

HOUSE FINANCE COMMITTEE

March 28, 2017

9:04 a.m.

9:04:38 AM

CALL TO ORDER

Co-Chair Foster called the House Finance Committee meeting to order at 9:04 a.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

Randall Hoffbeck, Commissioner, Department of Revenue;
David Teal, Director, Legislative Finance Division; Mike Navarre, Mayor, Kenai Peninsula Borough.

SUMMARY

HB 115 INCOME TAX; PFD CREDIT; PERM FUND INCOME

HB 115 was HEARD and HELD in committee for further consideration.

CSSB 26(FIN)

APPROP LIMIT & PER FUND:DIVIDEND;EARNINGS

CSSB 26(FIN) was HEARD and HELD in committee for further consideration.

Co-Chair Foster addressed the meeting agenda.

#sb26

CS FOR SENATE BILL NO. 26(FIN)

"An Act relating to an appropriation limit; relating to the budget responsibilities of the governor; relating to the Alaska permanent fund, the earnings of the Alaska permanent fund, and the earnings reserve account; relating to the mental health trust fund; relating to deposits into the dividend fund; relating to the calculation and payment of permanent fund dividends; and providing for an effective date."

9:05:55 AM

RANDALL HOFFBECK, COMMISSIONER, DEPARTMENT OF REVENUE, addressed a PowerPoint presentation titled "Permanent Fund Protection Act CSSB 26 (FIN)" dated March 28, 2017 (copy on file). He relayed that much of the information in the presentation was previously presented therefore, he would skip over slides. He read from slide 3 related to the intended use of Permanent Fund earnings.

USE OF PERMANENT FUND EARNINGS

"This proposal, if approved, would amend the Constitution of the State of Alaska by ... establish[ing] a constitutional permanent fund into which at least 25 percent of all [mineral royalties] received by the State would be paid. The principal of the fund would be used only for income-producing investments permitted by law and the income from the fund would be deposited in the general fund of the State and be available to be appropriated for expenditure by the State unless otherwise provided by law."

Ballot Proposition No. 2
Permanent Fund from Non-Renewable Resource
Revenue Constitutional Amendment

Co-Chair Foster noted that Representative Kawasaki had joined the meeting. He asked committee members to hold questions until the end of the presentation.

Commissioner Hoffbeck turned to slide 4 and spoke to the question "Why use Permanent Fund earnings?"

FY18 Budget	\$4.2 billion
FY18 Budget Gap	\$2.8 billion

Potential Tools to Close the Gap

Motor Fuels Tax Increase	\$0.1
Broad Based Tax	\$0.6
Oil Tax Credit Reform	\$0.1
Max. Cuts Proposed (over 3 years)	\$0.75
SB26 (net dividend)	\$1.9

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Commissioner Hoffbeck addressed slide 5 titled "Structure for using the Permanent Fund":

1. Rule-Based Framework (Saving, Spending, Dividend)
2. Stabilize the Budget
3. Protect the Dividend
4. Protect the Permanent Fund
5. Maximize the use of the Earnings Reserve

Commissioner Hoffbeck moved to slide 6 titled "CSSB 26 Structure Review" that addressed the bill structure via a chart. He relayed that the status quo did not meet any of the five key points listed on slide 5. He added that SB26 alone would eventually degrade the corpus of the Permanent Fund (PF) and risk depleting the Earnings Reserve Account (ERA) over time. He voiced that SB 26 with a full fiscal plan met all the five elements of the defined structure for use of the fund.

Co-Chair Foster noted that Representative Pruitt had joined the meeting.

Commissioner Hoffbeck turned to the chart on slide 7 titled "CSSB26 Revenue Review." He reported that SB 26 contained an appropriation spending cap of \$4.1 billion that excluded the Capital budget and debt. In FY 18, existing undesignated general fund (UGF) revenues were \$1.6 billion

and the planned ERA draw would be \$1.9 billion, leaving a deficit of \$0.6 billion. He turned to the graph on slide 8 titled "Median UGF Revenue and Budget" that depicted the state's deficit over time.

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Commissioner Hoffbeck advanced to slide 20 titled "CSSB 26 Scenario Modeled":

Deposits: 25% of royalties deposited into the permanent fund.

Draw Calculation

Maximum POMV:

For first 3 years, 5.25% of the average value of the fund in the first 5 of the last 6 years.

Beginning in FY 2021, 5% of the average value of the fund in the first 5 of the last 6 years.

Draw Limit: The maximum POMV amount is reduced by \$1 for every \$1 that UGF royalties and production taxes exceed \$1.2 billion.

Dividend Calculation:

25% of the maximum POMV calculation (before applying the draw limit).

Overwriting the above calculation, the dividends for CY2017, CY2018 and CY2019 are \$1,000 per person (the fund starting value accounts for the CY17 dividend).

Inflation Proofing: Any ERA balance over 4 times the full POMV calculation (after the current year draw) is transferred to the corpus.

