenario

Mr. King moved to slide 19, titled "2017-2026 Employment Forecasts." He indicated that the graph depicted that all forecasts were the same through 2017 because the policy remained the same. The red dotted line presumed the status quo and showed the recession in 2017 and the economy stabilize in subsequent years. He explained that the reason was the economy had gone through the contraction in the oil industry and in state government and government spending would stabilize. The economy went from a peak employment of approximately 465 thousand in 2015 to under 445 thousand through 2026. He noted that "in the best case scenario" 15,000 to 20,000 jobs in the state's economy would be lost. He continued that with the next two scenarios, either a broad based tax or significant reductions in the PFD, the employment projects were essentially the same. He qualified that with the two scenarios there was a significant "functional difference on the ground." He delineated that rural residents or low earners preferred an income tax to reductions in the PFD, conversely, high wage earners preferred reductions in the PFD. However, the aggregate effect in the overall economy was the same. He spoke to the fourth scenarios effect on employment. The full PFD dividend coupled with budget cuts considerably reduced overall employment - instead of taking a bit of income from everyone, it would slice a portion of jobs from the economy. The individuals would have a hard time finding jobs and would not spend. He communicated that by eliminating 10 state jobs, 6 to 7 private sector jobs would also be lost due to the less spending generated by the state employees. He contributed the data to an ISER study by Dr. Mouhcine Guettabi, Assistant Professor of Economics, ISER, who concluded that a reduction of state employment was "the most detrimental option in regards to overall employment" due to lost dollars spent by the unemployed state workers.

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Mr. King discussed "2017-2026 Population Forecasts" on slide 20. He stated that without additional expenditures in the economy (the status quo) the model predicted a net negative effect on population beginning in 2017. The natural reproductive rate may slow as the economy worsens.

The population effects took longer than the economic effects for the other three scenarios. He reviewed a summary of his model conclusions on slide 21, titled "REMI Summary Results: 2017-2026:"

Employment

Employment bottoms out in 2018-2020.

Sq: -13,000 jobs

S1: -25,000 jobs

S2: -24,000 jobs

S3: -33,000 jobs

Without additional fuel for the economy, employment does not meaningfully recover between now and 2026.

Population

Population loss from baseline in 2016:

Sq: -13,000 residents

S1: -32,000 residents

S2: -31,000 residents

S3: -34,000 residents

While employment starts to recover around 2019, population declines start in 2017 and continue through 2026.

Mr. King highlighted slide 22, titled "Key Takeaways 1:"

Mathematically, solving the "fiscal gap" is not a challenge.

The resources are there.

Solving the "expectations gap" is an incredible challenge.

The hardest myths to bust are those we tell about ourselves.

There is no such thing as a universal essential service.

We are in an ideological struggle over what our state should look like now.

Our progress has been hampered by denial and uncertainty about the duration of our situation.

Mr. King believed that it was difficult to overcome things that were not true about ourselves. He spoke to two generations in the state that were not used to paying taxes that he viewed as a societal stumbling block. He concluded with slide 23, titled "Key Takeaways:"

Without stimulus or spending stabilization, we have 2-3 years left in this recession.

The size of second phase of the recession will be a direct function of oil prices and the battles being wages in Juneau.

Not much aggregate difference between PFD reduction and a broad-based personal income tax because both reduce income for all or nearly all Alaskans.

The \$3.2 UGF plan has the greatest overall effects because it involves directly cutting 18,000+/-State supported jobs with indirect effects accounting for the remaining 12,000+ in losses.

People without jobs are more likely to sell homes and leave, whereas reducing everyone's income a little leaves a poorer, but economy more intact.

Mr. King alerted the committee that as a business owner the prospect of no economic stimulus or stabilization was "terrifying." He could not hire more people or grow his business with the status quo's future economic unpredictability. He believed that the size of the recession was going to depend on the decisions the legislature made. He commented that by actually making a decision and communicating it to the public, the communication was as important as the decision that was made. He thanked the committee on behalf of all 14 of the combined efforts of dedicated employees at Northern Economics.

