The Institute of Social and Economic Research developed this slide show to help Alaskans understand the state’s fiscal dilemma and the policy choices we face.
Overview

- Trends in state revenues and spending
- Major options for closing the gap
- The PF Endowment
- PF Dividends
- Sales and income taxes

This presentation discusses how various options for raising additional state revenue would affect Alaska households. We’ll start with a little history about state spending and explain why there is a state budget deficit, often called the “fiscal gap.” Then we’ll briefly describe all the options for dealing with the fiscal gap, but focus the rest of the talk on the big ticket items: using permanent fund earnings and establishing state sales or income taxes.
How has state spending changed over time? As you can see in this chart, total state spending has increased since 1983. But if you break that spending down, you can see that the increase has all been in permanent fund dividends, shown in yellow, federal funds, shown in green, and restricted state funds, shown in blue. The state’s unrestricted general fund spending—shown in red-- has actually declined.

Notes:
One third of the state budget is unrestricted general purpose funds, shown in red in the chart. The legislature has broad discretion to appropriate these for any public purpose. The major sources of unrestricted revenues are oil royalties and taxes, excise and business taxes, fees for services, and investment earnings. State restricted funds, shown in blue, are revenues earmarked by law for specific purposes. These include certain program receipts such as university tuition, Alaska Marine Highway fares, fishing and hunting license fees, or dividends from Alaska Housing Finance Corporation, and a few designated taxes such as the cigarette tax and the fish tax. The green segment is federal money earmarked for specific program purposes. The annual debate over the state budget primarily concerns how to raise and spend unrestricted general purpose revenues– the red segment in the chart.
Over the years, the buying power of each dollar spent has declined. In the last ten years, price levels have increased 23 percent, and the state’s population has grown 11 percent. This graph adjusts state spending for inflation and population growth. The graph includes the state’s own funds, restricted and unrestricted—the red and blue bars in the previous chart—but excludes federal funds and the Permanent Fund. The amount of goods and services the state can buy per person has decreased 14 percent over the last decade. Real per person state spending is now at the level it was in 1971, before oil from the North Slope first began to flow.
Why is there a budget deficit?

- 80% of unrestricted revenues are from oil
- Oil revenues are declining

![State Unrestricted GF Revenues and Spending](image)

If state spending has declined, why is there a budget deficit? This graph shows state unrestricted revenues and spending over the last twenty years. The red bars in the background show state general fund spending, from the chart you saw in the earlier slide. The blue and green bars in the foreground show unrestricted state revenues. Where the red bars show above the blue, spending is greater than revenues. This is deficit spending. The state budget has been in deficit for ten of the last twelve years.

Note that the green non-oil revenues are small and steady. The oil revenues shown in blue, are large, highly unpredictable, and declining. As you can see, state unrestricted revenues from oil have declined faster than state spending has declined.
Why are oil revenues declining? As you can see from this graph, total oil production peaked in 1988, declined until 1999, and then leveled off. Production from the giant Prudhoe Bay oil field is now less than half of the level it was in 1988, and is still declining. The new oil fields coming on line are neither as large nor as profitable as Prudhoe Bay. The state severance tax formula reduces the tax rate on these smaller, more marginal fields. The state receives less than half as much per barrel of oil from new fields compared with Prudhoe Bay. Even if we increase oil production over the next decade, oil revenues are likely to continue to decline.

Notes:
Could we raise oil taxes? Yes, but not enough to fill the gap. Few of the proposals floated in recent years reliably raise more than about $100 million dollars per year. Major new oil taxes might increase revenue in the short term but be counterproductive in the longer term, discouraging investment in new fields. One proposal worth exploring is making the current severance tax more progressive. This might encourage investment by lowering taxes when oil prices are low, yet increase taxes when prices are high such that the average taxes paid over the long run increase.
How does the state cover the budget deficit?

- The budget deficit has been covered by funds withdrawn from the Constitutional Budget Reserve Fund.
- The CBR has under $2 billion.

Source: Alaska Department of Revenue

How does the state cover the budget deficit? The Alaska Constitution requires a balanced state budget. The state has been covering the deficit with annual withdraws from the Constitutional Budget Reserve Fund. This is a one-time savings account funded from legal settlements with the oil companies. Few new large deposits are expected. The balance in the CBR is less than 2 billion dollars. The Alaska Department of Revenue expects that the state could run out of money in the Constitutional Budget Reserve sometime in 2007 or 2008.