Commissioner Hoffbeck addressed the difference between the current version of the bill and the original bill. He noted that the original version of the bill specified that the POMV was 5.25 percent for the life of the plan. In the original version, the Permanent Fund Dividend (PFD) was calculated at 20 percent of the maximum POMV calculation plus 20 percent of the royalty revenue. A \$1,000 PFD was guaranteed for two years. Additionally, the current version

extended the \$1,000 dividend another year for a total of three years. He turned to slide 21 titled "CSSB 26 Scenarios Modeled."

SB26 with Full Fiscal Plan (full deficit closure, no additional draws)

The model assumes that the permanent fund framework is immune to any UGF deficit

This means that there are no unplanned withdrawals from the ERA

SB26 with no other Measures (structural deficit remains, requires additional draws)

The model uses the \$4.1 billion appropriation limit in SB 26 plus OMB's capital and debt payment budgets as the budget assumption

Any deficit remaining after the planned withdrawal from the ERA is filled first from the CBR; after the CBR is depleted, budget deficits are filled by unplanned withdrawals from the ERA

SB26 with \$750 million in cuts over 3 years

The model uses the \$4.1 billion appropriation limit in SB 26 plus OMB's capital and debt payment budgets as the budget assumption

Deficits are reduced incrementally by \$300, \$250, and \$200 million. Any deficit remaining after the planned withdrawal from the ERA is filled first from the CBR; after the CBR is depleted, budget deficits are filled by unplanned withdrawals from the ERA

Commissioner Hoffbeck moved to slide 22 and spoke to a graph titled "Budget Assumptions." He relayed that the graph depicted the difference in the budget assumptions of the three scenarios. The gold bar represented SB 26 with \$750 million in cuts, the green dash represented the budget under Office of Management and Budget's (OMB) 10 - year plan, and the blue dash line represented SB 26 plus the capital budget and debt service. The spending cap in the bill mirrored the budget forecast provided by OMB.

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Commissioner Hoffbeck turned to slide 27 titled "UGF Revenue with POMV and Draw Limit" and addressed a graph titled "UGF Revenue & Oil Price."

A formula that includes a draw limit:

Gradually reduces the amount drawn from the ERA as oil revenues increase

Stabilizes UGF revenue through a range of oil prices

Grows the fund more, producing larger draws and dividends in the future

Commissioner Hoffbeck moved to slide 28 titled " SCENARIO: UGF Revenue without Draw Limit" and spoke to the graph depicting the scenario. He pointed to the revenue volatility created without a draw limit. He moved to slide 29 and spoke to the scenario showing UGF revenue with a draw limit. He noted that the revenue volatility evened out. He turned back to slide 28 and noted that the draw in 2041 was \$5.6 billion under a volatile structure without a draw limit compared to \$7 billion reported on slide 29, which "turned off the use of the fund" and preserved funds when revenues were high. He added that over time, the draw limit also had an impact on available revenues.

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Commissioner Hoffbeck advanced to slide 32 titled "CSSB 26, Full Fiscal Plan." He noted that the graph depicted the unrestricted general fund (UGF) available from the ERA. He reported that with a full fiscal plan the draw grew from \$1.867 billion in FY 18 to \$3.296 nominal or \$1.954 billion real dollars in 2041. He turned to slide 33 titled "CSSB 26, No Fiscal Plan" and pointed out that the graph showed the 2041 value at \$2.489 billion nominal or \$1.475 billion and represented a loss. Slide 34 included a line graph showing UGF revenue titled "CSSB 26 Modeling Comparison: UGF Revenue - Funds Available for Services." He summarized that the status quo line over time without a fiscal plan depicted the money available for government services was degraded. He skipped to slide 37 that illustrated dividend durability under CSSB 26 with a full fiscal plan. He

explained that in FY 18, the median value of the dividend was \$1000 and by 2041 was \$1,606 nominal or \$941 in real dollars, which grew at a rate close to inflation but did represent 6 percent less purchasing power over time. He scrolled to slide 39 titled "CSSB 26, No Fiscal Plan" that included a line graph showing the status quo effect on the dividend declining to \$1,277 nominal or \$749 real dollars in 2041. He moved to slide 39 titled "CSSB 26 Modeling Comparison: Dividend" that graphed the dividend over time under the different plans. He observed that the Senate's plan for SB 26 with \$750 million in cuts equated to a full fiscal plan, but whether that number of cuts could be achieved was questionable. He pointed to the dotted line that represented the status quo precipitously declining beginning in 2024; at that point the Constitutional Budget Reserve (CBR) and excess revenues in the ERA were depleted, which threatened a dividend payment. The graph also showed the degradation of the dividend over time

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Commissioner Hoffbeck addressed CSSB 26 inflation proofing and fund durability in the following slides. He turned to slide 43 titled "CSSB 26, Full Fiscal Plan - Fund Size." He indicated that the corpus of the PF was approximately \$54 billion which grew to \$111 billion nominal or \$65 billion in real dollars by 2041 under the full fiscal plan. The ERA failure rate over 24 years was less than one percent. He characterized the full plan as "close to a slam dunk." He reviewed Slide 44 titled "CSSB 26, No Fiscal Plan" that showed the scenario losing real value at \$78 billion nominal or \$46 billion in real dollars by 2041 and that the ERA failure rate slid to 46 percent. Slide 45 titled "CSSB 26 Modeling Comparison: Fund Size - Nominal Fund Value" included a line graph showing representations of various plans including the status quo and the different versions of SB 26. He concluded on slide 49 that contained a summary of the bill.

