

3/19/02

HFC

SUBCOM.

REVENUE

OPTIONS

HFIN

FILE

A GENERIC FISCAL PLAN FOR ALASKA

Presented to

HOUSE FINANCE COMMITTEE
ALASKA STATE LEGISLATURE

By

ALASKA FISCAL POLICY COUNCIL

MARCH 19, 2002

GENERIC FISCAL PLAN

CRITERIA

FAIR -- spread the burden fairly and equitably among Alaskans and across industries

SUSTAINABLE -- preserve financial and other assets

REALISTIC -- realistically close the gap using real assumptions

GRADUAL -- phase in measures over several years

COMPLETE -- all the pieces displayed

POSITIVE -- minimize economic impact and disincentives to development

FLEXIBLE -- maximize capability to adjust to changing circumstances

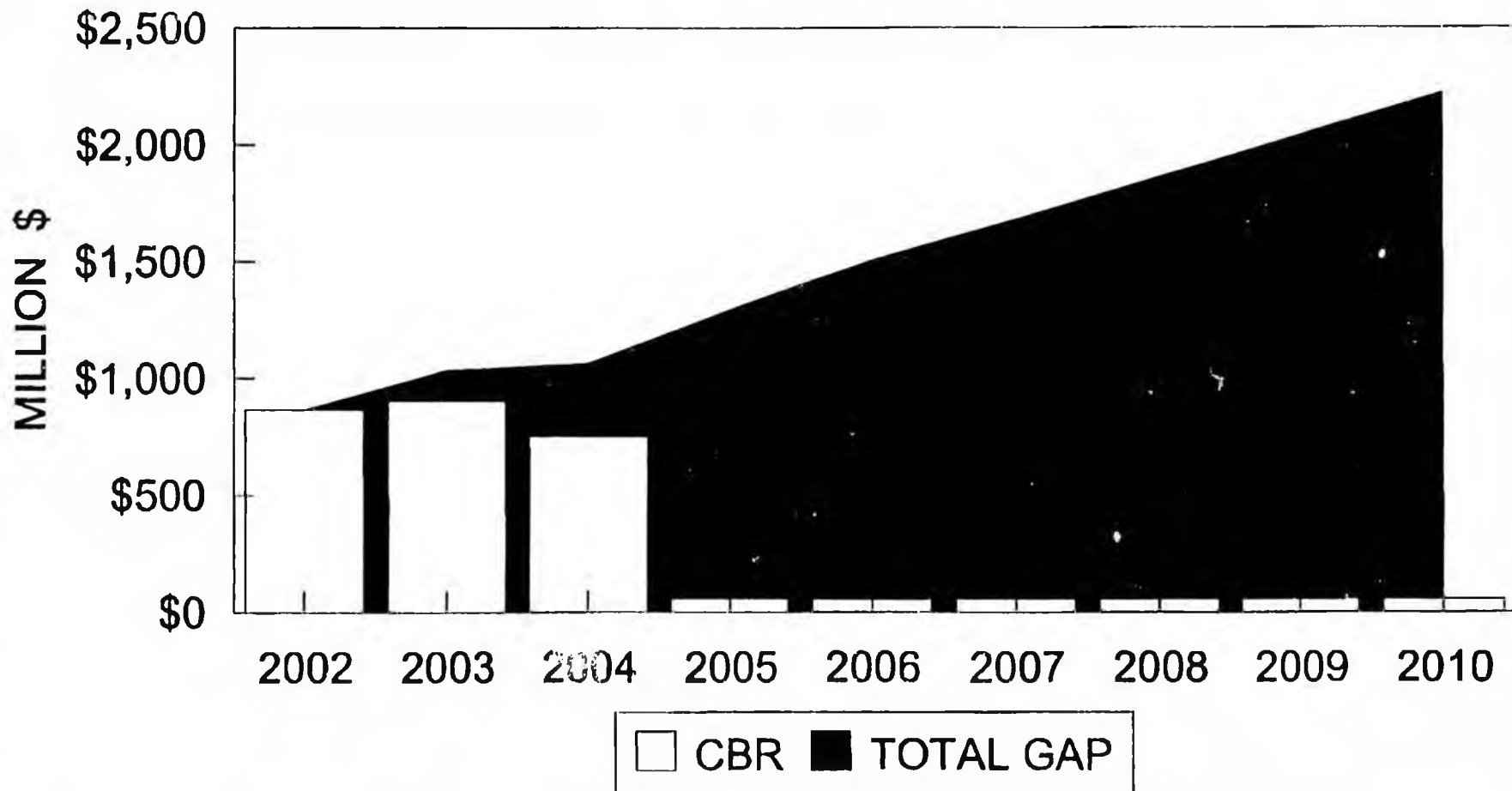
EFFICIENT -- minimize bureaucratic costs