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^PRESENTATION: ALASKA'S ECONOMY

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DR. RALPH TOWNSEND, DIRECTOR, INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH (ISER), UNIVERSITY OF ALASKA, provided a PowerPoint presentation titled "Presentation to House Finance Committee" dated February 10, 2017 (copy on file). He pointed to the disclaimer at the bottom of the first page that read:

ISER publications and presentations are solely the work of individual authors and should be attributed to them, not to ISER, the University of Alaska Anchorage, or the research sponsors.

Dr. Townsend mentioned that the purpose of the disclaimer reflected public educations "long tradition" of making the resources of its faculty and staff available to the public independent of the institution itself." Mr. Townsend clarified that ISER attempted to maintain neutrality and did not advocate for specific legislation. He spoke to his short tenor in Alaska, having moved to the state the summer of 2016 and reported that he lacked the vast experience of living in the state and the historical perspective and institutional knowledge of previous ISER directors.

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Dr. Townsend moved to slide 2, titled "Managing 4 key Alaska Assets:"

1. Oil and gas resources
2. Financial assets (Permanent Fund, ER, CBR, etc.)
3. Physical infrastructure
4. Human capital

Dr. Townsend discussed that the oil resource in Alaska generated a very unstable flow of revenue but was typically not problematic because what it generated at its minimum was enough to invest in human capital and then determine how to allocate the rest to physical infrastructure and financial assets. He mentioned that currently, the oil reserves were declining in its present value while the state's financial asset was increasing. The state was at a point where the oil revenue was drying up and created economic uncertainty. Consequently, the state had to manage both the financial assets and oil resources and both assets were volatile. The problem had become more complicated because the oil revenue was declining and the state had to manage the financial asset with its inherent variabilities.

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Dr. Townsend continued to slide 3: "Economic Context".

1. Moderate recession began late 2015 and is forecast to go into at least early 2018.
2. State budget decisions will affect length and severity of recession.

Dr. Townsend elucidated that the recession was a "bit worse" than predicted and what had become more clear was that the decisions about the state budget needed to consider what was going on in the broader economy.

Dr. Townsend continued to slide 4 titled: "Why a multi-year plan:"

- I. Both risk and opportunity
 - Being forced into a large one or two year adjustment will seriously harm economy.
 - Change is inevitable, but Alaska's savings allow a multi-year adjustment.

Dr. Townsend spoke to slide 5, titled "Using The ER Balance To Conceptualize Budgetary Risks:"

1. Drawing from the Earnings Reserve (ER) is essentially inevitable.
2. Will that draw be *ad hoc* or planned?
3. What is the risk that the ER draw, planned or *ad hoc*, will take the ER to/near zero?
4. What will happen if the ER balance goes to/near zero?

Dr. Townsend believed that in the near future it was inevitable the state would need to draw funds from the Permanent Fund Earnings Reserve Account (ERA) to balance the budget. He questioned the risks and what would happen if the reserve balance came close to zero. He worried that there were a number of strategies that ran substantial risk of reducing the ERA to zero within 10 years. He added that the scenarios involved some "bad luck" but that proper planning moved the possibility towards more financial control of the state's future by substantially reducing the

possibility the earnings reserve would get to zero in the future and would reduce the size and pain of the necessary adjustments.

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Dr. Townsend moved to slide 6, titled "Hence, Planning":

- Planning will reduce the probability of getting to the point that the ER is exhausted.

- Planning will reduce the size (and pain) of adjustments if "bad luck" gets us close to exhausting the ER.

Dr. Townsend related that private business was advocating for a fiscal plan and understood that budget adjustments included some combination of changes to state spending, taxes, or the PFD. Variables in the plan will affect different businesses differently but created certainty. However, no plan was unpredictable and created instability.

Dr. Townsend advanced to slide titled "Why a multi-year plan?"

II. Business impacts are inevitable and will not be uniform.

- Both further spending cuts and additional revenues seem unavoidable.
- Different cuts and taxes will affect businesses differently.