CSSB 26

1. Provides a rule-based framework for use of permanent fund earnings
2. Stabilizes UGF revenues from petroleum and permanent fund earnings; also limits spending from all revenue sources

3. Protects the dividend
4. Protects the inflation-adjusted value of the permanent fund
5. Robust use of the earnings reserve

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Co-Chair Seaton spoke to the revenue limit and referenced charts in previous testimony. He asked the department to provide the data he referenced. Commissioner Hoffbeck replied that he did not have the data, but would follow up later. Co-Chair Seaton asked whether the model contained data that associated the real economy with what would occur with implementation of \$750 million in cuts in terms of job loss, slowing the economy, and other effects versus a revenue scenario. Commissioner Hoffbeck answered in the negative. The model was largely a numbers formula and did not include feedback loops on the various plans.

Representative Pruitt spoke to a royalty reduction change from 50 percent to 25 percent on new oil. He asked whether the governor endorsed the change. He wondered about the thought process if oil production increased in the future and maintaining reduced royalty money deposited into the PF. Commissioner Hoffbeck answered that the plan was intended to be permanent. The choice had been made during revenue surpluses to deposit more royalty into the corpus of the Permanent Fund, but that was no longer the case and the plan reverted to the constitutionally mandated amount.

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Representative Pruitt suggested maximizing the use of the Permanent Fund earnings. He felt that limiting the PF deposit did not account for the fact that the state would never gain more into its savings even if oil production increased. He envisioned a time when throughput increased. In 20 years he did not want to try to account for why more savings were not deposited into the PF in times of increased throughput. Commissioner Hoffbeck answered that because the bill cut off the PF draw it automatically "flipped the revenue into the corpus of the fund." He related that if the ERA grew to four times the size of the draw the appropriation would go back into the corpus of the fund. He cautioned against harvesting the revenue in high

revenue years and not following the plan, which would reduce future savings. He warned that higher revenue may lead to some situations where the long-term goals for durability were not met. He felt that a few years spike in revenue did not warrant changing the plan. Representative Pruitt asked about the four times draw. He wondered when the commissioner expected that the draw would take place and what estimated amount would be moved into the corpus.

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Commissioner Hoffbeck replied that the answer was elusive and depended on volatile factors. He noted that the plan would be starting with a much higher than anticipated ERA due to market returns, but the answer was unknown. Representative Pruitt referred to the modeling provided to the committee and the three options for moving forward with a fiscal plan. He commented that the fiscal plan did not address the priority of the options that he stated as; preserving the PF, amount of PFD, or ensuring enough for government spending. He asked what stood out as the most important of the three concepts when considering the fiscal plan. Commissioner Hoffbeck did not believe there was a hierarchy but shared that all options were considered when developing the plan. He thought that funding government services was a "very important component" and the sole reason for a fiscal plan. He offered that after traveling around the state and listening to public testimony, it had become clear that the dividend had to be preserved at some level. The amount that could be drawn from the fund on an annual basis for services and the PFD while still maintaining the real value of the ERA over time had to be a significant consideration.

Representative Wilson referred to slide 4 of the presentation. She spoke to the FY 18 \$2.8 billion budget gap and the \$1.9 billion ERA draw under the bill. She commented that the budget gap was either filled by generating revenue via a broad-based tax or cutting government services by \$750 million. Commissioner Hoffbeck replied that the gap could be filled by a combination of cuts and taxes.

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Representative Wilson voiced that the administration had already talked about shared services creating savings. She

spoke to the possibility of taxes and smarter government. She surmised that the different options would have different impacts on the economy and asked whether there was a hierarchy related to the impacts on the economy. Commissioner Hoffbeck agreed that the options all had impacts on the economy that could not be avoided. He communicated that the "true measure was what was the relative difference between the impacts." The only option that did not have an impact in the short-term was spending savings but eventually depleting savings resulted in consequences. Representative Wilson did not think anyone thought only using money from savings or the status quo was an option. She spoke to the impact on the rest of the state. She believed the relevant question was how each of the options impacted the state's economy and how to keep the economy operating optimally. Commissioner Hoffbeck answered that her statement was the reason a fiscal plan was necessary. The government had less money to infuse into the economy therefore, it was important to rely more heavily on private sector investment. A fiscal plan would act as an inducement to private sector investment by creating certainty.

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Co-Chair Foster noted Vice-Chair Gara had joined the committee meeting.