STABLE -- maximize revenue predictability

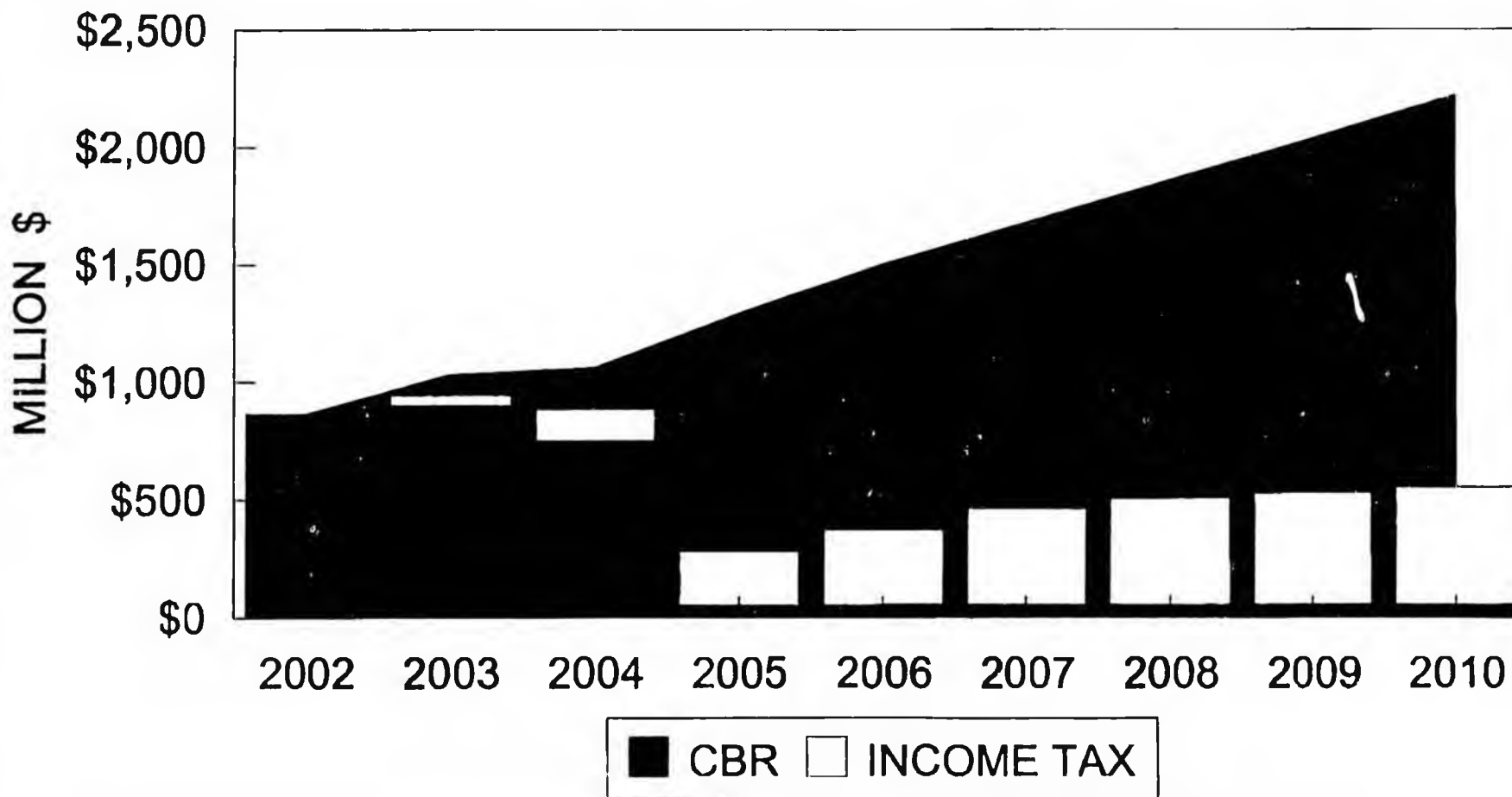
TRANSPARENT -- keep it simple, logical, and politically possible