Dr. Townsend believed most businesses understood that business impacts were inevitable. He moved to slide 8, titled " Examples of Business Effects:"

- Sales tax: Impact from Internet competition.
- PFD cut: Impact on rural businesses
- Higher property taxes from education cost shift to local government: Capital investments face higher taxes/lower returns
- No capital budget: Demand for Professional Services much lower.

Dr. Townsend elaborated that higher property taxes were particularly bad for companies that make large fiscal plant

investments, which could be a "very substantial part of its operating costs." He summarized that budget cuts would affect different businesses differently and managers wanted to know what the future held.

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Dr. Townsend moved to slide 9: "A Footnote on Budget Forecasts: Inflation."

Inflation needs to be treated identically in revenues and expenditures.

- All can be in "nominal" terms, using the same measures and expectations about inflation.

- All can be in "real" terms, which is the same as "today's dollars." Economists typically use real calculations.

Dr. Townsend stressed that if some numbers were nominal and others were real it would result in the wrong calculation. He remarked that real dollars was what a certain amount was worth in the future, i.e., what \$100 dollars buys today versus its worth in 20 years. He noted that had seen calculations of 6.9 percent return on the Permanent Fund when predicting PFD payout and emphasized that the figure clearly included inflation - it was beyond the real rate of return that could be achieved by a fund the size of the Permanent Fund. He warned that certain data predicted that state government spending would be flat in nominal terms, however flat nominal spending meant 2 percent of the services provided would need to be cut due to inflation. He cautioned against the situation of using nominal terms in budget calculations. He illustrated that 2 percent over 10 years was 20 percent and on a \$4 billion budget that amounted to removing \$800 million from the budget. He spoke about the difficulties in providing consistent assumptions when calculating inflation in the Permanent Fund.

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Dr. Townsend moved to slide 10, titled "Tax Policy 101."

Broad and low.

Dr. Townsend commented that economists overall assessment of good tax policy was "broad and low." He defined that it was better to have an income tax that included all of the

income at 2 percent than to institute an income tax that had loopholes for 50 percent and was effectively a 4 percent tax rate. Everyone wanted to be included in loopholes and the higher the tax rate the more it paid to look for the loopholes. Broad and low meant the tax system would not distort the decisions that people were making. He directed attention to slide 11, titled "Economic Consequences of Taxes:"

1. Administrative and compliance costs
2. People spend resources to reduce taxes
3. People shift economic activity to less productive uses to reduce taxes

(2) and (3) are hidden, but often the real cost of poor tax policy. Hence "broad and low."

Dr. Townsend cautioned that the higher the tax rate, the greater the incentive to spend money on less productive endeavors that reduced taxes. He added that people change what they do to avoid taxes. He exemplified the strong tax preference for investments in housing. Individuals were able to deduct property taxes and interest and "for a long time there had been a very favorable depreciation schedule with respect to residential housing." He deduced that the favorable policies encouraged investment in residential housing. He emphasized that the decisions people made to avoid paying taxes were more important to consider than the administrative costs of the tax system. He moved to slide 12, titled "Tax Policy 102:"

Equity and efficiency are often in conflict in tax policy.

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Dr. Townsend continued that the things that reduced the broad social costs of tax policy often resulted in "the inequitable distribution of the burden of taxation." He spoke to a tradeoff between equity and efficiency. He advanced to slide 13: "Regressive vs. Progressive:"

- Regressive: percent of income paid in tax falls as income increases. (Note that total tax paid may still increase as income increases.)

- Progressive: percent of income paid in tax increases as income increases.

Dr. Townsend explained that in a regressive tax, a percent of income paid in tax falls as income increases (total tax paid may still increase as income increases). A progressive tax was a percent of income paid in tax increases as income increases. He opined that societal favoring of progressive taxes was a value judgement. He added that not many people were in favor of regressive taxes, which he believed was unfortunate. He noted the term itself sounded undesirable. He believed people went looking for other reasons not to like regressive taxes (e.g. administrative costs - which were often very small). He contended that the consensus that society was "in favor of progressive taxes was not as broad as one would hear in the public discourse."