Representative Ortiz asked whether the anticipated \$1.2 billion in oil revenue was included in the model. Commissioner Hoffbeck replied in the affirmative. Representative Ortiz asked whether he modeled where \$750 million in cuts would come from. He thought it was important to know the answer to determine the effects on the state's economy. Commissioner Hoffbeck replied that the model did not include the specific information. He spoke to the intent voiced by the Senate about cuts to education, the university, health and social services, and transportation. He mentioned modeling broad based cuts in prior testimony and showing that the impact was passed on to local communities. He stated that any cut had some specific "collateral damage." Representative Ortiz asked whether there was any consensus from Institute of Social and Economic Research (ISER) or other groups showing which model would least impact the economy. Commissioner Hoffbeck replied that ISER and other economist had "pontificated" on how the various options would impact the economy.

Vice-Chair Gara spoke to SB 26 without a full fiscal plan. He asked about the administration's position on the success of the SB 26 only option. Commissioner Hoffbeck answered that the administration believed the state needed a full fiscal plan. The administration felt that the bill was a good structure for using the Permanent Fund but was an incomplete solution.

Co-Chair Seaton corrected that the FY 18 draw in HB 115 Income Tax; PFD Payment/Credit was the same as in SB 26. He spoke to a gross tax versus a net profits tax. He asked whether budget cuts were coming out of the economy upfront and where an income tax, based on profits after money had been generated, made a difference in the reaction from industry. He noted that the oil industry strongly favored a net profits tax. He stated that he was not hearing the same argument regarding up front cuts versus an income tax.

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Commissioner Hoffbeck answered that the answer depended on what a business believed about its profits; what amount could be reinvested in the business and how much was "harvested" back into the economy. He suggested that money that could be reinvested to grow the business could impact economic growth over time. Much of it depended on what the assumptions were regarding the ultimate use of the profits. He added that if programs were cut that served a need they would need to be fulfilled somewhere else. He voiced that the equation was complex. Co-Chair Seaton referred to slides 28 and 29 related to the draw limit. He asked for further detail on the slides. Commissioner Hoffbeck replied that the dark green area on slide 28 represented other existing UGF revenues and was stable. The light green area represented other new UGF revenues implemented to close the fiscal gap. The gold area was the POMV draw from the PF. The light blue area represented royalties and the dark blue areas represented production taxes. The graph contained all the revenue sources available for funding government sources and the PFD. He remarked that investment earnings could be volatile but using the five-year average on earnings removed the volatility. He delineated that instituting a draw limit "absorbed" the volatility in the price of oil at high oil prices by reducing the draw from the ERA. He surmised that the draw limit essentially putting the volatility in the PF draw on the downside: the draw was decreased at higher oil prices but not increased

at low oil prices. The volatility would consequently reside in the gold section [slide 29] of the POMV draw, which "dramatically smoothed out the revenue available for government services."

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Co-Chair Seaton remained curious about the "other" UGF revenues. He asked whether the plan was equating cuts to the other revenues and if cuts would have to be recurring to reach a full fiscal plan with reductions only. Commissioner Hoffbeck answered that the graph assumed that a revenue package was adopted. A plan based solely on decreased expenditures would shift everything down and use reduced numbers. Co-Chair Seaton looked at the inclined new revenues line in FY 18 and FY 19. He asked if it was due to the ramp up time required prior to generating the full amount of new revenue. Commissioner Hoffbeck answered in the affirmative. He stated the chart on slide 29 had been based on HB 115's inclusion of an income tax.

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AT EASE

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RECONVENED

Co-Chair Foster invited Mr. Teal to walk through the fiscal modeling.

[10:00:29 AM](#)

DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, provided a dynamic Excel fiscal model [Note: two pages of the fiscal model titled "LFD Fiscal Model" dated March 27, 2017 (copy on file) were static representations.]. He indicated there had been a few questions about the difference between SB 26 and HB 115.

Representative Wilson referred to the top left corner of the model graph titled "UGF Revenue\Budget". She asked him to model the \$750 million in budget cuts including increases for inflation proofing over the next three years. Mr. Teal relayed that the model was "fairly simplistic." He noted that the cut reduced the budget by \$750 million each year resulting in growing the state's reserves. Representative Wilson asked that as the line was increasing

what percentage was the increase versus a flat budget. She voiced uncertainty over using the 10-year plan provided by OMB. Mr. Teal responded that the 10-year plan showed OMB's expectations and was a new version. He reported that OMB expected a flat budget for FY 18 and FY 19 and subsequent budgets that grew 2.2 percent with inflation. Representative Wilson asked how the model looked without the cuts but with implementation of an income tax. Mr. Teal modeled a \$750 million income tax versus \$750 million in spending reductions resulted in graphs that looked very similar. Representative Wilson asked when the income tax grew to \$750 million. She thought that the proposal was to collect \$668 million in income tax. Mr. Teal answered that roughly the tax was rounded up to \$700 million. He noted that the \$50 million did not affect the model. Reductions or revenue had the same impact on the model.

Representative Guttenberg asked whether the top left chart included inflation proofing and the budget. He asked whether the \$750 million in cuts were built into the graph. Mr. Teal answered in the negative. He explained that reductions were not part of the model, but was an option that could be selected.

