HB

258

INTRODUCED:
REFERRED:

Original sponsors: Hayes and Szymanski

IN THE HOUSE BY THE FINANCE COMMITTEE

2d CS FOR SS FOR HOUSE BILL NO. 258 (FINANCE)

IN THE LEGISLATURE OF THE STATE OF ALASKA

THIRTEENTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act establishing a special investment tax credit; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. LEGISLATIVE FINDINGS AND INTENT. The legislature finds and declares that

(1) there exist areas of the state south of the Arctic Circle in which the factors of established population centers, established infrastructure, access to ice-free ports, and substantial uncommitted reserves of natural gas combine to provide an optimum basis for gas processing development for an export market;

(2) devlopment of gas processing facilities in the areas will minimize adverse population and environmental impacts on the other areas of the state;

(3) development of gas processing facilities in the areas will promote full and stable employment, promote the creation of export markets for the natural energy resources of the state, and promote the long-term development of other natural resources in the state;

(4) it is in the statewide public interest, and is declared to be a public purpose, to promote the prosperity and general welfare of all citizens of the state by stimulating the development of gas processing facilities in such areas;

(5) it is further in the statewide public interest, and is declared to be a public purpose, to promote the exploration, drilling of wells, development, and mining of minerals and other natural deposits (other than oil and gas) in the state, to assist the state by diversifying its economy, to make it less dependent on oil and gas, provide increased employment opportunities and provide an incentive for investment in the state; and

(6) the establishment of a special investment tax credit is necessary in order to promote and accomplish the objectives listed in (1) - (5) of this section.

* Sec. 2. AS 43.20.021(d) is amended to read:

(d) Where a credit allowed under the Internal Revenue Code is also allowed in computing Alaska income tax, it is limited to 18 percent for corporations of the amount of credit determined for federal income tax purposes which is attributable to Alaska. This limitation shall not apply to the credits allowed by AS 43.20.036(j) and (k).

* Sec. 3. AS 43.20.036 is amended by adding new subsections to read:

(j) For purposes of calculating income tax payable under under this chapter the taxpayer may apply as a credit against a tax liability 100 percent of the investment credit allowed as to federal taxes under § 38 of the Internal Revenue Code (26 U.S.C. § 38) on the full amount of qualified investment put into use south of the Arctic Circle in the state for each taxable year for gas processing facilities; for the purposes of this para-

graph, "gas processing facilities" means plants and facilities for processing any product, other than crude oil, of an oil or gas well, to produce liquefied natural gas, methanol or urea, excluding any pipelines from oil and gas wells to any plants and facilities. The amount of credit allowed under this subsection shall be subject to the limitations imposed by (b) of this section, except that the amount of qualified investment will not be limited to the first $20,000,000 of qualified investment. Any credit which is allowed under this subsection shall not also be allowed under (b) of this section. No credit shall be allowed under this subsection for any investment credit which is allowed as to federal taxes for leased property by reason of § 168(f)(8) of the Internal Revenue Code (26 U.S.C. § 168(f)(8)).

(k) For purposes of calculating income tax payable under this chapter the taxpayer may apply as a credit against a tax liability 100 percent of the investment credit allowed as to federal taxes under § 38 of the Internal Revenue Code (26 U.S.C. § 38) on the full amount of qualified investment put into use in the state for each taxable year for exploration, drilling of wells, development, or mining of asbestos, bauxite, block steatite talc, celestite, chromite, coal, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, peat, quartz crystals (radio grade), rutile, sulphur, uranium, zircon, or the ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, copper, gold, iron, lead, lithium, manganese, mercury, molybdenum, nickel, platinum and platinum group metals, silver, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc; for the purpose of this subsection, "mining" has the meaning given in § 613(c)(2) of the Internal Revenue Code (26 U.S.C.

§ 613(c)(2)). The amount of credit allowed under this subsection shall be subject to the limitations imposed by (b) of this section, except that the amount of qualified investment will not be limited to the first $20,000,000 of qualified investment. Any credit which is allowed under this subsection shall not also be allowed under (b) of this section. Credit shall not be allowed under this subsection for any investment credit which is allowed as to federal taxes for leased property by reason of § 168(f)(8) of the Internal Revenue Code (26 U.S.C. § 168(f)(8)).

* Sec. 4. This Act applies to qualified investments made after December 31, 1983 and before January 1, 1990.

* Sec. 5. This Act takes effect immediately in accordance with AS 01.10.070(c).

Alaska State Legislature

BETTYE FAHRENKAMP, Chairman
ROBERT H. ZIEGLER, SR., Vice Chairman
DICK ELIASON
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Senate

Committee on Resources

MEMO

To: Senate Resources Committee

From: Senate Resources Staff

Date: May 15, 1983

Subject: HB 258

Attached is a proposed Senate Resources Committee Substitute for HB 258 which establishes a special investment tax credit.

The main provisions of the proposed committee substitute are:

(1) A special state investment tax credit is allowed for gas processing projects. This special credit will be equal to 100% (currently 18%) of the federal investment tax credit. This credit will be allowed on the first $250 million of qualified investment in the state.

(2) A special state investment tax credit is allowed for exploration, drilling of wells, development and mining of mineral resources. This special credit will also be equal to 100% of the investment tax credit. The credit will be allowed on the first $250 million of qualified investment in the state.

(3) The full special investment tax credit will be allowed on the first one million dollars of state liability. On amounts in excess of one million dollars in state tax liability, 50% of the credit can be used to offset state corporate tax liability.

DRAFT

For an Act entitled: "An Act establishing a special investment tax credit; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. LEGISLATIVE FINDINGS AND INTENT. The legislature finds and declares that

(1) development of gas processing facilities in the state will promote full and stable employment, promote the creation of export markets for the natural energy resources of the state, and promote the long-term development of other natural resources in the state;

(2) it is in the statewide public interest, and is declared to be a public purpose, to promote the prosperity and general welfare of all citizens of the state by stimulating the development of gas processing facilities in the state;

(3) it is further in the statewide public interest, and is declared to be a public purpose, to promote the exploration, drilling of wells, development, and mining of minerals and other natural deposits (other than oil and gas) in the state, to assist the state by diversifying its economy, to make it less dependent on oil and gas, provide increased employment opportunities and provide an incentive for investment in the state; and

(4) the establishment of a special investment tax credit is necessary in order to promote and accomplish the objectives listed in (1) - (3) of this section.

* Sec. 2. AS 43.20.021(d) is amended to read:

(d) Where a credit allowed under the Internal Revenue Code is also allowed in computing Alaska income tax, it is limited to 18 percent for corporations of the amount of credit determined for federal income tax purposes which is attributable to Alaska. This limitation shall not apply to the credits allowed by AS 43.20.036(j) and (k).

*Sec. 3. AS 43.20.036 is amended by adding new subsections to read:

(j) For purposes of calculating income tax payable under this chapter the taxpayer may apply per taxable year as a credit against a tax liability 100 percent of the investment credit allowed as to federal taxes under Internal Revenue Code Section 38(26 U.S.C. 38) on the first $250 million of qualified investment put into use in the state for a gas processing project. For the purposes of this, "gas processing project" means the integrated plant, facilities and equipment, including but not limited to facilities and equipment used for conditioning, extraction, fractionation, storage, handling and pollution control, for preparation of consumer or transportation gas, or for processing any product, other than crude oil, of an oil or gas well, into liquified natural gas, casinghead gas or fabricated petrochemical products, including but not limited to methanol, ammonia, urea, olefins, propanes, butanes, polymers and intermediate hydrocarbon products, but excluding any pipelines from oil and gas wells to or from any plants and facilities. The amount of credit allowed under this subsection shall be subject to the limitations imposed by (b) of this section, except that the amount of qualified investment will not be limited to the first $20,000,000 of qualified investment and shall not be subject to the limitation imposed by AS

43.20.021(d). No credit shall be allowed under this subsection for any investment credit which is allowed as to federal taxes for leased property by reason of section 168(f)(8) of the Internal Revenue Code (26 U.S.C. 168(f)(8).

(k) For purposes of calculating income tax payable under this chapter the taxpayer may apply per taxable year as a credit against a tax liability 100 percent of the investment credit allowed as to federal taxes under Internal Revenue Code Section 38 (26 U.S.C. 38) on the first $250 million of qualified investment put into use for a project in the state for each taxable year for exploration, drilling of wells, development, or mining of the minerals, wells and other natural deposits listed in Section 613(b) of the Internal Revenue Code (26 U.S.C. 613 (b)); for the purpose of this subsection, "mining" has the meaning given in Section 613(c)(2) of the Internal Revenue Code (26 U.S.C. 613 (c)(2)). The amount of credit allowed under this subsection shall be subject to the limitations imposed by (b) of this section, except that the amount of qualified investment will not be limited to the first $20,000,000 of qualified investment and shall not be subject to the limitation imposed by AS 43.20.021(d). Credit shall not be allowed under this subsection for any investment credit which is allowed as to federal taxes for leased property by reason of Section 168(f)(8) of the Internal Revenue Code (26 U.S.C. 168 (f)(8)).

* Sec. 4. The credit applied under subsections (j) and (k) shall be applied as follows: (a) to an amount of up to one hundred percent of the initial one million dollars of tax liability, and (b) to an amount not in excess of 50 percent of the tax liability in excess of one million dollars. Any unused portion of the credit

shall be subject to the carryforward provision contained in Section 46 (b)(3) of the Internal Revenue Code (26 U.S.C. 46(b)(3)).

* Sec. 5. AS 43.20.036(j) is repealed December 31, 1992.

* Sec. 6. The Department of Revenue may prescribe and publish regulations necessary for the implementation of this Act.

* Sec. 7. This Act takes effect immediately in accordance with AS 01.10.070(c).

CS FOR SPONSOR SUBSTITUTE FOR HOUSE BILL NO. 258 (L&C)

AN ACT ESTABLISHING A SPECIAL INVESTMENT TAX CREDIT.....

Section 1. Legislative Findings &Intent

Discusses the need for development of gas processing facilities, well drilling, development and mining of minerals, diversification, of the economy and the need for providing tax incentives to meet the above objectives.

Section 2. AS 43.20.021 (d) is amended to add that the provisions in (d) shall not apply to the credits allowed under the new subsections provided in Section 3 of this bill.

Section 3. AS 43.20.036 is amended by adding 2 new subsections.

1. AS 43.20.36 (j)
   - Provides that a taxpayer may apply as a credit against a tax liability, 100 percent of the investment allowed as federal taxes on the full amount of qualified investment put to use south of the Arctic Circle for gas processing facilities.
   - Defines gas processing facility
   - Provides that the amount of credit allowed shall not be subject to limitations imposed by (b) ($20,000,000, not counting air plooution equipment) but any credit which is allowed under this subsection shall not also be allowed under (b) of this section.
   - Also does not allow credit allowed as to federal taxes for leased property.

2. Same as above, but applies to exploration and drilling of wells, developing or mining of natural mineral deposits.
   - Identifies wher definition of mining is for the purposes of this subsection.

Section 4. Provides the tax years affected under this bill.

Section 5. Immediate effective date.

NOTE****Language on line 29, pg 2 and line 18, pg 3, sure could be improved.....

Alaska State Legislature

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Senate

Committee on Resources

TO: Senate Resources Committee Members

FROM: Senate Resources Committee Staff

RE: CSHB 258 (L&C) Establishing a special investment tax credit.

DATE: April 28, 1983

HB 258 would provide additional tax credits for gas processing facilities located south of the Arctic Circle and for development of mineral prospects anywhere in the state.

Alaska Statutes currently provide for a tax credit for qualified investments of 1.8% of the amount invested up to the first $20 million of investment each year. The proposed legislation would increase the percentage to 10% (same as federal tax law) and remove the investment ceiling.

The Committee will be receiving testimony on the bill from the Departments of Revenue and Law. Their testimony will address several concerns in the legislation. Some of these concerns are: the constitutionality of excluding development above the Arctic Circle from the investment tax benefits; the loss of State revenue; and whether the investment tax credit would be a stimulus to mineral and gas processing projects in the state.

STATE OF ALASKA

DEPARTMENT OF REVENUE

BILL ANALYSIS

Sponsor Substitute for House Bill No. 258

Title: An Act establishing a special investment tax credit and providing for an effective date.

General Effect of Bill: The Bill would create a special investment tax credit on qualified investments for corporations putting into use gas processing facilities south of the Arctic Circle and corporations engaged in the exploration, drilling of wells, development, or mining of the natural deposits listed in I.R.C. §613(b) south of the Arctic Circle.

Effect on Current Law: Current law provides for an investment credit of 18 percent of the investment credit allowed under the I.R.C. upon the first $20,000,000 of qualified investment put into use in the State for each taxable year. The new Act provides that the investment credit allowed for those corporations subject to the Act shall be the full amount of the investment credit allowed under the I.R.C. with no limit on the amount of qualified investment credit.

Recommendation of Department: The Department of Revenue recommends a thorough study of the effects of the Bill be conducted. The study should include an analysis of the incentive the Bill will provide to the targeted corporations, a review by the Department of Law as to the constitutionality of the geographic limitations of the Bill, the projected revenue impacts to the State. Current Position of Department: The Department is naturally in favor of encouraging the best and highest use of the State's resources but further analysis of the means proposed in the Bill is required before taking a position.

TECHNICAL ASPECTS OF BILL

Section 1: This section of the Bill presents the legislative findings and intent for the Bill. It is found that the development of gas processing facilities south of the Arctic Circle and mineral development is in the best of the interests of the State. Subsection 6 finds that the establishment of the special investment tax credit is necessary in order to promote and accomplish the objectives listed in the first five subsections.

Section 2: Section 2 adds a sentence to AS 43.20.021(d) which effectively states that the Alaska Investment Credit which is normally limited to 18% of the credit allowed under the I.R.C. would not apply to the special investment credit created in the Bill.

Section 3: Section 3 amends AS 43.20.036 by adding subsection (j). The new subsection would provide that the amount of investment credit

allowed on qualified investment put into use south of the Arctic Circle for gas processing facilities is equal to the full amount of the credit under the I.R.C. Whereas the current investment credit is limited to the first $20,000,000 of qualified investment put into use in the State for each taxable year, this section would remove that limitation. The section also defines what constitutes gas processing facilities.

Section 4: Section 4 is similar to section 3 but applies to corporations putting into use investments south of the Arctic Circle for exploration, drilling of wells, development, or mining of the natural deposits listed in §613(b) of the Internal Revenue Code. The section again provides for the credit to equal 100% of the federal investment credit and removes the limitation of the credit being applicable to the first $20,000,000 of qualified investment put into use in the State.

Explanation of Changes from Current law: AS 43.20.021(d) and AS 43.20.036(b) provide for an investment credit equal to 18% of the investment credit allowed as to federal taxes under the Internal Revenue Code on the first $20,000,000 of qualified investment put into use in the State for each taxable year. For example, if a corporation had a qualified investment of $25,000,000 during tax year 1983, it would be allowed an investment tax credit on the first $20,000,000 of that investment. If the federal credit was 10% of the qualified investment, the federal credit would be equal to $2,000,000 and the Alaska credit equal to 18% of that or $360,000. The corporation could then apply that credit to its tax liability for 1983 and reduce its tax payment to the State.

If the investment credit for the corporation is greater than the tax liability before the application of the credit, the corporation can carryback the excess credit to each of the 3 prior taxable years preceding the unused credit year and carryover the excess credit to each of the 15 years following the unused credit year. For example, if the corporation above had a tax liability to the State of $180,000 for tax year 1983 before the application of the credit, the credit would completely eliminate the tax due to the State and leave $180,000 of credit to be carried back or forward and applied to other years.

The Bill would remove the limitation that the credit would be limited to the first $20,000,000 of qualified investment put into use in the state for each taxable year. In addition, the amount of the credit would be equal to the full amount of the credit allowed as to federal taxes under I.R.C. § 38. Returning to the example above, the corporation making $25,000,000 of qualified investment in the State in 1983 would be entitled to an investment credit of $2,500,000. Again, if the 1983 tax liability prior to the application of the credit was $180,000, the corporation would have $2,320,000 of unused credit to carry back and carry forward.

It is important to note that not all of the investment credit given to a corporation as a result of the Bill would be enjoyed on a dollar for dollar

basis. Corporations enjoy a deduction for State taxes in computing their Federal income tax liability. With a tax rate of 46% on taxable income over $100,000, 46¢ out of every dollar saved in Alaska taxes would go to the Federal Treasury. Again using the example above, of the $180,000 credit enjoyed by the taxpayer in 1983, 46% or $82,800 would be paid to the Internal Revenue Service.

The Bill would effectively increase the investment credit on the first $20,000,000 of qualified investment by more than 550%, from 18% of the Federal credit to 100%. It would also allow for the first time, an investment credit on qualified investment in any taxable year which exceeds the $20,000,000. The fiscal impact of the credit would not be limited to the year in which the investment was made, but may have an effect for 3 prior years and 15 subsequent years.

Fiscal Impacts Of Bill: The actual fiscal impacts of the Bill are indeterminable. The impacts are dependent on corporate decisions regarding business investments, the future profitability of mining and gas processing ventures in the State and the number of years in which the investment tax credit could be applied to reduce tax liabilities.

Legal Ramifications: There are several legal problems with the Bill, both in its substance and in its drafting. In the area of substance, the Bill has a geographic limitation, the new credit will only be available south of the Arctic Circle. There would be potential for an equal protection challenge by corporations operating North of the Arctic Circle. The rational basis standard would probably be the standard to be applied in such a challenge and some argument could be made in favor of the distinction for gas processing plants because of the findings in § 1 of the bill however, no findings or intent are supported for the limitation on the exploration, drilling of wells, development and mining of minerals and other natural deposits. The State is currently involved in litigation with $2.3 billion at stake involving the taxation of oil producers and pipeline operators under AS 43.21. The plaintiff taxpayers challenged that tax on the basis of equal protection. To the extent that this Bill would endow a greater benefit on corporations operating south of the Arctic Circle a similar equal protection challenge could be expected from corporations otherwise qualifying for the credit but making investments north of the Arctic Circle.

There are drafting problems in the Bill itself. In §§ 3 and 4 the limitations imposed under AS 43.20.036(b) are deemed not to apply to the new credits. AS 43.20.036(b) contains two limitations: (1) that the investment credit is only available to the first $20,000,000 of qualified investment; and (2) that the qualified investment must be put into use in the State. The Bill should be amended and the applicable sentences changed to read:

> The amount of credit allowed under this subsection shall be subject to the limitations imposed by (b) of this section except that the amount of qualified investment will not be limited to the first $20,000,000.

The Bill incorporates provisions of the Internal Revenue Code by Reference and sometimes problems arise where the Code changes with resulting impacts in Alaska law. For example, the natural deposits for which a corporation must explore, drill develop or mine are listed in § 613(b) of the Internal Revenue Code. That subsection has been amended several times since its first enactment and will probably be subject to further amendments. The Drafter has cited P.L. 89-809 and P.L. 88-571 as parallel authority, however, those Public Laws merely amended § 613(b) rather than listed the deposits currently in § 613(b). The better alternative would be to list those specific deposits which the Bill would encourage the development of through the special investment tax credit.

OTHER CONSIDERATIONS AND ALTERNATIVES TO THE BILL

Mining operations in Alaska are subject to three non-federal taxes, the Alaska Corporation Net Income Tax (AS 43.20), the Alaska Mining License Tax (AS 43.65) and local property taxes. A study by the Department of Commerce and Economic Development compared the mineral tax structure in Alaska with eleven other states. The conclusions were positive: 1) Alaska's tax structure is average compared with the eleven other states in the study and provides a relatively attractive tax environment for mining; 2) Alaska's progressive tax structure is based on net proceeds, superior to gross-proceeds types of taxes because tax rates go down as production declines.

In February, 1983, the Resource Development Council, Inc., along with the Office of Minerals Development, Alaska Department of Commerce & Economic Development, sponsored the International Conference on Coal, Minerals and Petroleum. In Carl Portman's "Executive Summary" for the proceedings of the conference, after recognizing that Alaska' mining activity was at an all time high, noted three obstacles to development of mineral deposits. The major obstacle to development of mineral deposits is the lact of transportation infrastructure. Another problem was that land allocations by the Federal government withdrew much of the State's high potential mineral land and restricted access to other State areas. Taxes were also mentioned, but the problems with taxes arose not out of the present tax structure, which was found to be reasonable, but out of the fear that mining taxes would be increased as the mining industry becomes increasingly productive.

Two out of the three concerns mentioned above are in the jurisdiction of the Alaska legislature, transportation infrastructure and taxation. Improving the transportation infrastructure in the state through the development of more and better roads, access to the railroad, marine shipping facilities and airports would benefit and encourage the industry with no leakage to the Federal Government such as that created by State tax credits. Improved transportation infrastructure also benefits the non-mining sectors because the high costs of transportation in the State are borne by every Alaskan who buys anything from bubble gum to bulldozers.

There are no current problems with taxation other than the fear that the structure might change with the success of mining operations. The non-petroleum mineral developers have not been blind to the fact that the severance tax

rates have increased and there have been changes in the corporation income tax since oil was first discovered at Prudhoe Bay. Though the opportunity to change tax structures presents itself at each legislative session, persons seeking to develop mineral deposits must forecast the future economic climate and decide whether the changes can be weathered and the mine remain profitable.

A tax credit, such as that proposed in the Bill could partially insulate the miner to the extent that carryover credits would reduce the liability in future years. However, because of the federal leakage, a tax credit is a mixed blessing, providing little more than half of the benefit to the miner compared to the cost to the State in lost revenue. Whereas the State has been able to support its operations largely through taxes on the petroleum industry, oil prices are dropping and current reservoirs are being depleted; lost revenues in other tax types correspondingly taken on greater significance.

For the tax years 1978, 1979 and 1980 corporate income taxes on mining businesses constituted between 6 1/2% and 10% of the total non-petroleum corporate net income tax collections. In turn, total non-petroleum corporate income tax collections were slightly more than 3% of the revenues from petroleum corporations. Because revenue estimates based on petroleum production are decreasing, the non-petroleum corporations will be contributing a greater proportion of total State revenues. In 1980, the mining industry was the fifth largest corporate income tax group of taxpayers in the non-petroleum sector.

The conclusion of this analysis is that tax benefits granted the non-petroleum sector should be carefully scrutinized to ensure that the costs to State revenue do not exceed total benefits to the State. Other incentive mechanisms, such as improvement of the transportation infrastructure, as above, or other incentives, such as those described below, should be examined to see which alternatives score higher under a cost versus benefit analysis.

One alternative would be a mineral development loan program. State funds or bond proceeds could be used to finance mineral development, or for that matter, gas processing facilities, without affecting tax revenue. The rates could be favorable and would directly benefit the mineral developer without Federal leakage. Loan applications could be reviewed within legislative guidelines to encourage the highest and best use of the State's natural resources, the interest would partially fund the operation of the program, and the developer would enjoy interest deductions for both State and Federal purposes. Either the current or a modified investment credit provision would supplement the tax benefits from such a loan program.

Another alternative would be to enact legislation similar to the Alaska Industrial Incentive Act, AS 43.25, or adopt industrial incentive tax credits such as those previously found in AS 43.26. The advantages of those alternatives over the investment credit approach in the Bill are that the effect on revenue to the State would be for a known period of time, and that businesses able to benefit from the tax exemptions would be selected by a State agency within legislative guidelines which encourage mineral development and construction of gas processing facilities.

SUGGESTIONS FOR IMPROVING THE PRESENT BILL

1. Remove the geographic limitations in the Bill. Development of gas processing facilities and State resources would be beneficial without regard to the region of development. Major oil companies have mining and gas processing interests and would be likely to raise a constitutional challenge to a geographic limitation.

2. Either keep the present limit on qualified investment or keep the current 18% of the Federal limit on the amount of the credit. The State has the potential of having 19 years of fiscal impact from an investment tax credit, the year it arises, 3 prior years and 15 subsequent years. Anything to make the impact predictable will aid the budget process.

3. Limit the number of years to which the investment credit could be carried backward or forward. As stated above, the Internal Revenue Code provides for 3 years back and 15 forward. A shorter period of time would be in the State's best interest.

4. Specifically list the minerals which the State wishes to encourage the development of rather than refer to the code. For example, the code lists gravel in the referenced section; is this a mineral the legislature wishes to subsidize with an investment tax credit?

5. Research whether the Bill would actually reach the desired results. Is an investment credit really going to make a difference in development decisions?

SUMMARY

This Bill seeks to encourage investing in gas processing facilities and certain mining activities south of the Arctic Circle through special investment tax credits. The special investment tax credits differs from the current credit in that there is no limit to the amount of qualified investment and the credit is equal to the full amount of the Federal credit. The new credits would have fiscal impacts on the tax year in which they arise and may have an effect in 3 prior and 15 subsequent years.

The legislature should explore the actual effectiveness of the proposed credit and whether other programs would reach the desired end more directly without such fall-out effects such as Federal leakage and unpredictability of future State revenue.

STATE OF ALASKA
FISCAL NOTE

Revision Date 4/11, 1983

I. REQUEST

Bill/Resolution No: CSSSHB 258 (L&C)
Title: Special Investment Tax Credit
Sponsor: Hayes & Szymanski
Requestor: Labor, Commerce & Finance

II. FISCAL DETAIL

Agency Affected: Revenue
Program Category Affected: Coll. & Mgmnt
BRU, Program of Subprogram(s) Affected:

EXPENDITURES/REVENUES: (Thousands of Dollars)

		FY 83	FY 84	FY 85	FY 86	FY 87	FY 88
	OPERATING						
100	PERSONAL SERVICES	-	-	-	-	-	-
200	TRAVEL	-	-	-	-	-	-
300	CONTRACTUAL	-	-	-	-	-	-
400	COMMODITIES	-	-	-	-	-	-
500	EQUIPMENT	-	-	-	-	-	-
600	LANDS & STRUCTURES	-	-	-	-	-	-
700	GRANTS, CLAIMS, ETC.	-	-	-	-	-	-
	TOTAL OPERATING	-	-	-	-	-	-
	CAPITAL	-	-	-	-	-	-
	REVENUE	-	-	-	-	-	-

FUNDING: (Thousands of Dollars)

	GENERAL FUND	-	-	-	-	-	-
	FEDERAL FUNDS	-	-	-	-	-	-
	OTHER (Specify Source)	-	-	-	-	-	-
		-	-	-	-	-	-

POSITIONS:

	FULL-TIME	-	-	-	-	-	-
	PART-TIME	-	-	-	-	-	-
	TEMPORARY	-	-	-	-	-	-
		-	-	-	-	-	-

III. SOURCE OF FUNDS TO OFFSET FISCAL IMPACT OF BILL:

IV. ANALYSIS: Attach a separate page for any Analysis.

Prepared By: Vincent D. Wright
Phone: 465-273
Division: Revenue - Research
Date: 4/7/83

Approved by Commissioner: Jeff O'Keefe
Date: 4/11/83
Department: Revenue

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IV. Analysis of CSSSHB 258

The incorporation of this expanded credit in effect would reduce state taxes as a deductible item at the federal level and thus increase the federal tax take.

The impact of this bill is negative to the state in terms of lost revenues. The quantitative impact cannot be assessed due to carry forward and carry backward provisions which vary from one existing operation to another. If the bill is intended for new facilities, the effect cannot be assessed until they are completed and in operation.

Alaska State Legislature

Speaker of the House of Representatives

Pouch V
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Official Business

SPECIAL INVESTMENT TAX CREDIT LEGISLATION

As projections of declining revenue loom in Alaska's near future, we must begin to diversify our economy so that both state government and local economies are not so heavily dependent on oil derived revenues. I have introduced legislation which would accomplish this goal by establishing a special investment tax credit. Such a credit would apply for investments to develop gas processing facilities South of the Arctic Circle and to investments for exploration, development and mining of minerals other than oil and gas throughout Alaska. A major priority of both myself and the House Majority is diversification of our economy. I believe enactment of this legislation would go a long way towards achieving that goal.

Currently state law limits the amount of investment tax credit (ITC) which is allowed to corporations in computing their Alaska income taxes to 18% of the amount of investment tax credit which is allowed for federal income tax purposes. So while the Federal ITC is 10%, the Alaska investment tax credit is only 1.8%. Current law also limits the ITC which is allowed in computing Alaska income taxes to the first $20 million of qualified investment put into use in the state for each taxable year. That limitation would be removed by this bill.

The Alaska tax credit would only apply to investments which also qualify for the federal credit. This is primarily personal proprty such as trucks, machinery and manufacturing equipment.

It would not include roads, buildings, mine sites and such things as feasibility studies. Using the $1 billion Quartz Hill mine project for example, a very limited amount of that development would qualify for the tax credit. But enough of an incentive would be created to attract industry to Alaska that currently is lacking.

The promotion of exploration, development and mining of minerals and other natural deposits in the state will encourage development of Alaska's non oil and gas mineral resources. This legislation would also accelerate the diversification of the state's economy and employment base.

One new addition to this legislation, not included in the version which passed the House last session, is inclusion of gas processing facilities South of the Arctic Circle. There are areas in Alaska where established infrastructure, access to ice free ports and substantial amounts of uncommitted reserves of natural gas combine to provide great potential for gas processing development and export activity. The development of these gas processing facilities will promote full and stable employment and minimize adverse population and environmental impacts.

I expect the impact on state revenues upon enactment of this legislation would be minimal. While initially there would be be a slight loss of revenue, the long range goal to promote investment and development would increase non petroleum related revenue in future years. The investment tax credit is a temporary tax reduction directly tied to profitable investment that will produce increased revenues in the future. Additionally, investments in targeted industries may substantially expand local governments sales and property tax bases. If the Prudhoe bay curve is accurate, and oil revenues begin to decline in the late 1980's, it is our responsibility to plan to offset that decline. I am confident it will have the support of the administration, which has stated a desire to reach this goal as well.

# # # # # # #

Alaska State Legislature

Speaker of the House of Representatives

Pouch V
State Capitol
Juneau, Alaska 99811
(907) 465-3720

Official Business

MEMORANDUM

April 27, 1983

To: Senator Bettye Fahrenkamp
Senate Resources

From: Rep. Joe Hayes
Speaker

Re: HB 258

I have been told the Senate resources committee will hear HB 258 re: special investment tax credit on Friday. My staff has given backup on this legislation to your staff. This memo is additional material to be considered.

There were several amendments proposed in the House which were opposed. In anticipation of a similar offering in the Senate, I wish to outline my objections in several areas.

The Department of Revenue wishes to list minerals in the bill which the tax credit would apply to rather than reference the IRS code as the bill now does. For the sake of uniformity and consistency it seems appropriate to maintain the IRS code reference rather than list minerals separately. Investment companies have a legitimate concern in expecting some consistency in taxation policies. In that regard, it makes sense that companies should expect the same provisions of a federal tax credit to apply to a state credit. If the IRS code should at some time delete a mineral that is of benefit to the state, it would be a minor matter to then amend our statutes. I think it most prudent to maintain the current reference as the bill does.

I also have some problems with any type of a sunset provision which may be proposed. Many developments, especially in mining are long term projects of 30 years or more. I think a sunset could discourage potential investment. Investors should not be under the threat of a sunset provision which would terminate the consitions under which an investment was originally made.

If, at some time, it is determined the tax credit is no longer accomplishing the goals for which it is intended, it would be possible for a future legislature to terminate the credit. I think this would be a more beneficial attitude than including a sunset clause which could still cause uncertainty and borderline investors to hold off from committing to an Alaskan investment.

There was a proposal to define gas processing facilities as those which produce only urea, methane and liquified natural gas. The bill now defines them as facilities which produce but are not limited to the production of those items. A facility can produce over one hundred by-products. I do not feel we should withhold the credit from production of the byproducts which may also be of benefit.

Finally, this bill is aimed at encouraging investment and jobs in three major areas...coal mining, general mineral development and gas processing. These areas will likely result in the greatest number of jobs in Alaska. While I am not specifically opposed to credits in other areas, I think the bill should be restricted to the areas it now addresses at this time. Further credits should be examined on their own merits and potential.

Thank you for your consideration and I encourage the committee's quick action on this important legislation.

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y · STATE CAPITOL
JUNEAU, ALASKA 99811
907-465 3800

M E M O R A N D U M April 11, 1983

SUBJECT: Equal protection analysis of HB 258

TO: Representative Albert P. Adams
Chairman, House Finance Committee
Attn: Louann Cutler

FROM: Richard C. Folta
Legislative Counsel

I have reviewed the "constitutionality of geographic classification in the investment tax credit bill" memorandum by Cook Inlet Region, Inc., concerning the above referenced bill. I concur in their view that the proposed legislation does not violate the constitution.

The Alaska Supreme Court has a more rigorous equal protection requirement than the U.S. Supreme Court, as elicited in State v. Erickson, 574 P.2d 1 (1978), as follows:

> . . . must look to the purpose of the statute, viewing the legislation as a whole, and the circumstance surrounding it. It must be determined that this purpose is legitimate, that it falls within the police power of the state, Examining the means used to accomplish the legislative objective and the reasons advanced. Therefore, the court must then determine whether the means chosen substantially further the goals of the enactment. Finally, the state interest in the chosen means must be balanced against the nature of the constitutional right invaded.

There are five purposes mentioned for the investment tax credit in HB 258, all of which are legitimate and proper. However, only the first purpose relates to why the credit is to be in effect only south of the Arctic Circle. All the other purposes are just as compelling for facilities north of the Arctic Circle. In my opinion the first purpose is constitutionally sufficient to sustain the goal of the

proposed enactment. The state interest in encouraging development south of the Arctic Circle where ice-free ports are available near established population centers appears to outweigh the tax discrimination that would be in effect on industries north of the Arctic Circle.

RCF:ljb
14-004

CIRI COOK INLET REGION INC.

Inter - Office Memorandum

TO: Lance Anderson, Vice President, Finance

SCA

FROM: Steve Hillard, Vice President and General Counsel

Date: March 28, 1983

Subject: CONSTITUTIONALITY OF GEOGRAPHIC CLASSIFICATION IN INVESTMENT TAX CREDIT BILL

You have asked for a review of the constitutionality of a geographic distinction contained in an bill drafted by CIRI and introduced in the Alaska State Legislature. The legislation will grant certain investment tax credits to those gas processors located south of the Arctic Circle. The question presented is whether this type of classification, based on geography, violates the United States or Alaska Constitutions.

Based upon a review of pertinent federal and state authorities, it is my view that the proposed legislation does not violate the United States or Alaska Constitutions.

I. Federal Constitutional Issues

It is useful to note at the outset that there is one significant constitutional provision which does not appear to apply to the proposed tax credit. The United States Constitution provides that all taxes levied by Congress shall be uniform throughout the United States. U.S. Const. Art. 1, Section 8. The United States Supreme Court has consistently interpreted this requirement to mean geographic uniformity. Knowlton v. Moore, 178 U.S. 41 (1900); Steward v. Davis, 301 U.S. 494 (1938). Under this interpretation, distinctions among the states are impermissible. Thus, the United States District Court for the District of Wyoming has recently held that the Crude Oil Windfall Profits Tax Act of 1980 is unconstitutional because it exempts oil produced from north of the Arctic Circle. Ptasynski v. United States, 82-2 USTC Para. 9654 (D.C. Wyo. 1982). The court noted that although rational justifications for the exemption do exist, the exemption is specifically forbidden by the Constitution. In short, the court appeared to hold that geographic distinctions are per se unconstitutional. The United States Supreme Court recently has determined to review this distinction.

In light of these precedents, it would appear that if Congress were to enact the proposed bill, the bill would run a strong risk of being held unconstitutional. The federal uniformity provision, however, by its terms applies only to acts of Congress, not acts of the states. Generally it has been held, for example, that there is nothing in the United States Constitution which requires state taxation to be uniform. See Carmichael v. Southern Coal Co., 301 U.S. 495 (1937). Thus, the proposed legislation does not violate the uniformity clause of the United States Constitution.

It is also possible to assert that the legislation violates the Equal Protection Clause of the Fourteenth Amendment. It might be contended, in other words, that the proposed legislation impermissibly discriminates against gas processors

located north of the Arctic Circle. The United States Supreme Court, however, has consistently held that where state "taxation is concerned and no special right, apart from equal protection, is imperiled, the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation." Lehnhauser v. Lake Shore Auto Parts, 410 U.S. 356 (1973); State Board of Tax Comm'rs of Indiana v. Jackson, 283 U.S. 527 (1931). The appropriate test to be applied to state taxation schemes is whether the state classification has a "rational basis" or whether it is "palpably arbitrary" or "capricious." Id. If "any state of facts reasonably can be conceived" to justify a classification, the Court will sustain it.

Applying the foregoing principles to the proposed legislation, it appears that the Supreme Court would uphold the classification. Although not in the context of a taxation case, the Supreme Court has specifically stated that the "Equal Protection Clause relates to equality between persons as such rather than between areas . . . . Territorial uniformity is not a constitutional requisite." Salsburg v. Maryland, 346 U.S. 545 (1954). In the tax area, the Court has upheld a state tax which provided for different tax rates based on the "gravity" of certain oil and which arguably discriminated between oil produced in Northern and Southern Louisiana. Ohio Oil Co. v. Conway, 228 U.S. 146 (1930). The Court held that the classification based on "gravity" was not unreasonable. Although not directly on point, since the case did not involve a specific geographic distinction, Conway does confirm that the Court will apply a relaxed standard of review to state taxation schemes and that all areas of a state need not have an equal tax burden.

A number of lower courts have specifically addressed state tax classifications based on geography. These courts have held that "distinctions based on geographical areas are not, in and of themselves, violative of the Fourteenth Amendment." Levy v. Parker, 346 F.Supp. 877 (E.D. La. 1972); McCarthy v. Jones, 449 F.Supp. 480 (S.D. Ala. 1973) (no "rational basis" for different tax rates for different counties); Weissinger v. Boswell, 330 F.Supp. 615 (M.D. Ala. 1979) (same). These courts have explained that a state "must demonstrate, if it wishes to establish different classes of property based on different geographical locations -- e.g., rural areas as opposed to urban areas -- that the classification is neither capricious nor arbitrary but rests upon some reasonable consideration of difference or policy." Id.

The question thus remains whether the justification asserted for the geographic classification in this case -- to encourage the location of a certain industry in a certain region of the State -- is sufficient to sustain the classification. Although I have not found a case directly on point, the Supreme Court has suggested that tax classifications designed to create incentives for business to locate within a state are permissible. In Allied Stores of Ohio v. Bowers, 358 U.S. 522 (1959), the Court stated that a tax statute which "encourages the location within the state of needed and useful industries by exempting them, though not also others, from its taxes is not arbitrary and does not violate the Equal Protection Clause of the Fourteenth Amendment." The same rationale would appear to apply equally well to the proposed legislation here, since it is designed to encourage location of a business in a particular part of the state.

II. Alaska Constitutional Issues

There are at least three potential issues under the Alaska Constitution. First, the legislation might violate an implied requirement of "equality and uniformity" of all state taxes. Second, the legislation might violate the Equal Protection Clause found in the Alaska Constitution, Article I, Section 1, which has been interpreted somewhat differently from the Equal Protection Clause of the Fourteenth Amendment. Third, the legislation might constitute a "local or special act" prohibited by Article II, Section 19 of the Alaska Constitution. Let me address the first two issues together, since they are interrelated.

It is necessary to begin with a bit of background. The vast majority of state constitutions embody some provisions for "uniform or equal" taxes. There is, however, no such provision in the Alaska Constitution. The general rule appears to be that in the absence of express provision in the state constitution, it is not essential that state tax statutes operate equally and uniformly. See generally 84 C.J.S. 2d. Taxation, Section 21 (discussing authorities). However, at least one court has held that the principle of uniformity in taxation applies even in the absence of an explicit constitutional provision. See, e.g., Commissioners of Sinking Fund of City of Louisville v. Ohio Valley Grocery Store Co., 240 S.W. 2d 56 (Ky.). Thus, there is at least some possibility that a court might imply a uniformity requirement in the Alaska Constitution.

This possibility is further complicated in the State of Alaska. Although the Constitution of the State of Alaska nowhere requires state taxes to be uniform, Section 9 of the Organic Act of Alaska, 48 U.S.C. Section 28, provides that "all taxes should be uniform upon the same class of subjects." Under the Organic Act, the courts have interpreted the requirement of uniformity to require geographic uniformity. In Hess v. Mullaney, 91 F.Supp. 139 (D.C. Alaska 1950), reversed on other grounds, 189 F.2d 417 (9th Cir. 1950), the court considered whether Alaska's first property tax violated the uniformity requirement of the Organic Act. The property tax levied a tax on all properties in the state, provided that if the property was located within an incorporated city, town or school district, that entity should assess and collect the tax. Plaintiff claimed that the tax was unlawful, since property would be taxed differently depending on where it was located. The District Court agreed, reasoning that classifications may not be based on geographical lines or mere location of the property.

This view was somewhat modified in a successor case, Hess v. Mullaney, 102 F. Supp. 430 (D.C. Alaska 1952), affirmed, 213 F.2d 635 (9th Cir. 1954). Although the court ultimately upheld the property tax, it acknowledged that "unquestionably, systematic geographical discriminations in the burdens of taxation have been held void." The court found, however, that "we assume that the uniformity clause of the Organic Act requires the same measure of uniformity or equality which is required by the Equal Protection Clause of the Fourteenth Amendment." The court held that under the "rational basis" test, it was reasonable for the legislature to have cities assess and collect taxes for property within their jurisdiction.

In light of the foregoing, a strong argument can be made that a separate and distinct "uniformity" requirement no longer exists in Alaska. First, the Alaska Constitution does not provide for uniformity. The Organic Act is a mere act of Congress, and, whatever its continuing effect in light of Alaska statehood, it

probably adds little to the provision of the Alaska Constitution. Second, even if the uniformity requirement of the Organic Act is still controlling, the Ninth Circuit in Hess v. Mullaney held that the Alaska uniformity requirement is no stricter than the equal protection requirement.

A recent case, State v. Reefer King Co., Inc., 559 P.2d 56 (Alas. 1976), support this view and is particularly relevant to this case. The case involved the constitutionality of a state tax which drew a distinction between "floating" and "shore-based" fish processors. Because the tax placed a higher tax rate on floating processors, the floating processors claimed that the statute created an illegal classification under the State equal protection clause. The Alaska Supreme Court rejected that contention. Although the classification could in one sense be deemed to be a "geographical" classification, the Court did not even mention the Hess v. Mullaney cases. Instead, the Court held that the classification should be tested against the State's equal protection analysis, which provides that a statutory classification must

> "be reasonable, not arbitrary, and must rest upon some ground of difference having fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced, shall be treated alike."

The Court held that the classification reflected a legislative judgment that shore-based processors make a more valuable contribution to the State's local economies than the floating processors. According to the Court, it is not arbitrary for the legislature to conclude that shore-based processors were to be preferred over floating processors, which distributed economic benefits over several locations. And, in important language for the present issue, the Court concluded that

> "The state may legitimately encourage, through tax incentives or exemptions, industries or types of industries which it considers desirable, and this method of encouragement does not deprive other taxpayers, who do not qualify for the benefit, of equal protection of the laws.

Two additional points should be made with respect to Reefer King. First, the case strongly supports the notion that the State of Alaska may make a classification in order to encourage businesses to locate in a particular area. A primary reason for CIRI's proposed legislation, of course, is to encourage gas processors to locate south of the Arctic Circle. Second, the equal protection test adopted by the Alaska Supreme Court is somewhat more demanding than the test used in interpreting the Equal Protection Clause of the Fourteenth Amendment. The Alaska test, for example, requires the classification to bear a "fair and substantial" relation to the purpose of the statute, rather than merely a "reasonable" relationship. More significantly, under the Alaska test, unlike the federal test, the courts will "no longer hypothesize facts which would otherwise sustain questionable litigation." Isakson v. Rickey, 550 P.2d 359 (1975). This means that in order to survive constitutional scrutiny, the proposed legislation must clearly articulate the purpose of the legislation and the rationale for the geographic classification. The rationale for the geographic classification is expressly contained in the investment tax credit bill.

There is one final issue. Article II, Section 19 of the Alaska Constitution provides that the "legislature shall pass no local or special act if a general act can be made applicable." In this case, it could be argued that the proposed legislation is a local or special act in that it favors a particular region of the State.

It is doubtful that the proposed legislation constitutes a local or special act. In Baucher v. Engstrom, 528 P.2d 456 (Alas. 1974), the Alaska Supreme Court stated that "legislation does not become local merely because it operates only on a limited number of geographical areas rather than on a statewide geographical basis. A legislative act may affect only one of a few areas and yet relate to a matter of statewide concern or common interest." Accord, Abrams v. State, 534 P.2d 91 (Alas. 1975); State v. Lewis, 559 P.2d 630, cert denied, 432 U.S. 901 (1977) (upholding the land exchange between CIRI, the United States and Alaska). Thus, to the extent the proposed legislation is a matter of statewide concern, which we believe it is, the proposed legislation is permissible.

More significantly, the Alaska Supreme Court in State v. Lewis held that the test for determining what constitutes "local or special" acts is substantially the same for determining what violates the State equal protection clause. If the equal protection standard is satisfied, "the legislation will not be invalid because of incidental local or private advantages." Id. In terms of our case, then, the crucial issue is whether the proposed legislation violates the State standard of equal protection. If not, Article II, Section 19 will not pose a problem.

SCH:lw

BEFORE THE SENATE RESOURCES COMMITTEE

LEGISLATURE OF THE STATE OF ALASKA

PREPARED STATEMENT

OF

WAYNE B. ALLRED

ASSISTANT CONTROLLER OF TAXES FOR

NORTHWEST ALASKAN PIPELINE COMPANY

HOUSE BILL NO. 258

APRIL 29, 1983

MY NAME IS WAYNE B. ALLRED. I AM THE ASSISTANT CONTROLLER OF TAXES FOR NORTHWEST ALASKAN PIPELINE COMPANY ("NORTHWEST"), WHICH IS THE AGENT AND OPERATOR FOR THE ALASKAN NORTHWEST NATURAL GAS TRANSPORTATION COMPANY. NORTHWEST, ON BEHALF OF THE PROJECT SPONSORS, HOLDS THE AUTHORIZATION TO CONSTRUCT A PIPELINE IN ALASKA TO TRANSPORT GAS FROM PRUDHOE BAY TO THE CANADIAN BORDER, AT WHICH POINT THE CANADIANS WILL FURTHER TRANSPORT THE GAS TO THE BORDER OF THE LOWER 48 STATES. NORTHWEST HAS RECEIVED NUMEROUS APPROVALS AND ENDORSEMENTS FOR THE PROJECT, WHICH IS OFFICIALLY TERMED THE ALASKA NATURAL GAS TRANSPORTATION SYSTEM (ANGTS). IN 1977, THE PRESIDENT OF THE UNITED STATES OFFICIALLY DESIGNATED THE ANGTS AS THE PREFERRED SYSTEM TO DELIVER ALASKA'S NORTH SLOPE GAS TO THE CONTINENTAL UNITED STATES, AND THE UNITED STATES CONGRESS RATIFIED HIS DECISION THAT SAME YEAR. ALSO DURING 1977, THE FEDERAL ENERGY REGULATORY COMMISSION ISSUED ITS PRELIMINARY APPROVAL, AND THE CANADIAN GOVERNMENT AND ITS NATIONAL ENERGY BOARD ENDORSED THE ANGTS PROJECT. IN DECEMBER OF 1981, THE U.S. CONGRESS VOTED TO APPROVE THE INCLUSION OF A GAS PROCESSING FACILITY IN THE PREVIOUSLY APPROVED GAS TRANSPORTATION SYSTEM. THIS GAS PROCESSING FACILITY IS TO BE CONSTRUCTED ON ALASKA'S NORTH SLOPE AT PRUDHOE BAY.