GENERIC FISCAL PLAN: PART 1

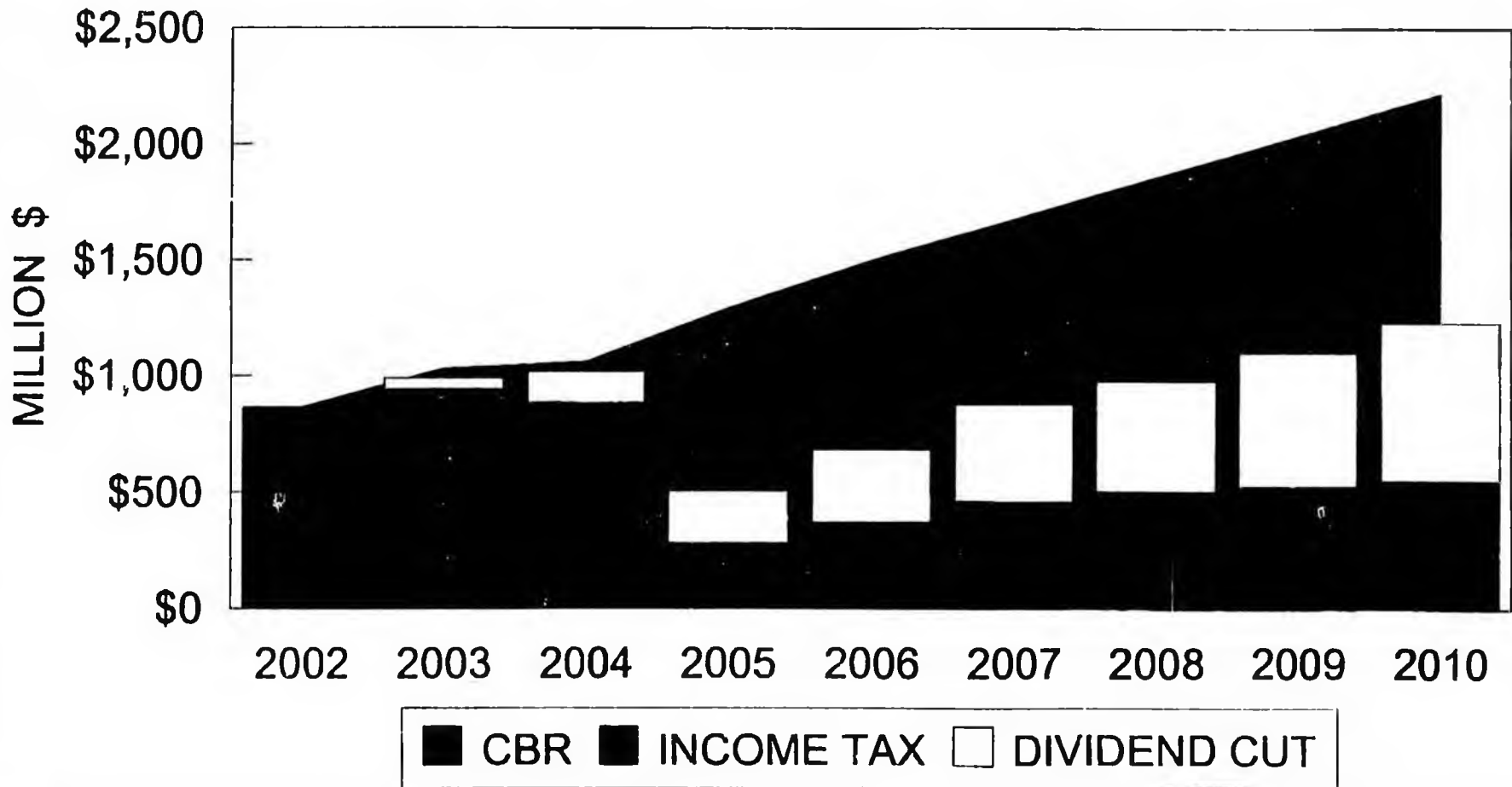
CBR



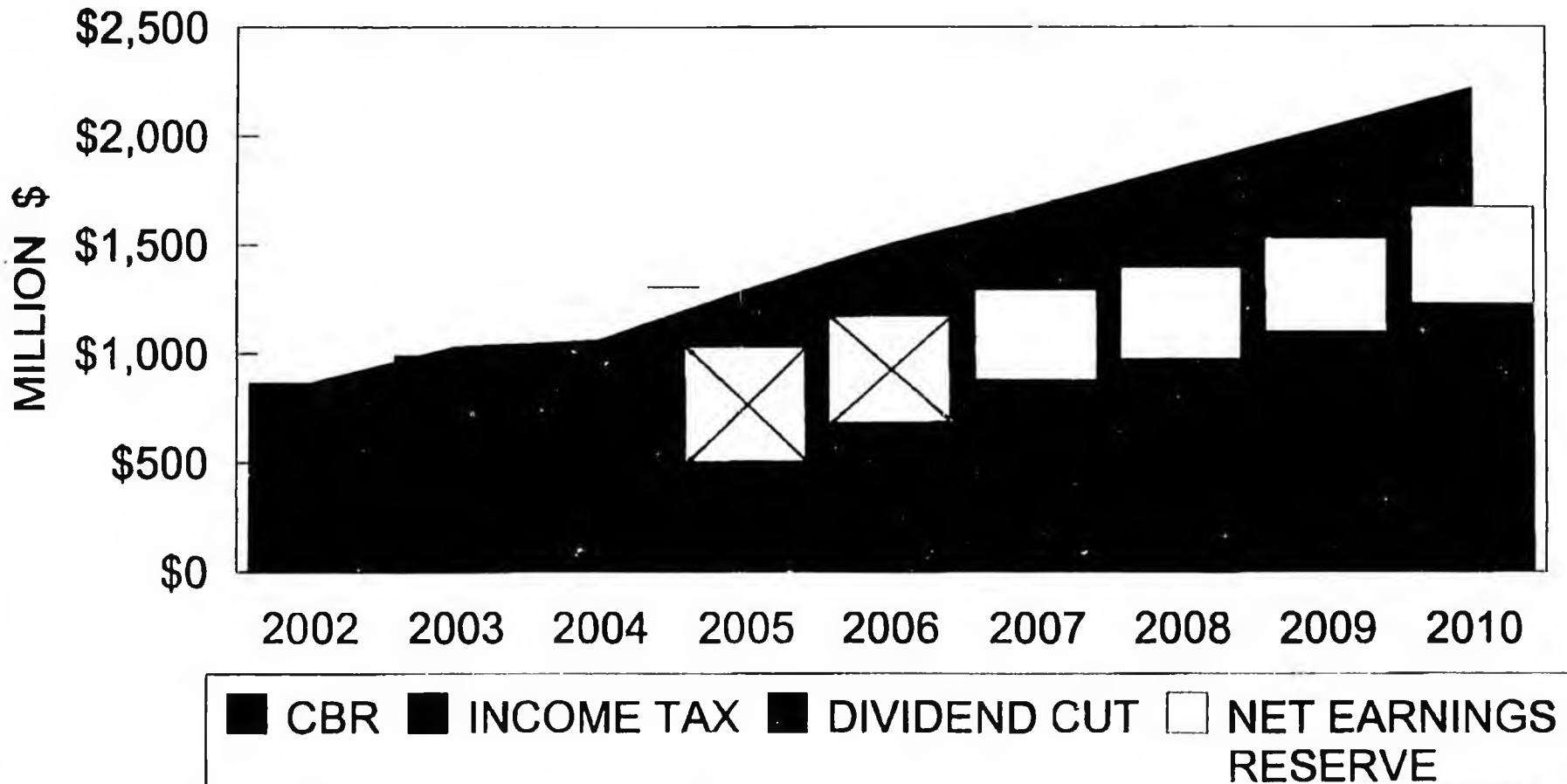