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Representative Guttenberg wondered what relation cutting 13 thousand jobs out of the economy had on the size of the budget or the payout of the Permanent Fund. He asked whether the data was included in the model or if the model was "just numbers." Mr. Teal answered that it was just numbers. He indicated that determining the effects of unspecified budget cuts was a very difficult endeavor. The easiest cuts for state government to make were reductions that transferred costs to municipalities. The scenario looked like a cut, but residents would pay increased local taxes. He stated that "there was no easy answer."

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Vice-Chair Gara appreciated the charts but qualified that the state had many expenses that rose higher than inflation; e.g. healthcare costs. He asked whether a budget built on the general inflation index would need cuts to make up for the expenses that rose higher than the rate of inflation. Mr. Teal replied in the affirmative. Currently, the biggest driver for inflation in state government was

the cost of living increases. He noted that current state employee contracts contained no increases. He did not expect costs to go up at the rate of inflation. He reported that the contracts were three-year items and when the contracts were renegotiated inflation may rise and might affect the 10-year plan. If the state did not keep pace with inflation, it was the equivalent to a real reduction in expenditures.

Co-Chair Seaton looked at the chart and asked Mr. Teal to factor in the \$750 million [in cuts] in the model. He asked about the size of the Permanent Fund under the SB 26 scenario in 2026. Mr. Teal replied the Permanent Fund was roughly \$70 billion. Co-Chair Seaton observed that it was \$67.5 billion. He asked about the meaning of the information on the chart. Mr. Teal explained that the data meant that the Permanent Fund was one percent above the FY 18 value inflated by 2.25 percent in FY 26. The PF was doing slightly better than keeping pace with inflation. Co-Chair Seaton requested that the model inputs switch to HB 115 with the income tax and remove the \$750 million in cuts. Mr. Teal replied there would be higher dividends up to \$1,400 instead of \$1,000 and the PF was roughly the same level at \$69 billion (\$2 billion higher) and was doing better than the rate of inflation (103 percent). He cautioned that the results were "very similar" with a margin of error factored in.

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Representative Wilson clarified she was not advocating for either bill. She stated that under the HB 115 scenario she would receive a higher PFD but would pay some or all the dividend back in taxes. Mr. Teal replied in the affirmative. Representative Wilson thought that the comparisons were not apples-to-apples and depended on tax brackets; a dividend could be completely wiped out depending on what kind of income tax an individual had to pay.

Representative Guttenberg discussed that if the \$750 million in cuts were added, the costs would be transferred to the local communities. He thought that teachers and healthcare would be affected. Costs did not go away they were just moved around. To get to an apples-to-apples comparison the issues needed to be factored in.

Representative Pruitt spoke to a difference between SB 26 and HB 115. He asked when the draws from the ERA began from the Permanent Fund in SB 26. He asked if there was a difference in the effect either bill had on the Permanent Fund.

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Mr. Teal answered that the Permanent Fund balance would be roughly the same in both bills because the payout was the same and earnings were assumed at 6.95 percent for both bills. The payout was 5.25 percent in the first three years in SB 26 and for two years in HB 115; subsequently, the payout became 5 percent. The almost identical draws resulted in a similar balance. Representative Pruitt asked whether SB 26 began the process in FY 18. He believed the intent of HB 115 from the perspective of the budget had assumed that the bill had been passed the prior year, FY 17. He did not believe SB 26 had the same effect. He remarked that the difference created a \$1.6 billion difference in earning potential of the PF. Mr. Teal answered that the difference was approximately \$2 billion in the ending fund balance. He explained that HB 115 took \$1.7 billion from the Permanent Fund in FY 17. Under SB 26 there was no scheduled FY 17 payout. The money remained in the Permanent Fund and resulted in the higher end balance. The FY 17 draw transferred money from the ERA into the corpus and left a balance under the four times limit. He furthered that the market value of the PF or ERA did not change, therefore, the payout did not change. It was a question of whether the legislature wanted the money in the ERA or the corpus. Representative Pruitt thought that the size of the CBR played a role in the PF balance. Mr. Teal replied in the affirmative. He detailed that the amount of deficit that remained and how the gap was addressed affected the outcome. The legislature had a choice of either removing money from the CBR, ERA or hold funds out the corpus; i.e., "transferring money to the corpus or not."

CSSB 26(FIN) was HEARD and HELD in committee for further consideration.

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AT EASE

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RECONVENED

#hb115

HOUSE BILL NO. 115

"An Act relating to the permanent fund dividend; relating to the appropriation of certain amounts of the earnings reserve account; relating to the taxation of income of individuals; relating to a payment against the individual income tax from the permanent fund dividend disbursement; repealing tax credits applied against the tax on individuals under the Alaska Net Income Tax Act; and providing for an effective date."

10:23:24 AM

MIKE NAVARRE, MAYOR, KENAI PENINSULA BOROUGH, provided a PowerPoint presentation titled "Alaska's Economy: Why we need a comprehensive fiscal plan for Alaska and Why broad-based taxes are being considered" dated March 28, 2017 (copy on file). He stated that he represented the point of view of local government and was here to help broaden the debate. He relayed his personal experience that included previous membership on the House Finance Committee. He turned to slide 2 titled "The Problem...":

\$2.8 billion* annual state deficit, and no easy answers

1. Budget cuts?
2. Taxes (sales, income, oil & gas, others)?
3. Permanent Fund earnings?
4. Economic development?

Mr. Navarre reviewed slide 3 titled "The Options..."