DUE TO THE RECENT RECESSIONARY ECONOMY, THE UPHEAVAL IN THE WORLD OIL MARKET, AND THE CURRENT SUPPLY-DEMAND-PRICING

IMBALANCE IN THE NATURAL GAS INDUSTRY, A DECISION WAS MADE BY THE PROJECT SPONSORS TO DELAY THE CONSTRUCTION OF THE PROJECT. HOWEVER, NORTHWEST AND ITS PARTNERS, ALONG WITH THE THREE PRODUCERS WHO OWN THE VAST MAJORITY OF THE PRUDHOE BAY GAS, ARE CONVINCED THAT THE FACTORS CAUSING THE DELAY ARE TEMPORARY AND THAT THIS NATION WILL HAVE AN ULTIMATE NEED FOR THE ALASKAN NORTH SLOPE NATURAL GAS. THEY ARE, THEREFORE, CONTINUING TO PROVIDE THE FUNDS NEEDED FOR THE ACTIVITIES NECESSARY TO MEET THE REVISED SCHEDULE FOR COMPLETION.

THE PROJECT SPONSORS ARE CONTINUING TO EXAMINE ALTERNATIVES FOR MARKETING THE GAS AND FINANCING THE PROJECT. AS YOU KNOW, IN THE PAST, WE HAVE OFFERED THE STATE AN OPPORTUNITY TO INVEST IN THE PROJECT. WE HAVE NEVER, TO THIS DATE, REQUESTED THAT THE STATE SUBSIDIZE THE PROJECT -- ONLY THAT IT CONSIDER MAKING AN INVESTMENT WITH A REASONABLE RATE OF RETURN TO ASSIST A PROJECT WHICH WILL HAVE SIGNIFICANT BENEFITS FOR CITIZENS OF ALASKA. HOUSE BILL NO. 258, HOWEVER, WHICH IS CURRENTLY BEFORE YOU, SEEKS SOMETHING ENTIRELY DIFFERENT. THE BILL PROPOSES TO ESTABLISH A SPECIAL INVESTMENT CREDIT FOR GAS PROCESSING FACILITIES CONSTRUCTED SOUTH OF THE ARCTIC CIRCLE. IT IS, IN FACT, AN INDIRECT STATE SUBSIDY FOR GAS PROCESSING FACILITIES WHICH MAY BE CONSTRUCTED IN THAT GEOGRAPHIC AREA OF THE STATE.

TO GIVE YOU AN IDEA OF THE FISCAL IMPACT OF THIS BILL, LET ME ILLUSTRATE WITH AN EXAMPLE RELATED JUST TO GAS PROCESSING FACILITIES.

IF, UNDER CURRENT ALASKA TAX LAWS, NORTHWEST WERE TO CONSTRUCT AND PLACE IN SERVICE A GAS PROCESSING FACILITY ON THE NORTH SLOPE, COSTING 5 BILLION DOLLARS, IT WOULD RECEIVE AN INVESTMENT CREDIT, OR TAX SUBSIDY, OF ROUGHLY 4 MILLION DOLLARS.

IF A SIMILAR GAS PROCESSING FACILITY WERE CONSTRUCTED SOUTH OF THE ARCTIC CIRCLE, SAY IN THE COOK INLET, AS ENVISIONED UNDER THE TAGS PROPOSAL, THE STATE COULD BE REQUIRED UNDER THIS BILL, TO PROVIDE ROUGHLY $400 MILLION IN TAX CREDITS OR TAX SUBSIDIES TO SUCH A FACILITY. ADDITIONALLY, THE STATE MAY ADDITIONALLY BE REQUIRED TO PROVIDE CREDITS OF SIMILAR MAGNITUDE FOR LIQUIFICATION FACILITIES.

IN CONCEPT, WHILE WE HAVE NOT SOUGHT LEGISLATION OF THIS NATURE, WE DO NOT OPPOSE THE ESTABLISHMENT OF AN INVESTMENT CREDIT CREDIT FOR GAS PROCESSING FACILITIES. IN FACT, WE WOULD SUPPORT THE PROPOSED CREDIT ABSENT ITS UNACCEPTABLE LIMITATION TO FACILITIES WHICH MAY BE LOCATED SOUTH OF THE 160th PARALLEL. H.B. 258 IN ITS PRESENT FORM, IS CLEARLY DISCRIMINATORY, PROBABLY UNCONSTITUTIONAL, AND APPEARS TO BE SPECIFICALLY DESIGNED TO GRANT AN UNWARRANTED PREFERENCE TO THE RECENTLY CONCEPTUALIZED TRANS ALASKA GAS SYSTEM ("TAGS").

THE TAGS PROPONENTS, HOWEVER, HAVE NOT YET EVEN DEMONSTRATED THAT THEIR PROPOSAL IS TECHNICALLY OR ENVIRONMENTALLY SOUND, THAT THERE ARE ANY REAL MARKETS FOR THE GAS, OR THAT CONGRESS WOULD CONSIDER IT A VIABLE ALTERNATIVE TO THE ANGTS.

RECENTLY, YOUR CONSULTANTS, BOOZ, ALLEN AND HAMILTON, ADVISED THE LEGISLATURE THAT ECONOMIC FACTORS WILL DETERMINE WHICH GAS LINE WILL BE BUILT AND WHEN IT WILL BE BUILT. THE CONSULTANTS ADVISED THAT WHILE YOUR ACTIONS COULD DO LITTLE TO HELP EITHER THE ANGTS PROJECT OR THE NEW TAGS PROPOSAL, YOU COULD, THROUGH YOUR ACTIONS, HARM THE PROSPECTS OF EITHER PROJECT. WE DO NOT BELIEVE THAT IT IS THE LEGISLATURE'S INTENT IN THIS BILL TO IMPEDE, DELAY OR HARM THE LIKELIHOOD OF CONSTRUCTION OF THE ANGTS PROJECT. WE, THEREFORE, RESPECTFULLY REQUEST THAT THE ANGTS PROJECT RECEIVE EQUAL TREATMENT IN THE BILL, AND THAT ALL GEOGRAPHICAL REFERENCES LIMITING THE USE OF THE TAX CREDIT, INCLUDING THE DESIGNATION "SOUTH OF THE ARCTIC CIRCLE," BE REMOVED FROM THE BILL. WITHOUT SUCH MODIFICATION, THE REAL MESSAGE YOU WILL SEND TO THE FINANCIAL MARKETS IS THAT YOUR SUPPORT FOR THE ANGTS PROJECT IS SO LUKEWARM THAT YOU ARE WILLING TO GIVE A TAX PREFERENCE, OF THE SORT NEVER OFFERED TO THE ANGTS, TO A MERE CONCEPT -- ONE THAT HAS NOT YET DEMONSTRATED ITS CREDIBILITY AND WHICH HAS NO SUBSTANTIAL SPONSORS, MUCH LESS ANY SOURCE OF THE MAJOR FUNDS REQUIRED.

IN SUMMARY, WE RESPECTFULLY SUGGEST THAT HOUSE BILL NO. 258 BE REVISED TO ELIMINATE ITS GEOGRAPHICAL LIMITATIONS WHICH ARBITRARILY DISCRIMINATE AGAINST ONE REGION OF THE STATE VIS-A-VIS ANOTHER AND UNFAIRLY PROMOTE A RECENT IDEA FOR TRANSPORTATION OF NORTH SLOPE GAS AT THE EXPENSE OF THE ANGTS PROJECT, WHICH IS MUCH MORE THAN AN IDEA. IT IS, IN FACT, A PROJECT WITH OVER SIX YEARS OF WORK, STUDY, GOVERNMENTAL REVIEW, AND LEGAL PROCEEDINGS BEHIND IT; AND ONE IN WHICH ALMOST $500 MILLION HAS ALREADY BEEN INVESTED. MUCH OF THAT MONEY, AS YOU KNOW, HAS BEEN SPENT HERE IN ALASKA.

THANK YOU FOR THE OPPORTUNITY TO PRESENT THESE VIEWS.

Hypothetical Mine - Alaska

David Heatwole - Alaska Miners Assoc.

Senate Resources Comittee

Ball Park Figures

A medium sized high grade mine

Production Rate - 1000 tons / day

Mine Life - 20 years

Capital Investment $ 200 million

Subject to I.T.C 50% - $100 million

Total I.T.C. for project = $10 million.

Annual Net Revenue - $ 35 million

State IC tax at 10% = $3.5 million
Mining License Tax of 7% - $2.5 million

Total Revenue to State

17 years State I.C. Tax = $45 million
17 years Mining License Tax = $40 million

Total = $85 million

Total I.C. Tax Credit $10 million

HB 258

ALASKA MINERS ASSOCIATION, INC.

509 W. Third Ave., Suite 17, Anchorage, Alaska 99501 (907) 276-0347

April 6, 1983

Senator Bettye Fahrenkamp
Alaska State Legislature
Pouch V (MS3100)
Juneau, Alaska 99811

Dear Bettye:

The Statewide Board of Directors of the Alaska Miners Association unanimously passed the attached resolution urging enactment of HB-258. The Alaska Miners Association represents approximately 1600 miners located throughout Alaska.

The Alaska Miners Association believes that the investment tax credits proposed in HB-258 will broaden Alaska's economic base. The people of Alaska are concerned about our state's dependence upon oil revenues and diversification of our state's economy is very important for the long term economic health in Alaska.

Many members of the legislature may be hesitant to consider a tax credit bill in the face of declining oil revenues. However HB-258 is an income-producing bill. It will send a strong signal to investors that Alaska is seriously attempting to attract mineral development and increase exploration and mining activity. The economic benefits accruing to the state will far outweigh the revenues lost by the tax credit.

The initial reduction in revenues by mineral investment would be small, less than ten million dollars annually. The tax credits will make Alaskan mineral investments more competitive on a world wide basis and lead to the establishment of a long term healthy mining industry.

We are asking for your help to obtain passage of this bill and make an investment in Alaska's long term economic future.

Sincerely yours,

ALASKA MINERS ASSOCIATION

Ronald Rosander

Ron Rosander
Vice President

RR/dlw
Attachment

ALASKA MINERS ASSOCIATION, INC.
509 W. Third Ave., Suite 17, Anchorage, Alaska 99501 (907) 276-0347

RESOLUTION - HOUSE BILL 258

Whereas the Alaska Miner's Association desires to foster the development of Alaska's mineral resources and,

Whereas the people of Alaska desire to broaden the economic basis of our state and,

Whereas the Investment Tax Credits proposed in HB-258 would provide financial incentives for the development of minerals in Alaska and indicate the strong support of the State of Alaska for a mining industry.

The Board of Directors hereby resolves to urge the Governor of Alaska, the Speaker of the Alaska State House, the President of the Alaska State Senate and the Chairpersons of House and Senate Resources Committee for expeditious passage of HB-258.

Approved

Fairbanks, Alaska

March 29, 1983

Paul Glavinovich - President

Sandra M. Thomas - Secretary

Department of Revenue
H.B. 258 Example

FACTS

A mining company doing business exclusively in Alaska makes a $500,000,000 investment on January 1, 1984 and a like investment on January 1, 1985.

ASSUMPTIONS

1. 65% of the investment in each year is qualified investment credit property.

   Examples of Qualified Investment Credit property would be:

   a. machinery & equipment
   b. other property which is an integral part of the manufacturing process, eg. silos, elevators, etc.

   Property that does not qualify would be:

   a. real property (other than that which is an integral part of the manufacturing process), eg. warehouses, office buildings, parking lots, etc.
   b. intangible personal property, eg. leases, royalty agreements, etc.

2. The investment produces a 15% pre-tax net rate of return on the new investment in the first year and a constant 7 1/2% pre-tax return thereafter.

3. Federal taxable income from 1981-1992 is $5M per year excluding that income attributable to the new investment.

4. Tax rates and limitations remain constant from 1984-1992.

5. No investments in qualifying property are made after 1985.

2200I

HB 258 Example

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	199
Federal												
Tax. inc. attributable to prior investment[3]	5M	5M	5M	5M	5M	5M	5M	5M	5M	5M	5M	5M
Tax. inc. attributable[2]	-	-	-	75M	75M	75M	75M	75M	75M	75M	75M	75M
Total taxable income	$5M	5M	5M	80M	80M	80M	80M	80M	80M	80M	80M	
Tax before I/C	2,280,750	2,280,250	2,279,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750
I/C before limitation[1]	0	0		32,500,000	32,500,000	0	0	0	0	0	0	0
I/C allowed[A]	1,233,462	1,233,462	0	31,266,538	31,266,530	0	0	0	0	0	0	0
Tax payable	1,047,288	1,047,288	2,279,750	5,513,212	5,513,212	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750
Alaska												
Taxable income	5.5M	5.5M	5.5M	80M	80M	80M	80M	80M	80M	80M	80M	80M
Tax	513,040	513,040	513,040									
Tax before I/C				7,516,000	7,516,00	7,516,000	7,516,00	7,516,00	7,516,000	7,516,00	7,516,000	7,516,00
I/C as computed before limitation				32,500,000	32,500,000							
I/C allowed for fed. purposes				31,266,538	31,266,538							
I/C utilized				(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(3,332,880
Tax payable				0	0	0	0	0	0	0	0	4,183,120
I/C CB from 1984	513,040	513,040	513,040									
Tax payable as adjusted	0	0	0									
Refund to taxpayer	513,040	513,040	513,040									
I/C CF to following year				23,444,880	48,428,880	40,912,880	33,396,880	25,880,880	18,364,880	10,848,880	3,332,880	0

Abbreviations

M - Million
Tax. Inc. - Taxable Income
I/C - Investment credit
Fed. - Federal
CF - Carryforward
CB - Carryback

[A] I/C CB from 1984
[A] I/C CB from 1985
$ - all numbers in dollars

DRAFT

Offered: 4/6/83
Referred: Finance

Original sponsors: Hayes and Szymanski

BY THE LABOR AND COMMERCE COMMITTEE

IN THE HOUSE

CS FOR SPONSOR SUBSTITUTE FOR HOUSE BILL NO. 258 (~~L&C~~ Resources)

IN THE LEGISLATURE OF THE STATE OF ALASKA

THIRTEENTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act establishing a special investment tax credit; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. LEGISLATIVE FINDINGS AND INTENT. The legislature finds and declares that

(1) there exist areas of the state [redacted] in which the factors of established population centers, established infrastructure, access to ice-free ports, and substantial uncommitted reserves of natural gas combine to provide an optimum basis for gas processing development for an export market;

(2) development of gas processing facilities in the areas will minimize adverse population and environmental impacts on the other areas of the state;

(3) development of gas processing facilities in the areas will promote full and stable employment, promote the creation of export markets for the natural energy resources of the state, and promote the long-term development of other natural resources in the state;

(4) it is in the statewide public interest, and is declared to be a public purpose, to promote the prosperity and general welfare of all citizens of the state by stimulating the development of gas processing facilities in such areas;

(5) it is further in the statewide public interest, and is declared to be a public purpose, to promote the exploration, drilling of wells, development, and mining of minerals and other natural deposits

(other than oil and gas) in the state, to assist the state by diversifying its economy, to make it less dependent on oil and gas, provide increased employment opportunities and provide an incentive for investment in the state; and

(6) the establishment of a special investment tax credit is necessary in order to promote and accomplish the objectives listed in (1) - (5) of this section.

* Sec. 2. AS 43.20.021(d) is amended to read:

(d) Where a credit allowed under the Internal Revenue Code is also allowed in computing Alaska income tax, it is limited to 18 percent for corporations of the amount of credit determined for federal income tax purposes which is attributable to Alaska. <u>This limitation shall not apply to the credits allowed by AS 43.20.036(j) and (k).</u>

*Sec. 3. AS 43.20.036 is amended by adding new subsections to read:

(j) For purposes of calculating income tax payable under this chapter the taxpayer may apply as a credit against a tax liability 100 percent of the investment credit allowed as to federal taxes under Internal Revenue Code Section 38 (26 U.S.C. 38 P.L. 87-834) on the first $500,000,000 of qualified investment put into use in the state for each taxable year for gas processing facilities; for the purposes of this paragraph, "gas processing facilities" means plants and facilities for processing any product, other than crude oil, of an oil or gas well, including but not limited to liquefied natural gas, methanol and urea processing plants and facilities, excluding any pipelines from oil and gas wells to any plants and facilities. The amount of credit allowed under this subsection shall not be subject to the limitations imposed by (b) of this section, but any credit which is allowed

under this subsection shall not also be allowed under (b) of this section. No credit shall be allowed under this subsection for any investment credit which is allowed as to federal taxes for leased property by reason of section 168(f)(8) P.L. 97-34 of the Internal Revenue Code (26 U.S.C. 168(f)(8) P.L. 97-34).

(k) For purposes of calculating income tax payable under this chapter the taxpayer may apply as a credit against a tax liability 100 percent of the investment credit allowed as to federal taxes under Internal Revenue Code Section 38 (26 U.S.C. 38 P.L. 87-834) on the full amount of qualified investment put into use in the state for each taxable year for exploration, drilling of wells, development, or mining of the natural deposits listed in Section 613(b) of the Internal Revenue Code (26 U.S.C. 613(b))(P.L. 89-809 and P.L. 88-571); for the purpose of this subsection, "mining" has the meaning given in Section 613(c)(2) of the Internal Revenue Code (26 U.S.C. 613(c)(2) P.L. 85-866). The amount of credit allowed under this subsection shall not be subject to the limitations imposed by (b) of this section, but any credit which is allowed under this subsection shall not also be allowed under (b) of this section. Credit shall not be allowed under this subsection for any investment credit which is allowed as to federal taxes for leased property by reason of Section 168(f)(8) of the Internal Revenue Code (26 U.S.C. 168(f)(8) P.L. 97-34).

* Sec. 4. This Act applies to tax years beginning after December 31, 1983.

*Sec. 5. This Act is repealed December 31, 1993.

*Sec. 6. This Act takes effect immediately in accordance with AS. 01.10.070(c).

STATE OF ALASKA
DEPARTMENT OF REVENUE

M E M O R A N D U M

TO: R. D. Stevenson
Special Assistant

FROM: Robert R. Kessel
Director, Audit Division RK

DATE: April 26, 1982

RE: HB 866 am

The bill would substantially expand the Investment Tax Credit for certain corporations. However, the bill falls short of its intended purpose to promote the development of farming, fishing, timber and mining and, in addition, is potentially very expensive.

I am not aware of any study which supports the conclusion that state income tax credits are a strong encouragement for investment in a particular state. Most studies, in fact, reflect that state income taxes have a low importance ranking when investment appraisals are made. In fact, supply of labor, financing, marketability, supply of raw materials, etc., are of the most relevancy.

Experience has shown that when a social or economic problem arises, often the first - and not carefully considered - answer is to use the tax system, whether the proposal comes from government or the private sector. However, tax credits seldom solve the social or economic problem. In fact, tax credits are useful only to those who have income taxes to pay (profitable) and who can therefore make use of the credits. Those who don't pay taxes - those with sufficient or no tax liability - thus receive no assistance from the tax credit program. If a tax credit were to cover these groups - the ones who really need it - it must be refundable; i.e., paid by the state even in the absence of tax liability, and a refundable credit really involves direct spending or subsidy.

It is questionable whether the Federal Investment Tax Credit has provided businesses the incentive to make investments and whether the credit has provided an accelerator effect on the economy as a whole.

Questions that have been asked at the Federal level include:

1. Does the credit flow through to stockholders in the form of dividends rather than used for capital expenditures?

2. Has the credit been used for foreign investment rather than domestic investment thus exporting more jobs overseas?

3. Has the investment tax credit actually increased investment in capital projects?

These very same questions must be asked if Alaska allows the investment tax credit to the extent of HB 866 am.

The extent of the investment tax credit in HB 866 am appears to be grossly misunderstood. The bill would allow the same amount of investment tax credit as is allowed on the Federal return. This is in spite of the tremendously large differentials in tax liabilities at the two levels. For example, if a taxpayer invested $5,000,000 in qualified investment property with the resulting investment credit of $500,000 (10%), the Alaska taxable income needed to absorb that amount would be about $5,400,000. In other words, not a cent of Alaska income tax would be paid if the corporation had a taxable income of $5,400,000. Conversely, the Federal tax liability on that amount, even with the investment tax credit, would be about $2,000,000

If a corporation invested $50,000,000 in qualified property, the Alaska taxable income needed to absorb the investment tax credit would be in excess of $50,000,000 whereas the Federal tax liability on the $50,000,000 would be about $18,000,000.

Since only profitable companies could utilize the investment tax credit, the reduction in Alaska State Income Taxes resulting from HB 866 am would increase Federal taxable income by a like amount. In essence, up to 46% of what is saved at the State level would simply be transferred to the Federal Government in the form of a higher Federal income tax liability.

In addition, Alaska already has an investment tax credit for all industies but limited to 18% of the Federal Tax Credit and a further limitation of $20,000,000 for qualified property eligible for the credit. The 18% directs itself to the fact that the tax rates are so different; i.e., maximum State rate - 9.4%, maximum Federal rate - 46%.

There are more qualified farmers than there is farmland available. The additional investment tax credit would give the existing farmers additional tax benefits but would do little to expand ownership to a new influx of farmers.

Most timber related companies already have more tax credits and carry-over losses than they can utilize. It is markets that are needed.

For fisheries, all except bottom fishing appears overly crowded. That fact is witnessed by the limited entry system controlling the harvest of fishery resources. Tax credits would not expand the market nor provide higher prices.

Mining, in general, is a highly capital intensive industry. The expanded investment tax credit would serve the purpose of providing almost permanent assurance that no tax would be due because of the fifteen year carry-over provision available for the investment tax credit.

Finally, the expanded credit could be very costly particularly in one instance. If U. S. Borax develops its Ketchikan Molybdenum mine to the extent publicly indicated, the investment tax credit to that corporation could be as high as $100,000,000 (based on investment cost of $1 billion). With the fifteen year carry-over provision for the investment tax credit, the investment tax credit of $100,000,000 could equate to the following revenue loss to Alaska (assuming U. S. Borax had sufficient taxable income to absorb):

Investment Credit applied against tax liability - per current law	
$1,000,000,000	
x 10% Investment Credit amount	
x 18% currently allowed for Alaska corporations	$ 18,000,000
Investment Credit applied against tax liability per this bill	
$1,000,000,000	
x 10%	100,000,000
Net Loss in Revenue	$ 82,000,000

The above assumes that the entire $1 billion would be eligible for the investment tax credit. The portion actually available could vary from 65-100%.

Borax activity will not impact the immediate future fiscally since production from the Ketchikan mine is not anticipated until the late 1980's.

The bill also creates a carry-back problem The investment tax credit can be carried back and would affect prior year taxes. Therefore, in essence, this bill provides for the potential of a refund of past years taxes. This potentially creates a constitutional question.

HB 866 am adds a provision not contained in HB 866. It is as follows:

> "(K) No Credit shall be allowed under (j) of this section for any investment credit which is allowed as to federal taxes for leased property by reason of Section 168(F)(8) of the Internal Revenue Code (26 U.S.C. 168(F)(8))."

One consequence of the Accelerated Cost Recovery System and revisions of the investment tax credit is that many companies are not able currently to use all their tax deductions and credits. In considering potential investments, these companies are at a competitive disadvantage and can become targets for tax-induced takeovers and merges. The Economic Recovery Tax Act of 1981 (ERTA) establishes what is referred to as a safe-harbor for characterizing transactions as leases rather than as sale. A lease transaction permits the lessee-user of property to transfer tax benefits to a lessor-investor, a sale transaction does not. If a lessee-user transfers the tax benefits back to the lessor, the user receives a significant portion of the tax benefits through reduced rental charges.

The new law provides more ease in transferability and its provisions eliminate many of the arguments which often had occurred between the taxpayer and IRS. However, the substantive law regarding lease transactions has not changed as a result of the Economic Recovery Tax Act (ERTA). Procedural law hs changed and provides for the ease in transferability of the tax benefits from lessee to lessor.

Section 2(K) of HB 866 am provides for an unworkable administrative process for the Department of Revenue. The Department does not have the staffing to determine if the pre-ERTA Federal

law provision would have caused a lease arrangement to be considered a sale. The taxpayer, as under pre-ERTA, would obviously class certain transactions as a lease rather than a sale and await our challenge as they previously did with the Federal Government. Therefore, no decrease in the fiscal note developed for HB 866 is foreseen and, if any, would be impossible to determine.

RRK/gb

Alaska State Legislature

SAU 83

Speaker of the House of Representatives

Pouch V
State Capitol
Juneau, Alaska 99811
(907) 465-3720

Official Business

HB 34

SPECIAL INVESTMENT TAX CREDIT LEGISLATION

As projections of declining revenue loom in Alaska's near future, we must begin to diversify our economy so that both state government and local economies are not so heavily dependent on oil derived revenues. I have introduced legislation which would accomplish this goal by establishing a special investment tax credit. Such a credit would apply for investments to develop gas processing facilities South of the Arctic Circle and to investments for exploration, development and mining of minerals other than oil and gas throughout Alaska. A major priority of both myself and the House Majority is diversification of our economy. I believe enactment of this legislation would go a long way towards achieving that goal.

Currently state law limits the amount of investment tax credit (ITC) which is allowed to corporations in computing their Alaska income taxes to 18% of the amount of investment tax credit which is allowed for federal income tax purposes. So while the Federal ITC is 10%, the Alaska investment tax credit is only 1.8%. Current law also limits the ITC which is allowed in computing Alaska income taxes to the first $20 million of qualified investment put into use in the state for each taxable year. That limitation would be removed by this bill.

The Alaska tax credit would only apply to investments which also qualify for the federal credit. This is primarily personal property such as trucks, machinery and manufacturing equipment.

It does not include roads, buildings, mine sites and such things as feasibility studies. Using the $1 billion Quartz Hill project for example, a very limited amount of that development would qualify for the tax credit. But enough of an incentive would be created to attract industry to Alaska that currently is lacking.

The promotion of exploration, development and mining of minerals and other natural deposits in the state will encourage development of Alaska's non oil and gas mineral resources. This legislation would also accelerate the diversification of the state's economy and employment base.

One new addition to this legislation, not included in the version which passed the House last session, is inclusion of gas processing facilities South of the Arctic Circle. There are areas in Alaska where established infrastructure, access to ice free ports and substantial amounts of uncommitted reserves of natural gas combine to provide great potential for gas processing development and export activity. The development of these gas processing facilities will promote full and stable employment and minimize adverse population and environmental impacts.

I expect the impact on state revenues upon enactment of this legislation would be minimal. While initially there would be be a slight loss of revenue, the long range goal to promote investment and development would increase non petroleum related revenue in future years. The investment tax credit is a temporary tax reduction directly tied to profitable investment that will produce increased revenues in the future. Additionally, investments in targeted industries may substantially expand local governments sales and property tax bases. If the Prudhoe bay curve is accurate, and oil revenues begin to decline in the late 1980's, it is our responsibility to plan to offset that decline. I am confident it will have the support of the administration, which has stated a desire to reach this goal as well.

# # # # # # #

The distinction of areas north + south of the Arctic Circle has some reason historical.

exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) Percentage depletion rates.—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

(2) 23 percent—

(A) sulfer and uranium; and

(B) if from deposits in the United States—anorthosite clay, laterite, and nephelite syenite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc.

(3) 15 percent—

(A) metal mines (if paragraph (2) (B) does not apply), rock asphalt, and vermiculite; and

(B) if neither paragraph (2) (B), (5) or (6) (B) applies, ball clay, bentonite, china clay, sagger clay, and clay used or sold for use for purposes dependent on its refractory properties.

(4) 10 percent—asbestos (if paragraph (2) (B) does not apply), brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

(5) 7½ percent—clay and shale used or sold for use in the manufacture of sewer pipe or brick, and clay, shale, and slate used or sold for use as sintered or burned lightweight aggregates.

(6) 5 per cent—

(A) gravel, peat, pumice, sand, scoria, shale (except shale described in paragraph (5)), and stone, (except stone, [illegible] in paragraph (7));

(B) clay used, or sold for use, in the manufacture of drainage and roofing tile, flower pots, and kindred products; and

(C) if from brine wells—bromine, calcium chloride, and magnesium chloride.

(7) 15 percent—all other minerals (including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (2) (B) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc, including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water, or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

(c) Definition of gross income from property.—For purposes of this section—

(1) Gross income from the property.—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) Mining.—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(3) Extraction of the ores or minerals from the ground.—The term "extraction of the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or min-

The depletion allowance bears little relationship to capital investment and continues as long as minerals are extracted, even though no money is actually invested in mineral deposit. Id.

Where taxpayer had no capital investment in city-owned gravel quarry and all equipment and machinery used in extraction of aggregate was removable and was not specially designed, taxpayer agreed to pay the city royalty on the aggregate mined and gained the advantage of having the source of aggregate close to its construction project at price substantially less than it would pay elsewhere and taxpayer's return on its investment and the extraction of the aggregate was realized not from the sale of the aggregate, but upon the profits, if any, derived from street paving contract with the city, taxpayer had economic advantage rather than economic interest and taxpayer was not entitled to depletion deduction. Hissler & McMurry Co. v. U. S., D.C.Wyo. 1972, 342 F.Supp. 432.

§ 312. Basis for cost depletion

Supplementary Index to Notes

Constitutionality ½

½. Constitutionality

This section and regulation dealing with cost or substituted basis to be used in calculating depletion deduction available in determining charitable organization's net investment income are not violative of U.S.C.A.Const. Amend. 16. Real Foundation v. U. S., C.A.Tex.1977, 550 F.2d 350.

2. Determination of basis

Where jury was not given chance to determine from conflicting testimony as to whether smaller size of previous sales of mineral rights rendered them noncomparable to sales by closely held corporation to its stockholders, new trial was required to determine comparability of previous sales as basis for valuation. Green v. U. S., C.A.Miss.1972, 460 F.2d 412.

Taxpayers' proportionate shares of the amortized cost of access logging roads were capital in nature constituting part of the adjusted depletion basis of the timber sold, thereby reducing the capital gain derived from the sale of the timber, and were not deductible as ordinary and necessary business expenses. Casey v. U. S., 1972, 459 F.2d 405, 198 Ct.Cl. 232.

Corporate taxpayer whose principal business activity consisted of acquisition, ownership and management of surface lands and coal thereunder, in computing and determining its deduction for depletion, should have been allowed to equitably apportion actual cost between land overlying coal, and remainder of farmland for which taxpayer was required to pay premium price in order to acquire right to strip acres under which there was coal, although taxpayer had burden of establishing by competent evidence proportionate cost or value of each portion of the land as of date of purchase. Beaver Dam Coal Co. v. U. S., C.A.Ky. 1966, 370 F.2d 414.

In paying Minnesota ad valorem taxes and taxes on royalties, taxpayer-corporation which was lessee of mineral properties in fact defrayed an obligation of the lessor, so that such taxes were a part of the rent or royalties and consequently were deductible from the base for computation of depletion allowance by lessee taxpayer-corporation. U. S. Steel Corp. v. U. S., D.C.N.Y.1967, 270 F. Supp. 253, affirmed 445 F.2d 520, certiorari denied 92 S.Ct. 940, 941, 405 U.S. 917, 30 L.Ed.2d 786.

§ 613. Percentage depletion

(a) General rule.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) Percentage depletion rates.—The values, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 23 percent—

(A) sulphur and uranium; and

(B) if from deposits in the United States—anorthosite, clay, laterite, and nepholite syenite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead lithium, manganese, mercury, molybdenum, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium tungsten, vanadium, and zinc.

(2) 15 percent—if from deposits in the United States—

(A) gold, silver, copper, and iron ore, and

(B) oil shale (except shale described in paragraph (5)).

(3) 14 percent—

(A) metal mines (if paragraph (1)(B) or (2)(A) does no apply), rock asphalt, and vermiculite; and

(B) if paragraph (1)(B), (5), or (6)(B) does not apply ball clay, bentonite, china clay, sagger clay, and clay used o sold for use for purposes dependent on its refractory properties

(4) 10 percent—asbestos (if paragraph (1)(B) does not apply) brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

(5) 7½ percent—clay and shale used or sold for use in the manufacture of sewer pipe or brick, and clay, shale, and slate used or sold for use as sintered or burned lightweight aggregates.

(6) 5 percent—

(A) gravel, peat, pumice, sand, scoria, shale (except shale described in paragraph (2) (B) or (5)), and stone except stone described in paragraph (7));

(B) clay used, or sold for use, in the manufacture of drain age and roofing tile, flower pots, and kindred products; and

(C) if from brine wells—bromine, calcium chloride, and magnesium chloride.

(7) 14 percent—all other minerals, including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(B) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water, or mosses;

(B) minerals from sea water, the air, or similar inexhaustible sources; or

(C) oil and gas wells.

For the purposes of this subsection, minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake within the United States shall not be considered minerals from an inexhaustible source.

(c) Definition of gross income from property.—For purposes of this section—

(1) Gross income from the property.—The term "gross income from the property" means, in the case of a property other than an oil or gas well and other than a geothermal deposit, the gross income from mining.

Cook Inlet Region, Inc. supports passage of the attached investment tax credit legislation because we believe:

First, that the bill will encourage critical additional investments into the State of Alaska's mining industries. By encouraging investment in this presently marginal industry through a temporary tax decrease the State is encouraging the private sector to accelerate the diversification of the State's economy and employment base.

Second, we believe passage of this bill sends a clear policy signal that the State is interested in participating and encouraging the mining industry by rewarding successful capital investment in the State.

Some of the most common questions asked regarding an investment tax credit in the State are answered as follows:

WHO QUALIFIES FOR THE TAX CREDIT?

All corporations paying Alaska corporate income taxes to the State could utilize the special tax credit to the extent they invest in qualified investment tax property in the mining industry.

WHAT IS "QUALIFIED INVESTMENT TAX PROPERTY?"

Qualified investment tax property is primarily tangible personal property, i.e., trucks, manufacturing equipment, etc. It does not include roads, buildings, mine sites, feasibility studies, overhead, etc. In a development project the amount of qualifying property will only be a part of the total investment in the project.

HOW IS THE INVESTMENT TAX CREDIT COMPUTED?

First, the amount of the actual investment in qualifying property by a corporation is determined. Then the property is grouped by useful lives and the following percentages are multiplied times the property basis:

0 to 3 Years	-0-
3 to 5 Years	-1/3-
5 to 7 Years	-2/3-
Excess of 7 Years	-All-

The result is then multiplied by 10% to determine the tax credit.

For example, if a $10,000 truck having a 6-year useful life was purchased and used in a mining project, $6,667 of the basis would qualify and the amount of the credit would be $667. The $667 could then be used to reduce the corporate income tax due on the company's profits.

WHAT IMPACT WOULD THIS BILL HAVE ON PROJECTIONS OF STATE REVENUES?

The bill should have a very minimal impact on current projections of State revenues. At present, only minimal amounts are being invested in the mining industry by tax paying corporations. If the passage of this bill succeeds in its intended purpose of increasing the investment in these resources, the fiscal impact on State revenues of the bill should be positive rather than negative. Additionally, investments in the mining industry could substantially expand local governments' sales and property tax bases.

WON'T THE STATE LOSE $82,000,000 ALONE ON THE U.S. BORAX DEVELOPMENT?

Certainly not. This erroneous calculation, which was raised concerning a similar bill last year, was made by assuming all of U.S. Borax's proposed one billion dollar investment would fully qualify for the tax credit. Obviously the substantial portion of U.S. Borax's investment will be for non-qualifying property such as roads, buildings, housing and the mine development itself.

Only a li.ited amount will be expended on the actual mining equipment which would qualify for the special investment tax credit.

ISN'T THIS BILL JUST ANOTHER SUBSIDY TO A SPECIAL INTEREST?

The investment tax credit is not a subsidy but rather a temporary tax reduction directly tied to profitable investment. The impact of the bill is beyond any special interest because of the broad impact it hopefully will have on industries that are Statewide.

WHY IS CIRI SO INTERESTED IN THE PASSAGE OF THIS BILL?

CIRI's interest in passage of this bill is directly related to the company's experiences in attempting to develop its natural resource base including Beluga coal, Seldovia chrome and other hardrock possibilities. When ANCSA passed in 1971 there was great optimism about releasing the "great wealth" held by the Native lands to the Regional Corporations, the stockholders and indirectly to the State economy. To date, to the best of our knowledge, there is not one major subsurface estate development underway on Native lands. The primary reasons for this are:

1. the delay in transfer of the lands.
2. the long lead times necessary to locate and develop mineral properties.
3. the costly infrastructure required and the decline in metal prices.
4. the lack of adequate capital by the Native Corporations for the tremendous investments required, and therefore the need to locate and negotiate major joint venture partners with the expertise and capital necessary.

This bill assists in overcoming some of the problems with attracting capital and convincing joint venture partners of the positive State policy towards development.

WON'T AN INVESTMENT DECISION BE MADE IRREGARDLESS OF A TAX CREDIT?

This is an academic argument that has been debated for twenty years since John F. Kennedy introduced the first investment tax credit in 1961. Since that

time the investment tax credit has been expanded and used on a Federal tax basis to encourage investment in

(1) Historical buildings rehabilitation
(2) Business energy saving devices
(3) Research facilities
(4) Single purpose agriculture structures
(5) Pollution control facilities

Currently discussion is underway to extend the investment tax credit to rehabilitation of the central business core of many of America's larger cities. Based on the continued expansion of the tax credit, it is reasonable to conclude that the investment tax credit is an effective tool to encourage additional investment in targeted areas.

HOUSE LABOR AND COMMERCE COMMITTEE

TESTIMONY OF DAVE HEATWOLE

for

HOUSE BILL 258

April 5, 1983

My name is Dave Heatwole and I am here to represent Alaska's mining industry. I am Chairman of the State Oversight Committee of the Alaska Miners Association, representing some 1,600 miners from large and small companies, and I have spent my entire professional career in the mining industry.

I believe all of you can agree with me that most Alaskans are very concerned about broadening out state's economic base. Why are we so dependent upon oil revenues? What are we going to do when the oil runs out?, are questions frequently asked by Alaskan public forums. What I would like to do today is give you some idea what the future mining industry could do for Alaska's economy and tell you why House Bill 258 is important to stimulate mining activity in our state.

Historically mining has always been important to Alaska -- The discovery of gold at the turn of the century led to Alaska's first great economic boom. Hard rock mining became active in the early 1900's with the development of the Kennecott and Alaska-Juneau mines. Mining was the mainstay of Alaska's economy until men and material restrictions of the second world war forced the closure of Alaska mines. After the war placer gold mining revived and is a significant part of Alaska's current economy. During 1982, the placer mining employed approximately 3,000 Alaskans and contributed approximately $250 million to the state's economy.

In the late 1960's - early 70's, a few major mining companies returned to Alaska to begin mineral exploration programs. These companies returned to Alaska to begin mineral exploration programs, because foreign expropriations and pending domestic mineral shortages-made domestic mineral investments much more attractive. Alaska offered the United State's last great unexplored frontier. This recent mineral exploration activity has produced a few major mineral discoveries which have announced plans to be in production before 1990:

- The Red Dog Deposits in Delong Mts., North of Kotzebue
- Green's Creek Deposit on Admiralty Island
- The Quartz Hill Deposit, near Ketchikan

The development of these deposits and other known occurrences could create a substantial addition to Alaska's economy -- mining, unlike oil, is a very labor intensive business. A majority of the new wealth created would stay in the state in the form of wages and goods purchased. John Whitney, a noted mineral economist, in 1979 predicted that the development of the deposits of NW Alaska, Red Dog and Ambler, would create over 1,000 new jobs in Alaska and produce annual gross sales on the order of $570 million (1979 dollars). The Alaska Miners Association published a report last July which predicted, that given the proper combination of world metal prices, Alaska investment climate and infrastructure development, Alaska's major mining industry, could by the year 2000 provide 6,000 new jobs and add an estimated 3.0 billion to Alaska's economy.

I believe these studies indicate that mining has the potential to significantly impact Alaska's future economy.

The development of major mining, depends on two factors which involve state government.

1. Availability of infrastructure.
2. A stable investment climate

I am not going to discuss infrastructure today, suffice to say it is of equal importance to investment climate.

In order to be developed, Alaskan mineral deposits are going to have to compete on a world-wide basis. Metals produced in Alaska are going to be sold at the same price as those produced in Western U.S., South America, or South Africa. To be competitive, Alaska's costs of productio.. must be comparable. Fortunately, nature has given Alaska some high grade deposits, which will help keep them competitive, but Alaskan costs are high.

By allowing investors to recoup their risk capital quicker the investment tax credits proposed in House Bill 258 will help keep the costs of Alaskan mineral development competitive. But more importantly, enactment of House Bill 258 will send a strong signal to outside investors that the State of Alaska is serious about developing its mineral industry by providing incentives for investment.

As stated in the attached letter to Speaker Hayes, House Bill 258 should be considered an income producing bill. The immediate cost of enactment is very small, but potential impact on the Alaska's future economy is quite substantial. For a diversified economy in Alaska, I urge you to pass this bill.

ALASKA MINERS ASSOCIATION, INC.

509 W. Third Ave., Suite 17, Anchorage, Alaska 99501 (907) 276-0347

April 1, 1983

Representative Joe L. Hayes
Speaker of the House
Alaska State Legislature
Pouch V
Juneau, Alaska 99811

Dear Representative Hayes:

The Statewide Board of Directors of the Alaska Miners Association unanimously passed the attached resolution urging enactment of HB-258. The Alaska Miners Association represents approximately 1600 miners located throughout Alaska.

The Alaska Miners Association believes that the investment tax credits proposed in HB-258 will broaden Alaska's economic base. The people of Alaska are concerned about our state's dependence upon oil revenues and diversification of our state's economy is very important for the long term economic health in Alaska.

Many members of the legisiature may be hesitant to consider a tax credit bill in the face of declining oil revenues. However HB-258 is an income - producing bill. It will send a strong signal to investors that Alaska is seriously attempting to attract mineral development and increase exploration and mining activity. The economic benefits accruing to the state will far outweigh the revenues lost by the tax credit.

The initial reduction in revenues by mineral investment would be small, less than ten million dollars annually. The tax credits will make Alaskan mineral investments more competitive on a world wide basis and lead to the establishment of a long term healthy mining industry.

We are asking for your help to obtain passage of this bill and make an investment in Alaska's long term economic future.

Sincerely yours,

ALASKA MINERS ASSOCIATION

Paul S. Glavinovich
President

PSG/vd
Attachment

ALASKA MINERS ASSOCIATION, INC.

509 W. Third Ave., Suite 17, Anchorage, Alaska 99501 (907) 276-0347

RESOLUTION - HOUSE BILL 258

Whereas the Alaska Miner's Association desires to foster the development of Alaska's mineral resources and,

Whereas the people of Alaska desire to broaden the economic basis of our state and,

Whereas the Investment Tax Credits proposed in HB-258 would provide financial incentives for the development of minerals in Alaska and indicate the strong support of the State of Alaska for a mining industry.

The Board of Directors hereby resolves to urge the Governor of Alaska, the Speaker of the Alaska State House, the President of the Alaska State Senate and the Chairpersons of House and Senate Resources Committee for expeditious passage of HB-258.

Approved

Fairbanks, Alaska

March 29, 1983

Paul Glavinovich - President

Sandra M. Thomas - Secretary

Alaska State Legislature

POUCH V
STATE CAPITAL
JUNEAU, ALASKA 99811
(907) 465-3834
(907) 465-3835

Senate

Committee on Resources

MEMO

To: Resources Committee Members

From: Resources Committee Staff

Date: May 12, 1983

Subject: HB 258, Investment Tax Credit

As was requested, attached are additional materials relating to investment tax credits.

Enclosures: "The Investment Tax Credit: An Early Try at Supply-Side Economics" (Dun's Review, November 1979)

"No big breaks for small business in the tax cuts" (Business Week, August 24, 1981)

State Taxation and Economic Development, Summary and Recommendations, by Roger J. Vaughan

"Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures" (Harvard Law Review, February 1970)

Footnote

The Investment Tax Credit: An Early Try At 'Supply-Side' Economics

"Supply-side economics [*page 66*] is not as new as many people seem to think," explains economist Walter Heller. Heller, who was Chairman of the Council of Economic Advisers under President John F. Kennedy, is thinking back specifically to the early 1960s, when he and a task force of other leading economists devised the nation's first investment tax credit as a way of stimulating capital spending by American business.

The task force was set up during the Kennedy campaign of 1960. (Actually, it had a trial run during Adlai Stevenson's campaign four years earlier.) Its assignment was to draw up an economic position paper to implement the candidate's repeated promise to "get America moving again." One of its specific chores was to lay out for the liberal Kennedy, a pragmatist in matters of taxation, the alternatives open to him in carrying out his campaign pledge to provide increased incentives for business investment, and thus give a boost to the entire economy.

Heading the task force was Stanley Surrey, a professor of law at Harvard and a longtime specialist on taxation, who later became Assistant Secretary of the Treasury under Kennedy. Other members included Heller, Professor E. Cary Brown of the Massachusetts Institute of Technology, whom Heller calls "the real father of the investment tax credit," Professor Richard Musgrave of Harvard and economist Joseph Pechman of the Brookings Institution.

Economic Problems

The alternatives available to this high-powered team of experts were somewhat limited by the condition of the economy. The effects of the recession of the late 1950s were still lingering, and unemployment was high. At the same time, Professor Brown recalls, the country was in a "balance-of-payments panic" because the deficit was soaring for the first time since World War II. As a final caveat, Kennedy let the economists know that he was determined that no budget deficit after he took office would be bigger than the largest that had occurred under President Eisen-

Heller: After a checkered history, the concept he helped formulate is now "firmly embedded" in the nation's tax structure

hower. As Brown observes: "That left very little room for tax deduction."

A broad tax cut, then, was out. So was an easy-money policy, with its potentially inflationary consequences. But to give business a lift, the experts decided, there were two viable alternatives on the supply side of the economy. One was a policy of accelerated depreciation, which would have been an aid to all business, old and new.

The other, which the task force eventually decided on, was a more specific way of spurring new capital spending: the 7% investment tax credit. For every $1 million a businessman invested in new plant and equipment, he would get a tax credit of $70,000. This idea was quickly supported by both the Treasury, then headed by Republican C. Douglas Dillon, and the Council of Economic Advisers.

Still, it took many long months to get the proposal through Congress. Even Kennedy was skeptical at first. When the task force met with him to explain the concept of the credit (a variant of which, incidentally, was already in use in some Scandinavian countries), his first question, Musgrave recalls, was: "If I give up a billion dollars in tax revenue, what will it buy for me?"

For a while, that blunt question stumped the economists, who had been thinking of the credit solely in more abstract terms of its impact on the tax structure. Eventually, however, they were able to convince Kennedy that the credit was a political as well as an economic bargain, because it would give the Administration "the biggest bang for the smallest reduction in taxes."

The Opposition

However, there was plenty of other opposition. Labor fought the credit as a giveaway to business, arguing instead for a general tax cut. "The labor leaders refused to see the credit for what it was—an attempt to increase capital per worker and thus boost national productivity," says Brown.