Notes:
The Department of Revenue recommends that a balance of $1 billion be left in the CBR to cushion variations in cash flow and the timing of revenues and expenditures.
What can we do about the deficit?

- Budget cuts and user fees
  - Economic development
  - Business or excise taxes
  - Permanent Fund earnings
  - Sales or income taxes

According to Alaska Department of Revenue projections, with state spending held constant, the budget deficit next year (FY2005) will be nearly $600 million and grow to over $1 billion by the end of the decade. What can we do about it? The five major solutions that are commonly discussed are:

- Budget cuts;
- Economic development;
- Miscellaneous excise taxes, user fees and taxes on industry
- Using Permanent Fund earnings; and
- Sales or income taxes.

More budget cuts and higher user fees have been instituted every year for the last decade. The current administration is promoting economic development. I will briefly explain why budget cuts, economic development and business taxes alone cannot solve the fiscal gap. Then I will focus the rest of my talk on the two biggest potential revenue sources: using permanent fund earnings, and broad based sales or income taxes.

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Notes

Excise taxes are taxes on specific products, such as alcohol, tobacco, or gasoline. The potential for new revenues through increased user fees and excise taxes is small--less than $100 million dollars. Our alcohol and tobacco taxes are already among the highest rates in the nation.
What would happen if we just cut the budget?

- The $900 million deficit is 1/3 of the state General Fund budget
- On average, every $1 million in state budget cuts will cost:
  - $900 thousand in federal funds;
  - 10 state and local government jobs
  - 8 private sector jobs.

Source: ISER

What would happen if we just cut the budget? Yes, the legislature can find more budget cuts. But small cuts will not close the fiscal gap. Cuts large enough to close the fiscal gap would eliminate essential services and entitlements. How can the legislature cut $900 million dollars out of the $2.5 billion dollar state general fund budget? That is more than one third of the budget. That represents:

- The entire kindergarten through university education budget; or
- All health, social services, and public protection programs combined.

Budget cuts also affect the state’s economy. When we cut state spending we also lose all the federal matching funds. On average, for every million dollars we cut from the state general fund budget, we lose $900 thousand in federal funds. [1] We also lose jobs and income for Alaskans. Scott Goldsmith at ISER estimates that every million dollars in state spending, on average, supports ten public sector jobs, eight private sector jobs, and $800 thousand dollars in personal income for Alaskans.

Notes

1. For operating programs the match averages one federal dollar for every $2 in state funds. For capital projects, the match averages 7 federal dollars for every state dollar spent.
Will economic development solve the fiscal problem? Under the current tax structure, no. We can develop our natural resources and expand our state’s industries and employment, but it won’t solve the $900 million dollar fiscal gap.

Compared to oil, revenues from our other industries are quite small. In fiscal year 2001, fishing, timber, minerals, and all other industries combined generated $114 million dollars in state revenues. Even if we could double revenues from these industries, it would fill less than one sixth of the deficit. [1]

Notes:
1. Alaska’s resource industries are also hard pressed economically. Alaska is a high cost producer, and the salmon, timber and mining industries are all suffering from low prices on world markets. We cannot expect to raise significant revenues from these industries. In fact, these industries do not even pay for themselves. The state pays more to manage our fisheries, lands, wildlife, minerals, and timber than we receive from them.
How much does a new private sector job cost government?

“Alaska disconnect” -- new jobs cost state and local governments more than they generate in tax revenues.

| State and local government costs of new job: | $6,300 |
| State and local revenues from new job: | $5,200 |
| Net cost to governments for a new job: | $1,100 |

Notes: Calculation assumes the new job is in Anchorage and does not require any new public infrastructure. The disconnect would be larger under other assumptions.

Sources: ISER map database; ISER calculations

Economic development also increases government costs. Development brings jobs and population growth to Alaska. The jobs support families, and families need roads, schools and other public services. Except for oil, industries in this state do not pay enough in taxes to pay for the public services their employees require.

For example, a new job in Anchorage where the costs of public services are relatively low, costs the state and local governments an average of $6,300 per year in public services. This includes state operating expenditures for education and transportation and all local government functions. A new job in Anchorage brings in only $5,200 per year in property taxes, business taxes and fees. So the net cost to government grows by $1,100 for each new job created in Anchorage. The cost to government per job is even greater for development in the remote areas of Alaska where public infrastructure is lacking.