GENERIC FISCAL PLAN: PART 2 BROAD BASED TAX



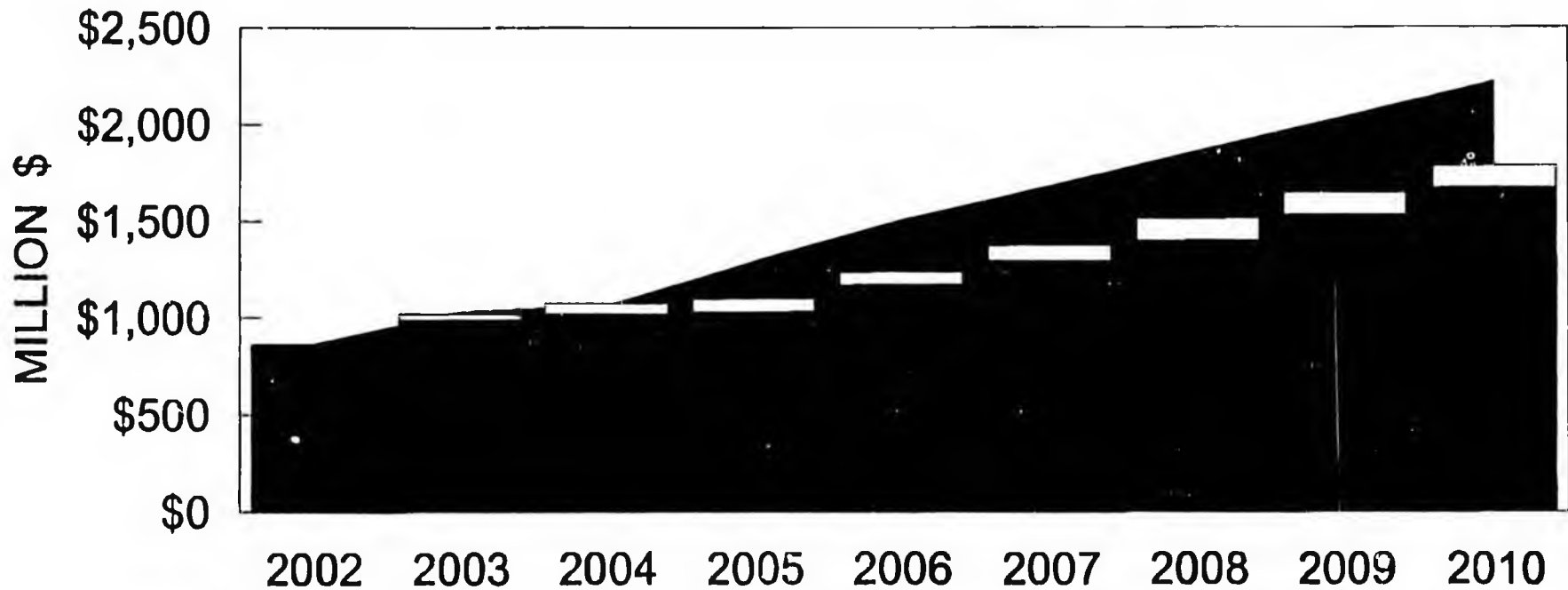
GENERIC FISCAL PLAN: PART 3 DIVIDEND CUT