Representative Ortiz asked whether there was any consensus among economists about which type of tax had a greater negative impact on the economy.

Co-Chair Seaton noted the question was substantial and would be answered after the presentation concluded.

Dr. Townsend summarized slide 14, titled " Alaska's current taxes-I:"

- Corporate income tax: 9.4 % max. (Among 4 highest.)
- Local property taxes: 10-12 mils. (Slightly above middle of pack.)
- No vehicle property tax. (Like 25 others.)
- Fuel tax \$.08/gal. (Lowest.)
- No personal income tax. (Like 6 other states; 2 tax dividend and interest.)

Dr. Townsend voiced that Alaska was unique in that some communities lacked property taxes. However most people lived in communities that did collect property taxes and the taxes were at or above the national property tax average.

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Dr. Townsend addressed slide 15, titled " Alaska's current taxes-II:"

- No state sales tax. (Like 4 other states.)

- No state lodging tax. (All 4 states without sales tax have lodging tax.)
- 10% car rental tax. (Second highest, with 5 other states.)
- Local sales taxes to 7.5%. Local rooms tax to 12%. (38 states have local sales taxes.)

Dr. Townsend related that the next four slides considered some "high level considerations" of various taxes. He moved to slide 16, titled "Sales Tax Effects"

- Moderately regressive
- Exemptions, esp. food, reduce regressivity at cost of collecting less revenue.
- "Broad" for sales taxes means including services.
- Competition from Internet sales.
- Federal income deductibility for itemizers.
- Estimated 10%-15% of purchases by tourists.

Dr. Townsend specified that a substantial amount of taxes were paid by tourists. However, it was difficult to obtain a good estimate of how much of the sales tax was paid by non-residents versus tourists.

Dr. Townsend addressed slide 17, titled " Income Tax Effects:"

- Rates can be progressive.
- Differential treatment of different income and expenses can be quite distortionary. E.g., tax preferences for housing.
- Impact on work decisions, esp. for second earners.
- Federal tax deduction for itemizers
- About 15% of wages to non-residents.

Dr. Townsend moved to slide 18 titled "Coordinating with Federal Tax:"

All state income taxes rely on aspects of Federal tax code.

- Adjusted gross income with further adjustments most common. Some also use federal deductions and exemptions. Then apply own tax rates.
- A minority use Federal income before adjustments.
- A few use their own income definitions.
- None define taxes as % of Federal liability

Dr. Townsend detailed that 30 states used adjusted gross income with further adjustments; their own deductions and exemptions. Another 7 states used adjusted gross income with the same federal deductions and exemptions or federal taxable income. Five states either had their own definitions or readjusted federal income in more complicated ways. He voiced that "at present, no states defined taxes using the federal liability as the starting point." He furthered that as of 1980 only 24 states had income taxes and at that time 6 states did employ the federal tax liability.

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Dr. Townsend addressed the effects of property taxes on slide 19:

Property Tax Effects:

- Arguments over progressive/regressive.
- Differentially affects those on fixed income.
- "Circuit breakers" reduce regressivity.
- Can create "tax competition" for industry.
- Federal tax deductibility for itemizers.

Representative Guttenberg asked for a definition of circuit breaker. Dr. Townsend answered that "Circuit Breakers" capped liability at a percentage of income; if property tax was more than a specified percent of income the state paid the difference. He added that there were variations; in some cases the community cannot collect the tax or offered provisions for renters. Circuit Breakers were "very widely used" in the country.

Dr. Townsend addressed slide 20, titled "Permanent Fund Dividend cuts:"

- PFD is a very progressive program.
- Therefore, cutting PFD has a strongly regressive effect.
- PFD cuts offset by federal income tax reductions.