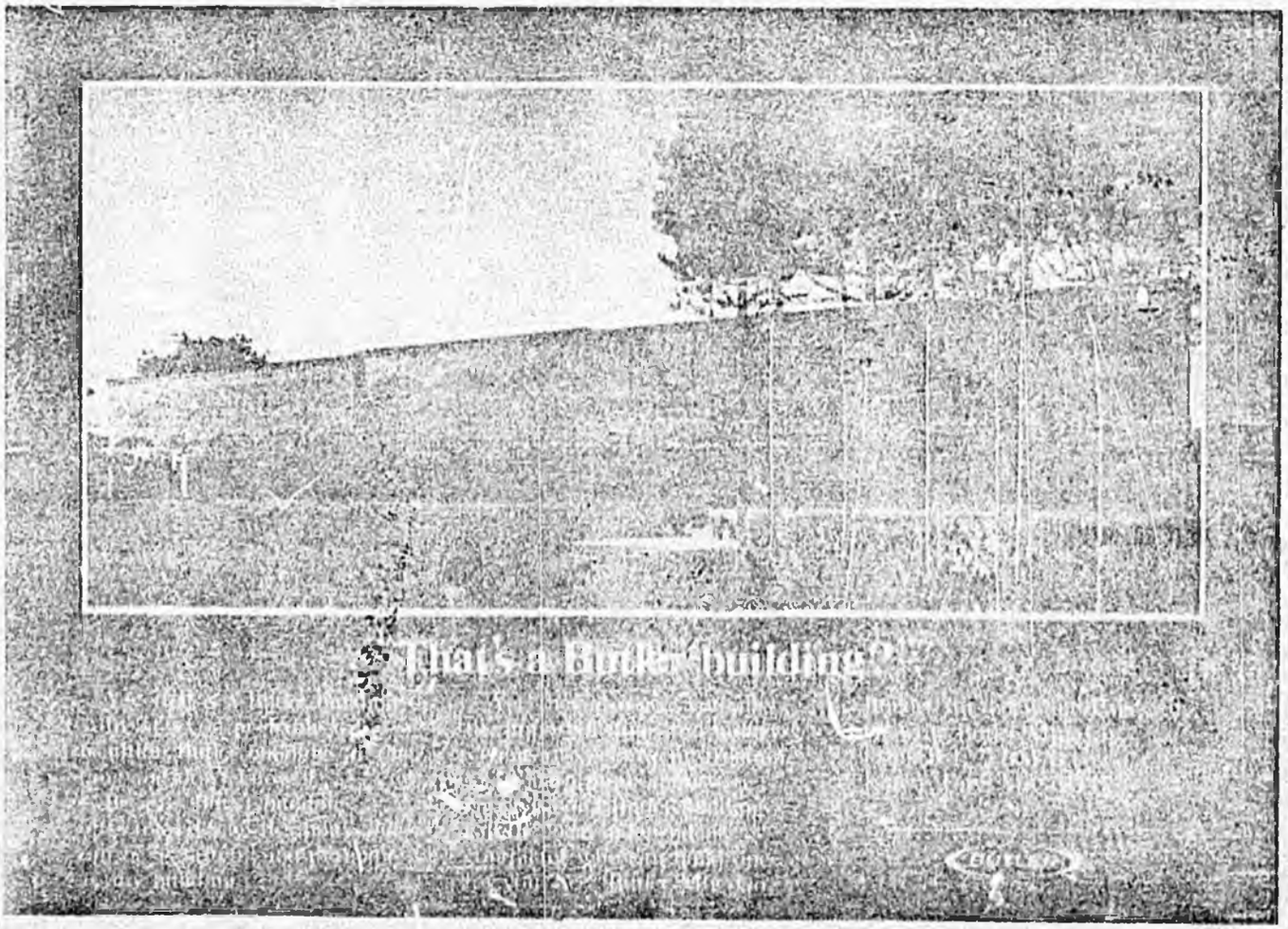
Some businessmen, too, were unenthusiastic. Several complained that the credit was "gimmicky." They also argued that while accelerated depreciation, which most of them preferred, would presumably be permanent, the credit could some day be reduced or even taken away. Confides Brown: "We wanted it that way, because we thought of it as a flexible countercyclical device."

At any rate, despite all the objections, the Administration rallied enough support so that the credit finally became law as part of the Revenue Act of 1962. It was, in fact, the first major tax legislation passed under the Kennedy Administration.

Even today, opinions differ as to how effective the investment credit was as an incentive, but the task force members generally think it did the job it was intended to do. Just as the businessmen had predicted, though, the credit did become something of an economic football: it was suspended and restored twice in subsequent years, as the government attempted to turn capital spending off and on.

In the past few years, however, the prevailing economic view of the credit has changed. Now, says Musgrave, most economists have concluded that it is not a practical countercyclical weapon to be used as a sort of off-and-on subsidy to business, but that it is more effective as a permanent incentive to business investment whatever the state of the business cycle.

And that is just what it is now, by law, at an increased rate of 10%. Today, says Heller, the credit, which had such a hard time winning acceptance originally, is "absolutely firmly imbedded" in the tax structure of the land. DSR



No big breaks for small business in the tax cuts

Some key parts of the new tax law will deliver a lot less than was originally expected to one sizable group of businesses. Small-business owners, now checking the fine print of the law, are finding that the new and simplified depreciation schedules will do little for many of them and that the reductions in corporate tax rates on incomes of less than $100,000 will amount to no more than a week's rent for a typical downtown store or small service business.

"You have nearly 14 million businesses grossing under $2 million each, and they employ about 58% of the work force," says Herbert Liebenson, president of the National Small Business Assn. "They produce 43% of the gross national product—but they got only 25% to 33% of the total business tax cut. A lot of our people supported this law without really understanding it." Liebenson feels that "as time passes you'll hear grumblings from the owners of more small businesses because the new formula for writing off the cost of plant and equipment does little for them." Some 85% to 90% of small businesses, he points out, are labor-intensive, not capital-intensive, especially in retail, service, and construction areas.

William Barth, small-business specialist at Arthur Andersen & Co., the Big Eight accountants, explains how a small-business owner can become frustrated "when he is confronted with the numbers." He cites the example of a small company that buys equipment next year for $10,000. Under the new law, the first-year write-off on this investment totals $7,000, or $3,400 more than under the old depreciation schedules. "But," Barth points out, "if the business is in the lowest corporate tax bracket, where the tax rate is changing to 16%, the tax saving from the additional depreciation will be only $544." Further, if the company borrowed the $10,000 to buy the equipment, it will probably be paying at least 20% interest, and the loan cost for the first year will be $2,000. Thus, under the new tax law, the $544 saving represents only 27% of the cost of the loan.

No motivation. "A tax deduction means much more to a larger company that can save up to 46¢ on the dollar," Barth notes. "The 16¢ saving simply isn't enough to motivate a small-business owner to buy new equipment." Several small-business organizations, Barth adds, pushed for a $25,000-a-year equipment write-off allowance, but Congress cut this back to $5,000 through 1983, scaling it up to $7,500 in 1984-85 and to $10,000 thereafter. Had the larger allowance survived, Barth says, "it would have materially helped 90% of all small businesses." He notes that "paper-thin tax cuts save a small business only the difference between $27,000 and $26,500 on $100,000 of taxable income."

By their nature, many small businesses will gain no direct benefit at all from the new depreciation schedules, which are clearly aimed at rewarding companies that invest heavily in capital goods. For example, there is no change in the three-year write-off period applied to autos and light trucks—usually very important investments for small retail and service businesses—although the investment tax credit on these vehicles was raised to 6% from 3.3%.

As Bruno Mauer, a Milwaukee wholesaler of metal tools, has discovered, "this law really doesn't help us [wholesalers] at all." Mauer explains that his company's investment is mainly in inventories and accounts receivable, which total more than $4 million. His company has only $900,000 invested in plant and equipment. "This sort of relationship is true in most wholesale lines," he adds.

Because the added write-off benefits depend on a company's making an investment, they are of no help to businesses that lack the funds to buy new plant and equipment. To overcome this, the new law includes rules intended to encourage special equipment-leasing deals. These rules, in effect, permit a company to rent capital assets instead of buying them while at the same time gaining at least part of the tax benefits normally accruing to buyers. The law shifts the normal tax advantage of buying to the lessor with the hope that the lessor, in turn, will agree to lower rental payments from the tenant or lessee.

Harder bargains. But what first looks like a break for small or cash-short companies may, in fact, be of little benefit to them. Leon Nad, tax director of Price Waterhouse & Co., points out that the new law also contains a provision that is likely to make lessors more, rather than less, demanding. The old tax law provided that the residual, or trade-in, value of leased property would revert to the lessor; the new law leaves this open to negotiation, and thus lessors could lose an advantage, prompting them to drive harder bargains.

A more liberal loss-carryover rule intended to aid distressed companies may also prove of little benefit to those it was intended to help. The new law stipulates that, for most businesses, losses incurred since 1975 can be carried over and used as offsets against profits for 15 years (up from 7 years in the old tax law). Nad of Price Waterhouse questions whether this is realistic. "If a company needs that long to cure its losses," he asks, "how could it survive?"

How the new tax law shortens depreciation lives

Investment	Old law	New law	Reduction in write-off times
	Years		Percent
Office buildings	41	15	63%
Oil refining and distribution equipment	13	5	61
Factories	37	15	59
Retail stores and shopping centers	36	15	58
Metals mfg. plant and equipment (composite)*	12.7	5.7	55
Apartment buildings	32	15	53
Office furniture and fixtures	8	5	37
Chemical mfg. plant and equipment (composite)*	9	5.7	37
Electric machinery mfg. plant and equipment (composite)*	8	5.8	27
Land improvements: roads, docks, etc.	20	15	25
Motor vehicle mfg. equipment	6	5	20
Autos and light trucks	3	3	—
Information and data systems	5	5	—

*Estimate

Data: National Small Business Assn.

7

From

STATE TAXATION AND
ECONOMIC DEVELOPMENT

by Roger J. VAUGHAN

SUMMARY AND RECOMMENDATIONS

State tax policy is in disarray: states compete for footloose firms by offering expensive tax holidays; households are in revolt against rising property tax burdens; cities demand state aid for social services; and the federal government mandates costly programs that must be paid for with state funds. By-passed by the federal grant programs spawned by the recent recession, state officials have been trapped in a reactive role and have been left out of the urban policy debate. The present state tax structure reflects the hasty application of band-aids rather than the considered surgery that is necessary to meet current economic problems.

This paper examined how the structure of state and local taxes can best be adapted to meet these problems. It approached the problem from a broad perspective, analyzing not only business taxes, but also the state/local fiscal structure and personal taxes, since these issues also influence the local pattern of development. The paper's conclusions, summarized below, should help local policy makers in the difficult tasks that confront them.

WHAT SHOULD A STATE ECONOMIC DEVELOPMENT STRATEGY LOOK LIKE?

Taxes are only one factor among many—and a relatively minor one—that affect state economic development. The quality of the local labor force, transportation facilities, energy prices, and population growth all contribute to shaping local development. In fact, population growth may be the single most important factor. Households are not only drawn by local job openings but also by an attractive residential and recreational environment. This implies that:

An economic development strategy must aim at attracting skilled workers as well as factories. Concentrating on industrial parks and business tax incentives at the expense of residential amenities will meet with only limited success.

As the distribution of jobs and people changes in response to technological change and other market forces, as well as to public sector policies, underlying market conditions change. Wages and land prices are driven up in growth areas, while costs fall in slower growing

regions. The future is not an indefinite extension of the past. A loss of manufacturing jobs may be counterbalanced by an increase in service industry employment. The lesson is that:

An economic development strategy must recognize changing local comparative advantage, and not attempt to wind the clock back. For the Northeast, and for many urban areas, manufacturing can no longer be the main engine of growth.

Most local employment growth occurs through the birth of new firms and the expansion of existing, small companies. Very little growth (or decline) results from the immigration (or outmigration) of firms. Taxes play only a minor role in the location decisions of migrating companies. Therefore:

An economic development strategy must focus on the overall economic climate, and not waste resources on special incentives for a few favored firms. It must encompass a broad range of policies, including training programs, infrastructure development, and capital mobility as well as a balanced tax structure.

Finally, the relatively small role played by taxes does not imply that state governments are powerless to influence growth and development. Positive and coordinated leadership and a minimum of red tape are important considerations.

WHAT GUIDELINES SHOULD A STATE EMPLOY TO IMPROVE ITS TAX STRUCTURE?

The primary purpose of taxes is to raise revenues to pay for local services. This must be achieved with as little disruption as possible to businesses and households, as fairly as possible, and at the lowest possible administrative cost. The following guidelines should help in the formulation of local fiscal policy.

Efficiency

- The overall burden of taxes should reflect the local preference for public services.
- The tax structure should not encourage undesirable reactions by taxpayers, such as business or household relocation.

Equity

- The greater a taxpayer's resources, the greater his tax payments should be.
- Taxpayers with similar resources should incur similar tax burdens, all other things being equal.

- The tax burden for taxpayers with similar resources should be related to the value of public services received.

Administrative Cost

The tax should be simple to collect and to enforce.
The tax revenue should be predictable.
The tax revenue should grow over time as the demand for public services grows.
- The tax revenue should be cyclically stabilizing.

These guidelines cannot be rigidly enforced, since they are not necessarily compatible. An increase in efficiency may only be achieved at a loss of equity, for example. But the guidelines do allow these trade-offs to be made explicitly as fiscal policy is debated.

There are also constraints on the extent to which state policy makers can pursue these goals. First, they must operate within the overall structure of fiscal federalism, in which they are limited by the actions of the federal and local governments. Second, states are limited by their desire to maintain sound bond ratings. And finally, they are limited by the fact that there is a great deal that is not known about who pays for specific taxes and how taxes affect business and household behavior.

WHAT SHOULD STATES DO ABOUT THE STATE/LOCAL FISCAL STRUCTURE?

The allocation of responsibility for revenue collection and service delivery between states and local governments has been seriously strained by recent developments. First, state governments are doing too little to equalize fiscal capacity among their component jurisdictions—a fact recognized in a number of recent court decisions concerning school finance and by the federal government in its recent grant programs. Second, the profusion of federal grants that enabled many fiscally troubled cities to survive the mid-1970s recession more-or-less intact are likely to dry up. States will be expected to step into the gap. Third, the property tax, the main source of local government revenue, has become the target of the taxpayers' revolt. It is increasingly difficult for high taxing jurisdictions to raise revenues.

There are several steps that states can take to improve the state/local fiscal structure:

- *Encourage metropolitan-wide tax base sharing.* Uniting poor central cities with their relatively affluent suburbs can provide much needed fiscal relief. Although this is a politically difficult step, states can provide some incentives by rewarding tax sharing areas with

higher grants—a policy that the federal government should follow.

■ *Retarget state revenue sharing grants.* At present, most state aid is distributed on the basis of population, which minimizes its redistributive impact. Aid can be better targeted to needy areas.

■ *Introduce or expand state-financed circuit breakers.* These are an effective way to provide relief to low-income households. To be as equitable as possible, these should be extended to renters and place an upper income limit on eligibility. Federal assistance should be provided, perhaps using the state portion of General Revenue Sharing.

■ *The progressivity of state taxes should be increased in those states with regressive systems.* This can be done either by switching from regressive to progressive taxes or increasing the progressivity of present taxes. However, a sudden and sharp increase in progressivity may encourage the outmigration of high-income households.

■ *States should continue to lobby for increased federal aid for programs targeted to the poor.*

WHAT SHOULD STATES DO ABOUT BUSINESS TAXES?

There is a popular myth that a reduction in the level of state business taxes will produce a flood of new development. The truth is very different. The level of business taxes has very little impact on the local growth rate or on the interstate location decisions of firms. To some extent, intrastate differences in business taxes contribute to the movement of firms away from high-taxing central cities to less heavily taxed suburbs and non-metropolitan areas. Payroll taxes exacerbate the problem of unemployment, particularly among the less-skilled. Investment may be deterred by high local taxes. Some policies which may improve the efficiency and equity of the present business tax structure include:

■ *States should resist the temptation to cut business taxes in order to stimulate development.* Reduced business taxes have little effect on location or investment decisions. While states should ensure that their taxes are not greatly out of line with those of their neighbors, a stronger case can be made for reducing personal taxes to encourage development by attracting skilled workers than for business tax cutting.

■ *States should take steps to reduce interjurisdictional differences in tax rates.* The relevant steps are described above.

■ *States should review their allocation formulas for firms operating in more than one state.* Several states have formed a tax compact to ensure that multi-state companies pay taxes on their full tax base. While other states should follow suit, this will necessitate a simplification of interstate tax legislation and a move toward a more standardized definition of tax base. Federal legislation will be necessary for this.

■ *Some states should consider using a tax on value added to replace their business taxes.* The Value Added Tax produces more stable revenue, is simpler to administer, and does not discourage investment as much as traditional business income taxes.

■ *States should consider encouraging their jurisdictions to shift some of the burden of the property tax away from improvements and onto land.* This would reduce the deterrent to new investment inherent in the property tax, and discourage speculative land holding (which delays urban redevelopment and creates sprawl). The administrative difficulties in such a shift are severe, but not insuperable.

WHAT SHOULD STATES DO ABOUT TAX INCENTIVES?

States have devoted considerable manpower and resources to devising tax breaks for firms that move in, firms that threaten to move out, and firms that promise to expand. There is little evidence that these costly programs have had much influence on either investment or location decisions. These misplaced energies and mortgaged tax receipts should be redirected in several ways:

■ *With federal assistance, states should reduce the special incentive programs they offer.* The federal government could penalize states that offer such incentives through provisions in grant allocation formulas. States should concern themselves with the overall economic climate, not on bribing a few footloose firms.

■ *States should act to reduce interjurisdictional incentive tax competition.* This can be done by reducing fiscal disparities, through legal prohibition, or through grant allocation policy.

■ *The exemption of the interest from industrial development bonds—and from state and municipal bonds—from federal and state income taxes should be replaced with an interest rate subsidy.*

■ *If states are to use tax incentives, they should be in the form of wage subsidies.* Wage subsidies reduce the cost of labor to employers and can be targeted to the hard-to-employ. They should be in the form of tax credits against payroll taxes to be most effective. A wage subsidy is one of the few policies that would effectively *create* jobs.

■ *States should rely more heavily on infrastructure development and the reduction of red tape as inducements to industry, and less on tax manipulation.*

WHAT SHOULD STATES DO ABOUT PERSONAL TAXES?

The present burden of personal taxes collected by state and local governments is inefficient and inequitable. It is *inefficient* inasmuch as high state income tax rates tend to reduce the net immigration of high income households,

leaving a heavier burden on the less affluent who remain. High taxes are also capitalized in high wages, discouraging local economic growth. High central city property taxes—used to finance extensive redistributive services—have encouraged the more affluent to move to more homogeneous suburban jurisdictions. High property taxes also tend to depress property values and discourage investment. The system is *inequitable* because the income tax in several states is regressive. Such income tax provisions as incentives for homeownership and standard deductions are also highly regressive. In addition, the property tax is regressive, and its inequity is compounded by poor administration. States have several options to improve the efficiency and equity of personal taxes:

- *Income Tax.* Standard deductions can be replaced by standard tax credits. Tax incentives for homeownership can be reduced, or mitigated by allowances for renters. The levels of tax credits and tax brackets can be indexed to the local cost of living, so that inflation does not provide governments with a "fiscal bonus." The deduction of state and local taxes from federal taxable income should be disallowed and replaced with extended federal revenue sharing. The tax structure should be simplified and standardized among states.
- *Property Taxes.* The efficiency of assessment should be greatly increased. State-financed circuit breakers and shifting some of the burden onto land would improve equity and efficiency.
- *Sales Tax.* Exemptions for food and medicine should be used in all states to improve equity. Some consideration should be given to extending the tax to cover professional services.
- *Fees and Charges.* Fees and charges offer an efficient and equitable way for states and localities to raise revenue and ensure effective use of public services, especially where there are prevailing tax limitations. They are especially effective in covering the costs of new development or redevelopment (sewering, water hook-ups, etc.).

INTRODUCTION

The 1970s have been anything but kind to state governments. Major metropolitan areas, traditionally both engines of growth and major sources of tax revenues, have lost jobs and veered toward fiscal insolvency. Mayors and federal officials have blamed states for not caring. Social programs, grown as a result of local political pressures and federal mandate, have inflated expenditures. Swollen federal grant programs have by-passed states and gone directly to local jurisdictions. The rise of the "New South" at the expense of the "Old North" has pitted Sunbelt states against Snowbelt states. The national economy, apparently recession-proof during the 1960s, has faltered, straining unemployment insurance funds, swelling welfare rolls, and leading the jobless to demand aggressive state economic development programs. Taxpayers, whose rising incomes and property values provided localities with annual fiscal dividends, have finally rebelled.

State governments have, for the most part, fallen into a reactive role. Their functions have proliferated, often unwillingly. They are forced to work through a bewildering number of regional organizations and special districts. Federal red tape has multiplied. States must compete with cities for federal funds.

These changes necessitate a rethinking of the role of the states within our intergovernmental system. This paper examines a part of this complex puzzle—how can the state/local tax structure be modified in order to be an effective economic development tool? In the past, state involvement in economic development has been principally concentrated on physical development. After nearly a year of monitoring state community assistance programs, the Advisory Commission on Intergovernmental Relations concluded that: "Although broadly based structural and fiscal reforms have been widely endorsed as mechanisms by which states might ameliorate local development patterns, the adoption of such reforms has been relatively limited (*Information Bulletin,* January 1979)." To encourage a more radical approach, we must ask a number of very basic questions. How do state business and personal taxes influence state economic development? What will the impact of the fiscal limitation movement be? How do federal programs and policies affect state fiscal actions? How can the structure of state taxes be changed to improve efficiency and equity?

The following chapter defines overall state economic development goals, both in responding to local development problems and in the way they interact, or conflict, with federal and local goals. Chapter

6. Iowa is one exception—it uses a single factor—gross sales.

7. The Multistate Tax Compact and the Uniform Division of Income for Tax Assessment.

8. The Value Added Tax in Michigan replaced not only the corporate income tax, but also a corporate franchise tax, an inventory tax, a business intangible tax, a financial corporations tax, an insurance company and a savings and loan company privilege tax.

9. There are three forms of VAT that differ in the way they treat depreciation:
- *Consumption VAT:* deducts purchases of capital equipment but does tax depreciation.
- *Net Income VAT:* taxes capital equipment when purchased but does not tax depreciation (i.e., assumes 100 percent depreciation in the first year).
- *Gross Product VAT:* Taxes both capital purchases and depreciation.

10. See Becker (1969); Carlson (1977); Cuddington (1978); and testimony before the House Committee on Banking, Currency and Housing by Lowell Harris, George Peterson, Philip Finkelstein, and Arthur Becker, September 28, 1976, reprinted by the Committee in *Rebirth of the American City*, U.S. House of Representatives, Washington, D.C., 1976.

11. In the 1950s, the lot comprised about 10 percent of the cost of a home; today, it is 25 percent (Carlson, 1977).

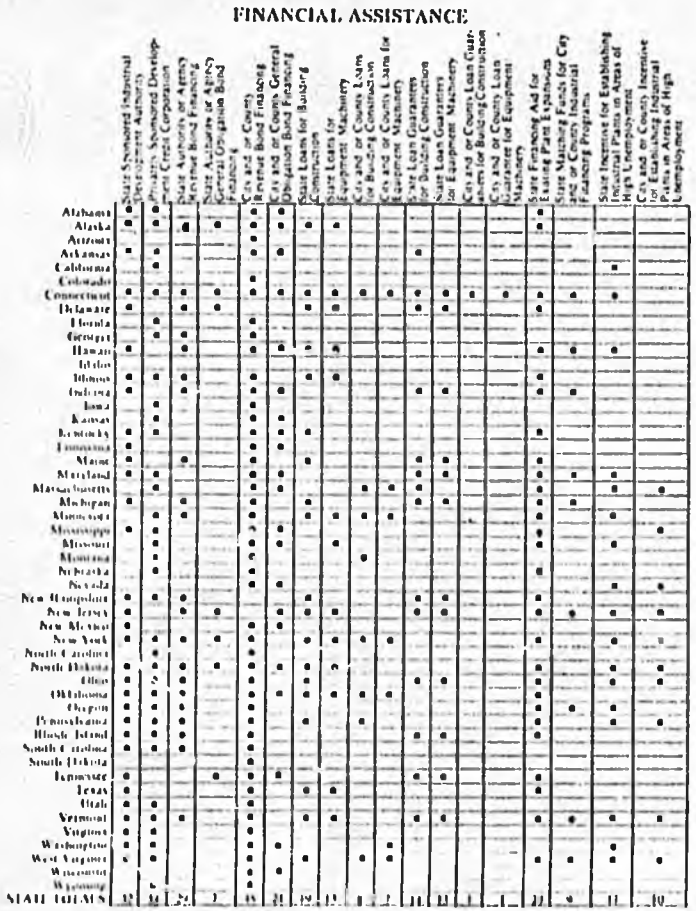
6

WHAT SHOULD STATES DO ABOUT TAX INCENTIVES?

A direct result of the belief that business taxes really matter has been the proliferation of special tax incentives designed by states and localities to attract new businesses and to encourage expansion and new investment among existing firms. There are no reliable estimates as to how much in tax receipts are currently foregone under these programs. Smokestack chasing is *de rigeur* for states that adopt an aggressive development program. However, the clear conclusion of this chapter is that, for the most part, *firms are rewarded for doing what they would have done even in the absence of the incentive.* The fixation of states and localities on attracting manufacturing firms by whatever fiscal means possible has arisen from the belief that a new firm will yield a fiscal surplus—that is, its contribution to local tax revenues outweighs the costs of providing public services to the firm and its employees (Groves and Riew, 1963; and Kee, 1968). More recent studies, however, have shown that a new firm is not an unmixed blessing. Even in a community with relative high unemployment, 100 new jobs does not reduce local unemployment by 100. At least 50 of those slots are likely to be filled by new immigrants who will require schooling, streets, sewers, and water. Other jobs might be filled by those not previously in the labor force. Secondary employment—retail and services—will also make demands for public services and do not necessarily yield a fiscal surplus. In fact, Gerweck and Epp (1976) show that secondary employment impacts may halve the net fiscal surplus resulting from a new factory. *When the state abates or exempts local taxes to induce a firm to move in, the net benefits may well become negative.*

The adoption of tax incentives tailored to the wishes of the few Fortune 500 companies that move is based on the mistaken belief that there is a fixed stock of manufacturing jobs in the nation and that the only way a state can improve its relative position is to steal from other states. The behavior is analagous to that of the homeowner who tries to maintain a green lawn by stealing his neighbors turf—at great effort every time his own land turns brown. It is much easier and more productive to water regularly and apply fertilizer. We should reiterate the conclusions from earlier chapters. There are very few footloose firms. If growth is to be accelerated, then it must come from increasing the local company birth rate or from expansion in existing local companies, especially small firms. *Development efforts must focus upon*

Table 18
Financial Assistance, Tax Incentives, and Special Services Offered by State and Local Governments



SOURCE: Adapted from "The Fifty Legislative Climates," *Industrial Development*, January/February 1978.

Note that the form in which states offer financial services, tax incentives, and special services differ widely. For a full description see the original source.

the overall economic climate, not upon expensive incentives to a few firms.[1]

Business incentive programs are designed not only to attract footloose industries but also to encourage existing firms to expand their level of operations to generate jobs locally. However, as we argued in the preceding chapter, high local business income and property taxes have not had much influence on investment decisions, and, therefore, temporary reductions as a reward for purchasing additional equipment are unlikely to have much impact. In fact, we will argue that reducing the tax on the income from capital to create jobs is perverse, since the policy does nothing to reduce the cost of labor. If a state insists on using tax incentives to generate employment, and we cannot hold out much hope for their effectiveness, it should try to counter the impacts of payroll taxes by introducing wage subsidies.

A systematic examination of business incentives is a large undertaking because of their bewildering variety. For example, we argued in the preceding chapter that the double weighting of out-of-state sales and non-membership in tax compacts should be considered as tax incentives. Table 18 lists some of the financial services, tax incentives, and special programs provided by states for firms. The incentives include exemptions from personal and corporate income tax for those firms moving in, guarantees that property taxes will not increase for 5 or 10 years, exemption of new manufacturing equipment from the sales tax, and accelerated depreciation. Special services encompass free land for industry, state funds for research and development, and state help in bidding on federal procurement contracts. Financial assistance runs from tax exempt revenue bond financing to state matching funds for local development efforts. The discussion in this chapter focuses mainly upon tax incentives, but some of these other development measures are also briefly discussed.

A review of aggressive promotion campaigns by states and cities reveals just how internecine the competition has become.[2] New York State advertises that "We're not giving business the business any more. We're giving it a break", Chicago claims to be "Fund City", and San Diego "is zoned for success," according to its $500,000 a year campaign. The Texas Industrial Commission advises, "When the old corporate tax bite eats away profits, CUT OUT FOR TEXAS." In 1977, nearly $7 million was spent in magazines alone, and the number of business promotion ads jumped by 40 percent in the first three months of 1978.

The rivalry for footloose industries has often been cast as the old and established Snowbelt trying to protect its economic base from the aggressive inroads of the tax cutting Sunbelt. The truth is very different. The fiercest rivalry is between adjacent states—a cut-throat regional struggle that mortgages future tax receipts and places established

factories at a disadvantage relative to the brash newcomers. Ohio and Pennsylvania rival for Volkswagen, while steel companies languish. Firms leave New York State for adjacent Connecticut, New Jersey, and Pennsylvania. Most of the states offering twenty or more special programs (cf. Table 18) are in the Northeast.[3] In fact, public pressure for such measures is most intense in states where the economic development rate has been slower than the national average. A recent survey by the Advisory Commission on Intergovernmental Relations (1977) suggests that public support for tax incentives for business is closely related to local economic fortunes and prospects.

Question: Some states have passed laws which give special tax breaks or other incentives to industries that will locate facilities or expand present operations in that state. Do you favor or oppose such a policy?

		Percent of Respondents by Region			
	Percent of Total U.S.	Northeast	North Central	South	West
Favor	50	57	48	52	42
Oppose	36	30	38	30	49
No Opinion	14	13	13	18	9

SOURCE: ACIR, *Changing Public Attitudes on Government and Taxes*, Washington, D.C., 1977.

If this wasteful competition is to cease, state officials must educate their constituents about the futility of these programs.

EFFICIENCY

Do tax incentives work? Do they attract new firms and encourage new investment? There is no evidence that these concessions have had any significant effect on local growth.[4] Tax concessions are ineffective precisely because state and local taxes are, themselves, relatively unimportant as location determinants.

The tax battle is not only waged between states, but between counties and municipalities within a state. County officials offered a new bicarbonate plant a 12 year property tax break for moving to Seneca County, Ohio, yet the corporation's controller was quoted as saying, "The tax abatement was a nice kicker on the end, but we chose Ohio mainly because of its strategic location for distribution and market growth."[5]

Weinstein (1977, p. 75) concludes that:

> Taken as a whole, these incentives probably represent a serious misallocation of resources. In the main the government is subsidizing firms

for performing activities they would have undertaken in any case. Furthermore, when one considers that any incentive designed to reduce a company's state or local tax bill will increase that firm's federal tax liability—the superfluity of tax incentives becomes even more apparent. The result is a form of reverse revenue sharing in the amount of 48 cents on the dollar.

Even if local investment expanded by 2 percent as a result of a local investment tax credit, this still means that 98 percent of credits are flowing to firms that would have invested anyway.

Not only are tax incentives ineffective, they are also costly. Harrison and Kanter (1976) estimate that the ten tax incentives offered by Massachusetts cost at least $100 million a year, revenues that could be used to reduce residential taxes or improve local services. In just over a year, New York City has exempted $461 million in properties from $44 million in taxes. St. Louis has exempted nearly $1 billion worth of real estate—half the city's property tax base. By the early 1980s, Michigan's incentives may cost $50 million in state revenues and $30 million in local revenues.

Of course, to determine whether a measure is worthwhile, it is important to compare its benefits with its costs. A local development incentive does not have to be very effective to be worthwhile if its costs are negligible. The few studies that have compared the costs and benefits of fiscal incentives do not provide a very optimistic picture, although they do show that, under some conditions, fiscal incentives may be cost effective. Morgan and Hackbart (1974) concluded that if locally accruing benefits are not less than 50 percent of value added in a local plant and not less than 5 percent of the investment is a result of an incentive, then that incentive may be cost effective from the viewpoint of the state, although, as we argued in Chapter 2, there is no guarantee that the nation as a whole is not worse off.

What of the few firms that may respond to some kind of fiscal incentive?[6] Are they the type of firm that can assist meeting local development goals? In an important article, Harrison and Kanter (1976) argue that the type of firm most likely to respond are firms in highly competitive industries, for whom small differences in costs make the difference between success and failure. Yet, they argue:

> . . . these are the industries that in general pay lower wages, offer worse working conditions, provide less stable employment, and make it more difficult for labor to organize. Thus, incentives that lower costs of doing business appear to be policy instruments—if they work at all—that are most likely to "goose" the sector of the economy with the least desirable jobs, while providing windfall profits to the segments of the business community that needs them the least (p. 59).

In short, tax incentives are ineffective, and what little impact they might have is not necessarily desirable.

EQUITY

Not only are tax incentives inefficient, they are also inequitable. First, the incentive will tend to go to large and financially healthy firms, since these firms will be earning a taxable income.[7] Nearly 50 percent of all firms had no federal tax liability in 1971, and 95 percent of all firms had federal tax liabilities of less than $25,000 (Table 19). Unless the incentives take the form of credits, most firms will not be influenced.

Second, why should a new company pay less in taxes than a comparable firm that is well established in the state? State policy makers should be aware that this program may harm their well established firms, by placing them at a competitive disadvantage with newer competitors locating in other tax cutting states.

A third equity problem is that state and local officials often weave

Table 19
Cumulative Distributions of Income Tax Liabilities for Corporations Filing Income Tax Returns in 1971, by Sector

Sector	Income Tax Liability		
	0	Below $10,000	Below $25,000
All Industries	49.0	90.5	94.8
Agriculture	53.3	94.2	97.8
Mining	61.2	86.6	91.8
Contract Construction	50.9	91.0	95.3
Manufacturing	48.4	82.4	87.8
Transportation and Communication and Utilities	53.1	90.6	94.5
Wholesale and Retail	43.1	88.7	94.2
Fire	47.3	92.1	95.9
Services	56.5	95.7	98.1

SOURCE: Robert Tannenwald, "Federal Tax Approaches to Regional Development," in Committee on Appropriations, *Patterns of Regional Change*, U.S. Senate, Washington, D.C., October 1977, p. 697.

together a special "development package" for a particular firm that is considering moving in, threatening to move out, or considering a major expansion. Naturally, officials can only do so if the firm is large. Programs can rarely reach down to small firms, even though past experience suggests that such firms are the main source of employment expansion.

A final equity issue is that almost all incentives are offered to the owners of capital; few are offered to labor. We have argued that payroll taxes and minimum wage laws have priced low-skilled labor out of jobs. It is possible to imagine that the long run impact of tax incentives might be to encourage the substitution of capital for labor and therefore to *reduce* the number of jobs, while enhancing the aggregate returns to the ownership of capital. If this impact is explicitly understood, enthusiasm for present tax incentives may diminish.

ADMINISTRATIVE COST The effectiveness of tax incentives might be greater if they were targeted toward smaller firms, which are the main engines of local growth (Schmenner, 1978). However, while it is administratively simple to identify and approach the relatively few large companies that are considering relocation, the market of small firms is impossibly large. There is a much higher failure rate among small firms, and thus the risk of providing a financial assistance/tax incentive package to these firms is high, and the overall administrative cost is likely to be much higher.

OTHER BUSINESS INCENTIVE PROGRAMS As Table 19 graphically shows, the menu offered to the lucky few businesses to arouse the interest of development officials is not limited to tinkering with the tax structure. The enterprising firm can enjoy low leases on publicly-built facilities, low interest rate loans, cash grants, and publicly-trained employees. Are these other measures more effective than tax incentives?

Our overall answer is that most of these programs are not of major importance to influencing company decisions. We can only touch on these programs briefly in this paper.[9]

Tax Exempt Bonds A major problem with state and local efforts to attract or retain industry is that they rely upon tax expenditures—tax exemption of bond interest payments, for example—and that these are very inefficient ways of channeling subsidies to industry. The federal tax structure has exempted the interest from state and local bonds, as well as bonds sold by local public development corporations, from federal income tax.

State and local authorities have, for the most part, extended this exemption to local income taxes. There are several problems with this form of capital market subsidy.

First, only a part of the tax receipts foregone by the federal and state treasuries actually go to reduce borrowing costs. The remainder is a subsidy to high income bond holders. Estimates place the personal subsidy at between 25 percent and 30 percent of foregone revenues. Morris (1976) estimates that the tax exemption of bond interest cost the federal treasury $4.8 billion in 1976, of which only $3.5 billion effectively reduced state and local borrowing costs. Intramarginal bondholders—those with very high marginal income tax rates who would have been satisfied with a lower tax free yield—enjoyed a subsidy of $1.3 billion. Total state and local interest payments in that year were approximately $10.5 billion.

Second, the market for tax free bonds has been narrowing as investors turn to alternative shelters. At the same time, public issues have had to compete with pollution control bonds. Commercial banks purchased 90 percent of net purchases in 1968, but only 10 percent in 1975. The lowering of the maximum federal income tax rate on personal income in 1976 may have reduced the number of household buyers. Pollution control bonds, granted tax exempt status in 1969, grew from only $100 million in 1971 to $2.2 billion in 1975, a year when state and local governments issued $31.6 billion in long term debt.

Third, the interest on state and local bonds is much more volatile than on taxable issues. This volatility results from the selling of municipal bonds by banks during periods when alternatives become much more attractive. The price falls and yields rise to induce other investors to absorb these sales. For example, the average yield on Aa municipals rose from 62 percent of the yield on Aa corporate bonds in January 1968 to 73 percent in June of 1970. A similar shift occurred between 1973 and 1975. A period when inflationary expectations rise leads to more rapid increases in public borrowing costs than in private borrowing costs. Soaring interest rates deter necessary public investments.

Local Credit Agencies Slow growth, it is popularly believed, may arise because of a shortage of loanable funds, or because of high interest rates. High interest rates apply nationwide, and although some regional variation is apparent (Straszheim, 1969), it is not significantly related to growth differences. The belief in a "credit-gap" has spawned a number of state and local practices that provide subsidized loans. Loan subsidies may be available through industrial development bonds, statewide industrial credit corporations, or state industrial finance corporations.

Industrial Development Bonds. Mississippi, in 1936, was the first state to authorize local industrial bonds. Local authorities are authorized to issue bonds to construct industrial facilities for lease to private firms. Interest on these bonds is exempt from federal and local income tax.[10] Aided firms pay rentals sufficient to cover the principal and interest on the bonds and facility maintenance. Facilities are generally exempt from state and local property taxation. Bonds may be secured by the taxing power of the issuing government (general obligation bonds) or by the property acquired with the bond revenue (revenue bonds).

Statewide Development Credit Corporations. Maine authorized the first state development credit corporation in 1969, and now 30 states have such corporations. These corporations are state chartered but privately financed, using revenues from stock sales, private borrowing, or from retained earnings. Their loans usually go to small, established manufacturing firms. Although most loans go for plant and equipment purchases, a sizable number do go for working capital. Almost all of these corporations have made profits. In all states except Alaska, local authorities have been permitted to set up development credit corporations.

There are now several thousand local development corporations concentrated in nonindustrialized areas and in industrialized areas with persistent, high unemployment rates. Some operate under the auspices of local chambers of commerce, others under local jurisdictions; some are non-profit corporations, others are organized as profit making corporations. Funds are raised through donations, sale of stock, private borrowing, or from the Small Business Administration. Most funds are used to construct industrial facilities to the specifications of particular firms; these facilities are then leased to the firms. Funds are also used to make working capital loans, purchase land, construct sites, or purchase leases on an anticipatory basis.

State Industrial Finance Authorities. Started in New Hampshire in 1955, there are now 13 states that have authorized such programs. State authorities either guarantee loans made by private lenders or make direct loans from state funds to industry by issuing industrial development bonds (IDBs).

Proponents of IDBs have pointed out that by exempting interest payments from federal taxable income, the rate of return that must be earned is reduced from 15 percent to 10 percent, allowing expansion into more marginal investments. Stober and Falk (1969) point out that the advantage also includes the fact that the local government that builds the facility faces no corporation income tax, and can thus break even if it only makes enough in receipts to cover interest payments. The lease payments it charges to industry are, therefore, less than the implicit lease payments a private firm would have to charge itself.

One problem with the variety of loan programs offered by states and localities is that they are usually administered by a variety of agencies, inhibiting cooperation and proliferating confusion. Milwaukee, by contrast, administers three loan programs—for housing rehabilitation, commercial rehabilitation and small business financing—through one super agency, the Department of City Development. The result has been the successful coordination and leverage of public funds.

Questionnaires that have been used to assess the role of IDBs are rarely convincing. In Alabama, one-third of 54 firms using IDB financing claimed they would have located elsewhere without that incentive, but fully ninety percent of eligible firms failed to take advantage of the provision (Alabama Business Research Council, 1970).

Overall, it appears that these loan subsidies are not cost effective development tools. States and local areas would be better off making direct cash grants to businesses--firms would feel as well off with a cash grant that is less than the foregone tax receipts under the present system—although this may not be politically palatable. Perhaps the answer is to concentrate on infrastructure development and new development finance corporations—policies whose benefits are less tied to a few large corporations.

WHAT CAN STATES DO?

The preceding discussion suggests several areas where states can take action or lobby for federal assistance:

- First, interstate tax competition should be reduced, perhaps with federal assistance.
- Second, states should act to reduce interjurisdictional tax incentive competition within their own borders.
- Third, income tax exemption for development financing bond interest payments should be replaced by interest subsidies.
- Fourth, states should focus on infrastructure development and cutting red tape rather than on tax incentives.
- Finally, if special incentives are to be used, they should be in the form of broadly applied wage subsidies rather than capital incentives.

Interstate Tax Competition

It is difficult for the individual state to act. Failure to offer tax incentives may well bring cries from local industry. Political opponents will be given a readily available, if ultimately fallacious, platform. The gubernational campaigns during the fall of 1978 echoed with cries for tax breaks. It seems clear that federal legislation is needed to make it hard for states to offer these bribes.

Can the federal government help? Outright prohibition is probably impossible, or extremely difficult, on constitutional grounds. There are, however, some measures that could be implemented:[6]

- Overall Economic Development Plans prepared by states and municipalities that offer special incentives could be rejected by EDA on the grounds that they fail to treat all companies equally. This would make those areas ineligible for Title II loan guarantees, and, perhaps, for Title IX grants.
- HUD could reject community development plans on the same grounds, and hold up CDBG and UDAG funds.
- General Revenue Sharing funds could be reduced for each dollar of local taxes foregone through an exemption or abatement program that did not apply uniformly to all firms.
- The corporation income tax code could include a federal tax penalty on firms granted special local tax exemptions.

It is difficult to assess the effectiveness of an initiative of this sort. State and local governments may substitute direct expenditures on infrastructure and business services in order to attract businesses. Reduced tax expenditures may influence economic development patterns.

Success depends on how broadly the anti-tax provisions are applied, and how much effort is devoted to enforcing them. Experience with hastily implemented countercyclical programs suggests that local governments can avoid ill-defined and loosely enforced federal regulations (Vernez and Vaughan, 1978). On the other hand, threat of withdrawal of education grants has been used, with some success, to encourage the integration of schools and the provision of special school services. Without a careful review of the relationship between federal enforcement activity and state and local behavior, and more details on how the program would be enforced, it is difficult to predict the outcome. Generally, states should rely less on firm-specific special incentives and more on actions that improve the overall business climate.

States should also rely more on across the board tax cuts and infrastructure development in order to attract industry. Most of these tax cuts should be directed at personal rather than business taxes, in response to taxpayer unrest.

Interjurisdictional Tax Competition States have considerable control over how their component jurisdictions shape their taxes to attract industry. Again, the most important measures are those that redistribute resources among jurisdictions (Chapter 4), but states could also penalize areas that step out of line in an aggressive tax incentive program.

Exemption of Local Municipal and Development Bonds from Income Tax States can do little to reduce reliance on local bond tax exemption, except through outright prohibition. If local public sector borrowing is to be made easier and cheaper, then states must appeal to the federal government to allow the issuing of taxable bonds which are eligible for a federal interest rate subsidy.

Given the prevailing atmosphere of fiscal restraint, it is reasonable to anticipate that an interest subsidy rate of 33-35 percent is politically feasible since this would involve little net increase in Treasury outlays and yet would provide state and local governments with substantial benefits. A report to the House Ways and Means Committee in 1976 estimated that a 35 percent subsidy would, in the long run, save state and local governments about $1.0 billion a year, and cost the Treasury only $140 million annually.

The shift into the taxable market will have a small effect on interest rates—an increase of between 0.01 and 0.03 on corporate rates (*Fortune*, 1973). Table 20 shows benefits of a $1 billion reduction in borrowing costs, both per capita and per $1000 of personal income, by state, and is based on the simplifying assumption that benefits are distributed among states according to their share of total state and local debt. States are grouped according to their fiscal "blood pressure" as calculated by the Advisory Commission on Intergovernmental Relations. It is apparent that benefits would be greatest in fiscally distressed states, states which tend to be located in the Northeast.

The targeting is not precise, however. Among the "low blood pressure" areas receiving high benefits are Alaska, Nebraska, and the District of Columbia. California and the New England states receive little assistance among the "high and rising" states. Actually, the benefits would be more effectively targeted toward fiscal distress than the table suggests. The taxable option will be exercised most readily by those distressed states and cities in the Northeast whose relatively low bond rating has either squeezed them out of the bond market or has left them paying very high rates. The proportional federal subsidy would mean that their subsidy per $1 million of bonds issued would be much higher than elsewhere. The broader market for taxable bonds will also lead to a reduction in the net interest rate they would have paid had they stayed in the tax exempt market, and reduce fluctuations.

The program has several desirable outcomes: it helps fiscally distressed areas; it encourages increased public borrowing at a time when lack of capital spending is viewed by some as nearing a crisis; it is

Table 20
Fiscal Blood Pressure and Benefits Per Capita and Per $1000 of Personal Income of a $1 Billion Reduction in State and Local Borrowing Costs

	p.c.	per $1000
High and Falling		
Wisconsin	3.3	.54
Arizona	4.8	.84
New Mexico	2.9	.55
Louisiana	4.9	.94
Wyoming	4.5	.70
Montana	2.7	.48
Oregon	6.7	1.09
Washington	8.9	1.33
Mississippi	3.1	.69
Unweighted Average	*4.6*	*.79*
Low and Falling		
South Dakota	2.0	.40
Iowa	1.9	.31
Colorado	3.3	.51
Utah	2.1	.41
North Dakota	2.5	.43
Indiana	2.0	.33
Idaho	1.3	.24
Kansas	3.8	.59
North Carolina	1.9	.35
Nebraska	7.8	1.30
South Carolina	3.1	.61
Texas	4.0	.66
Oklahoma	3.1	.55
Florida	3.7	.62
Tennessee	4.3	.82
Alabama	3.3	.65
Arkansas	2.1	.44
Unweighted Average	*3.1*	*.54*
High and Rising		
New York	10.0	1.41
Vermont	4.9	.91
Massachusetts	6.1	.92
California	3.7	.53
Hawaii	7.9	1.13
Minnesota	5.0	.81
Maine	3.7	.70
Nevada	4.4	.64
Maryland	6.0	.88
Rhode Island	4.6	.74
West Virginia	4.0	.76
Michigan	4.0	.59
Michigan	4.0	.59
New Jersey	4.7	.64
Delaware	7.7	1.09
Pennsylvania	5.5	.85
Unweighted Average	*5.4*	*.82*
Low and Rising		
Kentucky	4.8	.89
Connecticut	6.4	.86
Alaska	21.9	2.24
Georgia	3.2	.59
New Hampshire	3.3	.57
District of Columbia	14.3	1.74
Virginia	3.3	.52
Missouri	2.5	.42
Ohio	3.2	.51
Unweighted Average	*7.0*	*.93*

SOURCE: States listed in descending order of "Blood Pressure" in each category, from Advisory Commission on Intergovernmental Relations, "*Measuring the Fiscal Blood Pressure of the States – 1964-1975*, M-111, Washington, D.C., February 1977, and Bureau of the Census, *Governmental Finances, 1976-1977*, U.S. Department of Commerce, Washington, D.C., November, 1978. The calculations assume that the benefits of the $1 billion savings are distributed in proportion to the states' share of total state local indebtedness.

paid for by the relatively affluent; and will tend, in aggregate, to shift spending toward the less affluent.