GENERIC FISCAL PLAN: PART 4 EARNINGS RESERVE / PF EARNINGS

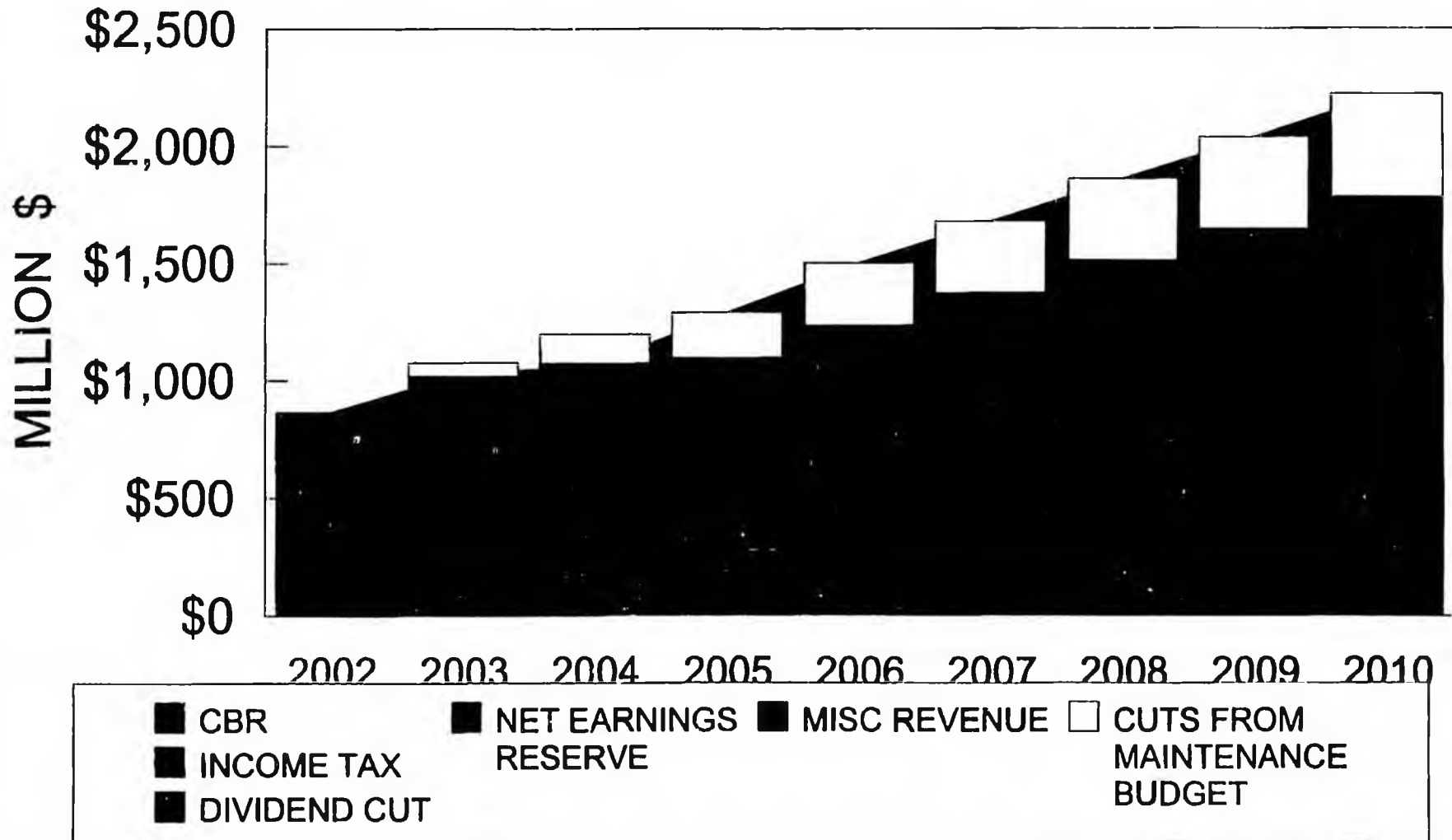


GENERIC FISCAL PLAN: PART 5 MISC REVENUE

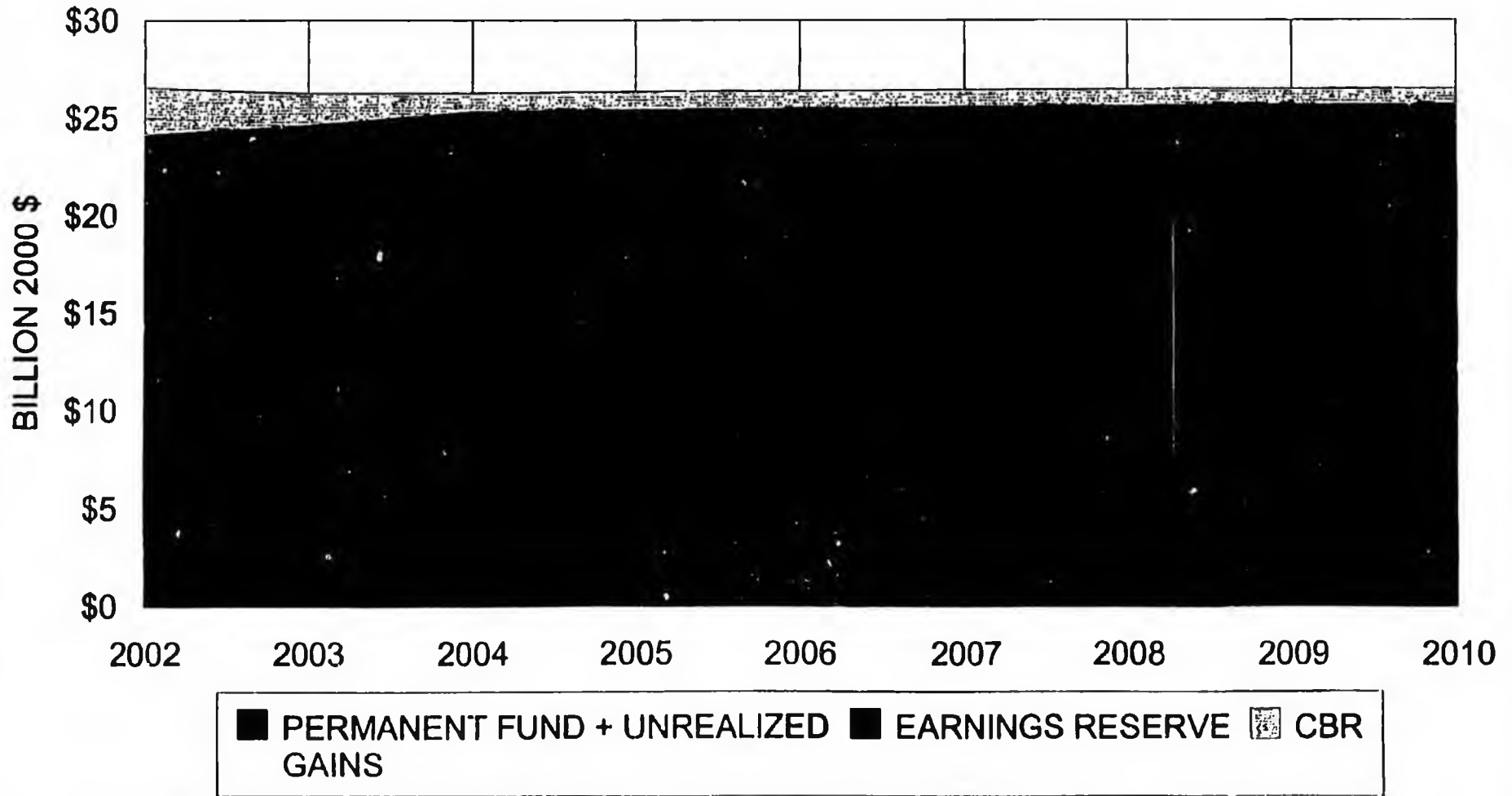


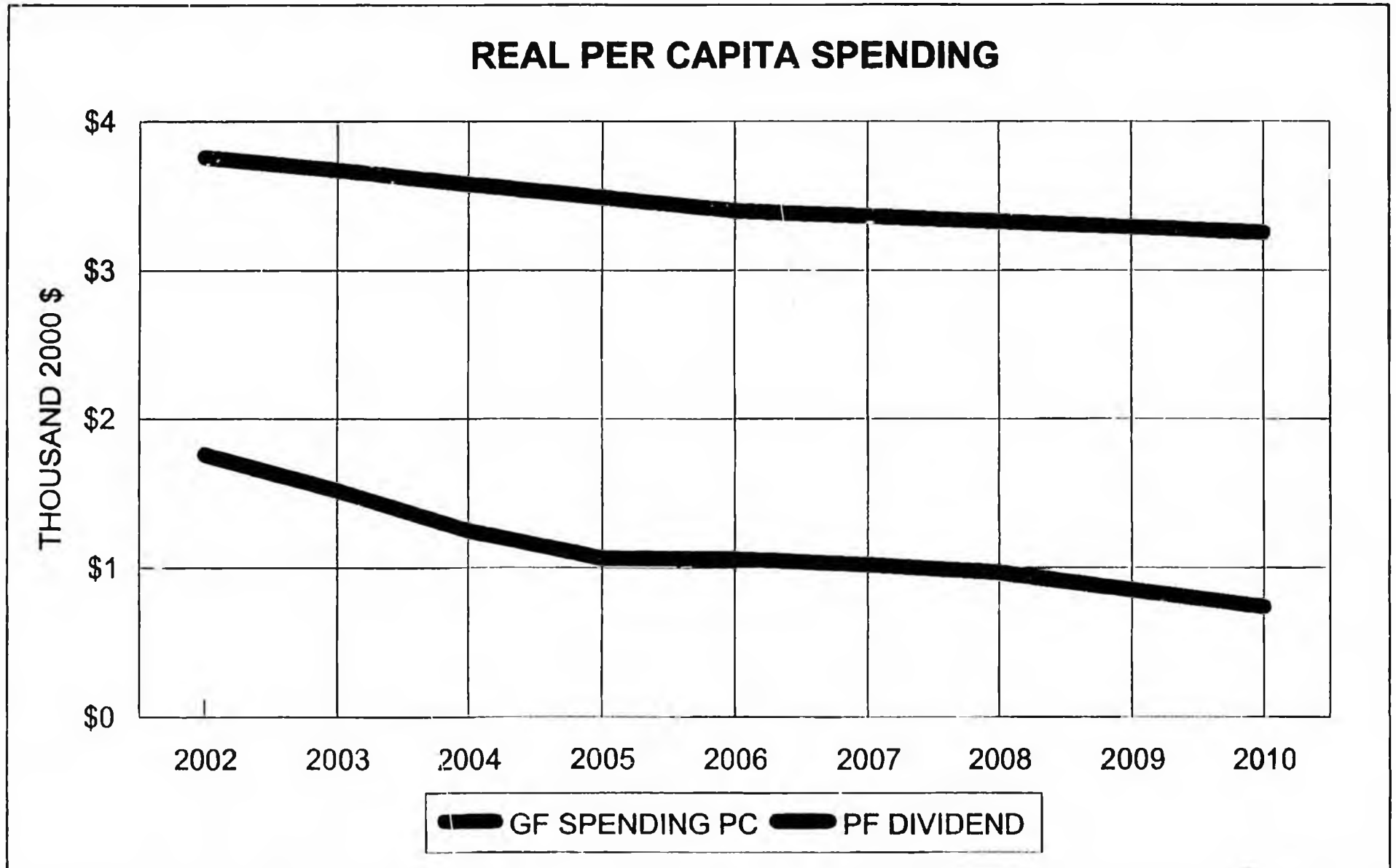
 CBR	 NET EARNINGS RESERVE	 MISC REVENUE
 INCOME TAX		
 DIVIDEND CUT		

GENERIC FISCAL PLAN: PART 6 BUDGET CUTS

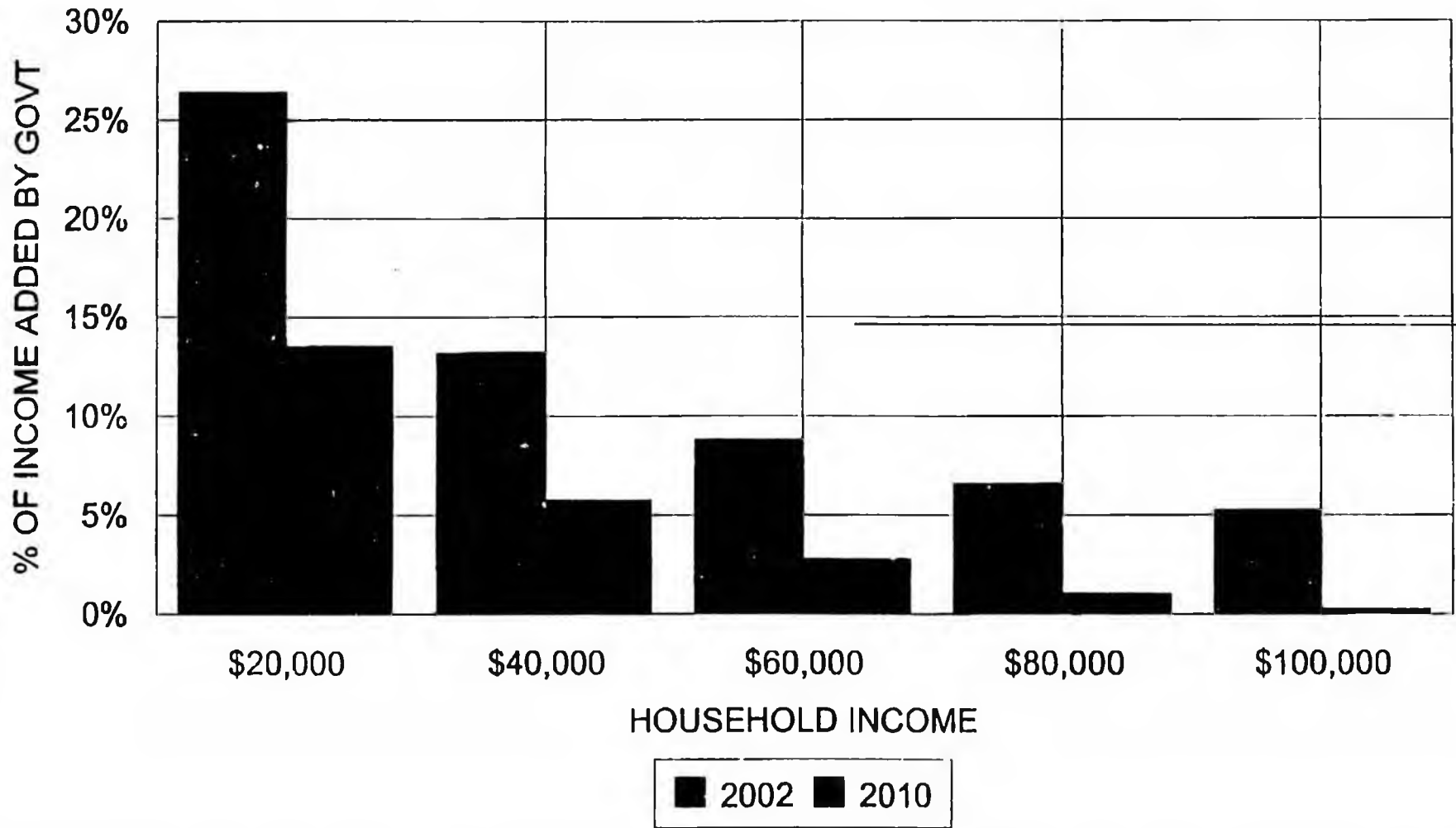


FINANCIAL ASSETS AT YEAR END INCLUDES PF, ER, CBR, AND UNREALIZED GAINS

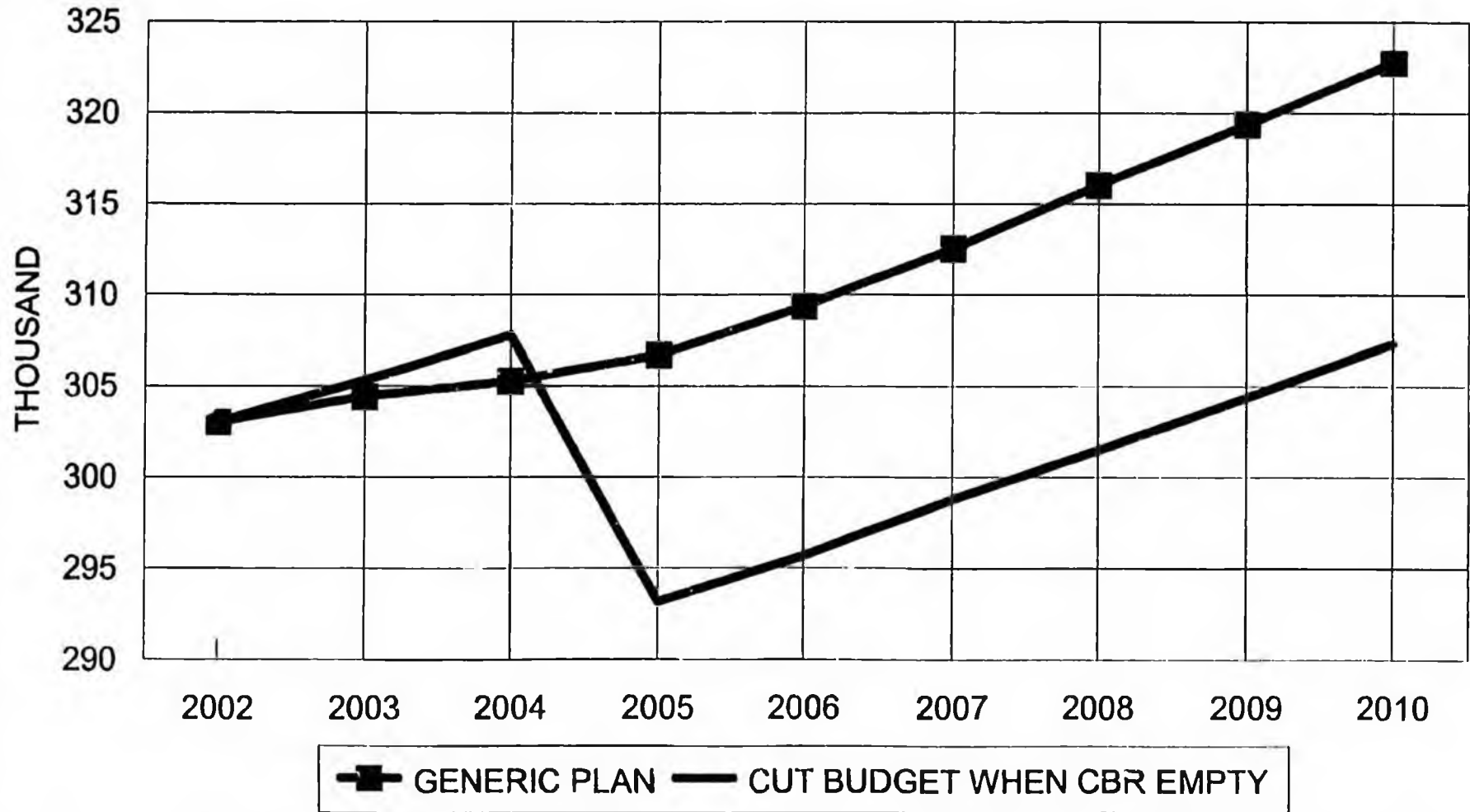




NET IMPACT ON HOUSEHOLDS CHANGE DUE TO DIVIDEND AND BROAD BASED TAXES



JOB GROWTH COMPARED TO "DO NOTHING" EFFECT OF TAXES AND DIVIDEND CUTS



GENERIC FISCAL PLAN [2002 VERSION 1]**IMPLEMENTATION**

The Generic Plan would be fully in place for the FY 2007 Budget

The SPREADSHEET and TIMETABLE describe one possible way to implement the Generic Plan, largely based upon proposed legislation. It is similar, in its main features, to many of the ideas put forward by the Fiscal Policy Caucus.

a. THE SIZE OF THE BUDGET

A temporary spending cap that sunsets with the FY 2007 budget is one way to impose budget discipline during the transition. After that time budget discipline would come from the annual determination, made by the legislature and administration, of the share of PF earnings used to fund the budget vs pay the dividend.