Dr. Townsend remarked that the only similarity to the PFD was the progressive social welfare systems of northern Europe. He noted there were two ways to shift taxes to other payers: 1) the federal government paid for part by reducing federal income taxes or 2) non-residents or

tourists pay it directly. He offered that the work ISER had done determined it was hard to estimate the amount of taxes paid by non-residents. The institute ascertained that it did not matter what type of taxes were levied or whether the PFD was cut, approximately 15 percent of the change would be paid either by the federal government in reduced taxes or by non-residents. He mentioned that Alaskans would pay roughly 85 percent. He noted that it was difficult to deduce who was really paying sales taxes.

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Dr. Townsend briefly presented slide 21, titled "State and Local Spending:"

Long run goal is to fund services whose value to Alaskans exceeds their cost.

Dr. Townsend stated that it was not possible to ignore in the short-term that laying offs had a negative effect. He believed that the long-run goal was to assess the value of the services provided.

Representative Ortiz asked what the term value in his statement meant. Dr. Townsend believed he meant economic value. For example, he referred to a court worker. He pointed to the economic value of reducing a two year court backlog to two months. He maintained that there was a real economic value to having a well-functioning court system that reduced the cost of lawyers and societal costs. He opined that value may be hard to measure, but it existed.

Dr. Townsend addressed slide 22, titled "Spending Cut Effects:"

- Impacts depend upon what you cut.
- Details matter, such as impact on federal receipts.
- Education cuts will increase local taxes.
- Other cuts (e.g., university) will shift costs.

Dr. Townsend commented that budget cuts had impacts on Alaskans.

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Dr. Townsend relayed he was not advocating for a specific plan. He addressed "Elements of a Multi-Year Fiscal Plan" (slide 23):

1. How Permanent Fund and related assets will be used.
2. How to manage volatility in net revenues from oil.
3. Multi-year expenditure plans, based on value to Alaskans.
4. Role/timing of additional taxes/costs to residents and businesses.
5. How will savings be used to work through current recession?

Dr. Townsend suggested that the timing for the taxes may be to phase them in. He emphasized that people knowing what to expect relative to a tax plan was important.

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In response to a question by Representative Wilson, Mr. King clarified that she was referring to year over year employment associated with the fiscal environment for the oil and gas industry and how changes in the tax credit program would affect employment. Representative Wilson affirmed and also wanted him to address spending and the "domino effect that happened as well." Mr. King replied that the issue was "incredibly complicated." He expounded that in addition to Alaska's tax structure, oil companies made financial decisions on an international basis. He acknowledged that in a broad context, the credits mattered to the oil industry. In the case of Alaska's interplay with the oil industry, it was difficult to draw firm conclusions or consequences from the decisions the industry made. He related that economists believed that it was "difficult to prove the counterfactual" or what could have been in the absence of oil tax credits. He deemed that pulling back on credits affected the small independent companies that were much more dependent on them. The longer-term question was what the value of the credits was and the net present value of the new oil discovered because of the credits 5 to 10 years in the future. He added that questions like what was the value of credits if the newly discovered oil was not near any infrastructure to transport it to market should be considered. The credits were meant to incentivize production and not short-term employment. He concluded that companies will respond to changes in the tax credit system but how and what would be the consequences were difficult

to determine. In response to a question by Representative Wilson, Mr. King answered that DLWD reported employment data on the borough level. He explained that it was possible to find employment information called the Quarterly Census of Employment and Wages Data or the monthly survey data on the Fairbanks North Star Borough through local government and look at employment in the individual sectors. He stressed the importance of analyzing the data to determine the effect of the credits and the broader implications of the state of the oil industry at the time. For example, if the price of oil was falling there may be no immediate layoffs and the question was to determine whether no change in the employment level was due to oil tax credits. He reported that sophisticated modeling was necessary to determine the impact of tax credits on industry wide variables.