Budget cuts

Easier said than done for all the reasons
Different priorities for state spending
Philosophical differences about government
Heated rhetoric exacerbates the differences
And everyone worries of negative economic impacts

Mr. Navarre moved to slide 4 [titled 10 in the presentation] and addressed a bar chart related to the state's fiscal challenge titled "Fiscal Challenge - Top Three Unrestricted General Funds Spending Categories Total \$3.4 billion." He wanted to depict why budget cuts were so difficult to make for things like education and health and social services. He addressed "The Options" on slide 5:

Taxes

- Easier said than done for multiple reasons
- Takes time to adopt regulations and implement
- Philosophical differences about taxation
- Heated rhetoric exacerbates the differences
- And everyone worries of negative economic impacts

Mr. Navarre highlighted slide 6 titled "Alaskans pay much less in state taxes than residents of any other state" that graphically depicted where Alaskans ranked regarding broad-based taxes compared to other locations in the country, measured by per-capita broad-based state tax revenues in 2014. He qualified that being ranked lowest "was not a good reason" by itself to implement taxes.

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Mr. Navarre turned to slide 7 titled "What's Different Today?" The chart portrayed the oil production curve that peaked in 1988 and trended downward ever since. He suggested that increased production achieved by capital investment necessitated a reasonably stable tax environment. He moved to slide 8 titled "The Unconventional Revolution has Vastly Improved America's Energy Outlook" and noted that he had borrowed it from a ConocoPhillips presentation. The graphs depicted the paradigm shifts from dependence on foreign oil imports due to low domestic production to dramatically increased production. He quickly moved to slide 9 titled America's "Big Four" Unconventional Fields are World-Class Discoveries" and showed an image of the US related to fracking and other oil production areas. He indicated that Alaska had to compete with the other areas to ensure adequate capital investment and oil production into the future. He moved to slide 10 titled "The Options..."

Permanent Fund earnings

Public perceptions (and anger over any changes)
Political consequences of any changes
Impacts to Permanent Fund growth
Impacts to the Permanent Fund dividend
And the constant concern over economic impacts

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Mr. Navarre addressed slide 11 titled "Permanent Fund information...":

\$46 billion: Protected by the Alaska Constitution

\$11 billion: Earnings reserve available for dividends, protecting the fund against inflation and public services – this number fluctuates as investments make or lose money

Deposits to the constitutionally protected principal:

40% came from oil and gas royalty payments
40% came from legislative action to inflation-proof the fund
20% came from legislative transfers of surplus oil dollars

Mr. Navarre stated that the public had a significant misunderstanding about the Permanent Fund and how the money got there. He believed that the overriding effort was "to save a non-renewable resource that could be used into the future to provide and change it into a renewable resource." He moved to slide 12 titled "The Options...":

Economic development

Broad public support for economic development
Provides opportunities for jobs
Positive economic impacts for communities

But does it help solve our fiscal situation?

Mr. Navarre did not believe there was any responsible fiscal plan that did not use earnings from the Permanent Fund. He believed there was a rationale for maintaining a dividend but thought other spending decisions for use of the PF was equally appropriate. He turned to slide 14

titled "Funds from the State to Kenai Borough." The total amount on the slide was \$103.9 million. He offered that reductions at the state level looked like reductions to the state budget but transferred costs or tax increases to the local level. He emphasized that the Public Employees' Retirement System (PERS)/ Teachers' Retirement System (TRS) was a "huge" burden and considering the historical facts, it was not "fair" to transfer more of the liability to municipalities. He addressed slide 16 titled "Assumptions for hypothetical economic development scenario" and emphasized the scenario was purely imaginary. The following slides articulated the assumptions.

The economic development proposal on the Kenai Peninsula Borough must be approved by both the state and the borough

The state and borough must both determine if the proposed economic development makes good fiscal sense, and decide yes or no

[10:34:05 AM](#)

Mr. Navarre provided a hypothetical proposal on slide 17 related to a new manufacturing plant:

Proposal: A new widget manufacturing plant wants to move to the Kenai Peninsula Borough

10,000 new jobs
10,000 new families
5,000 new students for the school district
10,000 new homes to house the families,
at average assessed value of \$200,000 per home
\$1 billion capital investment by the
Widget Manufacturing Co. of America LLC

Mr. Navarre related that the purpose of the slide was to demonstrate the state and local government's ability to capture some of the revenues from economic development to pay for the cost of services. He moved to slides 18 through 22 and continued to address the scenario. Slide 18:

- \$5 million a year in additional borough sales taxes
- \$20 million a year in borough and service area property taxes on homes
- \$10 million a year in borough and service area property taxes on widget factory investment

Slide 19:

- 5,000 students would be more than a 50% gain over current school district enrollment. The state pays almost 2/3 of school district budget. A 50%-plus increase in the borough contribution is about \$27.5 million a year.