b. BALANCING THE BUDGET

The final balancing of the budget would draw upon the CBR through FY 2004, the Earnings Reserve in FY 2005 and FY 2006, and a share of Permanent Fund Earnings in following years.

c. THE CBR

The CBR continues to fill the fiscal gap through the FY 2004 budget, when about \$1 billion would remain. After that the CBR becomes a "cushion" to smooth out fluctuations in oil revenues around their downward TREND—the original idea for the CBR. (The CBR earnings are a continuing revenue source.)

d. BROAD BASED TAXES

A progressive personal income tax (the rate increasing with income) would be established with collections beginning in CY 2003. The rates would start low and gradually increase over 5 years, reaching their target rates in CY 2007 at which time the tax would generate about \$450 million.

e. THE DIVIDEND

The existing dividend formula would remain in place through the FY 2006 dividend payment (made in the fall of 2006), except that it would include a deduction equal to the projected personal income tax revenues for the year. Starting in FY 2007 the legislature would determine the size of the dividend as the share of PF earnings not used to fund regular state programs.

f. MISCELLANEOUS REVENUES

Other taxes and revenue generating measures that might be implemented include: reduction of the contribution rate to the Permanent Fund down to the constitutionally mandated 25 %, increase in the alcohol or fuel tax, and imposition of a cruise ship or employment tax.

g. THE EARNINGS OF THE PERMANENT FUND

Permanent Fund earnings are deposited into the Earnings Reserve based on the existing methodology until FY 2007 when the endowment rule goes into effect. Starting in that year 5 % of the moving average of the market value of the fund is transferred directly into the General Fund.

h. THE EARNINGS RESERVE

Permanent Fund inflation proofing is deferred for the FY 2003 through FY2005 budgets with the cash remaining in the Earnings Reserve. This reserve cushion ensures our ability to fund government and the dividend during the transition in the event of a series of years of poor Permanent Fund earnings. In FY 2006 the deferred inflation proofing is repaid and the balance of the Earnings Reserve becomes an emergency fund.