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Vice-Chair Gara addressed Dr. Townsend and inquired why states had shifted away from using a percentage of federal income tax. Dr. Townsend responded that one consideration was certainly to avoid any fluctuation in federal tax rates impacting the amount of tax the state collected. For instance, a 10 percent decrease in the federal tax rate resulted in a 10 percent reduction in state tax. In addition, not relying on a percentage of federal income tax allowed states to make their own decisions on capital gains, maintain control over what they were taxing, and increased stability (the federal government often decreased taxes during a recession - the opposite of what states typically needed.) He indicated that ultimately, it was not difficult for a state to use adjusted gross income as a basis for its income tax rate. However, he spoke to the ease of a state using a percentage of the federal income tax that did not increase the "compliance cost." He delineated that many reasons existed for separating out deductions and exemptions. He exemplified that the most important reason was that 20 percent of a state's tax payers resided in the state for part of the year and most states wanted control of allocating their income and exemptions in their calculations. The administration of a state's independent tax system was only slightly more complicated than a percentage of federal income tax. However, it was possible to design a state tax based on a percentage of federal income tax with its own unique features, which was what most states attempted to do.

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Vice-Chair Gara surmised that a state would design its own tax table that mimicked a desired percentage of the federal tax liability, providing stability versus basing an income tax on adjusted gross income that fluctuated. Dr. Townsend answered that presently, most states coordinated some aspects of their tax system with the federal system such as the definition of income. He elucidated that regarding deductions and exemptions, some states use the federal codes with the caveat that the state retained the authority to review changes periodically and decided whether to adopt or reject them. He reminded the committee that in the 1980s when there had last been a state income tax, substantial credits were not available for the typical tax payer. Currently, the federal tax system had many credits for things like higher education and child care that substantially reduced tax liability. If the state used a percentage of the federal tax rates the state had to absorb the credits.

Representative Kawasaki related his experience as a member of a fiscal policy committee in 2011 where ideas on a state fiscal plan was discussed but not adopted. He asked about the quickest ways to reverse the recession without harming the state. Mr. King responded that "the opportunity to get out of recession the fastest had gone by" and past several years earlier. He thought that the emphasis going forward was to decide what kind of state should emerge in the future and act without doing substantial harm to the economy. He deduced that since a fiscal plan that adopted an annuity type approach that stabilized spending by employing the ERA and "rolling in the CBR and what was left of the Statutory Budget Reserve (SBR)" past several years earlier the state was currently facing stabilizing state spending at a much lower level. He maintained that another consequence was that the state had to wait for a rebound of oil prices and could not invent a new industry that generated as much revenue. He spoke to Dr. Townsend's idea of "broad and low" taxes to introduce the concept of paying for services while attempting to determine the services the state really needed to provide, and to provide the services well in order for people to have confidence in their state government. He felt that the broad cuts over the past couple of years did not address the question. He provided examples of ways the cuts had impacted the Department of Fish and Game that resulted in negative consequences. He

believed that people needed to recognize that opportunities were lost and that the state needed to adapt to the future and think about the economy holistically.

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Dr. Townsend surmised that if the state attempted to solve the fiscal crisis in two years the state would end up with a four-year recession, which he believed would negatively impact the housing market and add further drastic consequences. He advocated for budget adjustments over a multi-year time period. He suggested delaying implementing taxes until 2019 and 2020. He stressed the importance of stabilizing the economy so businesses had the "confidence" to make investment decisions based on future certainty. He restated the importance of creating certainty by specifying the fiscal approach the state would take and implementing the plan over several years.

Representative Ortiz referred to Dr. Townsend's concept of broad and low tax rates and cited the 9.4 percent corporate tax rate, one of the four highest corporate income taxes in the country. He asked whether the corporate tax was broad and included exemptions.

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Mr. King replied that he was an owner of an S corporation and he did not pay corporate income taxes to the state, due to the structure of the tax system taxes could "flow to his personal income taxes." He added that many of the S corporations and LLCs fell under the same category. He opined that he was not opposed to a sales and income tax in exchange for services. Many in the professional business sector were willing to pay taxes, but wanted the burden spread fairly.