Infrastructure Development and Red Tape Cutting

States have typically packaged tax and financial incentives with infrastructure development. Loans and loan guarantee offers are normally packaged together with considerable public investments in necessary infrastructure.

To attract Volkswagen to Pennsylvania, the auto manufacturer was offered not only a low interest $200 million loan, but also a promise to complete construction on railroads and highways leading to the New Stanton site. Ohio gave Honda grants totaling $2.5 million to help finance the building of rail spurs and publicly-owned water and sewer facilities, and even provided CETA funds to cover employee training costs.[12]

A major advantage of developing local infrastructure rather than offering specific tax incentives is that many firms can benefit from better roads, sewers, water supply, and fire and police protection. Such benefits need not be limited to a few large firms. The state, with its superior resources, can step in and help local communities with their development problems.

The state of Massachusetts, in cooperation with local governments, approached the problem of decaying mill towns by recycling old mills and buildings into housing, shopping centers, and recreational facilities.[13]

There are other alternatives to tax incentives. "City officials here think that businesses want good parking, clean neighborhoods and decent land – not gimmicks," claims William Schneider, Executive Director of the City-Wide Development Corporation in Dayton, Ohio.[14] Tax incentives cannot address the roots of the problems that lead to slow growth and rising unemployment. Infrastructure development (or redevelopment) can.

A major barrier to the effective use of "place enhancing" programs to spur local development is the artificial barrier between "economic development" and "community development" programs. This distinction is fostered, at the federal level, by the separation, and lack of coordination, between HUD's community development focus and EDA's emphasis on economic development, although the types of projects financed by each are quite similar. Planning activities for these programs at the state and local level are often undertaken by separate agencies.[15] These agencies seldom interact.

A second barrier to a coordinated "packaging" approach to solving development problems is the ambivalent role of state governments. While states have primary responsibility for planning and distributing funds for highways and water treatment, and partial responsibility for

EDA regular projects and CETA, local jurisdictions have a major share of LPW, CDBG, and parts of CETA. This approach to fund distribution by the federal government impedes coordinated local development efforts. States would do well to rationalize local development efforts by clearly delineating state and local responsibilities. However, the major responsibility must lay with the federal government, and at present, reorganization efforts seem to have been abandoned.

Thus we must conclude that a packaged infrastructure building approach to local economic development has the most promise, but also that there are significant institutional barriers that prevent the realization of its full potential.

Wage Subsidies[16] Incentives could be used to create jobs by reducing the cost of hiring additional labor. We have argued that payroll taxes have raised the cost of labor —particularly unskilled labor—and have contributed toward the problem of unemployment. The number of jobs available would increase if this cost were reduced.[17]

A wage subsidizing incentive could take several forms. The simplest form would be modelled on the investment tax credit, and allow a tax deduction for any increase in the firm's payroll. Thus if its payroll increases by $10,000 in a year, the firm may deduct, say, $1,000 from its taxable income. This is analogous to the federal employment tax credit adopted in 1977. This measure naturally provides most of its assistance to growing areas where employment would be expanding anyway, and does little to focus on the hard-to-employ. The new Targeted Jobs Tax Credit is applicable only to the hard-to-employ, and can be taken as a credit as well as a reduction in taxes. It meets many of these objectives. An alternative would be to provide employment vouchers to unemployed individuals, based upon their past income and unemployment experience. An employer could redeem these vouchers —either for cash or reduced payroll taxes —for each week that they provided the worker with a job. The cash value, or subsidy, would decline over time as the subsidized worker gained work experience.

Consider a simple numerical example. Someone unemployed more than thirty weeks and with a household income of less than $6000 in the previous year could present an employer with vouchers worth $75 per week, a subsidy that would slowly decline to zero over a 24 month period. He or she would compete —presumably for unskilled jobs— in the labor market and could secure a job paying close to the minimum wage—$116 for a forty hour week. The employer would be reimbursed for most of the wage costs. If the worker were employed for a full year, the employer would receive tax subsidies of $2808 toward a wage bill of $6032. During the second year, the subsidy would fall to $1078.

The program has the advantage of actually increasing the number of jobs available, and in targeting those jobs to the needy. The recently passed targeted jobs tax credit offers federal subsidies of about $1700 for employers hiring eligible workers. States could add to the program, offering reduced payroll or property taxes, and using CETA funds to cover part of the program cost.

A potential disadvantage of a wage subsidy is that employers might fire an employee as soon as the subsidy was reduced to hire a more subsidized worker. This objection is more apparent that real. First, there need be no sudden cut-off of the subsidy. Second, hiring and firing involves costs to the employer. And third, there would be an increase in the number of jobs available. The policy merits much deeper consideration than it has received in the past.

FOOTNOTES TO CHAPTER 6

1. Logically, reducing the death rate of firms could also boost local growth, but death rates do not vary much among areas, and seem fairly intractable to local policies.

2. These slogans were described in a column by James Sterba in the *New York Times*, July 18, 1978.

3. The exceptions are Alabama, Minnesota, and Tennessee.

4. Bird, 1966, parts I and II; Bridges, 1965; Due, 1961; Hellman, Wassall, and Falk, 1976; Hodge, 1979; Gurwitz, 1977; Harrison and Kanter, 1976 and 1978; Morgan and Hackbart, 1974; Mulkey and Dillman, 1976; and Williams, 1967.

5. Quoted in Jerry Jacobs, "Battling for Business," *People and Taxes*, September 1978, p. 9.

6. Some studies have found tax incentives to be cost effective from the viewpoint of local government. These have tended to ignore the secondary impacts of development, such as population growth. See, for example, Moes (1941); Rinehart (1963), and Sazama (1970).

7. These problems are not present, of course, with property tax incentives, since property taxes must be paid whatever the level of profit of the firm.

8. The concentration of non taxpaying firms is likely to be greatest in distressed areas, precisely where the stimulus is most needed.

9. Many of these topics are covered in other volumes in this series.

10. Section 107 of the Revenue and Expenditure Control Act of 1968 denies federal tax exemption to industrial development bond issues exceeding $5 million. Such issues fell sharply from $1.6 billion in 1968 to $0.5 billion by 1978. But bonds for water treatment were exempt from the $5 million limit, and by 1976, $4.5 billion in water treatment bonds were issued.

11. For a fuller discussion, see Vaughan (1979)

12. See Cornia, Testa, and Stocker (1978) and Haskins (1977).

13. See Neal R. Pierce, "States as City Savers," *The Washington Post*, 10/11/77.

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TAX INCENTIVES AS A DEVICE FOR IMPLEMENTING GOVERNMENT POLICY: A COMPARISON WITH DIRECT GOVERNMENT EXPENDITURES

Stanley S. Surrey *

The tax code contains a great number of special provisions which provide credits, deductions, and other tax advantages intended to achieve non-tax goals considered desirable by Congress. In fiscal 1968, these provisions represented tax expenditures of over 45 billion dollars. Professor Surrey argues that the tax incentive is generally inferior to the direct subsidy as a means of achieving social goals: that incentives are usually less equitable, since they benefit persons in high tax brackets most, and more difficult to develop and administer, since they are handled by tax committees and administrative agencies which have little expertise in non-tax social policy. He suggests a strong presumption against their use.

SUGGESTIONS are constantly being made that many of our pressing social problems can be solved, or partially met, through the use of income tax incentives. Moreover, the present federal income tax is replete with tax incentive provisions. Some were adopted to assist particular industries, business activities, or financial transactions. Others were adopted to encourage non-business activities considered socially useful, such as contributions to charity. This article will deal with the question of whether tax incentives are as useful or efficient an implement of social policy as direct government expenditures, such as grants, loans, interest subsidies, and guarantees of loans. The discussion will be in terms of the federal income tax, but it is intended to be helpful for other jurisdictions and other forms of taxation as well.

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I. The Nature and Extent of Existing Tax Incentives

The term "tax expenditure" has been used to describe those special provisions of the federal income tax system which represent government expenditures made through that system to achieve various social and economic objectives. These special provisions provide deductions, credits, exclusions, exemptions, deferrals, and preferential rates, and serve ends similar in nature to those served by direct government expenditures or loan programs. In any specific functional area the Government may use direct expenditures, interest subsidies, direct federal loans, and federal insurance or guarantee of private loans as alternative methods to accomplish the purposes which the special tax provision seeks to achieve or encourage.

The use of the phrase "special provisions" clearly involves a major definitional question: which tax rules are special provisions and therefore tax expenditures, and which tax rules are just tax rules; simply part of the warp and woof of a tax structure? The description and analysis of tax expenditures contained in the fiscal 1968 report to the Secretary of the Treasury used these guidelines: [1]

> [The analysis] lists the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax . . . .
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> * * *
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> The study does not attempt a complete listing of all the tax provisions which vary from a strict definition of net income. Various items that could have been added have been excluded for one or more of several reasons:
>
> (a) Some items were excluded where there is no available indication of the precise magnitude of the implicit subsidy. This

[1] 1968 Sec'y Treas. Ann. Rep. on the State of the Finances 326–30; *see* Statement of Joseph W. Barr, Secretary of the Treasury, in *Hearings on the 1969 Economic Report of the President Before the Joint Economic Comm.*, 91st Cong., 1st Sess. 8–44 (1969) (containing a "Comparison of Budget Outlays and Tax Expenditures by Function Fiscal Year 1970"). *See also* Statement by Stanley S. Surrey on the Tax Expenditure Budget, in *Hearings on Economic Analyses and Efficiency in Government Before the Subcomm. on Economy in Government of the Joint Economic Comm.*, 91st Cong., 1st Sess. (Sept. 16, 1969). For a discussion of the definitional task, see Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 Nat. Tax J. 244 (1969), and Surrey & Hellmuth, *The Tax Expenditure Budget — Response to Professor Bittker*, 22 Nat. Tax J. (to be published). The latter article also discusses the relevance of the tax expenditure concept to taxes other than the income tax. *See also* Wolfman, *Federal Tax Policy and the Support of Science*, 114 U. Pa. L. Rev. 171, 173–74 (1965).

is the case, for example, with depreciation on machinery and equipment where the accelerated tax methods may provide an allowance beyond that appropriate to the measurement of net income but where it is difficult to measure that difference because the true economic deterioration or obsolescence factor cannot be readily determined.

(b) Some items were excluded where the case for their inclusion in the income base stands on relatively technical or theoretical tax arguments. This is the case, for example, with the imputed rent on owner-occupied homes, which involves not only a conceptual problem but difficult practical problems such as those of measurement.

(c) Some items were omitted because of their relatively small quantitative importance.

Other features of our income tax system are considered not as variations from the generally accepted measure of net income or as tax preference but as part of the structure of an income tax system based on ability to pay. Such features include personal exemptions and the rate schedules under the individual income tax, including the income splitting allowed for married couples filing joint returns or for heads of households. A discussion of income splitting and the dependent's personal exemption is thus considered outside the scope of this study on tax expenditures.

It must be recognized that these exclusions are to some extent arbitrary . . . . The immediate objective, however, of this study is to provide a list of items that would be generally recognized as more or less intended use of the tax system to achieve results commonly obtained by government expenditures. The design of the list seems best served by constructing what seemed a minimum list rather than including highly complicated or controversial items that would becloud the utility of this special analysis.

* * *

. . . The assumption inherent in current law, that corporations are separate entities and subject to income taxation independently from their shareholders, is adhered to in this analysis.

These guidelines readily identify a significant number of provisions in existing law which we can all agree are "special" and represent tax expenditures: tax benefits for the aged, natural resources provisions such as percentage depletion allowances, the investment credit, excessive real estate depreciation. These provisions are identifiable as tax expenditures for the additional reason that they have been defended, either by their beneficiaries or by Congress in adopting them, on the grounds that they achieve a particular purpose, claimed to be desirable, other than the measurement of net income under an income tax.

On the basis of these guidelines, the Treasury analysis iden-

tified a long list of tax expenditures, with estimates in terms of fiscal year 1968. The expenditures were classified according to the functional categories of government expenditures used in the budget, with the addition of two special categories: Aid to State and Local Governments, and Capital Gains: [2]

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[2] Statement of Joseph W. Barr, *supra* note 1. Footnotes are here omitted. The Tax Reform Act of 1969, Pub. L. No. 91-172 (Dec. 30, 1969), cut back a number of these expenditures, and added a few new ones. See p. 713 and pp. 730-37 nn. 39-41 *infra*.

No significant tax expenditures are made in the budget categories of Space, Interest, and General Government.

The Treasury analysis contained the following comments on revenue estimates:

> All estimates of tax expenditures resulting from special tax provisions represent revenues lost on an annual basis. The estimates of revenue foregone are, in general, based on the assumption that such provisions never existed, or, alternatively, that such provisions have been withdrawn sufficiently long ago that we are now beyond the period needed to permit an equitable transition to a new tax situation.
>
> The revenue cost estimated for these special provisions is not in many cases the revenue change which would result in the first full year if these provisions were withdrawn. Replacement of some or all of these provisions by direct expenditures or lending programs might change the level and composition of economic activity. The revenue cost of each special tax provision presented for 1968 would, of course, generally vary over time with growth in the economy and changes in various parts of the tax base. Also, a realistic approach to any change in these provisions would provide in many situations transition arrangements which would effect the revenue change gradually over a period of years.
>
> Another key assumption is that economic activity for the year would not have been affected by the absence of these special provisions. This, of course, is a simplifying assumption for tax expenditures undoubtedly have significant effects on the composition and perhaps the level of economic activity. Also, in the absence of these tax benefits, there would doubtless have been changes in Government direct spending and net lending to accomplish some of the objectives of the existing provisions. No attempt has been made to speculate how the budget and the economy might differ if none of these provisions were in the law.

Statement of Joseph W. Barr, *supra* note 1, at 34. Thus, in effect the estimating techniques used are similar to the "first effect" estimates typically given by the Treasury to indicate the revenue effect of any proposed change.

Professor Henry Aaron has compiled another inventory of existing tax incentives, arranged according to the types of economic decisions which the tax provision influences. Aaron, *Inventory of Existing Tax Incentives: Federal*, in TAX INSTITUTE OF AMERICA, SYMPOSIUM ON TAX INCENTIVES (to be published) [hereinafter cited as INCENTIVES SYMPOSIUM]. He uses the term tax incentive to denote any tax provision which is "defended or advocated primarily because it so alters resource allocation as to improve economic efficiency." He excludes "tax provisions defended primarily because they are alleged to have favorable effects on the distribution of income by income class, family status, age groups or other socio-economic categories." Thus, he would exclude tax expenditures for the aged and the blind. His tax incentives fall into three main categories: those influencing *household behavior* — spending patterns (for example the charitable contributions deduction), place of employment (for example the exemption of certain income earned abroad), or portfolio choice (for example capital gains); *business behavior* — investment in capital (for example the investment credit), composition of the wage offer (for example the exclusion of employer contributions to pension plans), industrial composition (for example the tax benefits to agriculture and natural

Tax Expenditures by Budget Function	Revenue Cost Millions of Dollars
National Defense	
Exclusion of Military benefits and allowances	$500
International Affairs and Finance	
Individual taxation:	
Exemption for certain income earned abroad by U.S. citizens	40
Exclusion of income earned in U.S. possessions	10
Corporate taxation:	
Western Hemisphere trade corporations	50
Exclusion of gross-up on dividends of less developed country corporations	50
Exclusion of controlled foreign subsidiaries	150
Exclusion of income earned in U.S. possessions	70
Total	370
Agriculture and Agricultural Resources	
Farming: Expensing and capital gains treatment	800
Timber: Capital gains treatment for certain income	130
Total	930
Natural Resources	
Expensing of exploration and development costs	100
Excess of percentage over cost depletion	1,300
Capital gains treatment of royalties on coal and iron ore	5
Total	1,405
Commerce and Transportation	
Investment credit	2,300
Excess depreciation on buildings	500
Dividend exclusion	225
Capital gains: Corporations (other than agricultural and natural resources)	500
Excess bad debt reserves of financial institutions	600
Exemption of credit unions	40
Deductibility of interest on consumer credit	1,300
Expensing of research and development expenditures	500
$25,000 surtax exemption	1,800
Deferral of tax on shipping companies	10
Total	7,775
Community Development and Housing	
Owner-occupied homes, deductibility of:	
Interest on mortgages	1,900
Property taxes	1,800

resource), business location (for example the Western Hemisphere Trade Corporations provision); and *state and local government behavior*—sources of finance (for example deductibility of state and local taxes).

For an inventory of incentives in state and local taxes, see Slater, in Incentives Symposium.

Tax Expenditures by Budget Function	Revenue Cost Millions of Dollars
Rental housing–excess depreciation	250
Total	3,050
Health and Welfare	
Aged, blind, and disabled:	
Additional exemption, retirement income credit and exclusion of OASDHI for aged	2,300
Additional exemption for blind	10
Exclusion for sick pay	75
Exclusion of unemployment insurance benefits	300
Exclusion of workmen's compensation benefits	150
Exclusion of public assistance benefits	50
Exclusion for employee pensions	3,000
Deduction for self-employed retirement	80
Exclusion of other employee benefits:	
Premiums on group term life insurance	400
Accident and death benefits	25
Medical insurance premiums and medical care	2,100
Privately financed supplementary unemployment benefits	25
Meals and lodging	150
Exclusion of interest on life insurance savings	900
Deductibility by individuals of charitable contributions (other than education) including untaxed appreciation	2,200
Deductibility of medical expenses	1,600
Deductibility of child and dependent care expenses	25
Deductibility of casualty losses	70
Standard deduction	3,200
Total	16,550
Education and Manpower	
Additional personal exemption for students	500
Deductibility of contributions by individuals to educational institutions	170
Exclusion of scholarships and fellowships	50
Total	720
Veterans Benefits	
Exclusion of certain benefits	550
Aid to State and Local Government Financing	
Exemption of interest on State and local debt obligations	1,800
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes):	
Individual income tax	1,350
General sales taxes	775
Gasoline taxes	400
Personal property taxes	150
Other taxes	125
Total	2,800

Tax Expenditures by Budget Function	Revenue Cost Millions of Dollars
Property taxes on owner-occupied homes (included under community development and housing)	1,800
Total, all State and local nonbusiness taxes	4,600
Capital Gains — Individual Income Tax	
Special provisions (increase in basis at death; exclusion of one-half of long-term gains; maximum tax rates of 25% on long-term gains)	3,500-3,500

The analysis also showed the relationship of tax expenditures to direct expenditures for these budget categories. In some cases the tax expenditures exceeded or were close to budget expenditures (Community Development and Housing, 204%; Commerce and Transportation, 114%; Natural Resources, 90%; Health and Welfare, 37%) (fiscal 1969 figures). In none of the categories listed above except for National Defense and Veterans were the tax expenditures less than 10% of budget expenditures. The total of the estimated tax expenditures, in a round number, was $45 billion.

If we take as our definition of tax incentive a tax expenditure which induces certain activities or behavior in response to the monetary benefit available, almost all of the tax expenditures included in the above analysis can be considered tax incentives. Many of the tax expenditures were expressly adopted to induce action which the Congress considered in the national interest. For example, the investment credit was intended to encourage the purchase of machinery and equipment; excessive bad debt reserves for some financial institutions were allowed to encourage the growth of savings and loan associations and mutual savings banks; the charitable deduction was intended to foster philanthropy; the preferential tax treatment of qualified pension plans was intended to foster broad pension plan coverage; and the corporate surtax exemption was intended to foster small business.[3] Other tax expenditures whose origins are cloudy are now defended as incentives to home ownership, as in the case of the deduction for mortgage interest and property taxes, or as aids to state and local governments' tax bases, as in the case of the deduction for state and local taxes. Other tax expenditure pro-

[3] Other tax expenditures in this class include the treatment under the foreign tax credit of dividends paid by the corporations of less developed countries, capital gains treatment in general, the exemption of credit unions, the special treatment of timber capital gains, the hundred dollar dividend exclusion, and the deduction for one-half of medical insurance premiums, group term life insurance, and income [illegible] road. Accelerated depreciation on real estate probably is another example, although it was adopted largely as a happenstance along with accelerated depreciation provisions designed to encourage investment in personal property.

visions were adopted as relief provisions to ease "tax hardships," or were adopted to simplify tax computations. Some of these provisions have come to be defended on the basis of their incentive effects: for example, the intangible drilling expenses deduction, the percentage depletion allowance, the Western Hemisphere Trade Corporation preferential rate, and the research and development expense deduction.[4] Moreover, to the extent that such tax relief — *i.e.*, tax treatment that is special and not required by the concept and general standards of a net income tax — is granted for an activity that is voluntary, the relief is in effect an incentive to engage in that activity, even though the provisions may not be defended on incentive grounds. For example, if meals and lodging furnished an employee on the premises of an employer are not taxed, the effect is to make employees more likely to choose such employment. If coal and iron royalties receive capital gains treatment and other royalties do not, investment preferences will be affected.[5]

The only tax expenditures that are not tax incentives, as we are using the expression, are expenditures related to involuntary activities of taxpayers. Most such provisions are designed to provide tax reduction in order to relieve misfortune or hardship — situations involving "personal hardships," as contrasted with the "tax hardships" that have brought about other special tax provisions, chiefly for business activities. The extra exemption for the blind is one example. The extra exemption for the aged is another — we can't grow old any faster because of the exemption.[6] Special provisions of this character are relatively few in

[4] Additional examples include the bad debt reserves for banks, the cash method of accounting for farmers, and the special personal exemption for students.

[5] Incentive effects are also produced by the exemption of military pay earned in combat zones.

[6] Perhaps the other tax benefits for the aged — the retirement credit and the social security exemption — also fall in this non-incentive category, though this is not so clear. The retirement credit provides some incentive to retire. Also, favoring retirement income may encourage saving for retirement. The employee sick pay exclusion may be in the non-incentive class, since sickness is presumably involuntary, yet the provision can have the incentive effect of inducing employers to provide such plans or unions to negotiate for such plans. The general medical expense deduction similarly has non-incentive characteristics, yet the presence of the deduction does tend to induce the purchase of health insurance and the greater use of medical services and equipment. The exclusion of unemployment insurance and public assistance benefits also has non-incentive characteristics, if we regard unemployment and need for public assistance as essentially involuntary conditions. Yet for some individuals the generality will not hold, and the tax result will add to the monetary inducement which makes the condition acceptable. The casualty loss deduction is also generally not an incentive, though in particular cases it may induce certain action that would otherwise be too risky, such as self-insurance, or ownership of a house in a hurricane area.

number. By and large, therefore, the classification guidelines in the Treasury Analysis which separate tax expenditures from other tax provisions also serve to identify existing tax incentives.

The recently considered tax expenditures are all in the tax incentive category. They include pollution control machinery credits, manpower training credits, educational expense credits, tax benefits for investing in low income housing, and tax benefits for business investment in central cities or rural areas. In all these situations the direct purpose of the proposed tax change is to provide monetary assistance or benefit through the tax laws so as to make the desired course of action financially more palatable to taxpayers involved, and thereby induce them to take that action. Whatever the purpose of the economic benefit involved — be it to make an expensive activity less costly, to reduce its risk, or to increase the rate of after-tax profit — the incentive effect is the desired effect.

II. Comparison of Tax Incentives with Direct Expenditures

This section of the discussion is concerned with criteria for evaluating the use of tax incentives as compared to the use of direct government expenditures. This evaluation does not involve the issue whether we should seek to achieve the particular goals for which tax incentives are now used or suggested. We can assume it is understood that each incentive must serve purposes which the nation wants to achieve and is willing to finance, rather than let the marketplace determine the extent to which the result will obtain. This is not to say that every proposal for a tax incentive is presented or defended with a careful analysis along these lines. Far from it — many sponsors of tax incentives simply assume that if the benefit sought is helpful to them in reaching a desired result, the incentive is in the public interest. But this discussion assumes that these issues have been decided. Therefore, we are assessing the use of tax incentives as a technique to provide the government assistance. The discussion is applicable to those tax expenditures intended to alleviate personal hardships, although we have indicated that they might not be classified as tax incentives.

There are, of course, as stated earlier, a variety of ways to provide government financial assistance — direct grants, loans, interest subsidies, guarantees of loan repayment or interest payments, insurance on investments, and so on. These methods are here called budgetary or direct expenditures. Skilled tax tech-

nicians and budgetary experts can take any tax expenditure and devise a budgetary expenditure approach to serve the same goals as a direct expenditure.[7] For example, the British for some years used an approach under their tax law somewhat similar to our 7% investment credit to encourage the acquisition of machinery and equipment. They subsequently dropped the tax technique and substituted direct cash payments.[8] The existing tax incentive for charitable giving could also be structured as a direct expenditure program, under which the Government would match an individual's contribution to charity with a proportional contribution of its own to the same charity.[9] Tax credits to an employer for manpower training could be structured as grants or contract payments to the employer. Tax benefits to the aged can be structured as cash to the aged. And so on.

It follows that a meaningful comparison between the tax incentive technique and the direct expenditure technique must involve *similar substantive programs*. There is no point to saying that in a particular situation a tax incentive is a more useful approach because it involves no government supervision over the details of the action to be induced, whereas a direct expenditure involves detailed supervision. To say so is not to compare a tax incentive with a direct expenditure but simply to compare a loosely controlled method of paying out government funds with a tightly controlled method. Direct expenditures can involve loose as well as tight supervision. Once we decide which substantive program we want then we can go on to decide which technique, tax incentive or direct expenditure, is preferable for that program.

The matter of what type of substantive program is best calculated to achieve the desired goal lies in the fields of cost-benefit and cost-effectiveness analyses. These methods are being used more and more to devise and test direct expenditures, and they should a priori be equally applicable to programs using a tax in-

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[7] *See* Stone, *Tax Incentives as a Solution to Urban Problems*, 10 WM. & MARY L. REV. 647, 651–53 (1969) (describing possible assistance devices for urban housing). *See also* Slitor, *Tax Incentives and Urban Blight*, in INCENTIVES SYMPOSIUM (generally defending tax incentives). For other discussions of tax incentives, see Blum, *Federal Income Tax Reform—Twenty Questions*, 41 TAXES 672 (1963); Kurtz, *Tax Incentives: Their Use and Misuse*, U. SO. CAL. 1968 TAX INSTITUTE 1.

[8] The tax provision was the Finance Act of 1954, 2 & 3 Eliz. 2, c. 44, § 16, repealed by the Finance Act of 1966, c. 18, § 35. Direct grants were instituted by the Industrial Development Act of 1966, c. 34, § 1.

[9] Where the charity was a religious institution, a direct government contribution would raise serious questions under the establishment of religion clause of the first amendment. But such a direct subsidy should be considered constitutional if the present tax provision is, since there is no practical difference between the two.

centive technique.[10] For present purposes I am assuming that the substantive analysis, as respects methodological approach, use of econometric techniques, and the like, should be of the same order whether a tax incentive or a direct expenditure is involved. This is not to say that this has been true with regard to tax incentives in the past. Far from it — and therein lie many of the problems with tax incentives. Nor can we say that it will be true as to future tax incentives, nor can we say that all direct expenditure programs are carefully thought through.

A meaningful comparison between the two techniques must also be *realistic*. Thus, it must recognize that a tax incentive does involve the expenditure of government funds. It is often said that a tax incentive is more useful than a direct expenditure because people do not like or will not respond to "subsidies." Such statements always assume that the direct expenditure is the "subsidy," whereas the tax benefit obtained in the tax incentive — the lower tax — is not so regarded. Perhaps we may find that this fiscal illusion has its usefulness, but we should at least be aware of what is the reality and what is the illusion.[11]

A. Some Asserted Virtues of Tax Incentives — Falsely Claimed

Against this general background we can now consider some of the virtues and defects generally claimed for tax incentives and, on the other side of the coin, for direct expenditures. The first level of consideration relates to virtues claimed for tax incentives, but, in light of the above background, falsely claimed.

1. Tax Incentives Encourage the Private Sector to Participate in Social Programs. — Frequently a tax incentive is urged on the ground that the particular problem to be met is great and that the Government must assist in its solution by enlisting the par-

[10] For recent examples of such studies applied to tax incentives relating to natural resources, see Consad Research Corp., *The Economic Factors Affecting the Level of Domestic Petroleum Reserves*, in HOUSE WAYS & MEANS COMM. & SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., UNITED STATES TREASURY DEPARTMENT, TAX REFORM STUDIES AND PROPOSALS (Comm. Print 1969); Mid-Continent Oil and Gas Association, Analysis and Comment Relating to the Consad Report on the Influence of U.S. Petroleum Taxation on the Level of Reserves, April 25, 1969; Consad Research Corp., *Comments on Mid-Continent (MIC) Oil and Gas Association Critique*, 115 CONG. REC. S14290-91 (daily ed. Nov. 13, 1969). As to buildings, see Taubman and Rausche, *The Income Tax and Real Estate Investment*, in INCENTIVES SYMPOSIUM; Taubman and Rausche, *Economic and Tax Depreciation of Office Buildings*, 22 NAT. TAX J. 334 (1969). As to the investment credit, see Brannon, *A Requiem for the Investment Tax Credit*, in INCENTIVES SYMPOSIUM (describing existing studies on the credit).

[11] Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 602-03 (1965).

ticipation of the private sector — generally business. The need for Government to participate can be fulfilled by a tax incentive, and this is asserted as a virtue of tax incentives — they provide government assistance. Thus, a tax incentive for manpower training proposed in the Senate was defended in these terms: [12]

> Tax incentives [are proposed] to encourage the fullest participation of the private sector in employment, upgrading, and training of less skilled people.
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> . . . .
>
> . . . A tax incentive program should [make] . . . it economically possible for American business to play an important role in our manpower program.
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> . . . .
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> . . . .
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> I understand the objections that are at times put forward to the use of the tax system for social purposes. However, I think it is time we realized that in order to encourage business to participate in programs of this nature, Government must be willing to meet business half way. The most convenient form for subsidizing a businessman is through his income tax.
>
> . . . [This bill] enlists the job-creating potential of private enterprise by realistically recognizing the high initial costs involved in hiring, training, and providing supportive services for low-skilled individuals.

But all this is a non-sequitur; it points not to the virtue of tax incentives but to the need for government assistance. The existence of that need has no relevance to the question whether the need should be met by an incentive or by a direct expenditure.

2. Tax Incentives Are Simple and Involve Far Less Governmental Supervision and Detail. — A whole swirl of virtues claimed for tax incentives is summed up in the general observation that they keep Government — that is, the government bureaucracy — out of the picture: that they involve less negotiation of the arrangements, less supervision, less red tape, no new bureaucracy, and so on. The manpower proposal referred to above was supported by this argument: [13]

> The advantages to a tax credit approach are numerous. The most important, however, is that the program can go into effect immediately upon enactment. Employment programs in the past have taken months and years to become operative. . . . Employers who participate in the program will receive a tax credit of 75 percent of the wages paid to the employee for the first 4

[12] 115 Cong. Rec. S5329, S5330 (daily ed. May 16, 1969) (statement of Senator Percy). The bill is S. 2192, 91st Cong., 1st Sess. (1969).

[13] 115 Cong. Rec. S5329, S5330 (daily ed. May 16, 1969) (statement of Senator Percy).

> months of employment, 50 percent for the next 4 months, and 25 percent for the balance of the individual's first year of employment. This is an uncomplicated program with the minimum of redtape. Any employer who hires a certified employee is eligible for the tax credit — it is as simple as that.

But this merely comes down to saying: "Let's have a manpower program under which the Government pays an employer who hires a certified employee an amount calculated as a percentage of the employee's wage." There is nothing so far that indicates whether the payment should be by way of a tax credit or a direct expenditure. If the employer can obtain government funds (*i.e.*, a reduction in tax through the tax credit) for his employment activities by filling out a schedule on a tax return, a manpower program could be devised instead under which he would receive the same monetary assistance by filling out the exact same schedule on a piece of paper that had "Department of Labor" at the top in place of "Internal Revenue Service."

A government that decides it is wise to pay out tax credit money via a simple tax schedule would be highly irrational if it also decided that it would be unwise to pay the same amount directly on the same basis. A dollar is a dollar — both for the person who receives it and the government that pays it, whether the dollar comes with a tax credit label or a direct expenditure label. Nor is a new bureaucracy needed to pay out these amounts as a direct expenditure — a check-writing process is all that would be needed in keeping with the parallel to the tax credit. Nor, similarly, must there be long negotiations, complex contracts, and the like. It is not the tax route that makes the program simple — it is a substantive decision to have a simple program. In many cases, it is true, direct expenditure programs are probably overstructured and the urging of tax incentives is a reaction to, and a valid criticism of, badly designed expenditure programs. The cure lies of course in better designed expenditure programs.

It should be added, parenthetically, that the alleged simplicity of tax incentives is likely to be illusory. Thus, the argument quoted above states that "[a]ny employer who hires a certified employee is eligible for the tax credit — it is as simple as that." But this is not really so, because the legislation actually proposed would have required the employer to be certified by the Secretary of Labor, and to be eligible for certification an employer would have had to prove that the employment program would not impair or depress the wages, working standards, or opportunities of present employees; that the business was not affected by strike, lockout, or similar conditions; that the employees in the program would be afforded an equal opportunity for full-time employment

after the expiration of the credit period; that a formal on-the-job training program would be available; and that there would be no discrimination on account of race, color, religion, or national origin. Further complexities were involved in the proposed system for determining the creditable wage base, which was to be defined as the higher of the minimum wage or the wage customarily paid by the employer for such services.[14] Similarly, the low income housing tax incentive legislation discussed in 1967 and 1968 was studded with requirements of "approval by the Secretary of Housing and Urban Development."

The tape was thus present in the tax credit program and its color was red. This is not to criticize the particular programs, but rather to observe that those who design tax incentive programs, just as those who design direct expenditure programs, may find that complex requirements become desirable.

3. Tax Incentives Promote Private Decisionmaking Rather Than Government-Centered Decisionmaking. — It is said that better progress will be made towards the solution of many social problems if individual decisionmaking is promoted, and that since tax incentives promote this they should be preferred to approaches that underscore government-centered decisionmaking. Senator Ribicoff, for example, has expressed the view that "[r]ecognition that tax incentives can account for real Federal expenditures should not obscure the fact that such programs can eliminate the need for additional bureaucratic apparatus while promoting the use of private capital and initiative toward socially useful projects." [15]

We need not discuss the merits of private enterprise as a device for solving social problems, except to note in passing that many business groups who in urging tax incentives stress the virtues of private enterprise overlook the fact that they are really stressing private enterprise *plus* government assistance. But wise or unwise, the contention that private enterprise should be allowed free play, without government interference, tells us nothing as to the choice between tax incentives and direct expenditures, given the same substantive program. This contention is really a variant of the previous "red tape" argument. Just as we could design a direct expenditure program that provides for reduction of red tape, so we could design one that provides more flexibility for private decisionmaking and less scope for government control.

[14] S. 2102, 91st Cong., 1st Sess. (1969). *See* p. 716 *supra*.

[15] JOINT ECONOMIC COMM., 1969 JOINT ECONOMIC REPORT, H.R. REP. No. 142, 91st Cong., 1st Sess. 20 (asterisk footnote). *See also id.* at 89 (views of Senator Talmadge); 3 CITY, April, 1969, at 5 (quoting Norman Ture to the effect that "incentives can bring into play previously unused or under-utilized resources most efficiently").

For example, the deduction for charitable contributions is sometimes cited as a method of government assistance that promotes private decisionmaking — the taxpayer, and not the Government, selects the charity and determines how much to give. But a direct expenditure program under which the Government matched with its grants, on a no-questions-asked and no-second-thoughts basis, the gifts of private individuals to the charities they selected, would equally preserve private decisionmaking. Similarly, the freedom of choice that states and local governments have as to how to use the funds they borrow with the assistance of the tax exemption for the interest on their bonds can be preserved by a direct expenditure program in which the federal government pays a part of the interest cost.[16]

It is true that many of the existing tax incentives are less structured than direct expenditure programs. But in part this reflects lack of scrutiny and foresight when the tax incentives were being planned or considered. If after a careful consideration it is decided that a simple structure is wise, then it would assume considerable irrationality to say that the simple structure will necessarily be kept if a tax incentive is used but scrapped in favor of a more complicated structure if a direct expenditure is used.

B. Some Asserted Defects of Tax Incentives

1. Tax Incentives Permit Windfalls by Paying Taxpayers for Doing What They Would Do Anyway. — It is generally argued that tax incentives are wasteful because some of the tax benefits go to taxpayers for activities which they would have performed without the benefits. When this happens, the tax credit or other benefit is a pleasant windfall, and stimulates no additional activity. With respect to many existing and proposed incentives this criticism is well taken, and indeed it is often difficult to structure a tax credit system which avoids this problem without increasing complexity and introducing arbitrariness. But this also is a problem not unique to the tax incentive technique. A direct expenditure program similarly structured would be equally open to the charge. For example, grants or contract payments made to employers who hire unskilled employees as part of a manpower program may go to employers who for one reason or another would have hired those employees anyway.

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[16] *See* Surrey, *Federal Income Taxation of State and Local Government Obligations*, 36 TAX POLICY, May-June 1969, at 1; Healy, *The Assault on Tax-Exempt Bonds*, 36 TAX POLICY, July-August, 1969), at 2; Surrey, *The Tax Treatment of State and Local Government Obligations — Some Further Observations*, 36 TAX POLICY, Sept.-Oct. 1969).

It may be desirable in particular programs to tolerate this inefficiency or windfall. Or it may be desirable to attempt to eliminate it, perhaps by constructing a program under which taxpayers bid for the government assistance needed and the assistance goes to the lowest bidders if otherwise qualified, just as in direct government purchasing. It may be that such a substantive program is difficult to operate through the tax technique, but other ways of reaching only the marginal decision could be built into a tax incentive. The significant question is what sort of substantive program is desired.

2. *Tax Incentives Are Inequitable: They Are Worth More to the High Income Taxpayer than the Low Income Taxpayer; They Do Not Benefit Those Who Are Outside the Tax System Because Their Incomes Are Low, They Have Losses, or They Are Exempt from Tax.* — This criticism of tax incentives in terms of their inequitable effects is properly levied against most of the existing tax incentives, and probably most of the proposed incentives. The existing incentives were never really carefully structured and in many instances just grew up, without serious thought ever having been given to the question whether they were fair in these terms. The entire process was molded by the fact that the positive tax structure was being affected, and within that structure tax benefits — deductions and exclusions — had these effects as a matter of course. The deductions and exclusions of the tax incentive provisions and their inequitable effects took on the protective coloration of the deductions and exclusions that were a part of the basic tax structure.

The fact that tax benefits for the aged and the sick provide no benefits for those aged or ill who are too poor to pay income taxes was not even thought of as a difficulty, since the focus was, as in any positive tax system, on writing the rules for *taxpayers*.[17] The problem was sometimes thought about in the context of an individual who fell outside the tax system because of current losses, and at times a carry-forward of incentive benefits was provided. Thought was occasionally given to the fact that the deduction of mortgage interest or charitable contributions is worth more to the top bracket taxpayer than the low bracket taxpayer, but the disparity was generally dismissed on the grounds that all deductions had that effect. Sometimes this matter was regarded as worrisome, and a tax credit was used instead

[17] The fact that deductions and exemptions benefit only taxpayers is, to take the large view, a product of the fact that we have only a *positive* income tax system. If we had a *negative* income tax as well, then direct expenditures would benefit those whose incomes were below the level of positive tax, and a continuum in treatment would prevail.

of a deduction, as in the case of the retirement income credit for the aged.

This unfairness persists even in recently proposed tax incentives. The proposed tax credit for educational expenses [18] would not have helped poor families with incomes below the taxable level. The proposed manpower training credit [19] would not help a new business experiencing initial losses and struggling to stay alive, or it would help only by deferring into the future, through a carry-forward provision, benefits needed at once.[20] No assistance is provided to a tax-exempt organization or local government incurring added expenses under its participation in manpower training activities.[21]

Thus, the lesson is hard to learn. The recent tax reform legislation contained a tax incentive for the rehabilitation of low income housing, using the device of five-year amortization of capital expenditures [22] which otherwise would be depreciated over a longer period. This device, which was proposed by the Treasury Department, has these interesting effects for individual taxpayers: for a taxpayer in the 70% bracket, the benefit is the equivalent of a 10% investment credit (assuming an expenditure with a 20-year life and discount rate of 10%); for a taxpayer in the 20% bracket it is the equivalent of a 5% credit. In terms of interest costs on a loan made for rehabilitation purposes, the benefit of five-year amortization is equivalent for the 70% bracket taxpayer to reducing an 8% interest charge to 3%; for the 20% bracket taxpayer it is equivalent to reducing the 8% charge to 7%. The inequitable effect of this tax incentive device is not mentioned either in the proposal or in the committee reports explaining it.[23]

It is thus clear that most tax incentives have decidedly adverse effects on equity as between taxpayers on the same income level, and also, with respect to the individual income tax, between taxpayers on different income levels. As a consequence of these inequitable effects, many tax incentives look, and are, highly ir-

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[18] Tax Reform Bill of 1969, H.R. 13,270, 91st Cong., 1st Sess. § 917 (1969). The provision was not retained in the final legislation.

[19] A similar unfairness existed in the proposed deduction for transportation expenses of handicapped persons. Tax Reform Bill of 1969, H.R. 13,270, 91st Cong., 1st Sess. § 915 (1969). This provision was not retained in the final legislation.

[20] S. 2192, 91st Cong., 1st Sess. (1969).

[21] Canada appears to be shifting from tax incentives to direct expenditures in providing government assistance to regional economic expansion. Regional Development Incentives Act of 1968-69, c. 56. One reason given is the ineffectiveness of tax incentives when new ventures are involved.

[22] Tax Reform Act of 1969, Pub. L. No. 91-172, § 521(a) (U.S. Code Cong. & Ad. News No. 12 (Dec. 30, 1969)), *amending* Int. Rev. Code of 1954 § 167.

[23] *See Hearings on H.R. 13,270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 5, at 4903-08 (1969) (statement of Charles Davenport).

rational when phrased as direct expenditure programs structured the same way. Indeed, it is doubtful that most of our existing tax incentives would ever have been introduced, let alone accepted, if so structured, and many would be laughed out of Congress. What HEW Secretary would propose a medical assistance program for the aged that cost $200 million, and under which $10 million would go to persons with incomes over $50,000, and only $8 million to persons with incomes under $5,000? The tax proposal to remove the 3% floor under the medical expense deductions of persons over 65 would have had just that effect.[24] What HEW Secretary would introduce a program under which Social Security benefits would be unaffected if the recipient's total income including the benefit were under $1,000, would be automatically increase by 14% if the recipient's income were between $1,000 and $1,400, by 15% if between $1,400 and $1,800, and so on up to 70% if over $100,000? That is the effect of the present exclusion from income of Social Security benefits. What HUD Secretary would suggest a housing rehabilitation subsidized loan program under which a wealthy person could borrow the funds at 3% interest but a poor person would have to pay 7% or 8%? That is the effect of the five-year amortization of rehabilitation expenditures contained in the recent Tax Reform Act.[25]

This criticism — that tax incentives produce inequitable effects and upside-down benefits — is valid as to the general run of tax incentives.[26] It demonstrates why tax incentives make

[24] Tax Reform Bill of 1969, H.R. 13,270, 91st Cong., 1st Sess. § 91 (1969). The provision was not enacted.

[25] Tax Reform Act of 1969, Pub. L. No. 91-172, § 521(a), [1969] U.S. Code Cong. & Ad. News No. 12 (Dec. 30, 1969)).

Professor Henry Aaron uses this example:

> Yesterday on the floor of Congress, Senator Illinois introduced legislation to provide cash allowances for most of the aged. Senator Illinois's plan is unique, however, in that it excludes the poor. The largest benefits, $70 per month, are payable to aged couples whose real income exceeds $10,000 per year. The smallest benefits, $14 per month, would be payable to couples with income between $1,600 and $2,600. Widows, widowers, and unmarried aged persons would receive half as much as couples. No benefits would be payable to those with very low incomes.

Professor Aaron states this is a way of describing the (then) additional $600 personal exemption for the aged. Aaron, *Tax Exemptions — The Artful Dodge*, Transaction, March, 1969, at 4.

[26] In the case of the corporate income tax, the absence of the progressive rate structure of the individual income tax makes the tax incentive less inequitable than in the individual income tax situation. Nevertheless, inequities do exist when a tax incentive deduction is used, since the larger corporations receive a 48% benefit (absent the surcharge) and the smaller corporations only a 22% benefit. Corporations incurring losses may receive no benefit. The use of a tax credit rather than a deduction would eliminate the first aspect, but would probably leave the loss corporation without assistance, since tax incentive credits in excess of tax liability typically are not paid out.

high-income individuals still better off and result in the paradox that we achieve our social goals by increasing the number of tax millionaires. The marketplace does not work this way — for the individual who earns his profits, even high profits, by meeting a need or desire of society, finds his rewards subject to the progressive income tax. The economic system is thus functioning as it is intended it should, and the tax system, which acts as a control, is also functioning as intended. But when rewards are in the form of tax incentives, the latter control is eliminated, and tax millionaires are produced.

The financial assistance afforded by the incentive, with the purpose of making profits high enough to induce the desired action by the taxpayer, is not itself included in income. The tax incentive thus provides both financial assistance and freedom from taxation. That freedom itself means much more to the well-to-do individual than to one in the lower brackets. The tax incentive is thus a method of reward and assistance that is just upside-down from the way the country decided — when it adopted a progressive income tax — that the rewards of the marketplace should operate in combination with the income tax. The use that has been made — and is being made — of tax incentives is thus destructive of the equity of a tax system. This is illustrated by the Treasury Department's first proposing a housing rehabilitation tax incentive and then having to suggest that the incentive is a tax preference which must be guarded against by including it in a minimum tax structure designed to prevent the wealthy from escaping all tax burdens.[27] The use of the direct expenditure route would have prevented this particular undermining of the tax system.