Slide 20 titled "Kenai Borough decision: The math":

- \$5 million a year in additional borough sales taxes
- \$27.5 million a year in increased school funding
- \$20 million a year in borough and service area property taxes on homes
- \$10 million a year in borough and service area property taxes on widget factory investment

Slide 21 titled " Kenai Borough decision: It adds up":

- \$7.5 million available for other expenses

Slide 21 titled " Kenai Borough decision: It's a winner":

- Decision: YES

Mr. Navarre addressed slides 23 through 26 related to the state of Alaska decision on new revenues.

Slide 24 titled "State of Alaska decision: Higher expenses":

- \$10 million a year in higher expenses for troopers, highways, courts, prisons, Medicaid, child care assistance, etc.
- \$45 million a year in increased school funding costs

Slide 25 titled "State of Alaska decision: It doesn't add up"

- \$550 million a year in additional expenses, no new revenues

Slide 24 titled "State of Alaska decision: Loser for the state"

- Decision: NO

Mr. Navarre observed that if the scenario were true the economic development increased the state's budget gap, illustrated on slide 27 titled: "Economic Development Decision." He mentioned on slide 28 titled "Why a broad-based tax..."

Without a broad-based tax, economic development could make the state's fiscal situation even worse

S&P's warning: "By introducing a statewide income or sales tax ... the state could generate several hundred million in unrestricted revenue annually. ... In our view, therefore, the state has sufficient potential fiscal resources

- if it can assemble the political will."

[10:37:28 AM](#)

Mr. Navarre moved to slide 29 and read the slide:

No wonder it's so difficult...

"We all bring our own biases, experiences and philosophies to the debate. When multiplied by the governor and his staff, 60 legislators and their staffs, then adding in the population of Alaska, factoring in talk radio, political parties, election dynamics, the media, right- and left-wing splinter groups, lobbyists, special interests and a multitude of constituencies for every item in the budget ... the problem doesn't seem all that difficult."

- Kenai Peninsula Borough Mayor Mike Navarre

Mr. Navarre turned to slide 30 titled "The Perfect Plan" that contained a blank slide followed by a photo of a baby and two kittens. He concluded that a perfect plan did not exist. He expounded that the debate over taxes would continue and result in political consequences. He believed that to attract the investment the state wanted and gain economic opportunities for the current and future generations the state needed a fiscal plan that accommodated the goal, "otherwise, we set up a false economy."

Representative Wilson remarked that the state had been very generous with education and PERS/TRS payments. She

mentioned municipal revenue sharing and maintained that the state had no revenue to share. She wondered at what point the state decided it could not pick up the extra share for certain municipalities' services. Mr. Navarre spoke to education and relayed that the state's constitution specified that the state would pay for education. He elucidated that the borough and municipalities paid a local share. He believed that educational costs were continuing to rise and were "insatiable." He commented that the state would have to make a significant change to the educational foundation formula to allow additional contributions from local government.

[10:40:59 AM](#)

Mr. Navarre addressed the PERS/TRS portion of the question. He noted that he experienced the issue from both sides; state and local perspectives. He related that from a local perspective the retirement program was established by the state and relied on the state's actuaries to define local government's contribution. Communities were issued their contribution rates by the state's actuaries, but a large error had been made in the calculations. A lawsuit had occurred, and the state settled the \$5 billion lawsuit without discussions or input with local government. He felt that the appearance was that local governments created the problem. He expounded that when positions were eliminated on the local level they had to pay into the retirement system for the next 25 years, which did not happen at the state level. He remarked that there was a lot of nuance to how PRS/TERS was being administered. He guessed that if litigation ensued between the state and local governments, "the local governments would probably come out on the short end" even if they won, because the state had "so many other tools they can use to penalize" local government. He noted that assigning proportions and blame was difficult and that the issue was extremely complex.

[10:44:17 AM](#)

Mr. Navarre spoke to the revenue sharing component of Representative Wilson's question. He noted that in 2006 a new program was added, where unincorporated communities; there were 27 communities in the Kenai Peninsula Borough, all received the allocations. He related that the money was put to beneficial community use, "but if it was jerked out from under the communities" the impact would be

"significant." He acknowledged that was part of the reason budget cuts were difficult. He related from past personal experience that the public had different perceptions of how the government worked and advocated for cuts from misunderstandings. Legislators had a higher level of understanding due to more access to information and direct experience in the process.

Representative Wilson clarified she did not believe the situation was the borough's fault. She asked whether the state was at a point to seriously consider the issue regarding communities that pay local taxes and those that do not. Mr. Navarre answered that all local governments were situated differently with various combinations of taxes. He cautioned that when talking about shifting costs to local governments, one size did not fit all and the consequences could be negative.