Co-Chair Seaton spoke to the 9.4 percent corporate income tax relative to the oil companies. He commented that the tax was based on worldwide apportionment and companies paid an average of 4.4 percent two years ago and most were paying zero at present. He observed that the amount of Alaskan corporate taxes paid depended on the worldwide profitability of the oil companies in Alaska. He asked about trying to implement a tax in a reasonable timeframe. He elaborated that the committee was considering an income tax of 15 percent of the federal tax rate. He reasoned that

developing exemptions and deductions decisions were problematic and "almost as big as a problem and as questioned as deciding on the tax itself."

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Dr. Townsend answered that the legislature could adopt the federal definitions of deductions and exemptions, which many states did. He detailed that most states had small adjustments for taxes paid on state or local bonds and treat income earned in other states slightly different. He voiced that designing a tax so that the legislature could declare to its citizens a tax of 15 percent of the federal income tax would be imposed "was a straight forward exercise." He related the importance of initially communicating what the tax would do and then dealing with administering the tax going forward. He suggested designing the tax through the tax brackets and subsequently dealing with credits and capital gains and other details. A tax based on a percentage of the federal income tax offered a structure that dealt more easily with the 20 percent of part-year residents.

Co-Chair Seaton relayed that he was referring to all of the efforts entities take to evade taxes in statute through lobbyists. He believed that every tax related decision the legislature had to make was in "peril because of the lobbying effort of all of the interests" pressuring for credits, exemptions, or deductions. Opening the tax to adjustments unique to the state would eliminate the opportunity to swiftly proceed in implementing the tax due to the lobbying process weighing in on every individual aspect of the tax.

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Mr. King maintained that an income tax attached to a percentage of federal liability actually invited the process Co-Chair Seaton wanted to avoid due to battles over adjustments. He relayed from personal experience paying taxes in North Carolina and recalled a very short income tax form for a simple tax based on adjusted gross income without deductions. He indicated that a state could set rates to achieve the effect desired. It was relatively easy to look at the structure of federal tax rates and use "a percentage of what people actually ended up paying as a portion of their income." He offered suggestions on how to

adopt a broad income tax based on adjusted gross income. He informed the committee that by adopting a tax based on a percentage of federal liability the earned income credit was also adopted by default resulting in half of the state's citizens not contributing because, after adjustments, were considered too poor to pay federal income taxes. However, if the state used a formula based on a percentage of adjusted gross income, the flexibility to share the burden more equally was greater than a system based on a percentage of federal liability. He declared that there were many advantages to using adjusted gross income and many states transitioned to its use.

Co-Chair Seaton referred to slide 9 of the ISER presentation in regards to nominal versus real terms in calculating budget forecasts and inflation. He referenced the Department of Revenue's (DOR), Revenue Source Book and its calculation of oil price over time. He wondered whether it was necessary to deduct or add 2.25 percent annually to account for inflation.

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Dr. Townsend replied that sorting out what a third-party had done when forecasting was difficult and nearly impossible to determine unless specified in the forecast. He cautioned that it was possible to include many variables in the calculations but it was imperative to determine whether the various numbers were equivalent. Co-Chair Seaton interjected that the question would be asked to DOR. He noted errors in the recent calculations on inflation and the rate of return for the Permanent Fund.

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Vice-Chair Gara referred to Co-Chair Seaton's point about the legislature being mired in "fights" when attempting to pass an income tax. He wanted fairness as an objective. He wondered whether it was possible to mimic the 15 percent federal income tax rate within each tax bracket but the state set its own tax rate. He asked about the ease of establishing that type of tax structure. Dr. Townsend replied in the affirmative and added that was exactly his point. He communicated that the rest of the states had a lot of experience with the income tax and they had all moved away from an income tax as a percent of federal income tax. He furthered that a structure was necessary

within the tax to deal with the atypical tax payer. He agreed with Co-Chair Seaton that any structure of income tax, would encourage "rent seeking." He defined rent seeking as various entities investing in lawyers and lobbyists to seek preferred treatment under the code. He believed that it was what was wrong with the federal tax code. He agreed that the same forces would be seen at the state level. He opined that a lower tax rate reduced the issues but rent seeking was "inevitable."

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ADJOURNMENT

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The meeting was adjourned at 3:48 p.m.