In some cases, however, the tax incentive could be fashioned to avoid this criticism, though the result would be a different program and one structured more closely along direct expenditure lines. For example, suppose in the case of the exclusion of Social Security benefits, that a uniform tax credit was used instead of the exclusion, the tax credit was included in taxable income, and any unused credit was paid to the taxpayer. This would be the equivalent of a direct expenditure program for all aged on a per capita basis, with positive taxpayers receiving a diminishing final share depending on their tax bracket, and those aged outside the tax system receiving their full share. The elements of inequity would be removed and the tax incentive technique would

[27] *See* article by Eileen Shanahan in N.Y. Times, Dec. 22, 1969, at 25, col. 4 ("There are four other major new tax preferences in the bill: tax incentives (which is what preferences always are at their birth) aimed at stimulating . . . the rehabilitation of old residential housing . . .").

be on the same footing as a direct expenditure under which each aged person received the same per capita amount. Indeed, this is how tax incentive programs *should* be structured if they are to be equitable and not involve the unfairnesses described. But this approach may only rarely be feasible given its novelty and the difficulties involved in convincing the business community and others who are the beneficiaries of tax incentives, let alone the policymakers in Government, of the appropriateness of making such changes as including the tax incentive amount itself in taxable income.[28]

As an aside, we can here see the importance of distinguishing tax expenditures and tax incentives — so-called special tax provisions — from those provisions considered a proper and necessary part of the structure of an income tax. If an item is *properly* deductible in the latter sense, it does come off at the taxpayer's top tax rate, and its benefits are confined to those who are taxpayers. Given the decision to have an income tax at all, the result is equitable, within the concept of an income tax. An income tax is a tax on *net* income and not a tax on gross receipts; therefore the deductions from gross income required to produce the net income base must be allowed. Those deductions, generally speaking, are the expenses and costs incurred in the process of producing or earning the gross income received by the taxpayer.

Thus, consider the deduction for moving expenses; it is a deduction and so benefits a taxpayer (reduces his tax) in accordance with his marginal tax rate. It also benefits only taxpayers; an employee who incurs moving expenses, but whose income is so low as not to leave him taxable, does not obtain any benefit or assistance. This is the correct result under a positive income tax system if the moving expense should properly be taken into account in the measurement of net income, as it should be if it is an expense in earning income rather than a personal expense. If it is the latter, the deduction is a subsidy or tax expenditure, inequitably cast, to induce labor mobility. Actually, the moving expense deduction is at the frontier of the positive income tax structure; a gradual shift is occurring, and such ex-

[28] Where the tax incentive amount is similar to a contribution to capital, it would not be included in income but would reduce the basis of property related to the contribution. *Compare* INT. REV. CODE OF 1954, §§ 118, 362(c).

There are other ways to structure a special tax provision to eliminate inequities. For example, the system of special bad debt reserves for financial institutions could be handled by allowing the deduction of the special reserve but then requiring the tax savings to be invested in special federal bonds that do not carry interest. This approach is now used in the tax treatment of special reserves for mortgage insurance companies. *See* HOUSE WAYS & MEANS COMM., 91st Cong., 1st Sess., UNITED STATES TREASURY DEPARTMENT, TAX REFORM STUDIES AND PROPOSALS, pt. 3, at 467 (Comm. Print 1969).

penses are coming to be regarded as a factor proper and necessary to the measurement of net income.[29]

3. Tax Incentives Distort the Choices of the Marketplace and Produce Unneutralities in the Allocation of Resources. — This criticism is in one sense always valid, because that is what the tax incentive is designed to do. Generally, the critic is also saying or implying that the distortion introduced by the particular incentive is undesirable for various reasons. In large part this criticism is true of many existing incentives for reasons earlier described. The criticism has relevance because the distorting effects of tax incentives often pass unnoticed. But the criticism is of course equally applicable to direct expenditures, some of which certainly are unwise. Again, we are not here concerned with the overall role of government or the extent to which and under what circumstances financial assistance is desirable to induce private action different from what the marketplace would provide. This criticism thus does not per se tell us when one or the other technique should be used.

It is interesting to note that even within the area sought to be benefited by the tax incentive, the design of the incentive may push or pull in unneutral directions, which may or may not be desirable. Thus, a tax credit for pollution control facilities focuses on expenditures for machinery as the method of control to the exclusion of other methods, such as a different choice of materials involved in the manufacturing processes.[30] A tax credit for businesses located in urban slums may focus concentration on monetary assistance to the neglect of the provision of technical assistance.

4. Tax Incentives Keep Tax Rates High by Constricting the Tax Base and Thereby Reducing Revenues. — This criticism of tax incentives states a fact that many overlook in their advocacy of tax incentives. The lack of an explicit accounting in the federal budget for the tax expenditures involved in tax incentives

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[29] *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 231 (U.S. Code Cong. & Ad. News No. 12 (Dec. 30, 1969) (expanding the deduction and extending it to include self-employed individuals). There is a hazy line between business expenses properly deducted from income for the purpose of an income tax, and personal expenses, which should not be deducted. Thus, commuting expenses are personal, but the expenses of providing comfortable working conditions in an office are business; wearing nice clothes at work is a personal expense but wearing uniforms is a business expense. The borderlines that evolve are a part of the "generally accepted structure of an income tax" that is used as a standard to identify tax expenditures. We sometimes speak of tax changes designed to provide incentives for taxpayers when what is really involved is the removal of imperfections in the design of a proper tax structure that inhibit their activities. *See, e.g.*, the discussion of the Foreign Investors Tax Act of 1966, in Stone, *supra* note 7, at 648.

[30] *See* Wilson, *Tax Incentives and Pollution*, in INCENTIVES SYMPOSIUM.

and the lack in most cases of an accounting in the tax statistical data combine to cause many to forget that dollars are being spent. As a consequence, the criticism that is made against direct expenditures — that they keep our tax rates high — is often lost sight of when tax incentives are involved. This criticism of tax incentives is thus a useful reminder that government funds are being spent, and that therefore whatever degree of scrutiny and care should be applied to direct expenditures should also be applied to tax incentives."[31] Tax incentives are usually open-ended: they place no limit on how much tax benefit a taxpayer can earn. Hence it is difficult to foretell how much will be spent by the Government through a particular incentive. It is difficult in the nature of things to structure most tax incentives in order to provide a limit on their use. Thus, tax incentives are much like the uncontrollable direct expenditures in the budget.

In the end, the issue is whether, as to any particular area, we want direct government provision of services or goods, government financial assistance (subsidies) to encourage and assist private action to provide the services or goods, or reliance on private action unaided by the Government. If we choose government provision or assistance, then dollars must be spent, and whether they are dollars forgone through lost tax revenues or dollars spent directly through direct expenditures, the effect on tax rates will be the same. So also will the effect on the economy if the government program succeeds, and the resultant effect on the revenue base and tax rates of the increased economic activity that such success may mean.

C. Summary of Asserted Virtues and Vices of Tax Incentives

This description of the virtues and vices of tax incentives yields these conclusions: the *asserted disadvantages* — waste, inefficiency, and inequity — are true of most tax incentives existing or proposed because of the way they are structured or grew up. The whole approach to tax incentives — one of rather careless

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[31] Senator Percy's statement on the manpower training bill included, in the section claiming that the proposed program was uncomplicated, the sentence: "This bill would require no Federal appropriations." 115 CONG. REC. S5330 (daily ed. May 26, 1969). If this is intended to convey the idea that government funds are not being used, it is subject to the criticism on this page of the text. If it is intended to convey the thought that such legislation can be passed more quickly than direct expenditure legislation because no appropriation bill is needed, it is really an attack on the whole process of appropriation bills. If it is intended to convey the thought that the Congress will spend tax expenditure dollars but not direct expenditure dollars, it appears to charge the Congress with being irrational, as to which see pp. 732–33 *infra*.

or loose analysis, failure to recognize that dollars are being spent, or to recognize the defects inherent in working within the constraints of the positive tax system — has produced very poor programs. But *if* the problems were recognized and *if* care were taken to design tax incentive programs that one would be willing to defend in substantive terms were the programs cast as direct expenditure programs, then these disadvantages would not be involved, except to the extent that they are inherent in government assistance itself. These are large conditions, and in some cases would be hard to bring about. For example, it would not be easy to give tax benefit assistance to groups outside the tax system but performing desired activities, such as local governments or tax-exempt organizations hiring the disadvantaged — direct payments outside the tax system would be needed. And it would not be easy to design tax incentive programs which were not inequitable as between taxpayers in high and low brackets and between taxpayers and nontaxpayers. Indeed, there is no tax incentive in existence or proposed that meets the above standards. But for purposes of comparison we are here assuming that the standards could be met under some tax incentive programs.

Similarly, the *asserted advantages* of tax incentives — greater reliance on private decisionmaking and less detailed requirements — to the extent that they are true in fact (and they are often only illusory) are really criticisms of the complications and supervision built into direct expenditure programs, or else a reflection of the structural weaknesses of the tax incentive program, depending on the amount of detail and supervision appropriate to the particular program. In a rational world, one should assume that if after careful study it is considered that certain complexities and details are not needed and can be left out of a tax incentive program, then they should and can simply be dropped from the direct expenditure program. Again, this may be a more difficult condition than appearance suggests, but it is probably less difficult to bring about than the conditions for repairing tax incentives, or at least no more difficult. Again, for purposes of comparison, we are also here assuming it can be done in direct expenditure programs.

D. What Is Lost by Using a Tax Incentive Rather Than a Direct Expenditure

Given, under the assumptions just made, the same substantive program, under which government assistance in the same amount is being given in ways and to persons that would be equally acceptable whether tax incentives or direct expenditures were used, what factors should determine the choice of framework for

a particular program? We can approach this question by asking: what is lost if the tax incentive technique is used? There are several answers.

1. Tax Incentives, by Dividing the Consideration and Administration of Government Programs, Confuse and Complicate that Consideration in the Congress, in Administration, and in the Budget Process. — Let us start with the congressional consideration of tax incentive programs. By definition, such programs are designed to induce action to meet a particular social goal — manpower training of the disadvantaged, education, housing, pollution control, or business location in desired areas, to use some recent examples — and would not be a part of the tax structure were they not deliberately cast as tax incentives. Such governmental programs would normally be considered by the appropriate congressional committee charged with the legislative area involved: the House Education and Labor and Senate Labor and Public Welfare Committees, the House and Senate Banking and Currency Committees, the House and Senate Interior and Insular Affairs Committees, the House Interstate and Foreign Commerce and Senate Commerce Committees, and so on. These committees are responsible for overseeing and developing legislation in their jurisdictional fields, and so are able to coordinate the Government's programs and policies. Tax legislation, however, goes to the House Ways and Means Committee and the Senate Finance Committee. These committees would normally not consider the substantive areas involved in tax incentive programs. Tax incentives suddenly charge them with acting on substantive matters outside their fields of responsibility simply because the program uses the tax system. Although tax committees are highly competent in tax matters, they do not have as much insight into these programs as the legislative committees normally handling the programs. A similar situation would prevail if the latter committees were suddenly to legislate on technical tax matters. Moreover, the tax incentive program considered by the tax committees would be isolated from the regular flow of legislation and activity in the field involved, and this isolation would make coordination and the consideration of priorities difficult. The purpose of the congressional committee system is to distribute expertise among the members of Congress. To cast solutions to social problems as tax measures and exchange expertise in those problems for unfamiliarity is, to say the least, both disruptive and unproductive.[32] Moreover, the jumbling of a number of different incentive

[32] The 1969 tax reform act is an example of the hasty judgments that may result from this system. Without any study at all the Ways and Means Committee, in dealing with that measure, committed the Government to an expenditure of nearly

programs in the tax committees would inevitably set in motion a "log-rolling" process, in which careful consideration would be displaced by trading for support among members. Such a process is difficult to control once a committee is operating outside of its area of expertise and with no clear limits of subject matter to restrain it.

These difficulties could perhaps be overcome. Tax committees might refer incentive proposals to the appropriate legislative committees and accept their judgments, or both groups of committees could consider the matter jointly. Approaches like these are sometimes used in areas where a trust fund having earmarked taxes exists. But the system is awkward and leaves unanswered questions — for example, which committee would exert continuing oversight over the program? Given all the trouble and care that must be taken to patch up an arrangement basically at variance with the normal practice, what is gained by choosing that arrangement in the first instance and thereby dividing the governmental consideration of the program?

Much the same can be said about the parallel effect at the administrative level. Social programs are normally administered by executive departments such as Labor, HEW, HUD, and Interior. Taxes are administered by the Internal Revenue Service. A social program cast in tax terms must in the first instance be administered by the IRS, whose expertise does not extend to these other areas. Problems of lack of coordination with other substantive programs would also arise because of the isolation of tax incentive programs. Again, these difficulties could be patched up to some extent — and probably would have to be — by having the appropriate executive department provide some guidance to IRS. But why the divided arrangement in the first place?

At the budgetary level such a division of responsibility makes oversight and control more difficult. Budgetary problems exist even where several relevant executive departments have a hand in the same program or area. The difficulties are compounded when one of the agencies (IRS) really doesn't belong there in the first place, and when it distributes the funds by tax reduction rather than direct expenditure.[33] Our present budgetary process

half a billion dollars for pollution control facilities installed by industry. Without any study at all the Treasury induced the committee to commit the Government to an expenditure of over $300 million for the rehabilitation of rental housing. Neither action was taken with any regard to the overall priorities in the pollution control and housing areas. *See* Surrey, *Federal Tax and Fiscal Policy: Some Aspects of Future Developments*, 38 TAXES 411 (1970).

[33] One defect in the administration of tax incentives by the IRS is that the IRS agents are "income oriented" and tend to look askance at deductions and credits having no relation to the measurement of income. This attitude could re-

badly compounds these difficulties by giving no recognition or accounting to what is being spent on existing tax expenditures. Until 1968, when the Treasury Department published its analysis of tax expenditure programs and a Tax Expenditure Budget, there was no accounting for the existing tax incentives. The necessary data were not available to the public and not comprehended within the Government. No one really knew what was being spent through the tax system or for what purposes.[34]

An additional problem is the difficulty of coordinating the treatment of tax incentives with the overall handling of direct expenditures. For example, when overall expenditure limits are directed by the Congress or when the President decides to cut expenditures it is essentially impossible to apply the restrictions to tax incentives. So far none of the various expenditure control tax incentives. So far none of the various expenditure control devices, such as those voted in recent years by the Congress, have in any way affected tax expenditures. Yet had these tax programs been structured as direct expenditures, they would have had no such immunity. In substantive terms they do not merit that immunity any more than the direct expenditures, yet their tax clothing shields them. For similar reasons, tax incentives are not covered by the annual budgetary review process; the Bureau of the Budget doesn't even know about many of them, or how much they cost. We do have "uncontrollable" areas in the budget, such as interest on the public debt, and since they can play havoc with a budget, an effort is made to keep them to a minimum, and

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sult in uneven administration of incentive programs. The agents, not seeing the purpose behind the deductions and credits, since they are not tax purposes and so are outside the general expertise and background of the agents, are likely to view the benefits as too generous and to raise audit problems for claimants. This is less likely to occur in the administration of a direct expenditure program since it would be in the hands of an agency interested in the success of the program. Thus the existence of an IRS audit system is not necessarily, contrary to the claim sometimes made, an argument for using tax incentives. Moreover, other agencies, such as the Department of Labor, have inspection or audit systems, and still others could develop them.

[34] *See Hearings on Economic Analysis and Efficiency in Government Before the Subcomm. on Economy in Government of the Joint Economic Comm.*, 91st Cong., 1st Sess. (1969) (statement of Stanley S. Surrey on the Tax Expenditure Budget).

It is sometimes said that a tax incentive has the advantage of "permanency" since tax provisions generally are only infrequently reexamined, whereas direct expenditures are usually reviewed annually, and that some programs to be effective require such permanency. However, it, as a general matter, periodic review of government expenditures is considered desirable, no program should be removed from that scrutiny except for compelling reasons. If in a particular case such reasons are determined to exist, then devices to postpone review are available under the direct expenditure route: for example, longer appropriations and trust funds. There need be no resort to the tax system simply to prevent periodic review

at least to identify them and try to estimate their effect. But in the budget process this is not done for tax incentives.

Overall, therefore, a resort to tax incentives greatly decreases the ability of the Government to maintain control over the management of its priorities. This is true both as to the substantive programs to be introduced, modified, or dropped and as to the amounts to be spent in particular programs and areas. These consequences run counter to the whole thrust of our concerns with the ordering of national priorities and with the wise allocation of our resources, which we have come to see as limited and therefore in need of careful management.

Some of these difficulties could be met. Tax incentives could be identified, amounts estimated, and the data incorporated in the budget. Unless this is done, comparisons of tax expenditures and direct expenditures must be comparisons of hidden programs with open ones. But even after such clarification, further difficulties would remain. Perhaps the President could be given authority to treat the tax incentive funds as direct expenditures for budgetary control purposes, and the incentives could be structured as far as possible to have them fall in the controllable rather than the uncontrollable expenditure pattern. Perhaps the tax incentive programs could be given yearly or biannual expiration dates, so that they could be reviewed in the same way as direct expenditures under the appropriation and budgetary procedures.

But these solutions, like those available for the problems of congressional consideration and administrative operation, raise the question, what is gained by turning what would normally be a direct expenditure program into a tax incentive program and then trying to structure the program so that it can nevertheless be handled as a direct expenditure program? Why the detour through the tax system? Why inject the tax system into the program, when the program can be effectively structured without it?

2. *Tax Incentives Will Not Improve the Tax System and Are Likely To Damage It Significantly.* — Certainly the tax system does not gain when expenditures are made through tax incentive programs. We have already seen that tax incentives are inimical to the equity of a tax system — indeed, in a sense that is necessary to their purpose and function. Moreover, the tax system is complex enough as it is, and to have a large number of tax incentives side by side with the provisions making up the structure of the tax itself can only cause confusion and a blurring of concepts and objectives.[35] Tax incentives make it more and more

[35] It has been pointed out that phrasing the assistance in terms of tax benefits may in some cases make it so difficult for potential beneficiaries to determine their

difficult to distinguish between what is subsidy and what is proper structure. This is especially so where the tax incentive is not identifiable as such but is merged into a provision that has a genuine relationship to the measurement of net income — as is, for example, the subsidy involved in accelerated depreciation for real estate, since some degree of depreciation is appropriate.

It is no answer to say, as do some cynics, that since the tax system today has so many special provisions there should be no objection, when worthwhile programs are involved, to adding still more to the heap. Rather, the effort should persist to contract those existing special provisions that are improper and wasteful. We know from long experience that provisions can be enshrined in tax laws far past their usefulness and long after their defects become clear. We should not, when alternatives are present, freeze in more special provisions, especially since programs in the complex areas of social policy to which many tax incentive proposals relate are essentially experimental in nature.

E. What Is Gained — Allegedly — by Using a Tax Incentive Rather Than a Direct Expenditure

Thus, a great deal is lost when tax incentives are used. What is to be gained by that approach compared with the direct expenditure approach? Some have advanced answers which are essentially political in nature, and, I think, rooted in illusions or irrationalities. Professor Aaron has observed that the popularity of the tax devices "derives from a peculiar alliance among conservatives, who find attractive the alleged reduction in the role of government that would follow from extensive use of tax credits, and liberals anxious to solve social and economic problems — by whatever means — before it is too late."[30] We have already discussed the illusion that tax credits for social purposes are simple and removed from the bureaucratic hand. The second illusion in the above argument is that the Congress will vote dollars through tax incentives that it refuses to appropriate through expenditure programs. Just why a Congress that focuses on the matter should be so inconsistent is not explained. Certainly many members of tax committees, such as Chairman Mills, have recognized that tax incentives do involve expenditures — "back-door expenditures" in his words — and that a legislator concerned with expenditure levels and expenditure control should not, while holding the front door shut, let hidden expenditures in through the back door. But perhaps irrationality will govern; perhaps administrators and

rewards that they will fail to take advantage of them. *Cf.* Stone, *supra* note 7, at 654.

[30] Aaron, *supra* note 25, at 5.

legislators will devise and accept programs structured as tax provisions which they would reject as direct expenditures, or will refuse to improve direct expenditure programs, or will spend money through tax incentives that they would not appropriate as direct expenditures. In that event, rational consideration will not change matters.

There is another answer, which also appears to be irrational or illusory. This is the claim that businessmen respond to tax credits but not to other forms of government assistance; that there is a glamour and magic possessed by dollars of tax reduction that will attract the businessman who would pass up dollars offered through direct expenditures. To the extent that this answer rests on the belief that tax incentives are really simpler, or that complexities can be sheared away only if tax incentives are used, it rests on beliefs already discussed and found either unrealistic or true only if the underlying government policies are themselves irrational. To the extent that the answer rests on the claim that business regards tax incentive dollars as "clean dollars" — just part of a tax computation — but sees direct expenditure dollars as somehow unclean because they are a subsidy, one can only answer that business probably does not respond this way, or that if it does, it is behaving irrationally. Experience with direct subsidies — the SST program for example — suggests that business firms are willing to and do calculate profit prospects in the light of government subsidies. Similarly, the argument that business is familiar with tax credits — though until the investment credit there were no credits widely used in the corporate tax system — but not with other forms of government assistance is certainly not always true. Lack of business familiarity could be overcome by publicizing direct subsidies. The manpower training credit proposal quoted earlier suggested that "the Department of Labor . . . be required to make [the proposal's] provisions known to the unemployed and potential employers in the business community."[37] Such a duty could equally well be placed on that Department if it were administering a direct expenditure program.

There may be an aspect of this asserted preference for tax incentive programs that is not illusion or irrationality, but more serious. It may be that legislators and the beneficiaries of tax incentive programs — businesses receiving accelerated depreciation or percentage depletion, state and local governments receiving tax exemption on their bonds — fear that once the public is fully aware of the amounts involved and can weigh expenditure costs against benefits received by the nation, the tax incentives

[37] 115 CONG. REC. S5329, S5330 (daily ed. May 16, 1969).

will be found wanting in many respects. In this view, the deeper the incentive is buried in tax technicalities and tax terminology, the more it looks like any other technical tax provision, the more it partakes of the protective coloration of the tax law that can be obtained by such outward similarity to ordinary tax provisions, then the more desirable the tax incentive becomes. The public must dig hard and deep to find the subsidy and evaluate it. But such an approach to government expenditures — the preference for the hidden subsidy over the open subsidy — is contrary to all experience with budgets, and to efforts to achieve a rational use of resources. If this is the argument for tax incentives, it should not be accepted.

III. Conclusion

What, then, is the balance sheet regarding these two methods of government assistance, direct expenditures and tax incentives? I conclude from the above observations that, as a generalization, the burden of proof should rest heavily on those proposing the use of the tax incentive method. In any particular situation — certainly any new situation — the first approach should be to explore the various direct expenditure alternatives. Once the most desirable of these alternatives is determined, if one still wishes to consider the tax incentive method for the same substantive program, the question must be what clear advantages can be obtained by using the tax method. Again, as a generalization, I think it unlikely that clear advantages in the tax incentive method will be found. Moreover, I stress strongly that the advantages must be clear and compelling to overcome the losses that accompany the use of the tax incentive, even the well-structured incentive. The problems of achieving a well-structured incentive are in themselves formidable. Even assuming that such problems as unfairness and windfalls are overcome, there are still the losses and drawbacks we have described: confusion and divided authority in the legislative and administrative processes, difficulties in maintaining budgetary control, confusion in perceiving and setting national priorities, and dangers to the tax structure itself.

It could be that a program of government assistance that is broadly based, relatively simple, and properly structured can be more readily administered if joined to the tax system. Some have defended the deductions for charitable contributions and personal interest and taxes on this ground, though pointing to the need to correct abuses and recognizing that the corrections would make the tax incentive more like a direct expenditure program. Others have defended the investment credit for the same reasons,

again with a recognition that improvements can be made.[39] But none of these incentives has had to meet the test of comparison with a carefully structured direct expenditure program. Only after that is done can we reach the point of well-informed choice.

These are general guidelines; there may be particular cases to which they do not apply because special considerations are involved. Even so, care must be taken to look hard at special considerations advanced as reasons for an exception to be made "in this particular case." The legislative halls are crowded with advocates skilled in tying their problems to the last exception and in devising techniques to make each step from the last precedent appear to be only short, logical, and harmless. Our gaze can thus be averted from the constantly widening gap between proper tax structure and each additional special provision.

One question raised by this discussion especially merits more research and thought. Just why is it that in many cases legislators appear willing, with hardly any thought, to accept an expensive tax incentive program when they would just as quickly reject a similar direct expenditure program, even a much smaller one? Why do they require lengthy study and analysis of direct expenditure programs before legislative and appropriation committees while they are ready to enact tax incentives on no more than generalizations and hunches? Is it that they do not realize, or stop to think, that dollars are spent by tax incentives? Is it that tax bills are so complicated that hardly anyone studies them unless prodded by an industry or taxpayer that is hurt, in his tax pocketbook, and that therefore provisions dispensing largesse slide by — although this would be a case of the proper concession of tax expertise to the tax committees papering over their lack of expertise in the areas involved in tax incentives. Is it that the legislators know full well what is involved, despite the complexity of tax bills, but believe the public will not perceive what is being done because of the complexity of tax bills and because tax expenditures do not show up in the budget? To claim this would almost be to claim that any expenditure of funds is acceptable to a legislator — the more money to constituents the better — but most legislators do not follow this principle.

We could ask similar questions about administrative agencies. Just why do administrators of direct expenditure programs allow tax incentive proposals to be pushed when the funds involved

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[39] Indeed, the relative simplicity of the investment credit, which is applied with very little supervision, may have misled businessmen into thinking all tax credits are simple in structure. Yet, as stated earlier, the tax credit proposals in social areas have far more details and complexities. On the investment credit generally, see Brannon, *supra* note 10.

in such programs could be used, and probably much better used, as coordinated parts of the direct expenditure programs? Is it that their policy is to accept gratefully contributions from any source? Is it that they will not face up to the need either to improve the direct expenditure program or squarely demonstrate the erratic and wasteful character of the tax incentive proposal? Is it that they are sometimes negligent in their legislative intelligence and are simply left at the legislative starting gate when the tax incentive is adopted? And why should a Treasury Department which is charged with preserving the integrity of the tax system ever willingly propose or accept a tax incentive solution except in the unusual and rare situation when a tax credit may possibly be properly tailored, and better suited to the purpose — conditions which do not appear to exist as to any of the recent proposals?

With *new* situations — that is, new or expanded government programs — we are in a position to follow a rational course in choosing between these methods. During the 1960's, as attention turned increasingly to government financial assistance to meet urgent social problems, almost every problem brought proposals of a tax incentive as the solution; often the tax incentive was the first solution to be advanced. The Treasury Department responded by pressing the White House staff and other agencies to devise, with the Treasury, non-tax alternatives for comparison on a cost-effectiveness basis. For example, the Treasury, with HEW, developed the federal guaranteed student loan program and expanded scholarship and work programs, so that they could be pushed in opposition to a tax credit for college tuition. In the manpower field, the Treasury urged strong and expanding federally-supported training programs which could be advanced instead of a tax incentive. The skepticism with which specialized tax incentives for social problems were regarded by the Treasury together with a realization that a negative answer to proposals of tax incentives did not solve the problems, thus led the Treasury to be a strong force within the Government in developing and pushing direct expenditure programs, both to counter tax incentive proposals and to move forward to meet the problems in other ways.

With *existing* tax incentives, the task is one that falls in the category of "tax reform," where progress is difficult and slow.[39]

[39] The 1969 TAX REFORM STUDIES AND PROPOSALS, *supra* note 10, related in the case of the income tax almost entirely to tax incentives and involved varying degrees of scaling down and restructuring. Only a few of the proposals related to defects in the fitting together of the tax structure proper (for example, multiple corporation provisions and mineral production payment provisions) or changes in the application of that structure, such as elimination or reduction of tax for those

This is especially so with incentives which have long histories. We do learn as the tax years pass by: the newer tax provisions are in general more carefully tailored with an eye to many of these problems than their predecessors. For example, compare the moving expense and medical expense deductions with those for personal interest and taxes as originally adopted. Or compare the structure of the 7% investment credit with the provision for accelerated depreciation for real estate as it appeared in 1954.[40] Unfortunately, we also can forget what we have learned, as the earlier discussion of the upside-down structure of the new five-year amortization for housing rehabilitation expenditures indicates.[41]

It seems likely that tax reform for many existing incentives will be in the direction of contracting the area of incentives by reducing the number of those eligible for benefits, reducing the extent of the benefits, and removing the undue advantages granted upper income groups. The degree of change will presumably vary with the breadth of the incentive: those that involve specific areas and provide tax benefits for a restricted group — for example, accelerated depreciation for real estate and the natural resource provisions — will, or at least should, be subject to serious cutbacks in scope and benefit, whereas incentives with broad reach — for example, the charitable, interest, and tax deductions — will be scrutinized for particular abuses. This, in general, is the tenor of the Tax Reform Act of 1969.

Once we begin to recognize that the existing tax incentives represent expenditures of funds that in many cases should be dispersed directly, we must develop legislative and administrative techniques to move the funds involved — to the extent that government assistance is still considered desirable — from the tax

below or around poverty income levels. This helps place in perspective the whole matter of tax reform. The 1969 tax reform act also follows this pattern, and most of its major reforms consist of reducing the scope of existing tax incentives, such as those relating to real estate, financial institutions, capital gains investment, natural resources, and farm activities.

[40] The investment credit structure itself pointed to problems, such as the precedent effect of a credit of this nature.

Another problem involved under the investment credit is related to the difficulties caused by confining the credit to taxpayers and placing a limit on the credit in terms of tax liabilities, thereby inducing concerns which could not use their credits to "barter" them to others and enlarge the tax abuses in leasing syndicates and similar arrangements. While the "bartering" may have widened the use of the credit by avoiding the limitation based on tax liability and thus corrected what may have been the undesirability of the limit, the detour too generously compensated the middleman lessor.

[41] The 1969 Act introduced other undesirable tax incentives, also using the five-year amortization technique: the provisions for pollution control facilities, railroad cars, and mine safety equipment.

expenditure budget to the regular budget. The tax committees or the Bureau of the Budget could indicate to the Congress and the administrative agencies concerned the amounts involved in particular tax incentive programs. A period of time would then be allowed for the appropriate legislative committees and administrative agencies to develop direct expenditure programs, and a time limit could be put on the duration of the tax incentive programs. At the end of this period the tax incentive would be ended and the new direct expenditure program funded with the dollars returned to the revenue side of the budget. Certainly, new tax incentive programs, if any are to be adopted, should have a time limit set on their operation, to permit such a shift to a direct expenditure program, or at least to permit evaluation of the effectiveness and operation of the tax incentive.[42]

For the present, a de-escalation of existing particular incentives would be progress, though it would leave a set of tax incentives that probably would not be used at all if we were able to treat the problems fully as new problems. But this is the path of tax history and indeed all legislative history. Knowing all this, let us at least attempt not to repeat past mistakes in future solutions.

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[42] The 1969 tax reform act puts five-year termination dates on the new five-year amortization incentives for pollution control facilities, rehabilitation of low income housing, railroad cars, and mine-safety equipment. Tax Reform Act of 1969 Pub. L. No. 91-172-4 § 70, (INT. REV. CODE OF 1954, § 169), § 521 (INT. REV. CODE OF 1954, § 167(k)), § 705 (INT. REV. CODE OF 1954, § 184), § 707 (INT. REV. CODE OF 1954, § 187) (U.S. CODE CONG. & AD. NEWS No. 17 (Dec. 30, 1969)). The more generous provision for recapture of depreciation of federally assisted housing projects also has a five-year termination provision. *Id.* § 521, *amending* § 1250(a)(1)(c)(ii).

Alaska State Legislature

BETTYE FAHRENKAMP, Chairman
ROBERT H. ZIEGLER, SR., Vice Chairman
DICK ELIASON
PAUL FISCHER
VIC FISCHER
BOB MULCAHY
ARLISS STURGULEWSKI

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Senate

Committee on Resources

MINUTES

May 16, 1983
3:08 p.m.

Beltz Room
Room 211, Capitol

MEMBERS PRESENT

Senator Fahrenkamp, Chair
Senator Ziegler, Vice Chair
Senator Eliason
Senator P. Fischer
Senator V. Fischer
Senator Mulcahy
Senator Sturgulewski

CALENDAR

HB 258 An Act establishing a special investment tax credit; and providing for an effective date.

SB 272 An Act making a special appropriation for payment as a grant to the Municipality of Anchorage for expansion of the Ship Creek Treatment Plant and phase II design and construction of the Eklutna Water Project; and providing for an effective date.

The Committee agreed to send a letter to the Senate President approving the governor's appointments to various boards and positions, reserving the right to vote against confirmation.

SB 272

Senator Sturgulewski moved to report the committee substitute out of committee with individual recommendations. The motion passed without objection.

HB 258

Senator Eliason moved to adopt the proposed committee substitute for discussion. The motion passed without objection.

Commissioner Bob Heath, Department of Revenue, went over the changes in the committee substitute and explained how the proposed state investment tax credit would work.

Senator Sturgulewski felt that very few companies would benefit from the bill, and said that this would reduce tax revenues. She felt the bill would not help the state in this time of declining revenues, and said that no good case had been made for passage of the bill.

Senator Vic Fischer said the bill was designed to promote economic development, but that the bill as written was an abomination. He felt it could be amended to be a good bill, but as it stands, it provides undeserved windfalls.

Senator Mulcahy moved to report the committee substitute out of committee with individual recommendations. The motion passed without objection.

The meeting was adjourned at 3:25 p.m.

Alaska State Legislature

BETTYE FAHRENKAMP, Chairman
ROBERT H. ZIEGLER, SR., Vice Chairman
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Senate

Committee on Resources

MINUTES

April 29, 1983
3:12 p.m.

Beltz Room
Room 211, Capitol

MEMBERS PRESENT

Senator Fahrenkamp, Chair
Senator Ziegler, Vice Chair
Senator P. Fischer
Senator V. Fischer
Senator Mulcahy
Senator Sturgulewski

CALENDAR

HB 284 An Act designating the bowhead whale as the state marine mammal.

SCR 19 Relating to a statewide system of trails.

HB 238 An Act establishing a special investment tax credit; and providing for an effective date.

HB 284

Representative Fuller urged that the Committee support the bill. He stated that the bowhead whale represents Alaska's history, culture and spirit.

Senator Mulcahy moved the bill be reported out with individual recommendations. The motion passed without objection.

SCR 19

Senator V. Fischer said that the State has the authority to coordinate a statewide trails system but has established no policy. The resolution asks the Governor to develop a plan for a trails system. There would be no fiscal impact, because most agencies involved are already working on various aspects of the system; it would be a matter of coordinating efforts. Fischer

moved that CS SCR 19 be reported out of committee with individual recommendations. The motion passed without objection.

CSHB 258

Deborah Vogt, Assistant Attorney General, said the bill is constitutionally unclear, and explained this point of view.

Joe Donohue, Deputy Commissioner, Department of Revenue, explained language suggested for a committee substitute. He explained how the tax credit might work, and compared it to the federal investment tax credit.

Roy Huhndorf, President, Cook Inlet Region, Inc., explained the bill's potential to stimulate and broaden the Alaskan economy, and urged adoption of the bill.

Dave Heatwole, Alaska Miners Association, said the Association had passed a resolution endorsing the bill, and explained how it would benefit the mining industry. He opposed exempting sand and gravel, and noted that the mining license tax would still generate revenue to the State.

Wayne Allred, Northwest Alaskan Pipeline Company, provided written testimony. He supported the tax credit without limitation of the location of facilities. He felt the bill, as written, is discriminatory and unconstitutional, and requested all geographical references be removed from the bill.

Jeff Day, assistant to Rep. Joe Hayes, agreed to relay questions and concerns to Rep. Hayes.

The Committee adjourned at 4:40 p.m.

STATE OF ALASKA

DEPARTMENT OF REVENUE

BILL ANALYSIS

Sponsor Substitute for House Bill No. 258

Title: An Act establishing a special investment tax credit and providing for an effective date.

General Effect of Bill: The Bill would create a special investment tax credit on qualified investments for corporations putting into use gas processing facilities south of the Arctic Circle and corporations engaged in the exploration, drilling of wells, development, or mining of the natural deposits listed in I.R.C. §613(b) south of the Arctic Circle.

Effect on Current Law: Current law provides for an investment credit of 18 percent of the investment credit allowed under the I.R.C. upon the first $20,000,000 of qualified investment put into use in the State for each taxable year. The new Act provides that the investment credit allowed for those corporations subject to the Act shall be the full amount of the investment credit allowed under the I.R.C. with no limit on the amount of qualified investment credit.

Recommendation of Department: The Department of Revenue recommends a thorough study of the effects of the Bill be conducted. The study should include an analysis of the incentive the Bill will provide to the targeted corporations, a review by the Department of Law as to the constitutionality of the geographic limitations of the Bill, the projected revenue impacts to the State. Current Position of Department: The Department is naturally in favor of encouraging the best and highest use of the State's resources but further analysis of the means proposed in the Bill is required before taking a position.

TECHNICAL ASPECTS OF BILL

Section 1: This section of the Bill presents the legislative findings and intent for the Bill. It is found that the development of gas processing facilities south of the Arctic Circle and mineral development is in the best of the interests of the State. Subsection 6 finds that the establishment of the special investment tax credit is <u>necessary</u> in order to promote and accomplish the objectives listed in the first five subsections.

Section 2: Section 2 adds a sentence to AS 43.20.021(d) which effectively states that the Alaska Investment Credit which is normally limited to 18% of the credit allowed under the I.R.C. would not apply to the special investment credit created in the Bill.

Section 3: Section 3 amends AS 43.20.036 by adding subsection (j). The new subsection would provide that the amount of investment credit

allowed on qualified investment put into use south of the Arctic Circle for gas processing facilities is equal to the full amount of the credit under the I.R.C. Whereas the current investment credit is limited to the first $20,000,000 of qualified investment put into use in the State for each taxable year, this section would remove that limitation. The section also defines what constitutes gas processing facilities.

Section 4: Section 4 is similar to section 3 but applies to corporations putting into use investments south of the Arctic Circle for exploration, drilling of wells, development, or mining of the natural deposits listed in §613(b) of the Internal Revenue Code. The section again provides for the credit to equal 100% of the federal investment credit and removes the limitation of the credit being applicable to the first $20,000,000 of qualified investment put into use in the State.

Explanation of Changes from Current law: AS 43.20.021(d) and AS 43.20.036(b) provide for an investment credit equal to 18% of the investment credit allowed as to federal taxes under the Internal Revenue Code on the first $20,000,000 of qualified investment put into use in the State for each taxable year. For example, if a corporation had a qualified investment of $25,000,000 during tax year 1983, it would be allowed an investment tax credit on the first $20,000,000 of that investment. If the federal credit was 10% of the qualified investment, the federal credit would be equal to $2,000,000 and the Alaska credit equal to 18% of that or $360,000. The corporation could then apply that credit to its tax liability for 1983 and reduce its tax payment to the State.

If the investment credit for the corporation is greater than the tax liability before the application of the credit, the corporation can carryback the excess credit to each of the 3 prior taxable years preceding the unused credit year and carryover the excess credit to each of the 15 years following the unused credit year. For example, if the corporation above had a tax liability to the State of $180,000 for tax year 1983 before the application of the credit, the credit would completely eliminate the tax due to the State and leave $180,000 of credit to be carried back or forward and applied to other years.

The Bill would remove the limitation that the credit would be limited to the first $20,000,000 of qualified investment put into use in the state for each taxable year. In addition, the amount of the credit would be equal to the full amount of the credit allowed as to federal taxes under I.R.C. § 38. Returning to the example above, the corporation making $25,000,000 of qualified investment in the State in 1983 would be entitled to an investment credit of $2,500,000. Again, if the 1983 tax liability prior to the application of the credit was $180,000, the corporation would have $2,320,000 of unused credit to carry back and carry forward.

It is important to note that not all of the investment credit given to a corporation as a result of the Bill would be enjoyed on a dollar for dollar

basis. Corporations enjoy a deduction for State taxes in computing their Federal income tax liability. With a tax rate of 46% on taxable income over $100,000, 46¢ out of every dollar saved in Alaska taxes would go to the Federal Treasury. Again using the example above, of the $180,000 credit enjoyed by the taxpayer in 1983, 46% or $82,800 would be paid to the Internal Revenue Service.

The Bill would effectively increase the investment credit on the first $20,000,000 of qualified investment by more than 550%, from 18% of the Federal credit to 100%. It would also allow for the first time, an investment credit on qualified investment in any taxable year which exceeds the $20,000,000. The fiscal impact of the credit would not be limited to the year in which the investment was made, but may have an effect for 3 prior years and 15 subsequent years.

Fiscal Impacts Of Bill: The actual fiscal impacts of the Bill are indeterminable. The impacts are dependent on corporate decisions regarding business investments, the future profitability of mining and gas processing ventures in the State and the number of years in which the investment tax credit could be applied to reduce tax liabilities.

Legal Ramifications: There are several legal problems with the Bill, both in its substance and in its drafting. In the area of substance, the Bill has a geographic limitation, the new credit will only be available south of the Arctic Circle. There would be potential for an equal protection challenge by corporations operating North of the Arctic Circle. The rational basis standard would probably be the standard to be applied in such a challenge and some argument could be made in favor of the distinction for gas processing plants because of the findings in § 1 of the bill however, no findings or intent are supported for the limitation on the exploration, drilling of wells, development and mining of minerals and other natural deposits. The State is currently involved in litigation with $2.3 billion at stake involving the taxation of oil producers and pipeline operators under AS 43.21. The plaintiff taxpayers challenged that tax on the basis of equal protection. To the extent that this Bill would endow a greater benefit on corporations operating south of the Arctic Circle a similar equal protection challenge could be expected from corporations otherwise qualifying for the credit but making investments north of the Arctic Circle.

There are drafting problems in the Bill itself. In §§ 3 and 4 the limitations imposed under AS 43.20.036(b) are deemed not to apply to the new credits. AS 43.20.036(b) contains two limitations: (1) that the investment credit is only available to the first $20,000,000 of qualified investment; and (2) that the qualified investment must be put into use in the State. The Bill should be amended and the applicable sentences changed to read:

> The amount of credit allowed under this subsection shall be subject to the limitations imposed by (b) of this section except that the amount of qualified investment will not be limited to the first $20,000,000.

The Bill incorporates provisions of the Internal Revenue Code by Reference and sometimes problems arise where the Code changes with resulting impacts in Alaska law. For example, the natural deposits for which a corporation must explore, drill, develop or mine are listed in § 613(b) of the Internal Revenue Code. That subsection has been amended several times since its first enactment and will probably be subject to further amendments. The Drafter has cited P.L. 89-809 and P.L. 88-571 as parallel authority, however, those Public Laws merely amended § 613(b) rather than listed the deposits currently in § 613(b). The better alternative would be to list those specific deposits which the Bill would encourage the development of through the special investment tax credit.

OTHER CONSIDERATIONS AND ALTERNATIVES TO THE BILL

Mining operations in Alaska are subject to three non-federal taxes, the Alaska Corporation Net Income Tax (AS 43.20), the Alaska Mining License Tax (AS 43.65) and local property taxes. A study by the Department of Commerce and Economic Development compared the mineral tax structure in Alaska with eleven other states. The conclusions were positive: 1) Alaska's tax structure is average compared with the eleven other states in the study and provides a relatively attractive tax environment for mining; 2) Alaska's progressive tax structure is based on net proceeds, superior to gross-proceeds types of taxes because tax rates go down as production declines.

In February, 1983, the Resource Development Council, Inc., along with the Office of Minerals Development, Alaska Department of Commerce & Economic Development, sponsored the International Conference on Coal, Minerals and Petroleum. In Carl Portman's "Executive Summary" for the proceedings of the conference, after recognizing that Alaska' mining activity was at an all time high, noted three obstacles to development of mineral deposits. The major obstacle to development of mineral deposits is the lact of transportation infrastructure. Another problem was that land allocations by the Federal government withdrew much of the State's high potential mineral land and restricted access to other State areas. Taxes were also mentioned, but the problems with taxes arose not out of the present tax structure, which was found to be reasonable, but out of the fear that mining taxes would be increased as the mining industry becomes increasingly productive.

Two out of the three concerns mentioned above are in the jurisdiction of the Alaska legislature, transportation infrastructure and taxation. Improving the transportation infrastructure in the state through the development of more and better roads, access to the railroad, marine shipping facilities and airports would benefit and encourage the industry with no leakage to the Federal Government such as that created by State tax credits. Improved transportation infrastructure also benefits the non-mining sectors because the high costs of transportation in the State are borne by every Alaskan who buys anything from bubble gum to bulldozers.

There are no current problems with taxation other than the fear that the structure might change with the success of mining operations. The non-petroleum mineral developers have not been blind to the fact that the severance tax

rates have increased and there have been changes in the corporation income tax since oil was first discovered at Prudhoe Bay. Though the opportunity to change tax structures presents itself at each legislative session, persons seeking to develop mineral deposits must forecast the future economic climate and decide whether the changes can be weathered and the mine remain profitable.

A tax credit, such as that proposed in the Bill could partially insulate the miner to the extent that carryover credits would reduce the liability in future years. However, because of the federal leakage, a tax credit is a mixed blessing, providing little more than half of the benefit to the miner compared to the cost to the State in lost revenue. Whereas the State has been able to support its operations largely through taxes on the petroleum industry, oil prices are dropping and current reservoirs are being depleted; lost revenues in other tax types correspondingly taken on greater significance.

For the tax years 1978, 1979 and 1980 corporate income taxes on mining businesses constituted between 6 1/2% and 10% of the total non-petroleum corporate net income tax collections. In turn, total non-petroleum corporate income tax collections were slightly more than 3% of the revenues from petroleum corporations. Because revenue estimates based on petroleum production are decreasing, the non-petroleum corporations will be contributing a greater proportion of total State revenues. In 1980, the mining industry was the fifth largest corporate income tax group of taxpayers in the non-petroleum sector.

The conclusion of this analysis is that tax benefits granted the non-petroleum sector should be carefully scrutinized to ensure that the costs to State revenue do not exceed total benefits to the State. Other incentive mechanisms, such as improvement of the transportation infrastructure, as above, or other incentives, such as those described below, should be examined to see which alternatives score higher under a cost versus benefit analysis.

One alternative would be a mineral development loan program. State funds or bond proceeds could be used to finance mineral development, or for that matter, gas processing facilities, without affecting tax revenue. The rates could be favorable and would directly benefit the mineral developer without Federal leakage. Loan applications could be reviewed within legislative guidelines to encourage the highest and best use of the State's natural resources, the interest would partially fund the operation of the program, and the developer would enjoy interest deductions for both State and Federal purposes. Either the current or a modified investment credit provision would supplement the tax benefits from such a loan program.

Another alternative would be to enact legislation similar to the Alaska Industrial Incentive Act, AS 43.25, or adopt industrial incentive tax credits such as those previously found in AS 43.26. The advantages of these alternatives over the investment credit approach in the Bill are that the effect on revenue to the State would be for a known period of time, and that businesses able to benefit from the tax exemptions would be selected by a State agency within legislative guidelines which encourage mineral development and construction of gas processing facilities.

SUGGESTIONS FOR IMPROVING THE PRESENT BILL

1. Remove the geographic limitations in the Bill. Development of gas processing facilities and State resources would be beneficial without regard to the region of development. Major oil companies have mining and gas processing interests and would be likely to raise a constitutional challenge to a geographic limitation.

2. Either keep the present limit on qualified investment or keep the current 18% of the Federal limit on the amount of the credit. The State has the potential of having 19 years of fiscal impact from an investment tax credit, the year it arises, 3 prior years and 15 subsequent years. Anything to make the impact predictable will aid the budget process.

3. Limit the number of years to which the investment credit could be carried backward or forward. As stated above, the Internal Revenue Code provides for 3 years back and 15 forward. A shorter period of time would be in the State's best interest.

4. Specifically list the minerals which the State wishes to encourage the development of rather than refer to the code. For example, the code lists gravel in the referenced section; is this a mineral the legislature wishes to subsidize with an investment tax credit?

5. Research whether the Bill would actually reach the desired results. Is an investment credit really going to make a difference in development decisions?