[10:48:18 AM](#)

Representative Wilson clarified she was asking about communities that were not forced into a borough and did not pay local taxes. She asked whether there would be a time the legislature needed to engage in discussions about the unincorporated areas of the state that did not contribute. She asked whether it was time to begin the conversation. Mr. Navarre answered the issue was something that had been discussed and debated since the beginning of statehood. He identified the problem in rural areas that did not have a tax base or a local economy. He surmised that the situation was inherent to the nature of Alaska. He pointed out that when a tax base was created; e.g., Red Dog Mine or the fishing industry in Unalaska, governments formed at the local level. Representative Wilson countered there were places in the state that did have local revenue and chose not to participate. She believed it was a necessary discussion to have because the disparity between communities would become more accentuated as the budget debate evolved.

[10:51:00 AM](#)

Vice-Chair Gara voiced that he did not want to settle for politically expedient measures to ensure his reelection and "leave a mess." He appreciated Mayor Navarre's call to action. He mentioned that some wanted to pass school costs onto municipalities. He asked whether in communities

without a tax cap, the increased costs were passed onto local citizens. Mr. Navarre responded in the affirmative. He elaborated that the Kenai Borough had oil and gas properties that the community assessed on a 10-mill average level. State reductions that shifted costs to local governments would likely increase the municipalities' mill levy. He deduced that the mill levy increase on oil and gas properties would reduce the properties revenue to the state. Whether increased costs were paid at the state or local level, economic impacts would occur. He believed it was better done at the state level rather than shifting costs to the local level. He felt that the cost shifting would exacerbate the rural urban divide. Vice-Chair Gara believed that lack of a fiscal plan created uncertainty for businesses. He asked for the mayor's opinion on the issue. Mr. Navarre relayed personal experiences. He replied that he had nine Radio Shack stores in various areas of the state and related that he had closed them because they had been struggling to make a profit even in a period of relative economic stability. He discussed that the decision had been difficult. He owned a restaurant chain in the state and recently decided not to invest in more outlets. As a business owner, he performed a five-year economic outlook and he determined not to reinvest due to a poor forecast. He emphasized focusing on the state's economy for the short and long-term and reminded the committee that any decisions or plans the legislature enacted could be adjusted as the economic situation changed.

[10:56:17 AM](#)

Vice-Chair Gara was not in favor of the \$65 to \$70 million in cuts others were proposing to education on top of the prior \$30 million. He asked how the prior and proposed cuts to education impacted the borough's schools. Mr. Navarre answered that the borough was increasing its local contribution to education and did not want to exacerbate the impacts that already had occurred because they were not keeping up with inflation. He believed that the long-term outlook was good, but he was concerned about the short-term impacts to a generation of children. He announced that the borough could not make-up the difference with the proposed cuts. He recounted that the local contribution was reduced and coupled with additional cuts, the borough would be "impacted in two ways."

Representative Pruitt stated the decisions of some local communities had driven some costs increases. He stated that the number of students had remained the same since 2007, but inflation over time had been about 17.5 percent. However, the state foundation formula funding had increased 35 percent. He suggested that local communities spent beyond its means and spent above inflation. He remarked that somehow the legislature was expected to fix decisions that had been made at the local level. He understood that the state had a constitutional mandate to fund education. He asked at what point the state had to step in because of decisions that had been made on the local level that were driving the costs. He wondered how to balance the issue.

[11:00:30 AM](#)

Mr. Navarre replied that part of the increase in costs were due to the changes in the formula regarding special needs. He shared that in the Kenai Peninsula Borough the student population decreased but due to the special needs the multiplier had increased. He attributed the factor as part of the reason for the increases. He relayed that if the district in Kenai lost 100 students it appeared they could cut staff; however, there were 42 schools so the fewer students spread out over the number of schools did not translate into a reduction of teachers. He supported the labor organizations, but discerned that successful labor negotiations spread to other community contracts and resulted in the overall creep in costs. He believed that often "priorities were messed up." He spoke to costs for healthcare versus costs for teachers. He discussed Mr. Navarre's unique perspective as a former lawmaker, business person, and mayor. He addressed utilization of schools. He knew that some of the schools in his community were being underutilized. He remarked that if the numbers were trending throughout the city maybe a consolidation could take place. He relayed that he had been told consolidation was not going to happen. He stressed that it was necessary to do things differently to create change. He believed going forward it was important for all entities "to have a conversation about efficient and "smart" spending." He recommended additional conversations with and among local communities.

[11:06:02 AM](#)

Mr. Navarre replied that the local governments would appreciate being part of the conversation. He agreed that things needed to change over time and efficiencies could be found on the local level. He shared that in the Kenai Peninsula Borough, the state paid 100 percent of pupil transportation. He shared that in Kenai there was one bus company with staggered routes that saved money. In Homer, there were two sets of buses than ran at the same time. He started a dialogue about changing the schedule to help the state achieve savings. Eventually, the routes and schedules were changed, and the action saved the state a little over \$500,000 per year.

HB 115 was HEARD and HELD in committee for further consideration.

Co-Chair Foster asked members to have amendments for the bill to his office by Friday at 4:00 p.m.

ADJOURNMENT

[11:08:49 AM](#)

The meeting was adjourned at 11:08 a.m.