Other states solve this problem with broad based income or sales taxes that bring in additional revenues as population and income grow.

Notes:
These calculations are based on 1999 and 2000 data. For details, see http://citizensguide.uaa.alaska.edu/11.BUDGET_FAQs/11.1.1_AK_Disconnect_Detail.htm
What about using earnings from the Permanent Fund? The Permanent Fund has two parts: the Principal and the Earnings Reserve. This chart shows money flows to and from both parts of the fund. Any of the four cash flows shown in orange could be used to fund state government without touching the principal of the Permanent Fund. First, oil royalties over and above the constitutionally required minimum could be deposited to the General Fund instead of to the Permanent Fund principal. Second, retained earnings—the earnings left over after dividends and inflation-proofing are paid—could be spent instead of re-invested. Third, the share of earnings going to dividends could be reduced to increase the share available for state government. And fourth, the share of earnings going to inflation-proofing could be reduced to increase the share available for state government.

Notes:
If the legislature appropriated retained earnings—the “surplus” earnings after inflation proofing and dividends are paid—to the general fund instead of depositing them to the principal or earnings reserve of the Permanent Fund, it would provide on average about $300 million per year toward filling the state budget gap without directly affecting dividends.
There is a pending proposal from the Alaska Permanent Fund Corporation to re-structure the permanent fund as an endowment. This is a much simpler and more conventional structure with all the fund money in a single pot. The available income from the fund each year to pay dividends and for other public purposes would be calculated as five percent of the average market value of the fund. This is the structure used by most college and foundation endowments.

This simple structure with no distinction between principal and earnings protects the value of the whole fund over time. Historically, investment earnings average about 8%. If 3% is held in reserve to cover the effects of inflation, that leaves 5% available as annual income, in perpetuity.

The current income formula is written into the Alaska Constitution. Changing it will require a vote of the people.
The major advantage of the percent of market value formula is that it is more stable and predictable. This graph from the Alaska Permanent Fund Corporation shows annual Permanent Fund income over the last twenty years calculated under the current formula, shown in blue, compared with the proposed percent of market value formula, shown in violet. You can see that the current formula has steep peaks and valleys, while the percent of market value formula is gently rolling. You can also see that the average over time is about the same.
POMV features

◆ Built-in inflation-proofing averages 3%
◆ 5% limit on spending
◆ Fund will continue to grow from deposits of new oil and mineral revenues

Two other differences between the current formula and the proposed percent of market value formula are that under percent of market value inflation proofing is automatic over time, not discretionary, and spending is capped at 5%. [1] Under either formula, the fund will continue to grow not only from investment earnings, but also from future deposits of oil and mineral rents and royalties as required by the Alaska Constitution.

Notes:
1. Under the current formula, it is up to the legislature each year to appropriate money from the earnings reserve back to the principal of the fund to cover the effects of inflation. Under the percent of market value approach, inflation proofing is automatic: it is built in to the formula. With an 8% average return on investments and a 5% cap on spending, an average of 3% per year is retained in the fund to cover inflation. Currently the legislature has authority to spend all of the realized earnings, which could be much higher than the proposed 5% cap, depending on fund earnings and transactions.
What will happen to dividends if we adopt the POMV formula?

What will happen to Permanent Fund Dividends if we change the formula? This is an unsettled political question. We could appropriate more for dividends or less for dividends than we do now. But whatever the allocation, with percent of market value, dividends will be more stable and predictable over the years than with the current formula.

In this graph, the pink line shows projected dividends under the current formula. Dividends will be lower in the next few years due to the downturn in the stock market in 2001-02. But we expect them to go up again as the market improves. The blue line shows dividends under the percent of market value formula with a 50/50 split between dividends and other uses. This formula promises more stable dividends that are higher for the next two years, but not as high later in the decade. With a 50/50 split, dividends would be similar to this year and grow slowly.

But dividends could be higher or lower than this, depending on how we allocate the available Permanent Fund income between dividends, state spending and other uses. The green line, for example, shows the POMV calculation with 75 percent of the payout distributed as dividends and 25 percent reserved for other purposes. Any allocation is possible. And there is a direct tradeoff between the amount available to fill the state fiscal gap and the amount available to pay dividends.