SUMMARY

This Bill seeks to encourage investing in gas processing facilities and certain mining activities south of the Arctic Circle through special investment tax credits. The special investment tax credits differs from the current credit in that there is no limit to the amount of qualified investment and the credit is equal to the full amount of the Federal credit. The new credits would have fiscal impacts on the tax year in which they arise and may have an effect in 3 prior and 15 subsequent years.

The legislature should explore the actual effectiveness of the proposed credit and whether other programs would reach the desired end more directly without such fall-out effects such as Federal leakage and unpredictability of future State revenue.

STATE OF ALASKA
FISCAL NOTE

Revision Date 4/11, 1983

I. REQUEST

Bill/Resolution No: CSSSHB 258 (L&C)
Title: Special Investment Tax Credit
Sponsor: Hayes & Szymanski
Requestor: Labor, Commerce & Finance

II. FISCAL DETAIL

Agency Affected: Revenue
Program Category Affected: Coll. & Mgmnt
BRU, Program of Subprogram(s) Affected:

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 83	FY 84	FY 85	FY 86	FY 87	FY 88
OPERATING						
100 PERSONAL SERVICES	-	-	-	-	-	-
200 TRAVEL	-	-	-	-	-	-
300 CONTRACTUAL	-	-	-	-	-	-
400 COMMODITIES	-	-	-	-	-	-
500 EQUIPMENT	-	-	-	-	-	-
600 LANDS & STRUCTURES	-	-	-	-	-	-
700 GRANTS, CLAIMS, ETC.	-	-	-	-	-	-
TOTAL OPERATING	-	-	-	-	-	-
CAPITAL	-	-	-	-	-	-
REVENUE	-	-	-	-	-	-

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER (Specify Source)	-	-	-	-	-	-
	-	-	-	-	-	-

POSITIONS:

FULL-TIME	-	-	-	-	-	-
PART-TIME	-	-	-	-	-	-
TEMPORARY	-	-	-	-	-	-
	-	-	-	-	-	-

III. SOURCE OF FUNDS TO OFFSET FISCAL IMPACT OF BILL:

IV. ANALYSIS: Attach a separate page for any Analysis.

Prepared By: Vincent D. Wright
Phone: 465-273
Division: Revenue - Research
Date: 4/7/83

Approved by Commissioner: [signature]
Date: 4/11/83
Department: Revenue

Distribution:
Original to Legislative Finance
Copy to Office of Management and Budget (for Legislature introduced bills)
Copy to Department (for Governor introduced bills)
Copy to Sponsor
Copy to Requestor (if different from Sponsor)

IV. Analysis of CSSSHB 258

The incorporation of this expanded credit in effect would reduce state taxes as a deductible item at the federal level and thus increase the federal tax take.

The impact of this bill is negative to the state in terms of lost revenues. The quantitative impact cannot be assessed due to carry forward and carry backward provisions which vary from one existing operation to another. If the bill is intended for new facilities, the effect cannot be assessed until they are completed and in operation.

Alaska State Legislature

Speaker of the House of Representatives

Pouch V
State Capitol
Juneau, Alaska 99811
(907) 465-3720

Official Business

SPECIAL INVESTMENT TAX CREDIT LEGISLATION

As projections of declining revenue loom in Alaska's near future, we must begin to diversify our economy so that both state government and local economies are not so heavily dependent on oil derived revenues. I have introduced legislation which would accomplish this goal by establishing a special investment tax credit. Such a credit would apply for investments to develop gas processing facilities South of the Arctic Circle and to investments for exploration, development and mining of minerals other than oil and gas throughout Alaska. A major priority of both myself and the House Majority is diversification of our economy. I believe enactment of this legislation would go a long way towards achieving that goal.

Currently state law limits the amount of investment tax credit (ITC) which is allowed to corporations in computing their Alaska income taxes to 18% of the amount of investment tax credit which is allowed for federal income tax purposes. So while the Federal ITC is 10%, the Alaska investment tax credit is only 1.8%. Current law also limits the ITC which is allowed in computing Alaska income taxes to the first $20 million of qualified investment put into use in the state for each taxable year. That limitation would be removed by this bill.

The Alaska tax credit would only apply to investments which also qualify for the federal credit. This is primarily personal proprty such as trucks, machinery and manufacturing equipment.

It would not include roads, buildings, mine sites and such things as feasibility studies. Using the $1 billion Quartz Hill mine project for example, a very limited amount of that development would qualify for the tax credit. But enough of an incentive would be created to attract industry to Alaska that currently is lacking.

The promotion of exploration, development and mining of minerals and other natural deposits in the state will encourage development of Alaska's non oil and gas mineral resources. This legislation would also accelerate the diversification of the state's economy and employment base.

One new addition to this legislation, not included in the version which passed the House last session, is inclusion of gas processing facilities South of the Arctic Circle. There are areas in Alaska where established infrastructure, access to ice free ports and substantial amounts of uncommitted reserves of natural gas combine to provide great potential for gas processing development and export activity. The development of these gas processing facilities will promote full and stable employment and minimize adverse population and environmental impacts.

I expect the impact on state revenues upon enactment of this legislation would be minimal. While initially there would be be a slight loss of revenue, the long range goal to promote investment and development would increase non petroleum related revenue in future years. The investment tax credit is a temporary tax reduction directly tied to profitable investment that will produce increased revenues in the future. Additionally, investments in targeted industries may substantially expand local governments sales and property tax bases. If the Prudhoe bay curve is accurate, and oil revenues begin to decline in the late 1980's, it is our responsibility to plan to offset that decline. I am confident it will have the support of the administration, which has stated a desire to reach this goal as well.

# # # # # # #

Alaska State Legislature

Speaker of the House of Representatives

Pouch V
State Capitol
Juneau, Alaska 99811
(907) 465-3720

Official Business

MEMORANDUM

April 27, 1983

To: Senator Bettye Fahrenkamp
Senate Resources

From: Rep. Joe Hayes
Speaker

Re: HB 258

I have been told the Senate resources committee will hear HB 258 re: special investment tax credit on Friday. My staff has given backup on this legislation to your staff. This memo is additional material to be considered.

There were several amendments proposed in the House which were opposed. In anticipation of a similar offering in the Senate, I wish to outline my objections in several areas.

The Department of Revenue wishes to list minerals in the bill which the tax credit would apply to rather than reference the IRS code as the bill now does. For the sake of uniformity and consistency it seems appropriate to maintain the IRS code reference rather than list minerals separately. Investment companies have a legitimate concern in expecting some consistency in taxation policies. In that regard, it makes sense that companies should expect the same provisions of a federal tax credit to apply to a state credit. If the IRS code should at some time delete a mineral that is of benefit to the state, it would be a minor matter to then amend our statutes. I think it most prudent to maintain the current reference as the bill does.

I also have some problems with any type of a sunset provision which may be proposed. Many developments, especially in mining are long term projects of 30 years or more. I think a sunset could discourage potential investment. Investors should not be under the threat of a sunset provision which would terminate the consitions under which an investment was originally made.

If, at some time, it is determined the tax credit is no longer accomplishing the goals for which it is intended, it would be possible for a future legislature to terminate the credit. I think this would be a more beneficial attitude than including a sunset clause which could still cause uncertainty and borderline investors to hold off from committing to an Alaskan investment.

There was a proposal to define gas processing facilities as those which produce only urea, methane and liquified natural gas. The bill now defines them as facilities which produce but <u>are not limited to</u> the production of those items. A facility can produce over one hundred by-products. I do not feel we should withhold the credit from production of the byproducts which may also be of benefit.

Finally, this bill is aimed at encouraging investment and jobs in three major areas...coal mining, general mineral development and gas processing. These areas will likely result in the greatest number of jobs in Alaska. While I am not specifically opposed to credits in other areas, I think the bill should be restricted to the areas it now addresses at this time. Further credits should be examined on their own merits and potential.

Thank you for your consideration and I encourage the committee's quick action on this important legislation.

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

M E M O R A N D U M April 11, 1983

SUBJECT: Equal protection analysis of HB 258

TO: Representative Albert P. Adams
Chairman, House Finance Committee
Attn: Louann Cutler

FROM: Richard C. Folta
Legislative Counsel

I have reviewed the "constitutionality of geographic classification in the investment tax credit bill" memorandum by Cook Inlet Region, Inc., concerning the above referenced bill. I concur in their view that the proposed legislation does not violate the constitution.

The Alaska Supreme Court has a more rigorous equal protection requirement than the U.S. Supreme Court, as elicited in State v. Erickson, 574 P.2d 1 (1978), as follows:

> . . . must look to the purpose of the statute, viewing the legislation as a whole, and the circumstance surrounding it. It must be determined that this purpose is legitimate, that it falls within the police power of the state, Examining the means used to accomplish the legislative objective and the reasons advanced. Therefore, the court must then determine whether the means chosen substantially further the goals of the enactment. Finally, the state interest in the chosen means must be balanced against the nature of the constitutional right invaded.

There are five purposes mentioned for the investment tax credit in HB 258, all of which are legitimate and proper. However, only the first purpose relates to why the credit is to be in effect only south of the Arctic Circle. All the other purposes are just as compelling for facilities north of the Arctic Circle. In my opinion the first purpose is constitutionally sufficient to sustain the goal of the

proposed enactment. The state interest in encouraging development south of the Arctic Circle where ice-free ports are available near established population centers appears to outweigh the tax discrimination that would be in effect on industries north of the Arctic Circle.

RCF:ljb
14-004

CIRI COOK INLET REGION INC.

Inter - Office Memorandum

TO: Lance Anderson, Vice President, Finance

FROM: Steve Hillard, Vice President and General Counsel

Date: March 28, 1983

Subject: CONSTITUTIONALITY OF GEOGRAPHIC CLASSIFICATION IN INVESTMENT TAX CREDIT BILL

You have asked for a review of the constitutionality of a geographic distinction contained in an bill drafted by CIRI and introduced in the Alaska State Legislature. The legislation will grant certain investment tax credits to those gas processors located south of the Arctic Circle. The question presented is whether this type of classification, based on geography, violates the United States or Alaska Constitutions.

Based upon a review of pertinent federal and state authorities, it is my view that the proposed legislation does not violate the United States or Alaska Constitutions.

I. Federal Constitutional Issues

It is useful to note at the outset that there is one significant constitutional provision which does not appear to apply to the proposed tax credit. The United States Constitution provides that all taxes levied by Congress shall be uniform throughout the United States. U.S. Const. Art. 1, Section 8. The United States Supreme Court has consistently interpreted this requirement to mean geographic uniformity. Knowlton v. Moore, 178 U.S. 41 (1900); Steward v. Davis, 301 U.S. 494 (1938). Under this interpretation, distinctions among the states are impermissible. Thus, the United States District Court for the District of Wyoming has recently held that the Crude Oil Windfall Profits Tax Act of 1980 is unconstitutional because it exempts oil produced from north of the Arctic Circle. Ptasynski v. United States, 82-2 USTC Para. 9654 (D.C. Wyo. 1982). The court noted that although rational justifications for the exemption do exist, the exemption is specifically forbidden by the Constitution. In short, the court appeared to hold that geographic distinctions are per se unconstitutional. The United States Supreme Court recently has determined to review this distinction.

In light of these precedents, it would appear that if Congress were to enact the proposed bill, the bill would run a strong risk of being held unconstitutional. The federal uniformity provision, however, by its terms applies only to acts of Congress, not acts of the states. Generally it has been held, for example, that there is nothing in the United States Constitution which requires state taxation to be uniform. See Carmichael v. Southern Coal Co., 301 U.S. 495 (1937). Thus, the proposed legislation does not violate the uniformity clause of the United States Constitution.

It is also possible to assert that the legislation violates the Equal Protection Clause of the Fourteenth Amendment. It might be contended, in other words, that the proposed legislation impermissibly discriminates against gas processors

located nort of the Arctic Circle. The United States Supreme Court, however, has consistently held that where state "taxation is concerned and no special right, apart from equal protection, is imperiled, the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation." Lehnhauser v. Lake Shore Auto Parts, 410 U.S. 356 (1973); State Board of Tax Comm'rs of Indiana v. Jackson, 283 U.S. 527 (1931). The appropriate test to be applied to state taxation schemes is whether the state classification has a "rational basis" or whether it is "palpably arbitrary" or "capricious." Id. If "any state of facts reasonably can be conceived" to justify a classification, the Court will sustain it.

Applying the foregoing principles to the proposed legislation, it appears that the Supreme Court would uphold the classification. Although not in the context of a taxation case, the Supreme Court has specifically stated that the "Equal Protection Clause relates to equality between persons as such rather than between areas . . . . Territorial uniformity is not a constitutional requisite." Salsburg v. Maryland, 346 U.S. 545 (1954). In the tax area, the Court has upheld a state tax which provided for different tax rates based on the "gravity" of certain oil and which arguably discriminated between oil produced in Northern and Southern Louisiana. Ohio Oil Co. v. Conway, 228 U.S. 146 (1930). The Court held that the classification based on "gravity" was not unreasonable. Although not directly on point, since the case did not involve a specific geographic distinction, Conway does confirm that the Court will apply a relaxed standard of review to state taxation schemes and that all areas of a state need not have an equal tax burden.

A number of lower courts have specifically addressed state tax classifications based on geography. These courts have held that "distinctions based on geographical areas are not, in and of themselves, violative of the Fourteenth Amendment." Levy v. Parker, 346 F.Supp. 877 (E.D. La. 1972); McCarthy v. Jones, 449 F.Supp. 480 (S.D. Ala. 1973) (no "rational basis" for different tax rates for different counties); Weissinger v. Boswell, 330 F.Supp. 615 (M.D. Ala. 1979) (same). These courts have explained that a state "must demonstrate, if it wishes to establish different classes of property based on different geographical locations -- e.g., rural areas as opposed to urban areas -- that the classification is neither capricious nor arbitrary but rests upon some reasonable consideration of difference or policy." Id.

The question thus remains whether the justification asserted for the geographic classification in this case -- to encourage the location of a certain industry in a certain region of the State -- is sufficient to sustain the classification. Although I have not found a case directly on point, the Supreme Court has suggested that tax classifications designed to create incentives for business to locate within a state are permissible. In Allied Stores of Ohio v. Bowers, 358 U.S. 522 (1959), the Court stated that a tax statute which "encourages the location within the state of needed and useful industries by exempting them, though not also others, from its taxes is not arbitrary and does not violate the Equal Protection Clause of the Fourteenth Amendment." The same rationale would appear to apply equally well to the proposed legislation here, since it is designed to encourage location of a business in a particular part of the state.

II. Alaska Constitutional Issues

There are at least three potential issues under the Alaska Constitution. First, the legislation might violate an implied requirement of "equality and uniformity" of all state taxes. Second, the legislation might violate the Equal Protection Clause found in the Alaska Constitution, Article I, Section 1, which has been interpreted somewhat differently from the Equal Protection Clause of the Fourteenth Amendment. Third, the legislation might constitute a "local or special act" prohibited by Article II, Section 19 of the Alaska Constitution. Let me address the first two issues together, since they are interrelated.

It is necessary to begin with a bit of background. The vast majority of state constitutions embody some provisions for "uniform or equal" taxes. There is, however, no such provision in the Alaska Constitution. The general rule appears to be that in the absence of express provision in the state constitution, it is not essential that state tax statutes operate equally and uniformly. See generally 84 C.J.S. 2d. Taxation, Section 21 (discussing authorities). However, at least one court has held that the principle of uniformity in taxation applies even in the absence of an explicit constitutional provision. See, e.g., Commissioners of Sinking Fund of City of Louisville v. Ohio Valley Grocery Store Co., 240 S.W. 2d 56 (Ky.). Thus, there is at least some possibility that a court might imply a uniformity requirement in the Alaska Constitution.

This possibility is further complicated in the State of Alaska. Although the Constitution of the State of Alaska nowhere requires state taxes to be uniform, Section 9 of the Organic Act of Alaska, 48 U.S.C. Section 28, provides that "all taxes should be uniform upon the same class of subjects." Under the Organic Act, the courts have interpreted the requirement of uniformity to require geographic uniformity. In Hess v. Mullaney, 91 F.Supp. 139 (D.C. Alaska 1950), reversed on other grounds, 189 F.2d 417 (9th Cir. 1950), the court considered whether Alaska's first property tax violated the uniformity requirement of the Organic Act. The property tax levied a tax on all properties in the state, provided that if the property was located within an incorporated city, town or school district, that entity should assess and collect the tax. Plaintiff claimed that the tax was unlawful, since property would be taxed differently depending on where it was located. The District Court agreed, reasoning that classifications may not be based on geographical lines or mere location of the property.

This view was somewhat modified in a successor case, Hess v. Mullaney, 102 F. Supp. 430 (D.C. Alaska 1952), affirmed, 213 F.2d 635 (9th Cir. 1954). Although the court ultimately upheld the property tax, it acknowledged that "unquestionably, systematic geographical discriminations in the burdens of taxation have been held void." The court found, however, that "we assume that the uniformity clause of the Organic Act requires the same measure of uniformity or equality which is required by the Equal Protection Clause of the Fourteenth Amendment." The court held that under the "rational basis" test, it was reasonable for the legislature to have cities assess and collect taxes for property within their jurisdiction.

In light of the foregoing, a strong argument can be made that a separate and distinct "uniformity" requirement no longer exists in Alaska. First, the Alaska Constitution does not provide for uniformity. The Organic Act is a mere act of Congress, and, whatever its continuing effect in light of Alaska statehood, it

probably adds little to the provision of the Alaska Constitution. Second, even if the uniformity requirement of the Organic Act is still controlling, the Ninth Circuit in Hess v. Mullaney held that the Alaska uniformity requirement is no stricter than the equal protection requirement.

A recent case, State v. Reefer King Co., Inc., 559 P.2d 56 (Alas. 1976), support this view and is particularly relevant to this case. The case involved the constitutionality of a state tax which drew a distinction between "floating" and "shore-based" fish processors. Because the tax placed a higher tax rate on floating processors, the floating processors claimed that the statute created an illegal classification under the State equal protection clause. The Alaska Supreme Court rejected that contention. Although the classification could in one sense be deemed to be a "geographical" classification, the Court did not even mention the Hess v. Mullaney cases. Instead, the Court held that the classification should be tested against the State's equal protection analysis, which provides that a statutory classification must

> "be reasonable, not arbitrary, and must rest upon some ground of difference having fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced, shall be treated alike."

The Court held that the classification reflected a legislative judgment that shore-based processors make a more valuable contribution to the State's local economies than the floating processors. According to the Court, it is not arbitrary for the legislature to conclude that shore-based processors were to be preferred over floating processors, which distributed economic benefits over several locations. And, in important language for the present issue, the Court concluded that

> "The state may legitimately encourage, through tax incentives or exemptions, industries or types of industries which it considers desirable, and this method of encouragement does not deprive other taxpayers, who do not qualify for the benefit, of equal protection of the laws.

Two additional points should be made with respect to Reefer King. First, the case strongly supports the notion that the State of Alaska may make a classification in order to encourage businesses to locate in a particular area. A primary reason for CIRI's proposed legislation, of course, is to encourage gas processors to locate south of the Arctic Circle. Second, the equal protection test adopted by the Alaska Supreme Court is somewhat more demanding than the test used in interpreting the Equal Protection Clause of the Fourteenth Amendment. The Alaska test, for example, requires the classification to bear a "fair and substantial" relation to the purpose of the statute, rather than merely a "reasonable" relationship. More significantly, under the Alaska test, unlike the federal test, the courts will "no longer hypothesize facts which would otherwise sustain questionable litigation." Isakson v. Rickey, 550 P.2d 359 (1975). This means that in order to survive constitutional scrutiny, the proposed legislation must clearly articulate the purpose of the legislation and the rationale for the geographic classification. The rationale for the geographic classification is expressly contained in the investment tax credit bill.

There is one final issue. Article II, Section 19 of the Alaska Constitution provides that the "legislature shall pass no local or special act if a general act can be made applicable." In this case, it could be argued that the proposed legislation is a local or special act in that it favors a particular region of the State.

It is doubtful that the proposed legislation constitutes a local or special act. In Baucher v. Engstrom, 528 P.2d 456 (Alas. 1974), the Alaska Supreme Court stated that "legislation does not become local merely because it operates only on a limited number of geographical areas rather than on a statewide geographical basis. A legislative act may affect only one of a few areas and yet relate to a matter of statewide concern or common interest." Accord, Abrams v. State, 534 P.2d 91 (Alas. 1975); State v. Lewis, 559 P.2d 630, cert denied, 432 U.S. 901 (1977) (upholding the land exchange between CIRI, the United States and Alaska). Thus, to the extent the proposed legislation is a matter of statewide concern, which we believe it is, the proposed legislation is permissible.

More significantly, the Alaska Supreme Court in State v. Lewis held that the test for determining what constitutes "local or special" acts is substantially the same for determining what violates the State equal protection clause. If the equal protection standard is satisfied, "the legislation will not be invalid because of incidental local or private advantages." Id. In terms of our case, then, the crucial issue is whether the proposed legislation violates the State standard of equal protection. If not, Article II, Section 19 will not pose a problem.

SCH:lw

BEFORE THE SENATE RESOURCES COMMITTEE

LEGISLATURE OF THE STATE OF ALASKA

PREPARED STATEMENT

OF

WAYNE B. ALLRED

ASSISTANT CONTROLLER OF TAXES FOR

NORTHWEST ALASKAN PIPELINE COMPANY

HOUSE BILL NO. 258

APRIL 29, 1983

MY NAME IS WAYNE B. ALLRED. I AM THE ASSISTANT CONTROLLER OF TAXES FOR NORTHWEST ALASKAN PIPELINE COMPANY ("NORTHWEST"), WHICH IS THE AGENT AND OPERATOR FOR THE ALASKAN NORTHWEST NATURAL GAS TRANSPORTATION COMPANY. NORTHWEST, ON BEHALF OF THE PROJECT SPONSORS, HOLDS THE AUTHORIZATION TO CONSTRUCT A PIPELINE IN ALASKA TO TRANSPORT GAS FROM PRUDHOE BAY TO THE CANADIAN BORDER, AT WHICH POINT THE CANADIANS WILL FURTHER TRANSPORT THE GAS TO THE BORDER OF THE LOWER 48 STATES. NORTHWEST HAS RECEIVED NUMEROUS APPROVALS AND ENDORSEMENTS FOR THE PROJECT, WHICH IS OFFICIALLY TERMED THE ALASKA NATURAL GAS TRANSPORTATION SYSTEM (ANGTS). IN 1977, THE PRESIDENT OF THE UNITED STATES OFFICIALLY DESIGNATED THE ANGTS AS THE PREFERRED SYSTEM TO DELIVER ALASKA'S NORTH SLOPE GAS TO THE CONTINENTAL UNITED STATES, AND THE UNITED STATES CONGRESS RATIFIED HIS DECISION THAT SAME YEAR. ALSO DURING 1977, THE FEDERAL ENERGY REGULATORY COMMISSION ISSUED ITS PRELIMINARY APPROVAL, AND THE CANADIAN GOVERNMENT AND ITS NATIONAL ENERGY BOARD ENDORSED THE ANGTS PROJECT. IN DECEMBER OF 1981, THE U.S. CONGRESS VOTED TO APPROVE THE INCLUSION OF A GAS PROCESSING FACILITY IN THE PREVIOUSLY APPROVED GAS TRANSPORTATION SYSTEM. THIS GAS PROCESSING FACILITY IS TO BE CONSTRUCTED ON ALASKA'S NORTH SLOPE AT PRUDHOE BAY.

DUE TO THE RECENT RECESSIONARY ECONOMY, THE UPHEAVAL IN THE WORLD OIL MARKET, AND THE CURRENT SUPPLY-DEMAND-PRICING

IMBALANCE IN THE NATURAL GAS INDUSTRY, A DECISION WAS MADE BY THE PROJECT SPONSORS TO DELAY THE CONSTRUCTION OF THE PROJECT. HOWEVER, NORTHWEST AND ITS PARTNERS, ALONG WITH THE THREE PRODUCERS WHO OWN THE VAST MAJORITY OF THE PRUDHOE BAY GAS, ARE CONVINCED THAT THE FACTORS CAUSING THE DELAY ARE TEMPORARY AND THAT THIS NATION WILL HAVE AN ULTIMATE NEED FOR THE ALASKAN NORTH SLOPE NATURAL GAS. THEY ARE, THEREFORE, CONTINUING TO PROVIDE THE FUNDS NEEDED FOR THE ACTIVITIES NECESSARY TO MEET THE REVISED SCHEDULE FOR COMPLETION.

THE PROJECT SPONSORS ARE CONTINUING TO EXAMINE ALTERNATIVES FOR MARKETING THE GAS AND FINANCING THE PROJECT. AS YOU KNOW, IN THE PAST, WE HAVE OFFERED THE STATE AN OPPORTUNITY TO INVEST IN THE PROJECT. WE HAVE NEVER, TO THIS DATE, REQUESTED THAT THE STATE SUBSIDIZE THE PROJECT -- ONLY THAT IT CONSIDER MAKING AN INVESTMENT WITH A REASONABLE RATE OF RETURN TO ASSIST A PROJECT WHICH WILL HAVE SIGNIFICANT BENEFITS FOR CITIZENS OF ALASKA. HOUSE BILL NO. 258, HOWEVER, WHICH IS CURRENTLY BEFORE YOU, SEEKS SOMETHING ENTIRELY DIFFERENT. THE BILL PROPOSES TO ESTABLISH A SPECIAL INVESTMENT CREDIT FOR GAS PROCESSING FACILITIES CONSTRUCTED SOUTH OF THE ARCTIC CIRCLE. IT IS, IN FACT, AN INDIRECT STATE SUBSIDY FOR GAS PROCESSING FACILITIES WHICH MAY BE CONSTRUCTED IN THAT GEOGRAPHIC AREA OF THE STATE.

TO GIVE YOU AN IDEA OF THE FISCAL IMPACT OF THIS BILL, LET ME ILLUSTRATE WITH AN EXAMPLE RELATED JUST TO GAS PROCESSING FACILITIES.

IF, UNDER CURRENT ALASKA TAX LAWS, NORTHWEST WERE TO CONSTRUCT AND PLACE IN SERVICE A GAS PROCESSING FACILITY ON THE NORTH SLOPE, COSTING 5 BILLION DOLLARS, IT WOULD RECEIVE AN INVESTMENT CREDIT, OR TAX SUBSIDY, OF ROUGHLY 4 MILLION DOLLARS.

IF A SIMILAR GAS PROCESSING FACILITY WERE CONSTRUCTED SOUTH OF THE ARCTIC CIRCLE, SAY IN THE COOK INLET, AS ENVISIONED UNDER THE TAGS PROPOSAL, THE STATE COULD BE REQUIRED UNDER THIS BILL, TO PROVIDE ROUGHLY $400 MILLION IN TAX CREDITS OR TAX SUBSIDIES TO SUCH A FACILITY. ADDITIONALLY, THE STATE MAY ADDITIONALLY BE REQUIRED TO PROVIDE CREDITS OF SIMILAR MAGNITUDE FOR LIQUIFICATION FACILITIES.

IN CONCEPT, WHILE WE HAVE NOT SOUGHT LEGISLATION OF THIS NATURE, WE DO NOT OPPOSE THE ESTABLISHMENT OF AN INVESTMENT CREDIT CREDIT FOR GAS PROCESSING FACILITIES. IN FACT, WE WOULD SUPPORT THE PROPOSED CREDIT ABSENT ITS UNACCEPTABLE LIMITATION TO FACILITIES WHICH MAY BE LOCATED SOUTH OF THE 60th PARALLEL. H.B. 258 IN ITS PRESENT FORM, IS CLEARLY DISCRIMINATORY, PROBABLY UNCONSTITUTIONAL, AND APPEARS TO BE SPECIFICALLY DESIGNED TO GRANT AN UNWARRANTED PREFERENCE TO THE RECENTLY CONCEPTUALIZED TRANS ALASKA GAS SYSTEM ("TAGS").

THE TAGS PROPONENTS, HOWEVER, HAVE NOT YET EVEN DEMONSTRATED THAT THEIR PROPOSAL IS TECHNICALLY OR ENVIRONMENTALLY SOUND, THAT THERE ARE ANY REAL MARKETS FOR THE GAS, OR THAT CONGRESS WOULD CONSIDER IT A VIABLE ALTERNATIVE TO THE ANGTS.

RECENTLY, YOUR CONSULTANTS, BOOZ, ALLEN AND HAMILTON, ADVISED THE LEGISLATURE THAT ECONOMIC FACTORS WILL DETERMINE WHICH GAS LINE WILL BE BUILT AND WHEN IT WILL BE BUILT. THE CONSULTANTS ADVISED THAT WHILE YOUR ACTIONS COULD DO LITTLE TO HELP EITHER THE ANGTS PROJECT OR THE NEW TAGS PROPOSAL, YOU COULD, THROUGH YOUR ACTIONS, HARM THE PROSPECTS OF EITHER PROJECT. WE DO NOT BELIEVE THAT IT IS THE LEGISLATURE'S INTENT IN THIS BILL TO IMPEDE, DELAY OR HARM THE LIKELIHOOD OF CONSTRUCTION OF THE ANGTS PROJECT. WE, THEREFORE, RESPECTFULLY REQUEST THAT THE ANGTS PROJECT RECEIVE EQUAL TREATMENT IN THE BILL, AND THAT ALL GEOGRAPHICAL REFERENCES LIMITING THE USE OF THE TAX CREDIT, INCLUDING THE DESIGNATION "SOUTH OF THE ARCTIC CIRCLE," BE REMOVED FROM THE BILL. WITHOUT SUCH MODIFICATION, THE REAL MESSAGE YOU WILL SEND TO THE FINANCIAL MARKETS IS THAT YOUR SUPPORT FOR THE ANGTS PROJECT IS SO LUKEWARM THAT YOU ARE WILLING TO GIVE A TAX PREFERENCE, OF THE SORT NEVER OFFERED TO THE ANGTS, TO A MERE CONCEPT -- ONE THAT HAS NOT YET DEMONSTRATED ITS CREDIBILITY AND WHICH HAS NO SUBSTANTIAL SPONSORS, MUCH LESS ANY SOURCE OF THE MAJOR FUNDS REQUIRED.

IN SUMMARY, WE RESPECTFULLY SUGGEST THAT HOUSE BILL NO. 258 BE REVISED TO ELIMINATE ITS GEOGRAPHICAL LIMITATIONS WHICH ARBITRARILY DISCRIMINATE AGAINST ONE REGION OF THE STATE VIS-A-VIS ANOTHER AND UNFAIRLY PROMOTE A RECENT IDEA FOR TRANSPORTATION OF NORTH SLOPE GAS AT THE EXPENSE OF THE ANGTS PROJECT, WHICH IS MUCH MORE THAN AN IDEA. IT IS, IN FACT, A PROJECT WITH OVER SIX YEARS OF WORK, STUDY, GOVERNMENTAL REVIEW, AND LEGAL PROCEEDINGS BEHIND IT; AND ONE IN WHICH ALMOST $500 MILLION HAS ALREADY BEEN INVESTED. MUCH OF THAT MONEY, AS YOU KNOW, HAS BEEN SPENT HERE IN ALASKA.

THANK YOU FOR THE OPPORTUNITY TO PRESENT THESE VIEWS.

HB 258

ALASKA MINERS ASSOCIATION, INC.

509 W. Third Ave., Suite 17, Anchorage, Alaska 99501 (907) 276-0347

April 6, 1983

Senator Bettye Fahrenkamp
Alaska State Legislature
Pouch V (MS3100)
Juneau, Alaska 99811

Dear Bettye:

The Statewide Board of Directors of the Alaska Miners Association unanimously passed the attached resolution urging enactment of HB-258. The Alaska Miners Association represents approximately 1600 miners located throughout Alaska.

The Alaska Miners Association believes that the investment tax credits proposed in HB-258 will broaden Alaska's economic base. The people of Alaska are concerned about our state's dependence upon oil revenues and diversification of our state's economy is very important for the long term economic health in Alaska.

Many members of the legislature may be hesitant to consider a tax credit bill in the face of declining oil revenues. However HB-258 is an income-producing bill. It will send a strong signal to investors that Alaska is seriously attempting to attract mineral development and increase exploration and mining activity. The economic benefits accruing to the state will far outweigh the revenues lost by the tax credit.

The initial reduction in revenues by mineral investment would be small, less than ten million dollars annually. The tax credits will make Alaskan mineral investments more competitive on a world wide basis and lead to the establishment of a long term healthy mining industry.

We are asking for your help to obtain passage of this bill and make an investment in Alaska's long term economic future.

Sincerely yours,

ALASKA MINERS ASSOCIATION

Ronald Rosander

Ron Rosander
Vice President

RR/dlw
Attachment

ALASKA MINERS ASSOCIATION, INC.

509 W. Third Ave., Suite 17, Anchorage, Alaska 99501 (907) 276-0347

RESOLUTION - HOUSE BILL 258

Whereas the Alaska Miner's Association desires to foster the development of Alaska's mineral resources and,

Whereas the people of Alaska desire to broaden the economic basis of our state and,

Whereas the Investment Tax Credits proposed in HB-258 would provide financial incentives for the development of minerals in Alaska and indicate the strong support of the State of Alaska for a mining industry.

The Board of Directors hereby resolves to urge the Governor of Alaska, the Speaker of the Alaska State House, the President of the Alaska State Senate and the Chairpersons of House and Senate Resources Committee for expeditious passage of HB-258.

Approved

Fairbanks, Alaska

March 29, 1983

Paul Glavino Jr. - President

Sandra M. Thomas

Sandra M. Thomas - Secretary

Department of Revenue
H.B. 258 Example

FACTS

A mining company doing business exclusively in Alaska makes a $500,000,000 investment on January 1, 1984 and a like investment on January 1, 1985.

ASSUMPTIONS

1. 65% of the investment in each year is qualified investment credit property.

   Examples of Qualified Investment Credit property would be:

   a. machinery & equipment
   b. other property which is an integral part of the manufacturing process, eg. silos, elevators, etc.

   Property that does not qualify would be:

   a. real property (other than that which is an integral part of the manufacturing process), eg. warehouses, office buildings, parking lots, etc.
   b. intangible personal property, eg. leases, royalty agreements, etc.

2. The investment produces a 15% pre-tax net rate of return on the new investment in the first year and a constant 7 1/2% pre-tax return thereafter.

3. Federal taxable income from 1981-1992 is $5M per year excluding that income attributable to the new investment.

4. Tax rates and limitations remain constant from 1984-1992.

5. No investments in qualifying property are made after 1985.

2200I

AMENDMENT Vic Fischer's

Offered in the SENATE

TO: CSSSHB 258(L&C)

Page 2, line 6:
Delete: "and (k)"
Insert: "- (l)"

Page 2, line 9:
Delete: "For"
Insert: "Subject to (l) of this section, for"

Page 2, line 11, following "liability"
Insert: "up to"

Page 3, line 2:
Delete: "For"
Insert: "Subject to (l) of this section, for"

Page 3, line 7, following "liability"
Insert: "up to"

Page 3, following line 23, insert a new subsection to read:

"(l) To claim an investment credit under (j) or (k) of this section, an application by the taxpayer shall be made to the department demonstrating that the credit is necessary to the viability of the taxpayer's proposed project and is advantageous to the economic growth of the state. After the commissioners of revenue, commerce and economic development, natural resources, labor, and the director of the office of management and budget have made recommendations, the application shall be forwarded to the governor. Credits under (j) or (k) of this section may be granted by the department only if the governor finds that the proposed project could not be reasonably undertaken without an investment credit and that it would be advantageous to the economic growth of the state. An investment tax credit up to 100 percent under (j) or (k) of this section may not exceed a term of 20 years."

INVESTMENT TAX CREDIT
HOUSE BILL 258

PURPOSE: The bill would provide investment tax credits on state corporate taxes for gas processing facilities, as long as they were located south of the Arctic Circle, and for the development of mineral prospects anywhere in the state.

CURRENT ALASKA INVESTMENT CREDIT: Alaska currently has a provision allowing corporations to deduct 1.8% of qualified capital investments as credits from their corporate taxes. The federal law allows 10% of qualifed investments as a credit. Current Alaska law also limits the investment tax credit allowable to the first $20 million of investments each year.

PROVISIONS OF HOUSE BILL 258: The bill would give additional tax credits (an increase from 1.8% to 10%) for capital investments in mineral development and gas processing. The bill also removes the $20 million limitation.

MAIN POINTS OF CONTENTION:

(1) The stated purpose of the bill is to provide a stimulus to get mineral and gas processing development underway. The logic is that this incentive would provide "spin-off" jobs that would make up the difference in lost revenue. Economists over the years have generally argued over whether the investment tax credit does indeed stimulate investment. Some maintain that it is a very important factor in investment decisions and in setting a favorable investment climate. Others argue that tax credits are a very minimal factor in industry startup, and that the most critical factors are resource availability, support infrastructure, and market conditions.

(2) The bill as currently drafted excludes gas processing plants north of the Arctic Circle. The concern centers around the question of whether a state can discrimate on the basis of geography. The Department of Law will be testifying on this point. Northwest Pipeline Company is especially interested in this question for obvious reasons. Cook Inlet who are the main proponents of the measure, have stated that they do not wish to get into the middle of the gas pipeline routing debate.

(3) The Department of Revenue has no idea about how much state revenue will be lost from enactment of the bill. A fiscal note cannot be prepared because of the unknowns involved in future capital investment plans.

(4) The final major concern is over whether giving the investment tax credit is in the best interest of the miners and persons interested in gas processing. This concern can be explained as follows: for every dollar the state loses in revenue, the individual investor would receive 54¢. The federal government would receive the other 46¢. Which way would investment in the state be helped, by a 54¢ tax break or by expending that dollar on infrastructure, loan funds, etc.

Alaska State Legislature

POUCH V
STATE CAPITAL
JUNEAU, ALASKA 99811
(907) 465-3834
(907) 465-3835

Senate

Committee on Resources

TO: Senate Resources Committee Members

FROM: Senate Resources Committee Staff

RE: CSHB 258 (L&C) Establishing a special investment tax credit.

DATE: April 28, 1983

HB 258 would provide additional tax credits for gas processing facilities located south of the Arctic Circle and for development of mineral prospects anywhere in the state.

Alaska Statutes currently provide for a tax credit for qualified investments of 1.8% of the amount invested up to the first $20 million of investment each year. The proposed legislation would increase the percentage to 10% (same as federal tax law) and remove the investment ceiling.

The Committee will be receiving testimony on the bill from the Departments of Revenue and Law. Their testimony will address several concerns in the legislation. Some of these concerns are: the constitutionality of excluding development above the Arctic Circle from the investment tax benefits; the loss of State revenue; and whether the investment tax credit would be a stimulus to mineral and gas processing projects in the state.

STATE OF ALASKA
FISCAL NOTE

Revision Date 4/11, 1983

I. REQUEST

Bill/Resolution No: CSSSHB 258 (L&C)
Title: Special Investment Tax Credit
Sponsor: Hayes & Szymanski
Requestor: Labor, Commerce & Finance

II. FISCAL DETAIL

Agency Affected: Revenue
Program Category Affected: Coll. & Mgmnt
BRU, Program of Subprogram(s) Affected:

EXPENDITURES/REVENUES: (Thousands of Dollars)

		FY 83	FY 84	FY 85	FY 86	FY 87	FY 88
	OPERATING						
100	PERSONAL SERVICES	-	-	-	-	-	-
200	TRAVEL	-	-	-	-	-	-
300	CONTRACTUAL	-	-	-	-	-	-
400	COMMODITIES	-	-	-	-	-	-
500	EQUIPMENT	-	-	-	-	-	-
600	LANDS & STRUCTURES	-	-	-	-	-	-
700	GRANTS, CLAIMS, ETC.	-	-	-	-	-	-
	TOTAL OPERATING	-	-	-	-	-	-
	CAPITAL	-	-	-	-	-	-
	REVENUE	-	-	-	-	-	-

FUNDING: (Thousands of Dollars)

	GENERAL FUND	-	-	-	-	-	-
	FEDERAL FUNDS	-	-	-	-	-	-
	OTHER (Specify Source)	-	-	-	-	-	-
		-	-	-	-	-	-

POSITIONS:

	FULL-TIME	-	-	-	-	-	-
	PART-TIME	-	-	-	-	-	-
	TEMPORARY	-	-	-	-	-	-
		-	-	-	-	-	-

III. SOURCE OF FUNDS TO OFFSET FISCAL IMPACT OF BILL:

IV. ANALYSIS: Attach a separate page for any Analysis.

Prepared By: Vincent D. Wright
Phone: 465-273
Division: Revenue - Research
Date: 4/7/83

Approved by Commissioner: Jeff Pickett
Date: 4/11/83
Department: Revenue

Distribution:
Original to Legislative Finance
Copy to Office of Management and Budget (for Legislature introduced bills)
Copy to Department (for Governor introduced bills)
Copy to Sponsor
Copy to Requestor (if different from Sponsor)

IV. Analysis of CSSSHB 258

The incorporation of this expanded credit in effect would reduce state taxes as a deductible item at the federal level and thus increase the federal tax take.

The impact of this bill is negative to the state in terms of lost revenues. The quantitative impact cannot be assessed due to carry forward and carry backward provisions which vary from one existing operation to another. If the bill is intended for new facilities, the effect cannot be assessed until they are completed and in operation.

Alaska State Legislature

Speaker of the House of Representatives

Pouch V
State Capitol
Juneau, Alaska 99811
(907) 465-3720

Official Business

SPECIAL INVESTMENT TAX CREDIT LEGISLATION

As projections of declining revenue loom in Alaska's near future, we must begin to diversify our economy so that both state government and local economies are not so heavily dependent on oil derived revenues. I have introduced legislation which would accomplish this goal by establishing a special investment tax credit. Such a credit would apply for investments to develop gas processing facilities South of the Arctic Circle and to investments for exploration, development and mining of minerals other than oil and gas throughout Alaska. A major priority of both myself and the House Majority is diversification of our economy. I believe enactment of this legislation would go a long way towards achieving that goal.

Currently state law limits the amount of investment tax credit (ITC) which is allowed to corporations in computing their Alaska income taxes to 18% of the amount of investment tax credit which is allowed for federal income tax purposes. So while the Federal ITC is 10%, the Alaska investment tax credit is only 1.8%. Current law also limits the ITC which is allowed in computing Alaska income taxes to the first $20 million of qualified investment put into use in the state for each taxable year. That limitation would be removed by this bill.

The Alaska tax credit would only apply to investments which also qualify for the federal credit. This is primarily personal proprty such as trucks, machinery and manufacturing equipment.

It would not include roads, buildings, mine sites and such things as feasibility studies. Using the $1 billion Quartz Hill mine project for example, a very limited amount of that development would qualify for the tax credit. But enough of an incentive would be created to attract industry to Alaska that currently is lacking.

The promotion of exploration, development and mining of minerals and other natural deposits in the state will encourage development of Alaska's non oil and gas mineral resources. This legislation would also accelerate the diversification of the state's economy and employment base.

One new addition to this legislation, not included in the version which passed the House last session, is inclusion of gas processing facilities South of the Arctic Circle. There are areas in Alaska where established infrastructure, access to ice free ports and substantial amounts of uncommitted reserves of natural gas combine to provide great potential for gas processing development and export activity. The development of these gas processing facilities will promote full and stable employment and minimize adverse population and environmental impacts.

I expect the impact on state revenues upon enactment of this legislation would be minimal. While initially there would be be a slight loss of revenue, the long range goal to promote investment and development would increase non petroleum related revenue in future years. The investment tax credit is a temporary tax reduction directly tied to profitable investment that will produce increased revenues in the future. Additionally, investments in targeted industries may substantially expand local governments sales and property tax bases. If the Prudhoe bay curve is accurate, and oil revenues begin to decline in the late 1980's, it is our responsibility to plan to offset that decline. I am confident it will have the support of the administration, which has stated a desire to reach this goal as well.

# # # # # # #

Alaska State Legislature

Speaker of the House of Representatives

Pouch V
State Capitol
Juneau, Alaska 99811
(907) 465-3720

Official Business

MEMORANDUM

April 27, 1993

To: Senator Bettye Fahrenkamp
Senate Resources

From: Rep. Joe Hayes
Speaker

Re: HB 258

I have been told the Senate resources committee will hear HB 258 re: special investment tax credit on Friday. My staff has given backup on this legislation to your staff. This memo is additional material to be considered.

There were several amendments proposed in the House which were opposed. In anticipation of a similar offering in the Senate, I wish to outline my objections in several areas.

The Department of Revenue wishes to list minerals in the bill which the tax credit would apply to rather than reference the IRS code as the bill now does. For the sake of uniformity and consistency it seems appropriate to maintain the IRS code reference rather than list minerals separately. Investment companies have a legitimate concern in expecting some consistency in taxation policies. In that regard, it makes sense that companies should expect the same provisions of a federal tax credit to apply to a state credit. If the IRS code should at some time delete a mineral that is of benefit to the state, it would be a minor matter to then amend our statutes. I think it most prudent to maintain the current reference as the bill does.

I also have some problems with any type of a sunset provision which may be proposed. Many developments, especially in mining are long term projects of 30 years or more. I think a sunset could discourage potential investment. Investors should not be under the threat of a sunset provision which would terminate the consitions under which an investment was originally made.

If, at some time, it is determined the tax credit is no longer accomplishing the goals for which it is intended, it would be possible for a future legislature to terminate the credit. I think this would be a more beneficial attitude than including a sunset clause which could still cause uncertainty and borderline investors to hold off from committing to an Alaskan investment.

There was a proposal to define gas processing facilities as those which produce only urea, methane and liquified natural gas. The bill now defines them as facilities which produce but are not limited to the production of those items. A facility can produce over one hundred by-products. I do not feel we should withhold the credit from production of the byproducts which may also be of benefit.

Finally, this bill is aimed at encouraging investment and jobs in three major areas...coal mining, general mineral development and gas processing. These areas will likely result in the greatest number of jobs in Alaska. While I am not specifically opposed to credits in other areas, I think the bill should be restricted to the areas it now addresses at this time. Further credits should be examined on their own merits and potential.

Thank you for your consideration and I encourage the committee's quick action on this important legislation.

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y · STATE CAPITOL
JUNEAU, ALASKA 99811
907-465 3800

M E M O R A N D U M April 11, 1983

SUBJECT: Equal protection analysis of HB 258

TO: Representative Albert P. Adams
Chairman, House Finance Committee
Attn: Louann Cutler

FROM: Richard C. Folta
Legislative Counsel

I have reviewed the "constitutionality of geographic classification in the investment tax credit bill" memorandum by Cook Inlet Region, Inc., concerning the above referenced bill. I concur in their view that the proposed legislation does not violate the constitution.

The Alaska Supreme Court has a more rigorous equal protection requirement than the U.S. Supreme Court, as elicited in State v. Erickson, 574 P.2d 1 (1978), as follows:

> . . . must look to the purpose of the statute, viewing the legislation as a whole, and the circumstance surrounding it. It must be determined that this purpose is legitimate, that it falls within the police power of the state, Examining the means used to accomplish the legislative objective and the reasons advanced. Therefore, the court must then determine whether the means chosen substantially further the goals of the enactment. Finally, the state interest in the chosen means must be balanced against the nature of the constitutional right invaded.

There are five purposes mentioned for the investment tax credit in HB 258, all of which are legitimate and proper. However, only the first purpose relates to why the credit is to be in effect only south of the Arctic Circle. All the other purposes are just as compelling for facilities north of the Arctic Circle. In my opinion the first purpose is constitutionally sufficient to sustain the goal of the

proposed enactment. The state interest in encouraging development south of the Arctic Circle where ice-free ports are available near established population centers appears to outweigh the tax discrimination that would be in effect on industries north of the Arctic Circle.

