Presentation to House Finance Committee

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February 10, 2017

Managing 4 key Alaska assets

1. Oil and gas resources

2. Financial assets (Permanent Fund, ER, CBR, etc.)

3. Physical infrastructure

4. Human capital

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.

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.

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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?

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.

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.

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.

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.

Tax policy 101

Broad and low

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.”

Tax Policy 102

Equity and efficiency are often in conflict in tax policy.

Regressive vs. Progressive

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

- Progressive: <u>percent</u> of income paid in tax <u>increases</u> as income increases.

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.)

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.)

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.

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.

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

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.

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.

State and Local Spending

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

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.

Elements of a multi-year fiscal plan

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?

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Short run impacts: Taxes & PFD (jobs per $100 million)

Change	Estimated impact
Flat income tax	544 to 786
Progressive income tax	544 to 786
Sales tax, more exclusions	477 to 775
Sales tax, fewer exclusions	482 to 798
Property tax	463 to 773
Dividend cut	558 to 892

Short run impacts: Spending cuts (jobs per $100 million)

Change	Est. impact range
Spending cuts targeted at:	
--Worker force reduction	1414 to 1677
--Capital budget	775 to 931
--Across-the-board pay cut	459 to 727
--"Across the board" cuts	980 to 1200