A 50/50 split would add about $600 million per year in revenue for the state. This would fill the projected state fiscal gap next year, but with a steadily growing fiscal gap it won’t be enough two years from now. We’ll need another $350 million by the end of the decade.
How much would households lose with dividend reductions?

After Tax Effects of Reducing Dividends
$541 per person=$350 million in state revenues

<table>
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<th>Household Income</th>
<th>Lost PFD income per person</th>
<th>Amount of PFD foregone</th>
<th>Amount net of federal income taxes</th>
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<td>$800</td>
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median income = $52,000

How much would it cost us out of pocket if we reduce dividends to pay for state government? While every Alaskan would forego the same amount of dividend, the net effect on our families would be quite different. A four person family will lose twice as much as a two person family. Also, since Alaska Permanent Fund Dividends are taxed by the federal government, reductions in dividends will reduce Alaskans’ federal taxes. The higher the federal tax bracket, the larger the savings in federal taxes. As a result, if dividends are reduced, higher income families will lose less income than lower income families of the same size.
The most popular reason for adopting a sales or income tax would be to fund public services without eliminating the dividend. But there are other sound reasons for adopting a broad based tax as part of the state’s fiscal plan. Foremost among them is the fact that only a sales or income tax will generate revenues that grow in proportion to the public costs of economic development. Taxes linked to population and income growth cure the development disconnect.

Broad based taxes such as sales or income taxes are economically efficient. The broader the tax base, the lower the tax rate required to raise a given amount of revenue. The lower the tax rate, the less effect taxes will have on people’s working and spending decisions.

Broad based taxes are a more stable and predictable revenue source than oil taxes. Diversifying state revenues and stabilizing state spending helps stabilize the Alaska economy and improve the investment climate. A comprehensive fiscal plan with a broad based tax will secure the state’s bond rating and reassure businesses that they will have the public services they count on, will not be suddenly faced with major new taxes, and will not face an economic downturn precipitated by massive budget cuts.
How much each taxpayer would have to pay under a sales tax depends on many things: the details of the tax plan, the particulars of each taxpayer’s family size and consumption habits and other circumstances. To illustrate the general principles, this graph shows a typical sales tax covering goods and services but excluding rent, utilities, prescription drugs and education expenses. You can see that higher income families tend to pay more in sales taxes because they spend more. But it is not proportional: A family with twice the median income pays about a third more in taxes.
How much each taxpayer would have to pay under an income tax depends on many things: the details of the tax plan, the particulars of each taxpayer’s family size, their mix of income and deductions, and other circumstances. To illustrate the general principles, this graph shows a typical state income tax based on a flat percentage of federal taxable income. Since state income tax payments are deductible from federal taxable income, tax payers who itemize their federal tax returns pass a share of their state income tax liability onto the federal government. The dotted line shows the amount households would pay before federal taxes, while the solid line shows the net amount after their federal tax offsets. The average tax savings-- the gap between the lines-- increases with income not only because the federal tax rates are higher, but also because more people itemize deductions, and the amount of deductions they claim also tends to increase with income.

Notes:
If the state tax were a flat percentage of the federal tax liability, it would be more progressive: the line would get steeper with income because federal tax rates are higher for upper income brackets. If the state tax were a flat percentage of federal Adjusted Gross Income, with no exemptions or deductions, the tax liability would be strictly proportional to income.
The graph shows tax liability, measured in dollars, as a function of income. You can see that people in the lower half of the income distribution pay the most with dividends cuts and the least with income taxes. People in the high income brackets pay the most with an income tax and the least with dividend cuts. Sales taxes fall in the middle.

In the 2000 Census, the median or middle household income in Alaska was about $52,000 dollars per year. The graph shows that for the same amount of state revenue raised, more than half of all Alaskan households would pay less tax under an income tax than under a sales tax or dividend cuts.
Economists usually measure tax incidence not in dollars, but as a percentage of total income. Measured this way, the difference between a sales tax, an income tax and reductions in dividends is more dramatic.[1] Reductions in permanent fund dividends, shown in blue, would be the most regressive: the average tax burden is a declining percentage of income as household income rises. Dividend reductions are regressive because dividends represent a much larger proportion of household income for Alaskans in the lower half of the income distribution.