RCF:ljb
14-004

CIRI COOK INLET REGION INC.

Inter - Office Memorandum

TO: Lance Anderson, Vice President, Finance

FROM: Steve Hillard, Vice President and General Counsel

Date: March 28, 1983

Subject: CONSTITUTIONALITY OF GEOGRAPHIC CLASSIFICATION IN INVESTMENT TAX CREDIT BILL

You have asked for a review of the constitutionality of a geographic distinction contained in an bill drafted by CIRI and introduced in the Alaska State Legislature. The legislation will grant certain investment tax credits to those gas processors located south of the Arctic Circle. The question presented is whether this type of classification, based on geography, violates the United States or Alaska Constitutions.

Based upon a review of pertinent federal and state authorities, it is my view that the proposed legislation does not violate the United States or Alaska Constitutions.

I. Federal Constitutional Issues

It is useful to note at the outset that there is one significant constitutional provision which does not appear to apply to the proposed tax credit. The United States Constitution provides that all taxes levied by Congress shall be uniform throughout the United States. U.S. Const. Art. 1, Section 8. The United States Supreme Court has consistently interpreted this requirement to mean geographic uniformity. Knowlton v. Moore, 178 U.S. 41 (1900); Steward v. Davis, 301 U.S. 494 (1938). Under this interpretation, distinctions among the states are impermissible. Thus, the United States District Court for the District of Wyoming has recently held that the Crude Oil Windfall Profits Tax Act of 1980 is unconstitutional because it exempts oil produced from north of the Arctic Circle. Ptasynski v. United States, 82-2 USTC Para. 9654 (D.C. Wyo. 1982). The court noted that although rational justifications for the exemption do exist, the exemption is specifically forbidden by the Constitution. In short, the court appeared to hold that geographic distinctions are per se unconstitutional. The United States Supreme Court recently has determined to review this distinction.

In light of these precedents, it would appear that if Congress were to enact the proposed bill, the bill would run a strong risk of being held unconstitutional. The federal uniformity provision, however, by its terms applies only to acts of Congress, not acts of the states. Generally it has been held, for example, that there is nothing in the United States Constitution which requires state taxation to be uniform. See Carmichael v. Southern Coal Co., 301 U.S. 495 (1937). Thus, the proposed legislation does not violate the uniformity clause of the United States Constitution.

It is also possible to assert that the legislation violates the Equal Protection Clause of the Fourteenth Amendment. It might be contended, in other words, that the proposed legislation impermissibly discriminates against gas processors

located north of the Arctic Circle. The United States Supreme Court, however, has consistently held that where state "taxation is concerned and no special right, apart from equal protection, is imperiled, the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation." Lehnhauser v. Lake Shore Auto Parts, 410 U.S. 356 (1973); State Board of Tax Comm'rs of Indiana v. Jackson, 283 U.S. 527 (1931). The appropriate test to be applied to state taxation schemes is whether the state classification has a "rational basis" or whether it is "palpably arbitrary" or "capricious." Id. If "any state of facts reasonably can be conceived" to justify a classification, the Court will sustain it.

Applying the foregoing principles to the proposed legislation, it appears that the Supreme Court would uphold the classification. Although not in the context of a taxation case, the Supreme Court has specifically stated that the "Equal Protection Clause relates to equality between persons as such rather than between areas . . . . Territorial uniformity is not a constitutional requisite." Salsburg v. Maryland, 346 U.S. 545 (1954). In the tax area, the Court has upheld a state tax which provided for different tax rates based on the "gravity" of certain oil and which arguably discriminated between oil produced in Northern and Southern Louisiana. Ohio Oil Co. v. Conway, 228 U.S. 146 (1930). The Court held that the classification based on "gravity" was not unreasonable. Although not directly on point, since the case did not involve a specific geographic distinction, Conway does confirm that the Court will apply a relaxed standard of review to state taxation schemes and that all areas of a state need not have an equal tax burden.

A number of lower courts have specifically addressed state tax classifications based on geography. These courts have held that "distinctions based on geographical areas are not, in and of themselves, violative of the Fourteenth Amendment." Levy v. Parker, 346 F.Supp. 877 (E.D. La. 1972); McCarthy v. Jones, 449 F.Supp. 480 (S.D. Ala. 1973) (no "rational basis" for different tax rates for different counties); Weissinger v. Boswell, 330 F.Supp. 615 (M.D. Ala. 1979) (same). These courts have explained that a state "must demonstrate, if it wishes to establish different classes of property based on different geographical locations -- e.g., rural areas as opposed to urban areas -- that the classification is neither capricious nor arbitrary but rests upon some reasonable consideration of difference or policy." Id.

The question thus remains whether the justification asserted for the geographic classification in this case -- to encourage the location of a certain industry in a certain region of the State -- is sufficient to sustain the classification. Although I have not found a case directly on point, the Supreme Court has suggested that tax classifications designed to create incentives for business to locate within a state are permissible. In Allied Stores of Ohio v. Bowers, 358 U.S. 522 (1959), the Court stated that a tax statute which "encourages the location within the state of needed and useful industries by exempting them, though not also others, from its taxes is not arbitrary and does not violate the Equal Protection Clause of the Fourteenth Amendment." The same rationale would appear to apply equally well to the proposed legislation here, since it is designed to encourage location of a business in a particular part of the state.

II. Alaska Constitutional Issues

There are at least three potential issues under the Alaska Constitution. First, the legislation might violate an implied requirement of "equality and uniformity" of all state taxes. Second, the legislation might violate the Equal Protection Clause found in the Alaska Constitution, Article I, Section 1, which has been interpreted somewhat differently from the Equal Protection Clause of the Fourteenth Amendment. Third, the legislation might constitute a "local or special act" prohibited by Article II, Section 19 of the Alaska Constitution. Let me address the first two issues together, since they are interrelated.

It is necessary to begin with a bit of background. The vast majority of state constitutions embody some provisions for "uniform or equal" taxes. There is, however, no such provision in the Alaska Constitution. The general rule appears to be that in the absence of express provision in the state constitution, it is not essential that state tax statutes operate equally and uniformly. See generally 84 C.J.S. 2d. Taxation, Section 21 (discussing authorities). However, at least one court has held that the principle of uniformity in taxation applies even in the absence of an explicit constitutional provision. See, e.g., Commissioners of Sinking Fund of City of Louisville v. Ohio Valley Grocery Store Co., 240 S.W. 2d 56 (Ky.). Thus, there is at least some possibility that a court might imply a uniformity requirement in the Alaska Constitution.

This possibility is further complicated in the State of Alaska. Although the Constitution of the State of Alaska nowhere requires state taxes to be uniform, Section 9 of the Organic Act of Alaska, 48 U.S.C. Section 28, provides that "all taxes should be uniform upon the same class of subjects." Under the Organic Act, the courts have interpreted the requirement of uniformity to require geographic uniformity. In Hess v. Mullaney, 91 F.Supp. 139 (D.C. Alaska 1950), reversed on other grounds, 189 F.2d 417 (9th Cir. 1950), the court considered whether Alaska's first property tax violated the uniformity requirement of the Organic Act. The property tax levied a tax on all properties in the state, provided that if the property was located within an incorporated city, town or school district, that entity should assess and collect the tax. Plaintiff claimed that the tax was unlawful, since property would be taxed differently depending on where it was located. The District Court agreed, reasoning that classifications may not be based on geographical lines or mere location of the property.

This view was somewhat modified in a successor case, Hess v. Mullaney, 102 F. Supp. 430 (D.C. Alaska 1952), affirmed, 213 F.2d 635 (9th Cir. 1954). Although the court ultimately upheld the property tax, it acknowledged that "unquestionably, systematic geographical discriminations in the burdens of taxation have been held void." The court found, however, that "we assume that the uniformity clause of the Organic Act requires the same measure of uniformity or equality which is required by the Equal Protection Clause of the Fourteenth Amendment." The court held that under the "rational basis" test, it was reasonable for the legislature to have cities assess and collect taxes for property within their jurisdiction.

In light of the foregoing, a strong argument can be made that a separate and distinct "uniformity" requirement no longer exists in Alaska. First, the Alaska Constitution does not provide for uniformity. The Organic Act is a mere act of Congress, and, whatever its continuing effect in light of Alaska statehood, it

probably adds little to the provision of the Alaska Constitution. Second, even if the uniformity requirement of the Organic Act is still controlling, the Ninth Circuit in Hess v. Mullaney held that the Alaska uniformity requirement is no stricter than the equal protection requirement.

A recent case, State v. Reefer King Co., Inc., 559 P.2d 56 (Alas. 1976), support this view and is particularly relevant to this case. The case involved the constitutionality of a state tax which drew a distinction between "floating" and "shore-based" fish processors. Because the tax placed a higher tax rate on floating processors, the floating processors claimed that the statute created an illegal classification under the State equal protection clause. The Alaska Supreme Court rejected that contention. Although the classification could in one sense be deemed to be a "geographical" classification, the Court did not even mention the Hess v. Mullaney cases. Instead, the Court held that the classification should be tested against the State's equal protection analysis, which provides that a statutory classification must

> "be reasonable, not arbitrary, and must rest upon some ground of difference having fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced, shall be treated alike."

The Court held that the classification reflected a legislative judgment that shore-based processors make a more valuable contribution to the State's local economies than the floating processors. According to the Court, it is not arbitrary for the legislature to conclude that shore-based processors were to be preferred over floating processors, which distributed economic benefits over several locations. And, in important language for the present issue, the Court concluded that

> "The state may legitimately encourage, through tax incentives or exemptions, industries or types of industries which it considers desirable, and this method of encouragement does not deprive other taxpayers, who do not qualify for the benefit, of equal protection of the laws.

Two additional points should be made with respect to Reefer King. First, the case strongly supports the notion that the State of Alaska may make a classification in order to encourage businesses to locate in a particular area. A primary reason for CIRI's proposed legislation, of course, is to encourage gas processors to locate south of the Arctic Circle. Second, the equal protection test adopted by the Alaska Supreme Court is somewhat more demanding than the test used in interpreting the Equal Protection Clause of the Fourteenth Amendment. The Alaska test, for example, requires the classification to bear a "fair and substantial" relation to the purpose of the statute, rather than merely a "reasonable" relationship. More significantly, under the Alaska test, unlike the federal test, the courts will "no longer hypothesize facts which would otherwise sustain questionable litigation." Isakson v. Rickey, 550 P.2d 359 (1975). This means that in order to survive constitutional scrutiny, the proposed legislation must clearly articulate the purpose of the legislation and the rationale for the geographic classification. The rationale for the geographic classification is expressly contained in the investment tax credit bill.

There is one final issue. Article II, Section 19 of the Alaska Constitution provides that the "legislature shall pass no local or special act if a general act can be made applicable." In this case, it could be argued that the proposed legislation is a local or special act in that it favors a particular region of the State.

It is doubtful that the proposed legislation constitutes a local or special act. In Baucher v. Engstrom, 528 P.2d 456 (Alas. 1974), the Alaska Supreme Court stated that "legislation does not become local merely because it operates only on a limited number of geographical areas rather than on a statewide geographical basis. A legislative act may affect only one of a few areas and yet relate to a matter of statewide concern or common interest." Accord, Abrams v. State, 534 P.2d 91 (Alas. 1975); State v. Lewis, 559 P.2d 630, cert denied, 432 U.S. 901 (1977) (upholding the land exchange between CIRI, the United States and Alaska). Thus, to the extent the proposed legislation is a matter of statewide concern, which we believe it is, the proposed legislation is permissible.

More significantly, the Alaska Supreme Court in State v. Lewis held that the test for determining what constitutes "local or special" acts is substantially the same for determining what violates the State equal protection clause. If the equal protection standard is satisfied, "the legislation will not be invalid because of incidental local or private advantages." Id. In terms of our case, then, the crucial issue is whether the proposed legislation violates the State standard of equal protection. If not, Article II, Section 19 will not pose a problem.

SCH:lw

Hypothetical Mine - Alaska

David Heatwole - Alaska Miners Assoc.

Senate Resources Comittee

Ball Park Figures

A medium sized high grade mine

Production Rate - 1000 tons/day

Mine Life - 20 years

Capital Investment $ 200 million

Subject to I.T.C 50% - $100 million

Total I.T.C. for project = $10 million.

Annual Net Revenue - $ 35 million

State IC tax at 10% = $3.5 million
Mining License Tax of 7% - $2.5 million

Total Revenue to state

17 years state I.C. Tax = $ 45 million
17 years Mining License Tax = $ 40 million

Total = $ 85 million

Total I.C. Tax Credit $10 million

from Dave Heatwole

INVESTMENT TAX CREDIT

Prepared by:

Alaska Department of Revenue

Robert D. Heath
Commissioner

Foreword

The federal tax laws are highly complex, and the interplay between the Alaska and federal law adds to that complexity. However, a basic understanding of the applicable tax principles and their ramifications is a prerequisite to any analysis of HB 258. The materials compiled in this document are designed to explain and illustrate the operation of those principles, as well as to present such other information necessary in the formulation of an informed decision on the appropriateness of the proposed legislation.

Introduction

Sponsor substitute for HB 258 establishes a special investment tax credit on qualified investments for corporations putting into use gas processing facilities south of the Arctic Circle and corporations engaged in the exploration, drilling of wells, development or mining of the natural deposits south of the Arctic Circle. The bill greatly expands the current Investment Tax Credit.

This handout is intended to provide information which will explain the investment tax credit provisions and provide other information for consideration before the bill becomes law:

This handout is sectionalized as follows:

Section 1: Provides a brief introduction to federal and state Investment Tax Credit Principles.

Section 2: There has been substantial controversy regarding what qualifies for the credit. This section discusses what qualifies.

Section 3: Provides a hypothetical example on the potential impact using various percentage and dollar limitations which might be suggested as modification to HB 258.

Section 4: Dramatically emphasizes the potential for tax leakage to an oil and gas corporation purchasing mining property.

Section 5: Mining Taxes - Brief Summary

Section 6: Brief review of property taxes

Section 7: Provides a synopsis of the results of a special study performed on Mineral Taxation in various states.

Section 8: Contains comments regarding Tax Incentive in general as well as comments on the reasonableness of Mining Taxes in Alaska.

Section 9: Tax benefits for corporations, in general

Section 10: Brief summary of future production which could well avail itself of large tax savings because of the expanded investment tax credit.

Section 11: Brief summary of Alaska Industrial Incentive Act (AS 43.25) and Alaska Industrial Tax Incentive Act (AS 43.26).

Section 12: Historical review of Alaska's revenues

Section 13: Executive Summary

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Section 1

Federal Income Tax Principles - Investment Credit

Investment credit is a dollar for dollar reduction in computed tax. IRC § 38(a).

The amount of the credit for newly acquired property is based upon "qualified investment". IRC § 46(a)(2)(A). Eligible 5, 10, and 15 year ACRS recovery property has a qualified investment equal to 100% of the cost of such property. In the case of eligible 3 year property, only 60% of the cost of the property qualifies as a "qualified investment". IRC § 46(c)(7).

10% of the total "qualified investment" equals the amount of the investment credit. IRC § 46(a)(2). The investment credit must be taken in the year the property is placed in service. Reg. § 1.46-3(d).

In 1983 and following years, the investment credit allowed in any one year is limited to the first $25,000 of tax plus 85% of the tax above $25,000. The percentage was 90% in 1982 and 80% in 1981. IRC § 46(a)(3).

Any investment credit which cannot be used because of the limitation isn't wasted as it is carried back to the 3 previous years and used to offset tax in those earlier years. If the carryback does not exhaust the credit, it may then be carried forward over the 15 years following the year in which the credit arose. If the credit is not fully used over this 19 year period, the remainder is allowed as a deduction from taxable income. IRC § 46(b).

Alaska adopts by reference in AS 43.20.021 the investment credit provisions of the Internal Revenue Code. However, part (d) of that section limits the credit to 18% of the credit determined for federal income tax purposes. In addition, AS 43.20.036 further limits the credit to only that computed on the first $20,000,000 of qualified investment put into use in Alaska for each taxable year.

Prior to 1976, the Alaska Corporation Net Income tax was computed as 18% of the federal tax payable. Legislation in 1975 amended that method to provide for a tax equal to 5.4% of taxable income and a surtax equal to 4.0% of taxable income. Also, the alternative tax on capital gains was set at 4.5% for corporations. Those percentages, when divided by the federal tax rates, produced an approximate effective tax rate of 18% for Alaska purposes. Thus, while the method of computing the Alaska tax changed, the envisioned tax rate was left intact. Both

federal and Alaska tax rates have decreased in the last few years.

The 18% Alaska tax rate prior to 1976 was somewhat deceptive because the effective rate of tax was actually less. In computing federal tax liability, a taxpayer is allowed to deduct from taxable income all state income taxes. Applying the 18% rate to the federal tax payable allowed a taxpayer to deduct Alaska taxes in computing the Alaska tax. The effect was to reduce what was envisioned as an 18% tax rate. The 1975 amendments remedied that result by enacting specific Alaska tax rates and disallowing any Alaska deduction for taxes based on or measured by net income.

Attachments: AS 43.20.021
AS 43.20.036
15 AAC 20.110

22, SLA 1980, unconstitutional as violative of the equal protection provision of art. I, § 1 of the Alaska constitution.

Sec. 43.20.021. Internal Revenue Code adopted by reference. (a) Subtitle F and chapter 1 of subtitle A of the 1954 Internal Revenue Code, Public Law 83-591, as amended, are adopted by reference as a part of AS 43.20.010 — 43.20.350, except that those provisions of the Internal Revenue Code adopted after December 31, 1975 which change or modify exemptions from tax or credits against tax are not adopted by reference as a part of AS 43.20.010 — 43.20.350 until the second January 1 following the effective date of the federal law. These portions of the Internal Revenue Code have full force and effect under AS 43.20.010 — 43.20.350 unless excepted to or modified by other provisions of AS 43.20.010 — 43.20.350.

(b) For purposes of calculating the federal tax payable on personal holding companies provided for in the provisions of Internal Revenue Code § 541, the rate is 12.6 per cent.

(c) For purposes of calculating the alternative tax on capital gains provided for in the provisions of Internal Revenue Code § 1201, the rate is 4.5 percent for corporations.

(d) Where a credit allowed under the Internal Revenue Code is also allowed in computing Alaska income tax, it is limited to 18 percent for corporations of the amount of credit determined for federal income tax purposes which is attributable to Alaska.

(e) Repealed by § 10 ch 1 SSSLA 1980 and § 9 ch 2 SSSLA 1980.

(f) For the purpose of calculating the minimum tax on tax preferences provided for in §§ 56 — 58 of the Internal Revenue Code (26 U.S.C. §§ 56 — 58), the rate is 18 percent for corporations of the applicable minimum federal tax rate.

(g) For purposes of calculating the accumulated earnings tax as provided in § 531 of the Internal Revenue Code, the rate is 4.95 percent of the first $100,000 of accumulated taxable income and 6.93 percent of accumulated taxable income in excess of $100,000. (§ 2 ch 70 SLA 1975; am §§ 1, 2 ch 125 SLA 1976; am §§ 12, 13 ch 113 SLA 1980; am §§ 3 — 5, 10 ch 1 SSSLA 1980; am §§ 3 — 5, 9 ch 2 SSSLA 1980)

Effect of amendments. — The first 1980 amendment, retroactive to January 1, 1980, in subsection (d), deleted "of the amount of the credit determined for federal income tax purposes" following "is limited to 16 percent", inserted "and fiduciaries," and added "of the amount of credit determined for federal income tax purposes which is attributable to Alaska"; and added subsection (g).

The second 1980 amendment, retroactive to January 1, 1980, deleted "and 4 percent for individuals and fiduciaries" from the end of subsection (c), "16 percent for individuals and fiduciaries and" following "limited to" in subsection (d), and "16 per cent for individuals and" following "the rate is" in subsection (f), and repealed subsection (e), which read: "For the purpose of calculating the maximum tax rate on earned income as provided for in § 1348 of the Internal Revenue Code (26 U.S.C. § 1348), the rate is 9.5 percent for individuals."

The third 1980 amendment, retroactive to January 1, 1979, made the same changes as the second 1980 amendment.

Editor's notes. — Section 52, ch. 113,

Editor's notes. — The repealed section derived from § 6, ch. 70, SLA 1975; § 2, ch. 8, SLA 1978; § 1, ch. 64, SLA 1980; § 19, ch. 113, SLA 1980.

For legislative findings and purpose of repealing acts, see § 1, ch. 1, SSSLA 1980, and § 1, ch. 2, SSSLA 1980, in the 1980 Temporary and Special Acts and Resolves.

NOTES TO DECISIONS

Constitutionality of chapter. — See note under same catchline following chapter analysis.

Income derived from sale of crab to Alaska processors. — Where income is derived from the sale of crab to Alaska processors, that income should be subject to the income tax. Where the crab were actually caught makes no difference. Sjong v. State, Dep't of Revenue, Sup. Ct. Op. No. 2269 (File No. 4255), 622 P.2d 967 (1981).

Sec. 43.20.036. Federal tax deductions and credits. (a) For purposes of calculating the income tax payable under AS 43.20.010 — 43.20.350, the taxpayer may not apply as a credit against his liability the foreign tax credit allowed as to federal taxes under Internal Revenue Code § 33 (26 U.S.C. § 33).

(b) For purposes of calculating the income tax payable under AS 43.20.011 — 43.20.350, the taxpayer may apply as a credit against his tax liability the investment credit allowed as to federal taxes under Internal Revenue Code sec. 38 (26 U.S.C. 38) upon only the first $20,000,000 of qualified investment put into use in the state for each taxable year. This limitation does not apply to the amounts invested in equipment which meets the definition of a certified pollution control facility as defined under Internal Revenue Code sec. 169 (26 U.S.C. sec. 169) as in effect on June 19, 1975, except that the date specified in Internal Revenue Code section 169(d) as a condition of qualifying a certified pollution control facility for a deduction does not apply.

(c) For purposes of calculating the income tax payable under AS 43.20.010 — 43.20.350, the taxpayer may apply as an exemption from his tax liability the tax exemption for domestic international sales corporations under Internal Revenue Code § 991 (26 U.S.C. § 991), except those taxpayers who are engaged in the exportation of nonrenewable resources.

(d) Repealed by § 10 ch 1 SSSLA 1980 and § 9 ch 2 SSSLA 1980.

(e) Repealed by § 10 ch 1 SSSLA 1980 and § 9 ch 2 SSSLA 1980.

(f) Repealed by § 10 ch 1 SSSLA 1980 and § 9 ch 2 SSSLA 1980.

(g) Repealed by § 10 ch 1 SSSLA 1980 and § 9 ch 2 SSSLA 1980.

(h) Repealed by § 10 ch 1 SSSLA 1980 and § 9 ch 2 SSSLA 1980.

(i) Repealed by § 10 ch 1 SSSLA 1980 and § 9 ch 2 SSSLA 1980. (§ 1 ch 153 SLA 1975; § 1 ch 171 SLA 1975; am § 3 ch 22 SLA 1980; am § 10 ch 1 SSSLA 1980; am § 9 ch 2 SSSLA 1980; am § 1 ch 117 SLA 1981)

to determine total unitary income subject to apportionment. This requirement applies to taxpayers who have elected to file a consolidated return under (a) of this section. (Eff. 4/14/82, Reg. 82)

Authority: AS 43.05.080
AS 43.20.031
AS 43.20.072

15 AAC 20.110. INVESTMENT TAX CREDIT. (a) For tax years beginning after June 30, 1980, a taxpayer may apply as a credit against his tax liability computed under AS 43.20 18 percent of the investment credit allowed under Internal Revenue Code section 38 upon only the first $20,000,000 of qualified investment put into use in the state for each taxable year.

(b) For calendar year 1980 and for any fiscal tax year which includes July 1, 1980. expenditures made before July 1, 1980 shall be used in calculating the credit upon only the first $500,000 of qualified investment put into use. Expenditures made after June 30, 1980 must be used in calculating the credit upon only the first $20,000,000 of qualified investment put into use in the state. For tax years which include July 1, 1980, the total qualified investment upon which credit may be claimed may not exceed $20,000,000 under any circumstances.

(c) Expenditures qualifying for the investment credit and subject to the $20,000,000 limitation must

(1) qualify for federal investment credit under section 38 of the Internal Revenue Code;

(2) be cash expenditures or binding payment agreements entered into after June 30, 1980; and

(3) be made for assets placed in service in the state.

(d) For purposes of this section, "placed in service in the state" means that the first use of the qualified investment is in this state. If the property is used elsewhere in the taxable year of acquisition and brought to this state during that same year, that property is considered used property and is subject to the limitations as provided in the Internal Revenue Code. If the property is to be used elsewhere during the taxable year of acquisition and brought to this state in another taxable year, the property does not qualify for the investment credit. Transportation equipment used within and outside of this state whose use commences in this state is considered new property. The qualified expenditure for interstate transportation equipment must be based on a prorated formula of days used in this state compared to days used elsewhere.

(e) The recapture of any credit taken must be done under Internal Revenue Code section 47 and must apply when the property is sold, transferred, abandoned, or removed from the state. Transportation equipment used in interstate transportation in this state on a regular basis which originally qualified for investment credit but which is subsequently not used in this state on a regular basis is subject to the recapture provisions of Internal Revenue Code section 47 at that subsequent time. (Eff. 6/2/82, Reg. 82)

Authority: AS 43.05.080
AS 43.20.021
AS 43.20.036
§ 24, Ch. 117, SLA 1981

15 AAC 20.120. ALTERNATIVE ENERGY EXPENDITURE CREDIT; ELIGIBILITY. (a) A taxpayer engaged in a trade or business who purchases, constructs, or installs an alternative energy system or an energy conservation improvement on behalf of or under contract for another is not entitled to the credit provided under AS 43.20.037.

(b) A credit will not be allowed under AS 43.20.037 for the purchase, construction, or installation of an alternative energy system or an energy conservation improvement which occurred before January 1, 1981, or after December 31, 1985. (Eff 3/28/82; Reg. 81)

Authority: AS 43.05.090
AS 43.20.037
Secs. 50, 53 and 55, ch. 83, SLA 80

15 AAC 20.122. ALTERNATIVE ENERGY SYSTEM SUBSTANTIATION. (a) A taxpayer engaged in a trade or business who purchases, constructs, and installs an alternative energy system must, in addition to maintaining a record of the cost of the system, be able to substantiate that the system has provided

Section 2

Roads and Other Property Qualifying for the Investment Credit

Property which qualifies for the investment credit is known as section 38 property. Section 38 property means property of which:

1. depreciation is allowable;
2. has an estimated useful life of three years or more; and
3. is either tangible personal property, or other tangible property (not including a building and its structural components) but only if such is used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such services, or is a research or storage facility used in connection with any of the foregoing activities.

The terms "manufacturing," "production," and "extraction," include the construction, reconstruction, or making of property out of scrap, salvage, or junk material, as well as from new or raw material, by processing, manipulating, refining, or changing the form of an article, as well as the mining of minerals. Thus, Section 38 property would include property used as an integral part of the extracting, processing, or refining of metallic and nonmetallic minerals, including oil, gas, rock, marble, or slate, as well as the construction of roads, bridges, or housing.

Property such as pavements and parking areas ordinarily is not used as an integral part of any of the specified activities. However, property is used as an integral part of one of the specified activities if it is used directly in the activity and is essential to the completeness of the activity. All properties used in acquiring or transporting raw materials or supplies to the point where actual processing commences (such as docks, railroad tracts and bridges) or in processing raw materials would be considered as property used as an integral part of manufacturing.

Following the introduction last session of other investment credit legislation, specifically CS HB 866, the question whether "roads" constructed by mining companies would qualify as Section 38 property was posed to the Department. That question can be answered best by reference to various Internal Revenue Service Rulings pertaining to that issue.

Roads may qualify as an integral part of a specified activity depending upon the purpose and use of the road. For example, roads (including marking devices, guardrails, and lighting) devoted solely to truck traffic relating to manufacturing activity and roads used regularly by trucks in transporting raw materials, supplies and finished and semi-finished products have been ruled by the IRS to qualify as Section 38 property for investment credit purposes. By contrast, roads provided solely for employee and visitor vehicle traffic would not be an integral part of the manufacturing activity and would not qualify. Revenue Ruling 71-555, 1971 2 C.B. 65. Paved parking lots of a manufacturing complex devoted to truck and trailer parking and paved outdoor storage areas used for the storage or raw materials, supplies, machinery temporarily removed from productive service, and finished and semi-finished products have been ruled to constitute other tangible property used as an integral part of a manufacturing operation qualifying as Section 38 property. Revenue Ruling 72-397, 1972 2 C.B. 8. That ruling also held that paved employee and visitor parking lots do not qualify as Section 38 property because such "does not contribute directly to the flow of production." Private Letter Ruling 8201002, 1982 PH 54,732 concluded that that phrase was not to be given an overly restrictive interpretation and ruled that a reconstructed portion of a dam used to generate hydroelectric power for a cotton wearing mill constituted Section 38 property.

Thus, roads and other tangible property will qualify as Section 38 property to the extent such directly contribute to the flow of production. Presumably, most if not all roads constructed for mining related purposes will qualify for the investment credit.

Attachment: Additional Rulings

Additional Rulings on Secton 38 Property

Concrete silo storage structures, located in the distribution and marketing areas of a taxpayer engaged in the production of cement, which structures are used for the bulk storage of fungible cement, qualified as "section 38 property" because they were storage facilities used in connection with the taxpayer's manufacturing and production of cement. [Rev. Rul. 72-365, 1972-2 C.B. 8.]

The Service has ruled that improvements consisting of a paved yard, concrete aprons, concrete pad, yard bumpers, and yard lighting made to a trucking terminal by a taxpayer engaged in short and long-haul trucking consistuted "other tangible property" used as an integral part of the furnishing of transportation services and thus, qualified as §38 property for purposes of the investment credit. [Rev. Rul. 68-1, 1968-1 C.B. 8] The paving was considered essential to the completeness of the transportation activity; the concrete aprons and pads were necessary in certain critical areas of the terminal yard to provide parking support in areas where heavy loads must be supported on small surface areas; and the yard bumpers defined the terminal yard and allowed for the safe parking and positioning of trailers of various lengths. The yard lighting was also considered an integral part of the transportation activity since a large part of the terminal work was performed at night.

In addition, logging truck roads (both permanent and temporary) constructed to harvest timber and transport the cut lumber to the taxpayer's mills and plants where the timber was processed was held to constitute "section 38 property" since they were integral parts of the taxpayer's operation of sawmills, his production of lumber, lumber products, or other building material, or his manufacture of paper, and thus integral parts of "manufacturing," "production," and "extraction." [Rev. Rul. 68-281, 1968-1, C.B. 22; Rev. Rul. 73-217, 1973-1 C.B. 35]

Section 3

Department of Revenue
H.B. 258 Example

FACTS

A mining company doing business exclusively in Alaska makes a $500,000,000 investment on January 1, 1984 and a like investment on January 1, 1985.

ASSUMPTIONS

1. 65% of the investment in each year is qualified investment credit property.

2. The investment produces a 15% pre-tax net rate of return on the new investment in the first year and a constant 7 1/2% pre-tax return thereafter.

3. Federal taxable income from 1981-1992 is $5M per year excluding that income attributable to the new investment. The $5 million taxable income is all derived from non-mining production activities.

4. Tax rates and limitations remain constant from 1984-1992.

5. No investments in qualifying property are made after 1985.

6. Mining production begins in 1984.

HB 258 Example

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Federal												
Tax. inc. attributable to prior investment[3]	$5M	5M	5M	5M	5M	5M	5M	5M	5M	5M	5M	5M
Tax. inc. attributable[2]	-	-	-	75M	75M	75M	75M	75M	75M	75M	75M	75M
Total taxable income	$5M	5M	5M	80M	80M	80M	80M	80M	80M	80M	80M	80M
Tax before I/C	2,280,750	2,280,250	2,279,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750
I/C before limitation[1]	0	0		32,500,000	32,500,000	0	0	0	0	0	0	0
I/C allowed	1,233,462	1,233,462	0	31,266,538	31,266,538	0	0	0	0	0	0	0
Tax payable	1,047,288	1,047,288	2,279,750	5,513,212	5,513,212	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750	36,779,750
Alaska												
Taxable income	5.5M	5.5M	5.5M	80M	80M	80M	80M	80M	80M	80M	80M	80M
Tax	513,040	513,040	513,040									
Tax before I/C				7,516,000	7,516,000	7,516,000	7,516,000	7,516,000	7,516,000	7,516,000	7,516,000	7,516,00
I/C as computed before limitation				32,500,000	32,500,000							
I/C allowed for fed. purposes				31,266,538	31,266,538							
I/C utilized				(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(7,516,000)	(3,332,880)
Tax payable				0	0	0	0	0	0	0	0	4,183,120
I/C CB from 1984	513,040	513,040	513,040									
Tax payable as adjusted	0	0	0									
Refund to taxpayer	513,040	513,040	513,040									
I/C CF to following year				23,444,880	48,428,880	40,912,880	33,396,880	25,880,880	18,364,880	10,848,880	3,332,880	0

Abbreviations

M - Million
Tax. inc. - Taxable income
I/C - Investment credit
Fed. - Federal
CF - Carryforward
CB - Carryback

$ - all numbers in dollars

Comparison Schedule Showing Alaska Revenue Loss Attributable to Investment Credit Provisions

	Percentage of Federal Credit	Alaska Investment Credit	Total Federal and Alaska Tax	Federal Tax	Alaska Tax	Alaska Revenue Leakage to Federal Government	Increased Leakage Compared to Present Law	Decrease in Alaska Revenue Compared to Present Law	Decrease in Alaska Revenue From Under Present Law Which Is Available to Taxpayers
Present Law: $20,000,000 Limitation on Qualified Investment and Alaska Investment Credit set at:									
	18%	360,000	311,947,720	243,124,600	68,823,120	165,600	0	0	0
$100,000,000 Limitation on Qualified Investment and Alaska Investment Credit set at:									
	18%	1,800,000	311,170,120	243,787,000	67,383,120	828,000	662,400	1,440,000	777,600
	36%	3,600,000	310,198,120	244,615,000	65,583,120	1,656,000	1,490,400	3,240,000	1,749,600
	50%	5,000,000	309,442,120	245,259,000	64,183,120	2,300,000	2,134,400	4,640,000	2,505,600
	75%	7,500,000	308,092,120	246,409,000	61,683,120	3,450,000	3,284,400	7,140,000	3,855,600
	100%	10,000,000	306,742,120	247,559,000	59,183,120	4,600,000	4,434,400	9,640,000	5,205,600
No Limitation on Qualified Investment and Alaska Investment Credit set at:									
	18%	11,700,000	305,842,120	248,341,000	57,483,120	5,382,000	5,216,400	11,340,000	6,123,600
	36%	23,400,000	299,506,120	253,723,000	45,783,120	10,764,000	10,598,400	23,040,000	12,441,600
	50%	32,500,000	294,592,120	257,909,000	36,683,120	14,950,000	14,784,400	32,140,000	17,355,600
	75%	48,750,000	285,817,120	265,384,000	20,433,120	22,425,000	22,259,400	48,390,000	26,130,600
[HB 258]	100%	65,000,000	277,042,120	272,859,000	4,183,120	29,900,000	29,734,400	64,640,000	34,905,600

Alaska Revenue Effect Under Corporation and Mining Tax Provisions

PRESENT LAW	1981-1992 Example
Alaska Tax Revenues Generated Under Corporation Income Tax Provisions	$68,823,120
Alaska Tax Revenues Generated Under Mining License Tax Provisions	28,858,500
	$97,681,620
H.B. 258	
Alaska Tax Revenues Generated Under Corporation Income Tax Provisions	$4,183,120
Alaska Tax Revenues Generated Under Mining License Tax Provisions	31,295,487[1]
	$35,478,607
Revenue Under Present Law	$97,681,620
Revenue Under HB 258	35,478,607
Revenue Loss	$ 62,203,013

[1]Adjusted to reflect increased mining taxes due to the reduction of corporation taxes which otherwise would be deducted.

Section 4

Tax Leakage - Oil & Gas Corporations

Alaska's Corporate Income Tax collections for FY83 are projected to reach $270 million. A majority of that amount ($235 million) will be received from oil and gas corporations taxed under the new income tax law (SB 524 - 1981). That law provides that if a corporation engaged in oil or gas production or pipeline transportation has taxable income from both its petroleum business and its other business, it shall report its total taxable income on a single return except that it shall compute its Alaska taxable income from its petroleum business separately on its return from its other Alaska business. The law provides, however, that the combined investment tax credit of the petroleum business and the other business can be applied to the consolidated tax liability of the petroleum business and other business. HB 258 provides for an opportunity for the major oil corporations to invest in property qualifying for the special investment tax credit provisions and thereby substantially offset the income tax liability of its oil and gas income. A handful of oil and gas corporations provide the majority of the $235 million, and it is those few corporations which will be in a position to substantially benefit from HB 258.

Exhibit A (page 15) compares tax of two companies standing alone with tax if an oil and gas company which owns a mining company. The example assumes for Alaska purposes no limitation on the amount of qualifying investment and full federal investment tax credit.

Major oil companies and mining company subsidiaries are as follows:

1. Atlantic Richfield (ARCO)
   a. Anaconda Mining Company

2. Standard Oil of Ohio (SOHIO)
   a. Kennecott Copper Company

3. Standard Oil of California (SOCAL)
   a. Chevron Resources

4. Gulf Oil
   a. Gulf Minerals

5. American Oil Company (AMOCO)
   a. Amoco Minerals

6. Phillips Petroleum Company
   a. Phillips Coal Company

7. Getty Oil Company
    a. Getty Minerals
    b. Getty Mining
    c. Plateau Mining
    d. Colorado Yampa Coal

Example 1:

Separate Filers - HB 258 Provision

		HB 258 Qualifying Company	Oil and Gas Company	Total Alaska Tax
1.	Qualifying Investment Property	$500,000,000	$500,000,000	
2.	Taxable Income	10,000,000	1,000,000,000	
3.	Alaska Income Tax before ITC	936,000	93,996,040	
4.	Investment Tax Credit (Federal Limitation)	4,124,500	50,000,000	
5.	Investment Tax Credit - AK	936,040	360,000	
6.	Alaska Tax Liability (3-5)	$ 0	$ 93,636,040	$93,636,040

Example 2:

Consolidated Return

1.	Consolidated Taxable Income	$1,010,000,000	
2.	Consolidated Alaska Income Tax before ITC	94,936,040	
3.	Consolidated Qualifying Investment Property	1,000,000,000	
4.	Consolidated Investment Tax Credit (Federal Limitation)	100,000,000	
5.	Alaska Investment Tax Credit - HB 258 Qualifying Company	50,000,000	
6.	Alaska Investment Tax Credit - Oil & Gas Company	360,000	
7.	Alaska Tax Liability (2-6)		$ 44,576,040

Net savings to oil and gas company (loss of revenue to State) $49,060,000

Note: See following page for comments regarding the investment tax credit and consolidations and reorganizations.

Investment Tax Credit and Consolidations and Reorganizations

1. There appears to be no prohibition or substantial restriction wherein an oil and gas corporation could not invest in non-oil and gas mining activity and wherein the available investment tax credit of the non-oil and gas mining activity could not be used to offset the consolidated tax liability.

2. An investment tax credit which would otherwise be unavailable to a member of the consolidated group in a separate return (because of insufficient income or tax) might become available to the group in a consolidated return.

3. The successor corporation in a reorganization stands in the "tax shoes" of the predecessor with respect to unused investment tax credit.

Section 5

License Tax on Mines and Mining
AS 43.65

Mining operations are subject to a mining license tax computed as follows:

Net Income Over $40,000 and not over $50,000	3%
Over $50,000 and not over $100,000	$1,500 plus 5% of excess over $50,000
Over $100,000	$4,000 plue 7% of excess over $100,000

All new mining operations are exempted from the tax for three and one-half years after production begins.

The Mining License Tax allows for generous deductions from gross income in computing taxable income, including:

1. Percentage depletion which often allows for a deduction from gross income an amount far in excess of the cost invested in the property.

2. Accelerated depreciation methods are allowed which enable a taxpayer to deduct a greater portion of asset investment in the early years of the asset life.

3. Income taxes paid to the State of Alaska are an allowable deduction on the Mining License Tax Return. Mining License Taxes are a deduction on the Corporation Income Tax Return.

4. Direct and indirect expenses.

The following page provides a history of Mining License Tax collection since FY 59 and compares that tax to the value of Mineral production. In FY 79, for example, for every $1 of mineral production, less then .1 of one cent was paid in mining license tax.

The total mining license tax collected between FY 59 and FY 82 (24 years) was $1,333,648 for an average of about $55,000 per year.

Historical Comparison
Mining License Tax vs.
Mineral Production Value

	Mining License Tax ($)	Value of Min. Prod. (Millions $)	% (Tax vs. Value)
FY 59	7314	20.2	.036
FY 60	33841	20.6	.164
FY 61	4865	17.0	.029
FY 62	15958	22.5	.071
FY 63	30248	34.1	.089
FY 64	46450	30.6	.152
FY 65	88127	47.6	.185
FY 66	66217	35.9	.185
FY 67	45671	41.7	.110
FY 68	57575	30.6	.188
FY 69	78279	30.5	.257
FY 70	45000	59.1	.076
FY 71	16600	47.4	.035
FY 72	30700	32.0	.100
FY 73	16000	47.4	.034
FY 74	28400	69.1	.041
FY 75	10500	67.7	.016
FY 76	69100	241.8	.029
FY 77	65200	170.5	.038
FY 78	95500	163.7	.058
FY 79	129000	185.5	.070
FY 80	138300	158.2	.087
FY 81	56000	181.6	.031
FY 82	158803	196.4	.081

Section 6

Property Taxes

Mining companies are subject to property taxes if the property is located in one of those taxing jurisdictions which subject property to taxes. These include the cities and boroughs of Anchorage, Naknek, Fairbanks, Pelican, Cordova, Craig, Haines, Dillingham, Juneau, Petersburg, Soldotna, Ketchikan, Kodiak, Palmer, Barrow, Sitka, Nenana, Nome, Skagway, Unalaska, Valdez, Wrangell, Yakutat, North Slope Borough, Kenai, Bristol Bay and Matanuska-Susitna. There is no statewide property tax.

Personal and real property are subject to property taxes. "Personal property" is defined to mean tangible property other than real property, such as merchandise and stock in trade, machinery and equipment, furniture and fixtures, motor vehicles and vehicles, boats and vessels and aircraft.

"Real property" means land and improvements and all possessory rights and privileges appurtenant to the property, and includes personal property affixed to the land or improvements.

Mining company property, in general, is subject to property taxes if located in one of the boroughs or cities which assess the property. Oil and gas property taxes are administered by the Department of Revenue under AS 43.56.

As of 1980, Alaska had 140 organized cities with 11 Home Rule cities, 21 first class and 108 second class cities. The 11 organized boroughs contain about 90% of the state's population. Since second class cities have limited taxing powers with no educational responsibility, property taxes are generally not levied by those second class cities.

Revenues - 1981

The commercial property tax revenue was about $22,500,000 in 1981 with the 11 boroughs collecting all but $775,000 of that amount. The revenue for 1982 was about $21,600,000. The amount of taxes paid by mining companies is a small portion of the total amount as most of the commercial property tax is paid by local businesses.

General

The U. S. Borax plant is located outside the taxing jurisdiction of Ketchikan and would not be subject to that borough's property taxes.

Mining company representatives have publicly stated that mining

companies pay sizable amounts of property taxes. Outside of gravel pits we have not been able to determine which mines pay large amounts. Generally speaking, there is no tax on reserves and most taxes paid on mining property are on personal property (equipment, etc.)

Most mining activity appears to be occurring in unorganized locations (non-tax). However, we have been informed that increased mining activity is occurring in organized boroughs and that assessors are becoming alerted to the potential property tax possibilities.

Section 7

Alaska Mineral Taxation Compared with Other States

A report entitled "Alaskan Mineral Taxation Compared to Taxes in Mines in Eleven States" was prepared by Whitney and Whitney, Inc. of Reno, Nevada. That report was an extension of a study done for the Wisconsin Association of Manufacturers & Commerce completed in January 1981. Six models consisting of small, medium and large versions of both underground and open pit mines were developed for computer analysis. These models were then used to compare the tax revenues generated over the life of each mine in eleven major mining states but not including Alaska.

The Whitney and Whitney report provided two conclusions:

1. Alaska's mineral tax structure is average compared with the eleven other states and provides a relatively attractive tax environment for mining.

2. Alaska's tax structure is progressive as the taxes are proportional to income levels. This is a positive and important aspect of mineral industry taxation because mines subject to gross proceeds taxes, which do not decline proportionately with income, shut down sooner in times of adverse economic conditions.

The study noted that cost differentials between Alaska and other states are significant in the following areas: (not considered in the tax comparison):

1. Exploration and development costs;
2. Capital costs;
3. Operating costs;
4. Infrastructure investment.

The most significant cost relates to infrastructure. Whereas, in most states infrastructure is often a minor component of mine development, it can be the largest cost in Alaska in bringing a mine to the production phase.

Taxes imposed by the states in the study include: (1) severance tax; (2) net proceeds tax; (3) property tax; (4) sales and use tax; and (5) state income tax.

Mineral activities in Alaska are subject to a mining license tax based on net income; corporate income tax based on net income and real and personal property tax levied by municipalities and boroughs. The state administers no general property tax. Property is assessed January 1st of each year at its "full and true value" which is defined as "the estimated price which the property would bring in an open market and under the prevailing market conditions

in a sale between a willing seller and a willing buyer both conversant with the property and with prevailing general price levels." The tax rates are fixed locally with a maximum rate of 3% for cities. The different boroughs and city tax rates can vary substantially from year to year.

In various measures used to assure competition for mining business among states, Alaska, for example, in the mine model for 5,000 tons of ore products per day, in open pit mining rated as follows among 12 states: (The higher the rating, the more appealing the tax burden)

1. Total state Tax Burden: Tie 6th and 7th of 12
   State Mineral Tax as a percent of sales: 8th of 12

2. Effective State Tax Rate (Tax as a percent of operating revenue) 7th of 12

3. Effective State and Federal Tax Rate (Tax as a percent operating revenue) 6th of 12

Summary:

It appears that Alaska taxes would rate in the mid-stream with other states. It further appears that costs other then taxes are a more important factor in Alaska mine development than are taxes.

Section 8

Tax Incentives

1. "Tax Incentives For Investments: The State of the Art" - by Richard M. Bird, Director of the Institute for Policy Analysis at the University of Toronto.

   Mr. Bird reaches three disconcerting conclusions relating to tax incentives:

   a. Economists and other researchers know amazingly little about the efficiency and effectiveness of the investment incentives used so profligately by many national governments.

   b. Available research techniques are incapable of improving this sad state of affairs very much.

   c. Available evidence suggests that tax incentives "are neither efficient nor effective in achieving most of the objectives for which they were supposedly introduced."

   Mr. Bird reaches other conclusions such as:

   a. Several studies show that investment incentives "affect not the level but the composition of investment."

   b. The change in composition of investment may reduce overall productivity or defeat whatever other goal the incentive may be pursuing.

   c. Tax incentives reduce government revenues otherwise available. This revenue loss can be financed through higher taxes or through spending cuts and these alternatives have potentially dramatic effects on investment behavior.

   d. Some studies indicate that the typical investment incentive either destroys jobs or, at best, creates a few jobs at enormous cost, though job creation is another of the commonly stated objectives of investment incentives.

2. Quote from article written by Alfred Rappaport, a professor at Northwestern University's Graduate School of Management

   "Tax credits and faster depreciation will not generate more investment unless business remodels its incentives to make managers plan for the long run."

Bibliography

Bridges, Bengamin, "State and Local Inducements for Industyr; National Tax Journal, Vol. XVIII, No. 1, 1965, pp. 1-14.

Morgan, William E. and Merlin M. Hackbart, "An Analysis of State and Local Industrial Tax Exemption Programs," Southern Economic Journal, Vol. 41, No. 2, 1976, pp. 200-205

Surrey, Stanley S., "Tax Incentives as a Device For Implementing Government Policy: A Comparison With Direct Governent Expenditures," Harvard Law Review, Vol. 83, No. 4, January, 1970, pp. 705-738

Vaughan, Roger J., "State Taxation and Economic Development," pp. 95-111

Miscellaneous Information

1. International Conference on Coal, Minerals and Petroleum Proceedings

Quotation from Executive Summary by Carl Portman, Public Relations Coordinator, Resource Development Council Inc. of Alaska:

> "The major obstacle to development of mineral deposits is the lack of transportation infrastructure. Another concern is taxation; although state taxes on the mining industry now are reasonable, the industry is wary because of the punitive taxes levied on petroleum production."

Quotation from Mr. David A. Heatwole's article "An objective view of Mining in Alaska":

> "Alaska currently has reasonable state taxes on the mining industry. The corporate income tax is 9 percent and the Alaska mining license tax is 7 1/2 percent net tax and provides a 3 1/2 year "holiday" from capital recoupment. The state does not have a property tax on minerals, but locally borough taxes can be substantial.

2. Extracts from memorandum dated May 10, 1982 to Senator Vic Fischer from Ira Winograd RE: Cook Inlet Regional Incorporated and HB 866, Investment Credit.

> "CIRI states that in a development project the amount of qualifying property will be a minor part of total investment. This is contradicted by Borax which informed the governor's office that 63 percent of its total projected expenditures would be eligible for the investment credit base."

> "CIRI disputes the Department of Revenue financial that the proposed credit would exempt Borax from $82 million in state taxes. This is contradicted by Borax which has informed the governor's office that it plans $950 million of qualifying investments. Thus, under HB 866, Borax would have $95 million worth of investment credit."

3. Investment Tax Credit Allowed - Other States

As of late 1981, only 17 states allowed some sort of investment tax credit. Most states have a very limited

investment credit, such as:

Alaska: limited to $20 million invested and 18% of Federal limitations

Montana: 30% of Federal credit but limited to small businesses.

New Mexico: 3 3/4% of cost is credited against withholding tax

Oregon: 10% of cost of investment which creates new jobs in economically lagging areas.

Connecticut: The Federal Investment tax is a deductible cost (not a direct tax credit).

Section 9

Corporate Income Tax (AS 43.20)
Current Tax - Business Incentives

Incorporated mining operations along with most other corporations are subject to a corporation income tax. Special tax benefits and credits, in addition to the investment tax credit, allowed corporate taxpayers include:

1. Percentage depletion which often allows for a deduction from gross income an amount far in excess of the costs invested in the property.

2. Accelerated depreciation methods which enable a taxpayer to deduct a greater portion of asset investment in the early years of the asset life. A recent example of a federal provision which was automatically adopted and which erodes our tax base is the "Accelerated Cost Recovery System" (ACRS) which Congress created in 1981 and which increases depreciation and reduces net taxable income.

3. Substantial changes have recently been made to Subchapter S laws. S corporations are, in essence, taxed as partnerships; i.e., the corporation pays no tax but the taxable income is passed through to the shareholders for federal taxation. Neither S corporations nor their share- holders pay any income tax to the State of Alaska. The changes in Subchapter S laws provide the opportunity for more and more corporations to elect S corporate tax status thereby further reducing the State's corporate tax rolls and corporate tax collections.

4. A targeted jobs tax credit is allowed for certain employers who nire individuals from certain target groups.

5. A corporation is entitled to a special deduction from gross income for dividends received from a domestic corporaton subject to income tax. This deduction is generally 85% of the dividend received.

6. Corporations obtain a reduced special tax rate for capital gains.

7. Consolidated tax returns can be filed wherein a profitable corporation can consolidate with an 80% or greater owned loss corporation and reduce its taxes.

8. Tax laws have been relaxed to allow for easier safe harbors for leverage leases. In essence, three-party financing leases can be widely used to transfer tax benefits from lessees who don't have enough tax liability to absorb them to lessors who could.

Section 10

Future Production

Three Alaskan companies have announced plans to put Alaskan deposits into production before 1990:

1. U. S. Borax - Quartz Hill Deposit

   a. Probably world's largest molybdenum deposit with reserves of approximately 1.5 billion tons.

   b. Borax is conducting a ten mile access road from tidewater to the deposit (probably eligible for the investment tax credit).

   c. Production to start in late 1987. Preproduction capital expenditure is estimated at $350 million.

2. Noranda - Green's Creek

   a. Noranda is the operator for the Pan-Sound joint venture (Noranda Martin Marietta, Bristol Bay Native Corporation).

   b. Silver-gold deposit. Announced reserves for the deposit are 3.5 million tons.

   c. Noranda plans to start construction during 1983.

3. NANA/Cominco Alaska, Inc. - Red Dog Deposit

   a. The NANA Corporation (Alaska Native Corporation) and Cominco Alaska, Inc. have announced a joint-venture development of the Red Dog Deposit located in Northwest Alaska.

   b. The zinc, lead and silver mine has open pit reserves of 85 million tones.

   c. Production to start in 1986. The mine will have an 80-mile road/rail system.

4. Bering River Coal Field

   Chugach Natives, Inc. in partnerships with four major Korean firms, has been investigating a $150 million development of the low sulfur, high BTU Bering River coal field near Copper River. Production is expected to begin in 1985 or 1986 with anticipation that about two million tons of coal would be exported annually to Korea.

5. Gold Mining

Several major companies are active in exploration and production, including Placid Oil at Cherry Summit.

In Nome, Alaska Gold Company has reserves for about 25 years of operation. Alaska Gold Company's production is estimated to have increased 30% recently from improved operational efficiency.

At Independence Mine in the Matanuska Valley, production was estimated to be 20,000 tons per year.

Section 11

Brief Sketch of Industrial Incentive Legislation

To encourage new Alaska business and industry the legislature enacted the Alaska Industrial Incentive Act (AS 43.25) which accepted applications from 1957 to 1968 and the Alaska Industrial Tax Credit Act (AS 43.26) which accepted applications from 1968 to 1971.

Under AS 43.25, a business could be exempted an unlimited amount of State or local taxes within a five or ten year period depending upon the amount of the investment. There were seventeen companies granted exemptions under this statute - six lumber and timber related, four petroleum related and the balance miscellaneous manufacturing businesses.

Under AS 43.26 the exemption was limited both in time and amount. The credit could not be for more than ten years and could not exceed 75% of the firms investment. In 1970, the amount was reduced to 50% of the investment. Eight firms were granted exemptions under AS 43.26.

Records are somewhat spotty in this area and specific amounts of credit granted or taken are hard to determine. It is our understanding that the Alaska Industrial Incentive Act and the Alaska Industrial Tax Credit Act were not generally effective in attracting new business. We recommend that the Departments of Commerce and Revenue conduct a review of the history of AS 43.25 and AS 43.26 to determine the actual effectiveness in attracting new business.

Section 12

HISTORICAL REVIEW OF ALASKA'S REVENUES

By
Robert Elliott, Research Analyst

The following report provides a brief historical review of how Alaska's revenues have changed in terms of collections and composition during the past twenty-four years of statehood.

The single most prominent event in Alaska's economic history has been the 1968 discovery of oil and gas at Prudhoe Bay. All areas within the state have subsequently been impacted by this event, none more profoundly than state revenues. Since the North Slope lease sale in FY 1970, revenue collections have experienced unprecedented growth. A total of $16.9 billion has been received since statehood in General Fund unrestricted revenues, with over 95 percent being collected since 1970 and over two-thirds being collected during the past four years. This dramatic growth is illustrated in Figure 1 where General Fund unrestricted revenues are plotted over the past twenty-four years since statehood.

FIGURE 1
HISTORICAL COMPARISON OF GENERAL FUND
UNRESTRICTED REVENUES
(STATEHOOD-PRESENT)

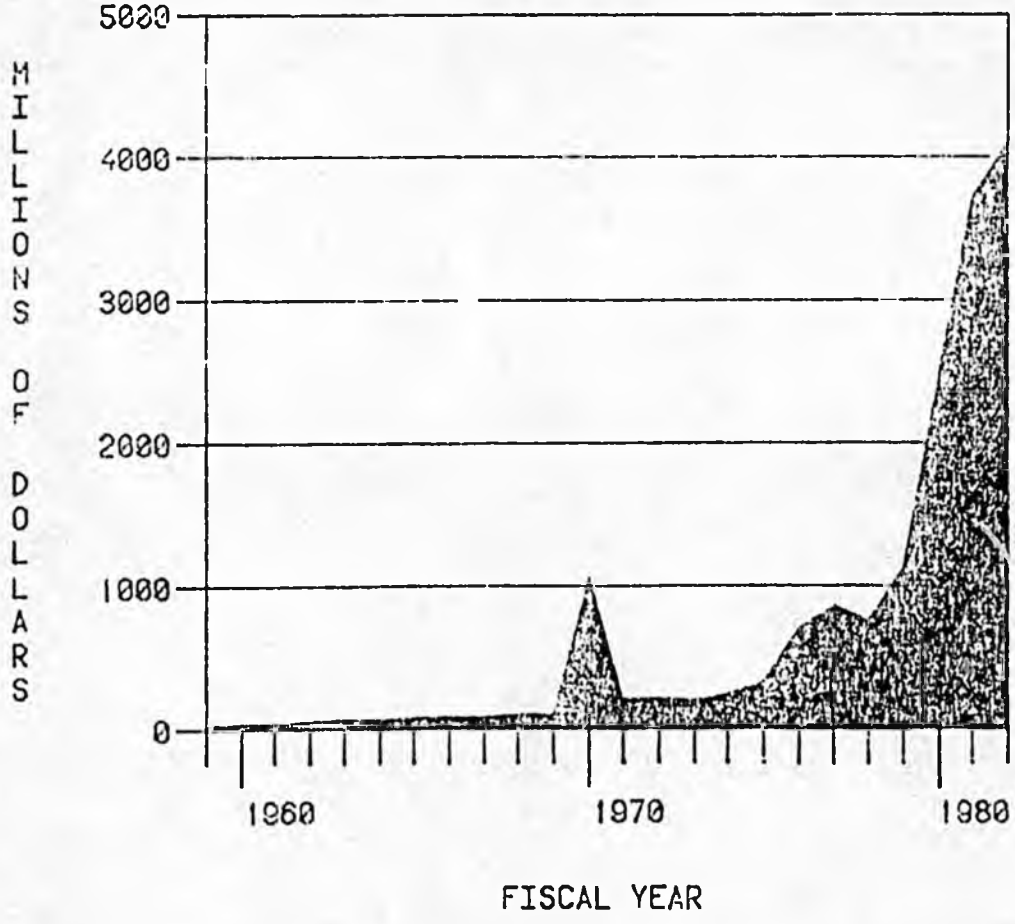


Figure 1 indicates the state has undergone two distinct periods of revenue growth since statehood, with the 1970 North Slope lease sale sharply separating the two periods. Beginning with statehood, the first period (1959-1969) appears to be one of virtually unchanged revenue sources and composition, as well as, one of relatively constant growth with an increase from $25.4 million in FY 1959 to $112.4 million in FY 1969, a 442 percent increase. Although the peak in FY 1970 marked the abrupt end to this first period, it is interesting to note that state revenues in FY 1970 amounted to over one billion dollars, which was one-third again as much as had been collected during the previous eleven years of the first period.

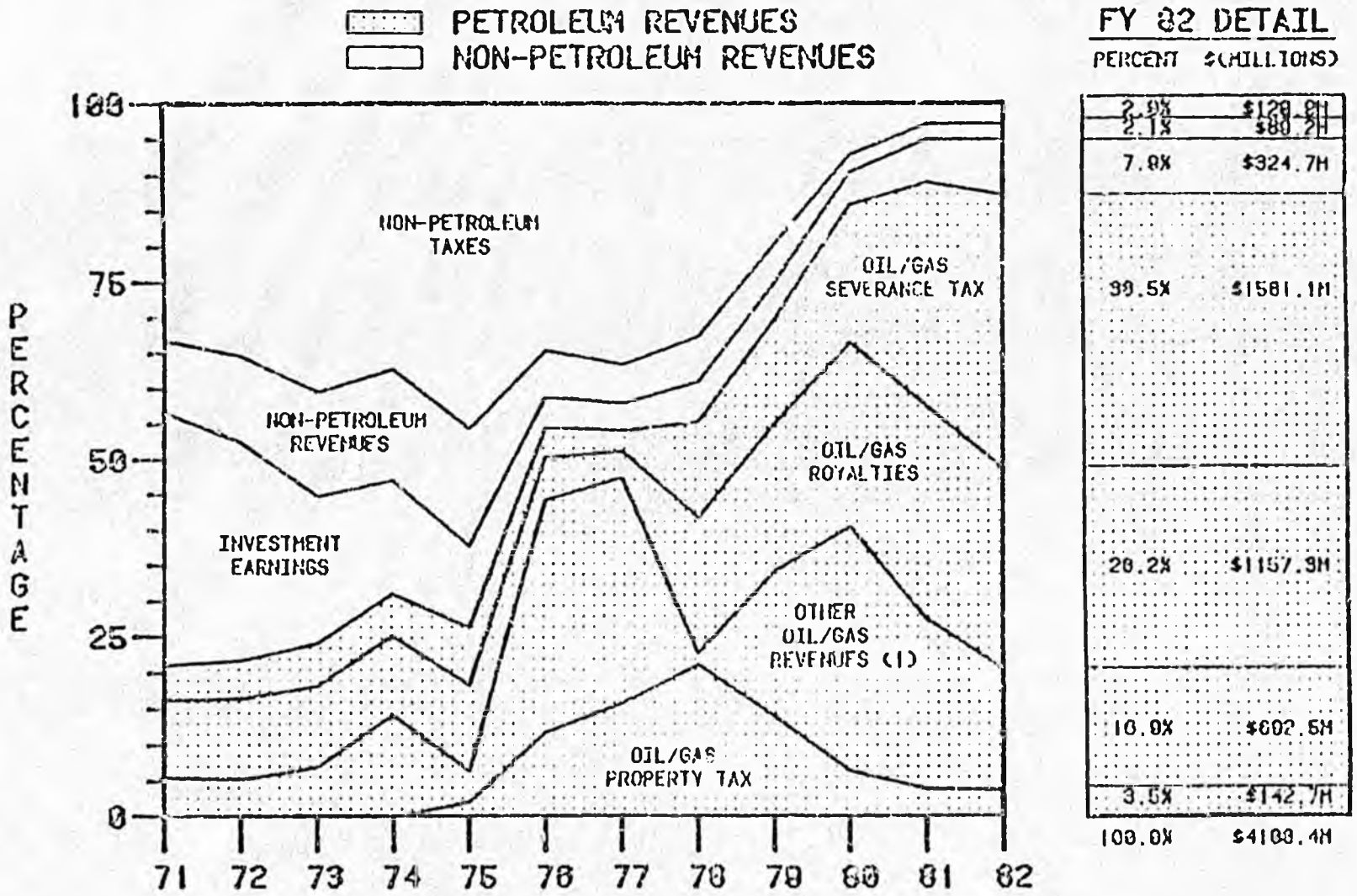
The second period (1971-1982) differs considerably from the first period highlighted by a dramatic increase in revenues from $220.4 million in FY 1971 to $4,108.4 million in FY 1982, a 1864.1 percent increase. The meteoric rise in revenue growth during this second period can be wholly attributed to petroleum development. Figure 1 illustrates this growth from the introduction of the lease sale in 1970 to the buildup of revenues during the pipeline construction in the mid-1970's to the upturn of revenues during the pipeline operation in the early 1980's.

State revenues are now largely dependent upon the development and production of petroleum resources. Of the $16.9 billion collected in revenues since statehood, over 80 percent has been comprised of petroleum revenues. This shift to dependency upon petroleum revenues occurred quite rapidly during the second period of revenue growth. Figure 2 illustrates how, over this period, different sources of revenue have changed their percentage composition of total General Fund unrestricted revenues for each year and how specific petroleum revenues have achieved such a dominant position over the past twelve years. It should be noted that although investment earnings are not defined as petroleum based, they are related indirectly since some earnings are based on Permanent Fund transfers during the past five years. Also, the bulge in investment earnings from FY 1971-74 is mostly due to investment activity of the North Slope lease sale investment account.

In examining Figure 2, it is clear that petroluem revenues have rapidly overtaken non-petroleum revenues as the primary revenue source. In a span of only twelve years, petroleum revenues have gone from 21 percent in FY 1971 to 87 percent in FY 1982 with the greatest percentage increase occurring with the introduction of the oil and gas reserves tax in FY 1976 (later repealed in FY 1978) and the introduction of the Corporation Petroleum Income Tax in FY 1979. Currently both the oil and gas production tax and royalties represent the two most dominant revenue sources, accounting for over $2.7 billion, or almost two-thirds of all unrestricted revenues in FY 1982. A more detailed breakdown of individual unrestricted revenues over the past twelve years (1971-1982) is provided in Table 2 at the end of this report.

FIGURE 2

HISTORICAL COMPARISON OF REVENUE SOURCES AS A PERCENTAGE OF GENERAL FUND UNRESTRICTED REVENUES



FY 82 DETAIL

PERCENT	$(MILLIONS)
2.9%	$120.8M
2.1%	$80.2M
7.8%	$324.7M
38.5%	$1581.1M
28.2%	$1157.9M
16.0%	$602.5M
3.5%	$142.7M
100.0%	$4108.4M

(1) INCLUDES FEDERAL MINERAL REVENUES, MINERAL RENTS, RESERVES TAX, BONUS SALES, AND CORPORATE-PETROLEUM INCOME TAX.

Coupled with this dependency on petroleum based revenues, there has been a further shift to reliance upon fewer major sources of revenue. Table 1 examines the ranking of the top five revenue sources for FY 1960, FY 1971, and FY 1982. Shown below each revenue source is the amount collected by that source (in millions of dollars), as well as the revenue source's percentage of total unrestricted revenues for that year.

Table 1

Rank	1960	1971	1982
1	Ind. Income Tax $8.9m/22.0%	Invest. Earnings $78.4m/35.8%	Oil/Gas Prod. Tax $1570.9m/38.2%
2	Fed. Oil/Gas Leases $5.6m/13.8%	Ind. Income Tax $35.5m/16.1%	Royalties $1157.3m/28.2%
3	Min. Lease Bonuses $4.0m/9.9%	Royalties $23.9m/10.8%	Oil/Gas Corp. Income $668.9m/16.5%
4	Hwy. Fuel Tax $2.5m/6.2%	Oil/Gas Prod. Tax $11.4m/5.2%	Invest. Earnings $324.7m/7.9%
5	Alcoholic Bev. Tax $2.2m/5.4%	Oil/Gas Prop. Tax $10.5m/4.8%	Oil/Gas Prop. Tax $142.7m/3.5%
Total	$23.2m/57.3%	$159.7m/72.7%	$3864.5m/94.1%

Table 1 indicates the composition of revenue sources changed significantly over the course of the three years shown; note that no single revenue source appears in the top five for all three examples. Furthermore, petroleum revenues have become more prevalent in later years, with FY 1982 having four out of the top five revenue sources directly based on petroleum revenues and the fifth (investment earnings) being indirectly based. Finally, and most importantly, there is a greater reliance upon fewer sources with the top five sources comprising 57.3% in FY 1960, 72.7% in FY 1971, and 94.1% in FY 1982.

Consequently, the present day revenue picture has developed into one which is pervasively dictated and primarily dependent upon petroleum development and production. Although this situation was not present during the first-half of Alaska's state history, it has rapidly expanded during the second-half and is expected to continue into the future with petroleum revenue projections being influenced by production, world market prices, and transportation costs. However, the state must eventually face the prospect of the subsequent future decline in petroleum production. It is at this time the state will have to face the dilemma of decreasing petroleum revenues, which may have just as significant an impact upon the state as did the present-day uptrend in petroleum revenues.

TABLE 2

STATE OF ALASKA - UNRESTRICTED REVENUES
TAX PORTION

($ millions)	FY 71	FY 72	FY 73	FY 74	FY 75	FY 76	FY 77	FY 78	FY 79	FY 80	FY 81	FY 82
Corporate General	6.1	6.5	6.8	8.2	17.3	31.1	35.8	33.5	24.8	17.9	34.8	34.8
Corporate - Petroleum	--	--	--	--	--	--	--	--	232.6	547.5	860.1	668.9
Fiduciary	--	--	--	--	.1	.1	.1	.1	.1	.1	--	--
Individual	35.5	39.1	43.4	49.2	86.9	146.2	210.4	145.7	117.2	100.5	--	--
TOTAL INCOME	41.6	45.6	50.2	57.4	104.3	177.4	246.3	179.3	374.7	666.0	894.9	703.7
Alaska Business License	5.6	6.1	6.7	7.5	11.2	19.1	23.2	21.7	28.2	4.2	5.4	5.5
Fish - Canned Salmon	3.5	2.7	1.7	1.4	1.6	1.8	3.8	5.5	6.7	4.3	5.9	8.6
Fish - Shore Based	.3	.3	.5	.9	.8	.8	1.9	2.3	3.3	7.6	11.0	8.7
Fish - Floating	.2	.2	.3	.5	.3	.5	.5	.5	1.9	2.7	3.8	5.5
Salmon Enhancement	--	--	--	--	--	--	--	--	--	--	--	2.4
Insurance Companies	3.0	3.5	3.7	3.8	4.4	6.1	8.1	10.0	10.8	10.4	10.6	12.5
Other	.4	.5	.6	.6	.7	1.0	1.3	1.6	1.9	2.1	1.2	1.4
TOTAL GROSS RECEIPTS	13.0	13.3	13.5	14.7	19.0	29.3	38.8	41.6	52.8	31.3	37.9	44.6
Gravel, Timber, Etc.	--	--	--	.3	.8	1.8	1.0	.8	1.7	1.6	2.7	--
Oil & Gas Production	10.5	11.4	12.0	14.8	26.6	27.9	23.7	107.6	173.6	506.2	1,169.9	1,581.1
Oil & Gas Conservation	--	--	--	--	--	.1	.1	.1	.2	.3	.3	.6
TOTAL SEVERANCE	10.5	11.4	12.0	15.1	27.4	29.8	24.8	108.5	175.5	508.1	1,172.9	1,581.7
Oil & Gas	--	--	--	--	6.6	83.4	139.1	173.0	163.4	168.9	143.0	142.7
Oil & Gas Reserves	--	--	--	--	--	223.1	270.6	--	--	--	--	--
Vehicle Registration	--	--	--	--	--	--	--	.2	.2	.1	.2	--
TOTAL PROPERTY	--	--	--	--	6.6	306.5	409.7	173.2	163.6	169.0	143.2	142.7
Alcoholic Beverages	4.9	4.8	5.2	5.7	6.6	7.3	8.0	7.6	7.4	7.4	8.3	9.0
Fuel Taxes - Aviation	1.6	1.5	1.3	1.6	2.8	3.0	2.5	3.3	3.4	4.0	4.1	6.3
Fuel Taxes - Highway	8.6	8.9	10.1	11.0	14.0	20.2	16.7	17.9	16.3	18.9	15.6	20.3
Fuel Taxes - Marine	.8	1.0	1.1	1.2	1.1	1.2	1.3	2.1	2.6	3.2	3.5	3.7
Tobacco Products	1.1	1.2	1.2	1.3	1.5	1.7	1.8	1.7	1.7	1.6	1.7	1.9
TOTAL SALE/USE	17.0	17.4	18.9	20.8	26.0	33.9	30.3	32.6	31.4	35.1	33.2	41.2
Estate	--	--	--	.1	.1	.2	.2	.2	.1	.2	.5	.3
School	1.4	1.5	1.6	1.6	2.2	2.6	2.6	2.4	2.5	2.6	--	--
TOTAL OTHER	1.5*	1.6*	1.6	1.7	2.3	2.8	2.8	2.6	2.6	2.8	.5	.3
TOTAL TAXES	83.6	89.3	96.2	109.7	185.6	579.7	752.7	537.8	800.6	1,412.3	2,282.6	2,514.2

*Includes disaster relief

Source: Department of Revenue, Revenue Sources FY 1971 - FY 1982. Revised November 1982.

STATE OF ALASKA - UNRESTRICTED REVENUES
NON-TAX PORTION

($ millions)	FY 71	FY 72	FY 73	FY 74	FY 75	FY 76	FY 77	FY 78	FY 79	FY 80	FY 81	FY 82
LICENSES & PERMITS												
Business	2.7	2.8	3.2	4.1	4.2	5.1	5.5	6.8	7.5	8.1	9.1	10.8
Non-Business	6.0	6.3	6.6	6.8	9.4	11.3	10.6	12.3	12.3	10.7	12.2	13.0
TOTAL	8.7	9.1	9.8	10.9	13.6	16.4	16.1	19.1	19.8	18.8	21.3	23.8
INTERGOVERNMENTAL RECEIPTS												
Federal Shared Revenues	9.7	9.0	7.7	8.0	10.6	6.4	2.5	3.6	4.1	4.8	8.5	21.7
STATE RESOURCE REVENUE												
SALE/USE												
Bonus Sales	.2	.3	3.8	24.8	1.0	--	--	--	--	342.4	7.6	5.0
Investment Earnings	78.4	67.3	43.2	41.1	38.5	31.7	34.8	44.2	59.2	119.9	227.8	324.7
Rents	3.2	3.3	3.7	4.0	4.3	4.1	3.4	2.3	2.1	3.0	5.4	3.5
Royalties	23.9	24.6	23.5	28.7	40.0	43.3	34.3	149.6	249.2	688.2	1,118.5	1,157.3
Sale of State Property	1.0	1.4	1.7	1.4	12.2	1.9	1.8	1.9	8.4	5.7	4.8	5.2
Gravel, Timber, etc.	--	--	--	--	--	--	--	--	--	--	--	1.2
TOTAL	106.7	96.9	75.9	100.0	96.0	81.0	74.3	198.0	318.9	1,159.2	1,364.1	1,496.9
FACILITIES RELATED CHARGES												
Airports	.6	.5	.7	.6	.5	.6	.7	.8	.9	.8	1.1	1.6
Ferry System--SE	6.5	8.1	10.1	9.6	12.0	13.9	15.4	14.0	17.1	18.7	21.0	25.2
Ferry System--SW	.6	.9	.9	1.0	1.2	1.3	1.5	1.6	1.8	2.4	3.4	4.0
Other	1.9	2.2	3.8	4	2.1	2.2	2.7	4.0	3.1	4.1	3.7	3.6
TOTAL	9.6	11.7	15.5	15.5	15.8	18.0	20.3	20.4	22.9	26.0	29.2	34.4
SERVICES RELATED CHARGES												
Court System	1.2	1.7	1.6	1.9	3.0	3.7	3.6	2.8	2.8	2.8	2.9	3.5
Other	.2	.3	.3	.4	1.4	.7	.9	1.7	2.3	2.0	4.1	6.1
TOTAL	1.4	2.0	1.9	2.3	4.4	4.4	4.5	4.5	5.1	4.8	7.0	9.6
TOTAL RESOURCE	117.7	110.6	93.3	117.8	116.2	103.4	99.1	222.9	346.9	1,190.0	1,400.3	1,540.9
Miscellaneous Revenue	.7	1.2	1.2	8.5	7.4	3.9	3.9	3.9	7.2	6.7	5.5	7.8
Total Unrestricted Non-Tax Revenue	136.8	129.9	112.0	145.2	147.8	130.1	121.6	249.5	378.0	1,220.3	1,435.6	1,594.2
Less: Native Claims Payments	--	--	--	--	--	--	--	22.4	45.6	131.4	--	--
TOTAL NET UNRESTRICTED NON-TAX REVENUE	136.8	129.9	112.0	145.2	147.8	130.1	121.6	227.1	332.4	1,088.9	1,435.6	1,594.2
Total Unrestricted Tax Revenue	83.6	89.3	96.2	109.7	185.6	579.7	752.7	537.8	800.6	1,412.3	2,282.6	2,514.2
TOTAL UNRESTRICTED REVENUE	220.4	219.2	208.2	254.9	333.4	709.8	874.3	764.9	1,133.0	2,501.2	3,718.2	4,108.4

EXECUTIVE SUMMARY

By
Carl Portman, Public Relations Coordinator
Resource Development Council, Inc.

As the world population doubles about every 35 years, it is mperative that production of fossil fuels and minerals be ncreased. With this population growth will surely come social, conomic and military chaos as food, fuels and mined products ecome scarce. America and others must prevent such scarcities rom occurring. New knowledge and technology must be found to ecover ores, minerals and petroleum more efficiently and to timulate discovery of new materials.

The more each nation can do to develop resources from its wn lands and assist with developing them in other countries, the ooner world shortages will disappear and the growing threat of esource wars reduced. The descendants of our world's nhabitants will rely on what we do today for their quality of ife.

In the past thirty years, U.S. policies and public opinion ave led to less production of domestic resources, creating a osition of huge trade deficits and reliance on sometimes nstable foreign supplies. In this light, the International onference on Coal, Minerals and Petroleum addressed world energy eeds, U.S. policies and the future of extractive industries. peakers and conference delegates debated issues dealing with evelopment on public and private lands and made ecommendations.

An optimistic pro-development attitude prevailed among the 25 persons in attendance at the conference, although there was bvious concern with the near-term outlook for sizeable exports f Alaska coal due to the world recession and falling oil rices. The two-day conference concluded with attendees offering our major consensus statements to policymakers nationwide:

LINKING NATIONAL DEFENSE, DOMESTIC AND FOREIGN POLICIES

1. There is a need at the federal level to link the nation's domestic, foreign and defense policies in a better way; so as (1) to strengthen Alaska's vital geopolitical role in the international development of Arctic and sub-Arctic natural resources now underway, and (2) to promote private ownership and initiative as the most efficient and responsible means of achieving that resource development which best serves the national interests and all of the citizens of Alaska, including owners of the native lands.

2. As a necessary step in developing a U.S. economic and political global strategy for the 1980s and beyond, there is a need for a minimum assesment of the minerals on all Alaskan lands, with provisions for special development of minerals on withdrawn lands; so as to contribute both to the national interest and to the national security.

EXPORTING ALASKA OIL

3. The export of Alaskan oil to Pacific Rim countries would generate many sound economic and geopolitical benefits to the nation as well as to the citizens of Alaska, and thus, merits the most serious and favorable consideration by the state and national policymakers; however, recognizing that a number of conditions would first have to be addressed.

CREATING AN ENTITY FOR ARCTIC RESEARCH AND POLICY

4. Senator Frank Murkowski's bill to create the Arctic Research and Policy Act deserves full support; provided that the resulting institutional framework is designed to serve broad, nationwide interests in Arctic development, including such activities as natural resource exploration and development technology.

MINERALS

Mining activity in Alaska is at an all-time high, including placer gold mining and exploration by major hard rock mining companies. Mineral exploration activities by major companies during the 1970s produced some exciting discoveries of large base and precious metal deposits. Three discoveries: U.S. Borax's Quartz Hill molybdenum deposit, Noranda's Greens Creek silver-gold deposit and NANA/Cominco's Red Dog lead/zinc deposit are scheduled to be into production before 1990.

The major obstacle to development of mineral deposits is the lack of transportation infrastructure. Another concern is taxation: although state taxes on the mining industry now are reasonable, the industry is wary because of the punitive taxes levied on petroleum production. Land allocations by the federal government have not only withdrawn much of the state's high potential mineral land, but have severely restricted access to many areas of the state.

Several positive factors including near-surface, high-grade deposits, strategic mineral deposits, proximity to the Orient and a development-oriented state administration will help promote mining in Alaska. However, the timing of major mineral

development will depend upon world metal prices, infrastructure development and less restrictive land management policies by both the state and federal governments.

If the economy of Alaska is to diversify and broaden beyond its present dependence upon the oil industry, the state must recognize its pivotal role and adopt an aggressive policy supporting the development of infrastructure that will serve the range of other resource industries.

The U.S. industrial infrastructure, defense capabilities and economic viability rest on adequate supplies of some two dozen or so non-fuel minerals. Of these, the U.S. currently is more than 90 percent import dependent on 13 and more than 50 percent dependent on an additional 13. Combine these elements of foreign supply with those concerning our energy needs, and the cumulative effect of all our mineral import dependencies constitutes possibly the greatest direct threat to our national security since the end of World War II.

This form of dependency makes the nation highly vulnerable to foreign powers. This vulnerability centers around one thing: cutoffs. Whether sudden or gradual, any significant interruptions of vitally needed minerals from foreign sources would lead to equally significant disruptions across the spectrum of American life.

One way of lessening vulnerability is to cut dependence on imports. In the case of oil, conservation and the development of various alternative sources of energy would diminish dependence on the Middle East. As for strategic non-fuel minerals, Congress and the Executive Branch are hammering out a set of strategic non-fuel minerals policies designed to alleviate high dependency on foreign supplies. Other means of protection against foreign supply cutoffs include stockpiling, substitution, conservation and recycling.

There is considerable debate as to whether or not and to what extent our public lands can and should be made available to minerals exploration and development. It is estimated that over 70 percent of federal land is closed or restricted to entry and mineral development under the mining/mineral leasing laws. It is believed that these lands contain significant deposits of a number of critical minerals on which we are now heavily dependent, for example: cobalt, platinum-group metals and chromium.

Considerable discussion took place regarding Soviet exploration and development activities in the Arctic. Last fall the Soviets embarked on an ambitious 15-year "Conquer the Arctic" plan aimed at recovering vast quantities of oil, gas, coal and minerals from the Bering Sea, Eastern Siberia and other Arctic areas. This new "master plan" has been viewed as a major historic policy shift.

The Soviets are now operating an Arctic technology center and are conducting advanced ice studies. They have recently ordered four drilling ships with ice-breaking capabilities from the West and plan to import resource development technology from the West. Their strategy is to put mineral, oil and gas development next to defense in terms of allocating the nation's rate of investment and investment outlays. The Soviet Arctic plan is based on global power projections, with Siberian and Arctic natural resources flowing to world markets as a surplus through an aggressive marketing strategy.

By contrast, the United States has no significant Arctic policy, which is scientific, technical, resource, military and defense oriented. Unless the Americans respond with a strategic Arctic policy, the U.S. will fall far behind in the Arctic.

PETROLEUM

Petroleum specialists focused on the problems and opportunities the industry faces in the Arctic at a time when the world oil market is growing at a slower rate than the world's economy.

Although Alaska may hold over half of all oil and gas reserves to be discovered in America, activities within the state could be severely curtailed by increased regulations and cumbersome government policies regulating development. Government permitting procedures are now delaying development of reserves. When these regulations and procedures are combined with the high costs of development in the Arctic and lower worldwide oil prices, there is little incentive on behalf of the industry to launch new exploration and development activities. Alaska's only trump card is that it has major deposits.

Experts also warned that the large capital expenditures of successful bidders on the Diapir Field sale should not be taken as an indication of the levels to be seen in areas such as the Bering Sea. High development costs, lack of transportation systems and potential operating restrictions are factors which could lead to the abandonment of Alaska exploration efforts in favor of areas that would lead to higher economic returns.

Turning to petroleum's share of future world energy requirements, the market is bound to continue growing but at a slower rate than the world economy partly because of the increasing efficiency with which energy is being used. Supply factors will prevent oil's share of energy consumption rising or stabilizing. On the contrary, oil's share is likely to fall, but with no clear trend in the level of oil demand over a 20-year period.

Excluded for practical purposes is the possibility that rapid worldwide economic growth throughout the rest of the century would expand the premium transportation markets for oil

so fast as to absorb all the oil that can be produced. So long as this does not happen, oil will continue to compete with gas, and both oil and gas will compete with other fuels in industrial, utility and household markets in most major countries. Oil's share in these markets will fluctuate with relative prices reflecting the supply factors in competing fuels.

The world incremental long-term demand as a whole will tend to be met by increases in the use of other fuels, particularly coal and nuclear, but including gas in some places. The share of gas may remain more or less constant for the world as a whole but will vary locally according to the cost of incremental supply.

In the near term, however, worldwide spare capacity in the oil industry will mean that its share will fluctuate with oil prices. Demand will recover somewhat. We are already in a fluctuating situation on both price and market share.

In projecting the price of petroleum in the future, various factors must be considered. Oil prices increase when the world cushion (excess of capacity over demand) is less than about five million barrels per day. This cushion will likely exist entirely within OPEC, with Saudi Arabia being the main swing supplier. Oil prices will decrease when demand on OPEC drops below about 20 million barrels per day.

Consequently, OPEC's "comfort range," within which prices should remain reasonably stable, is 20 to 25 million barrels per day. This translates to a "comfort range" of about 5 to 10 million barrels per day in Saudi Arabia if it is assumed to absorb the entire swing.

Above the "comfort range" OPEC helps prices increase sooner, faster and further than they would in a totally free market. Below the "comfort range" OPEC inhibits price declines that would be expected in a totally free market. It is in this area that OPEC has to date shown its greatest strength as a cartel.

Long-term price forecasts (in the year 2000) range from $30 to $55 per barrel (in 1982 $). By that time, the OPEC cushion will have decreased to such an extent that "real" annual price increases can be expected on the order of $1 per year. Because of the many uncertainties involved, a "best guess" case is not very meaningful. Perhaps most pertinent is the conclusion that there is likely to be no "real" price increase before the early 1990s.

Petroleum must be looked upon as a depleting resource. As it becomes scarcer in the world and production declines, its price must increase to encourage conservation and switching to other energy sources. Consequently, oil will increasingly be diverted to higher-valued end uses. And no amount of cartel activities or government price or allocation controls can prevent this result.

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Export of Alaska Oil

If oil exports to Japan and other Pacific Rim countries become reality, Alaska should consider imposing a three percent economic security and development tax on the oil sale price and dedicate the tax revenues to construction of railroads, ports and other facilities to encourage more development of Alaska coal, hard-rock minerals, oil, gas and other resources. This proposal met with general support among those in attendance.

A three percent tax on a barrel of oil selling for $30 would come to 90 cents, yielding the state $100 million annually if exports were at a level of 300,000 barrels a day.

An announcement was made regarding the extension of United States sovereignty to 200 miles off the nation's shores by forming an "exclusive economic zone" within the next several weeks. The announcement follows President Reagan's rejection of the International Law of the Sea Treaty.

The "exclusive economic zone" proclamation would give the U.S. exclusive jurisdiction for mining and would establish sovereignty, not merely management authority, over fishing within the 200-mile limit. Passage over those waters would not be affected as international law applies.

The U.S. has been exercising its sovereignty only over those waters above the outer continental shelf and in many areas the shelf stops well short of the 200-mile limit. However, the extent of that shelf has never been established and the proclamation would have the effect of establishing definite limits.

COAL

Because of huge supply and worldwide distribution, coal should provide a secure backstop for the utilization of oil and gas. Buyers of this fuel, especially in the short term, will have numerous sources from which to draw. By utilizing buying practices pioneered by Japanese trading companies, the price of this commodity should remain exceedingly competitive, with the exception of "windows" of panic buying as in 1974 and 1980/81.

The future of United States steam coal in the world market depends upon a number of interrelated factors:

* The long-term role of world economic growth
* Effects of structural changes altering the rate of growth in energy consumption as economies expand
* the share of energy requirements met by coal
* the availability and price of coals from competing sources

Forecasts show that lower growth rates in energy consumption are likely as the amount of energy required per dollar of GNP is

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expected to be only 75 percent of that required in 1973. This means that total energy requirements in 1990 and 2000 will be approximately one third less than previous forecasts indicated. By 1990 coal should provide almost 25 percent of total energy reqirements and by 2000, coal's market share will be almost 30 percent.

The United States became a factor in the steam coal market in late 1979. The U.S. is now exporting steam coal at an annual rate of about 27 million tons and should maintain this level through the mid-1980s. But, because coal supply capability far exceeds coal demand, America is faced with stiff competition - from Australia, Poland, Canada, China and South Africa. The U.S. is the high-cost coal supplier for many reasons; costs of inland transportation are very high and are not under the control of the coal supplier. Ports have not yet been dredged to take advantage of the economies of scale available to larger vessels. The distance from America to foreign customers is greater. But, the U.S. also has advantages that can outweigh the extra cost, provided that the differentials with other countries are not too great. These advantages include:

- a diversified reserve base sufficient to meet exports as well as domestic coal requirements without materially increasing mine mouth coal prices.
- a diverse and competitive coal industry
- a stable and skilled labor force
- a reliable, though costly, transportation infrastructure
- a politically stable government which encourages exporting

In the short run, these advantages will not help the U.S. increase steam coal exports. Demand is now stagnant while supply is increasing. America's participation in the steam coal market through the mid-1980s will be primarily on a spot or short-term basis. Foreign long-term agreements will be the exception and not the rule.

Most steam coal exports will be from the East and Gulf coasts. Western exports will not increase from the current two million plus tons annually until after 1985. The reason for this split is simple: there are larger markets for U.S. coal in Europe than in the Pacific Rim.

Over the longer term, the picture is brighter with exports reaching 58 million tons in 1990. Major markets will be in Europe through 1990, but soon after, demand for U.S. steam coal should pick up in Korea, Taiwan and Japan and by 1995, at least 28 million tons will be exported to Pacific Rim nations.

As for Alaska, the state may contain up to half of America's coal reserves. Most of the bituminous coal is in Arctic Alaska. Subbituminous coal is dominent in Southern Alaska, but it is much harder to market, despite its proximity to tidewater. There is a need to prove the stability of subbituminous coal if it is to be marketed seriously. Conference delegates were warned that

the state should conduct more detailed analyses of its coal-export potential and markets before embarking on large investments for new ports, rail and other facilities.

Alaska Governor Bill Sheffield announced that the state has scheduled its first competitive coal lease sale in eleven years for May 17, 1983 and that his administration plans to establish a long-term coal leasing schedule. The May sale will offer 1,677 acres in the Beluga River coal field, representing a scaled-down version of the 25,000-acre sale proposed by the Department of Natural Resources. Depressed market conditions were cited as the main reason for the small sale.

From the Korean perspective, demand for coal is expected to increase to 43 million tons in 1986 from the present level of 29 million tons. According to the chief of a 24-member Korean delegation attending the conference, Korea's energy policy for the next decade and beyond promises to provide an important coal market in the Far East, and the United States with its ample reserves of coal, could play an important role as a stable supply source.

RESOURCE DEVELOPMENT

Alaska land ownership patterns reflect the unusual history of the state. The communities which now own land were settled early and the land settled was acquired pursuant to the early public land laws. Other large transfers of land from the federal government awaited Alaska Statehood and the settlement of the Alaska Native land claims. These were delayed for countless reasons and only when the Alaska National Interest Lands Conservation Act was passed, was it feasible to expect steady conveyance. Congress' enactment of the lands conservation bill has meant that well over 100 million acres of land is now permanently in restrictive classifications which place even more pressure on private lands, including that owned by native corporations.

These conservation areas will directly affect investment in the state's resources. The areas and the resulting restrictions limit access to land that can be developed where one must cross the conservation areas. They also reduce the pool of land left for general entry for mining and leasing as well set tough rules for air quality and water quality compliance for years to come.

Developers of large resource projects in Alaska reaffirmed their commitment to conduct exploration and future mineral development with great care for the environment. U.S. Borax officials stated that their problems in developing the world-class molybdenum deposit at Quartz Hill have not been with the state and federal regulations, but with special-interest environmental groups who used their legislative influence, the regulatory process and frivolous delaying legal maneuvers to attempt to stop the project.

The Interior Department promised conference delegates to facilitate natural resource development within the state. The Interior is terminating all unnecessary federal land withdrawals, soon will publish regulations to facilitate transportation across federal lands and will continue to give high priority to state and native land conveyances.

Governor Sheffield reiterated his administration's commitment to speed up the processing of state permits, provide leadership in the direction of funding for major construction projects and create a capital investment fund to begin developing ports, rail extensions, highways and lower-cost sources of electricity.

The State must commit to resource development; that is, it must become a partner in the effort - a partner whose only commitment is that Alaska's mineral resources are developed and that they are developed in an economically and environmentally responsible manner. This need must be communicated so that the people of Alaska will allow its representatives to do more than police and regulate. They must be allowed and encouraged to work with the private sector to expedite exploration and development in a manner compatible with the resource development and environmental goals and policies of the state.

file HB 258

Senators Paul Fischer and Gilman moved and asked unanimous consent that they be shown as present. Without objection, it was so ordered.

The presence of Senators Ferguson and Vic Fischer was noted.

Senator Ray moved that the journal for the one hundred forty-first legislative day, Senate Supplement No. 92 and House and Senate Joint Supplement No. 25 be approved as certified. Without objection, it was so ordered.

Senator Ray moved that the Senate recess to a call of the Chair for a leadership caucus. Senator Rodey announced a minority caucus. Without objection, the Senate recessed at 10:20 a.m.

AFTER RECESS

The Senate reconvened at 10:41 a.m.

MESSAGES FROM THE GOVERNOR

HB 258

Message was received May 28 and read:

May 28, 1984

Re: CONFERENCE CS FOR HOUSE BILL NO. 258

An Act establishing a special investment tax credit; and providing for an effective date

Chapter 60, SLA 1984

Dear President Kerttula:

Today I signed into law CCSHB 258. This bill creates a special industrial incentive investment tax credit for gas processing projects and for the exploration, development, and production of minerals (other than oil and gas) in Alaska. The credit will encourage investment and development of natural resources in the State.

HB 258 cont'd

The State corporate income tax is a graduated tax with a maximum rate of about 9-1/2 percent of income (AS 43.20.011). The federal corporate income tax rate goes up to 46 percent of income (26 U.S.C. § 11). The allowable federal credit is 10 percent of the investment (26 U.S.C. § 38). CCSHB 258 increases the credit available under state law to the same level as federal law on selected types of investment which need encouragement in Alaska. As the federal government believes the 10 percent rate appropriate to encourage investment to build industry throughout the country, it seems to me that Alaska should have the same rate because our investment situation is so much more challenging than that found in many other states.

To obtain the maximum special industrial incentive tax credit under CCSHB 258, an investment of $250,000,000 in Alaska is required. This is further limited by the requirements that no more than 60% of the tax liability may be offset by this credit, thus assuring a flow of funds to the State to provide essential services. It is important to note this credit is available only to the company making the qualified investment and not to members of an affiliated group of corporations filing a consolidated return.

I believe that the State must make every conceivable effort to promote new resource development. Our efforts may be especially critical now, when the most promising of our mineral development prospects continue to face depressed world markets. With today's lackluster metal prices, and with the exorbitant cost of capital, a marginal improvement in the economic feasibility of a project through the investment tax credit in HB 258 could be decisive. I have in mind the Quartz Hill project near Ketchikan, the Johnson River prospects announced recently by Cook Inlet Region, Inc., and the Red Dog property in Northwest Alaska. Substantial employment and other local benefits will be created by these projects that far exceed in value the tax revenues lost.

The risk of losing the potential major benefits of HB 258 are far more serious to the State than the risk of losing a comparatively small amount of income to the treasury. Therefore, I have signed CCSHB 258.

Sincerely,

/s/ Bill Sheffield

Bill Sheffield
Governor