Sales taxes, shown in pink, are regressive because higher income households spend a higher percentage of their income on untaxed items such as education, travel, home mortgages, and savings.

Income taxes, shown in green, are progressive: the average tax burden is a rising percentage of total income. [2]

The most common arguments for and against income and sales taxes concern fairness. Some people think that a sales tax is more fair, because everyone pays.[3] Others think an income tax is more fair, because the tax is in proportion to ability to pay. Both points of view have a long tradition and are philosophically defensible. Fairness is in the eye of the beholder.

Notes:
1. Dividend reductions and income taxes are shown net of federal tax offsets.
2. The tax shown here is a flat percentage of federal taxable income and is mildly progressive. If the state income tax was keyed to federal tax liability, it would be more progressive: the average tax burden would be a rising percentage of income. If the state tax was a flat percent of adjusted gross income before exemptions or deductions, it would be a perfectly flat tax: neither regressive nor progressive.
3. Fewer than three percent of Alaska households have no federal taxable income.
Another dimension of fairness is horizontal equity: for families with the same income, who should pay more: larger families or smaller families? If you say larger families should pay more taxes because they use more public services, you subscribe to the benefits theory of taxation. If you say larger families should pay less in taxes because they have less disposable income, less income per person to pay for basic necessities, then you subscribe to an ability to pay theory of taxation. Larger families of course would pay a lot more in reduced dividends than in sales or income taxes compared with smaller families.
How much would non-residents and the federal government pay under dividend reductions or a sales or income tax? This chart compares the proportions of total revenue collected. The blue sections show the taxes paid-- or dividends foregone-- by Alaska residents. The yellow sections in the bars show the taxes collected from non-residents. For a general sales tax, about 10% of tax revenues would be collected from non-residents visiting Alaska. For an income tax, about 7% would come from non-residents working in the state. The blue and white hatched section is the amount of the reduced federal tax liability. For dividends foregone, this is the corresponding amount of foregone federal tax liability. For state income taxes, this is the value of itemized deductions on federal taxes. Overall, about 20 percent of dividends foregone and about 14 percent of state income tax collections would ultimately be paid by the federal government.

The total amount of taxes paid by Alaska residents is less for an income tax than for a sales tax or dividend cuts.

Notes:
Estimates of nonresident shares come from the Alaska Department of Revenue, Revenue Sources, Spring 2002.
Summary of Economic Impact

Comparing dividend reductions, income and sales taxes raising the same amount of revenue:

◆ Income taxes would keep more money in the Alaska economy
◆ A majority of Alaskan households would pay less with income taxes
◆ Retirees and large families would pay less with income taxes
◆ The in-state economic multiplier would be higher with income taxes

To summarize, comparing the economic impact of sales and income taxes is straightforward. For identical amounts of state revenue raised, an income tax would bring more money into the Alaska economy than a sales tax. This is primarily because of the federal tax offset.

It is also because with income taxes more retirees and more of their retirement income would stay in the state. Retirees typically pay less in income taxes than in sales taxes because withdraws from savings and many sources of retirement income, including a portion of social security income, are exempt from federal taxable income. Sales taxes on the other hand increase the cost of living for retirees.

A majority of households pay less in income taxes than sales taxes. The more progressive the tax, the larger is the majority of households that would be better off under an income tax.

The less money Alaskans pay out in taxes the more money Alaska households have to spend on other things. Low income households spend more of their after-tax income in-state than high income households. The dollars they spend turn over more times in the state’s economy and support more local jobs.
Where can I go for more information?

- For comprehensive information, look for ISER’s Citizen’s Guide to the Budget Web site: [http://citizensguide.uaa.alaska.edu/](http://citizensguide.uaa.alaska.edu/)
- For current budget numbers see the Legislative Finance Web site: [http://www.legfin.state.ak.us/](http://www.legfin.state.ak.us/)
- For revenue projections and analysis see Revenue Sources at: [http://www.tax.state.ak.us/SourcesBook/SOURCES.htm](http://www.tax.state.ak.us/SourcesBook/SOURCES.htm)
- For a copy of this presentation go to: [http://www.iser.uaa.alaska.edu/](http://www.iser.uaa.alaska.edu/)

Thank you for caring enough about the issues to spend time at this educational forum. I will do my best to answer any questions that you may have. For questions I can’t answer, I will refer you to ISER.

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