GENERIC FISCAL PLAN [2002 VERSION 1]

	\$864	\$1,032	\$1,062	\$1,280	\$1,502	\$1,679	\$1,880	\$2,037	\$2,221
TOTAL FISCAL GAP [MILLION \$]	\$864	\$1,032	\$1,062	\$1,280	\$1,502	\$1,679	\$1,880	\$2,037	\$2,221
BUDGET CUTS BELOW MAINTENANCE	\$0	\$57	\$123	\$192	\$266	\$305	\$347	\$391	\$437
BROAD BASED TAX (INCOME TAX)	\$0	\$45	\$135	\$225	\$315	\$405	\$450	\$473	\$497
PF EARNINGS	\$0	\$0	\$0	\$750	\$800	\$832	\$891	\$1,002	\$1,118
MISC EXCISE TAXES	(\$0)	\$30	\$54	\$87	\$65	\$81	\$118	\$115	\$111
CONSTITUTIONAL BUDGET RESERVE	\$864	\$900	\$750	\$58	\$58	\$56	\$56	\$56	\$56
PLAN EXPENDITURES =	\$3,448	\$3,385	\$3,288	\$3,233	\$3,298	\$3,377	\$3,447	\$3,468	\$3,488
GENERAL FUND	\$2,408	\$2,480	\$2,487	\$2,524	\$2,562	\$2,639	\$2,718	\$2,799	\$2,883
PF DIVIDEND	\$1,040	\$935	\$799	\$709	\$734	\$738	\$729	\$668	\$603
PLAN REVENUES =	\$3,448	\$3,385	\$3,288	\$3,233	\$3,298	\$3,377	\$3,447	\$3,468	\$3,488
GENERAL FUND	\$2,408	\$2,450	\$2,487	\$2,524	\$2,562	\$2,639	\$2,718	\$2,799	\$2,883
GF CURRENT SOURCES	\$1,544	\$1,475	\$1,548	\$1,426	\$1,326	\$1,265	\$1,205	\$1,153	\$1,100
OIL	\$1,191	\$1,152	\$1,223	\$1,100	\$999	\$936	\$877	\$826	\$772
NON-OIL	\$353	\$323	\$325	\$326	\$327	\$329	\$328	\$327	\$328
GF NEW SOURCES	\$864	\$975	\$939	\$1,098	\$1,238	\$1,374	\$1,513	\$1,646	\$1,783
PF DIVIDEND	\$1,040	\$935	\$799	\$709	\$734	\$738	\$729	\$668	\$603
DIVIDEND AMOUNT	\$1,760	\$1,564	\$1,322	\$1,161	\$1,189	\$1,182	\$1,156	\$1,047	\$934
PC OF SPENDING	\$3,758	\$3,782	\$3,797	\$3,812	\$3,827	\$3,899	\$3,973	\$4,047	\$4,123
PERMANENT FUND START OF YEAR	\$21,047	\$21,850	\$22,136	\$22,348	\$22,534	\$25,408	\$26,335	\$27,283	\$28,251
+ OIL REVENUES	\$223	\$186	\$210	\$188	\$185	\$157	\$151	\$144	\$134
+ INFLATION PROOF	\$680	\$0	\$0	\$0	\$684	\$770	\$797	\$825	\$853
+ IN FROM EARNINGS RESERVE & CBR	\$0	\$0	\$0	\$0	\$2,025	\$0	\$0	\$0	\$0
= BAL. END OF YEAR	\$21,950	\$22,136	\$22,346	\$22,534	\$25,408	\$26,335	\$27,283	\$28,251	\$29,238
UNREALIZED GAINS START OF YEAR	\$1,383	\$203	\$165	\$134	\$108	\$88	\$71	\$58	\$47
+ EARNINGS	(\$1,189)	\$17	\$13	\$11	\$9	\$7	\$6	\$5	\$4
- OUT TO EARNINGS RESERVE		\$55	\$45	\$38	\$29	\$24	\$19	\$16	\$13
= BAL. END OF YEAR	\$203	\$165	\$134	\$108	\$98	\$71	\$58	\$47	\$38
EARNINGS RESERVE START OF YEAR	\$2,384	\$2,013	\$3,094	\$4,404	\$5,189	\$3,219	\$3,243	\$3,262	\$3,278
+ IN FROM UNREALIZED GAINS	\$0	\$55	\$45	\$36	\$29	\$24	\$19	\$16	\$13
+ EARNINGS (PF+ER)	\$1,348	\$1,881	\$2,065	\$2,180	\$2,284	\$2,340	\$2,417	\$2,495	\$2,575
- PF INFLATION PROOF	\$680	\$0	\$0	\$0	\$684	\$770	\$797	\$825	\$853
- OUT TO DIVIDEND (PAID AFTER FY)	\$1,040	\$935	\$799	\$709	\$734	\$738	\$729	\$668	\$603
- OUT TO GF SPEND				\$750	\$800	\$832	\$891	\$1,002	\$1,118
- OUT TO PF					\$2,025				
= BAL. END OF YEAR	\$2,013	\$3,094	\$4,404	\$5,189	\$3,219	\$3,243	\$3,262	\$3,278	\$3,290
CBR START OF YEAR	\$2,895	\$2,400	\$1,658	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
+ REVENUES	\$100	\$45	\$0	\$0	\$0	\$0	\$0	\$0	\$0
+ EARNINGS	\$189	\$113	\$82	\$56	\$56	\$56	\$56	\$56	\$56
- SPENT	\$864	\$900	\$750	\$56	\$56	\$56	\$56	\$56	\$56
= BAL. END OF YEAR	\$2,400	\$1,658	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
TOTAL \$\$\$ ASSETS START OF YR	\$27,809	\$28,566	\$27,052	\$27,883	\$28,811	\$29,715	\$30,649	\$31,602	\$32,575
TOTAL EARNINGS	\$328	\$2,090	\$2,171	\$2,254	\$2,329	\$2,402	\$2,478	\$2,556	\$2,636
NEEDED TO INFLATION PROOF	\$834	\$797	\$812	\$835	\$864	\$891	\$919	\$948	\$977
EARNINGS NET INFLATION PROOFING		\$1,293	\$1,359	\$1,418	\$1,465	\$1,511	\$1,559	\$1,608	\$1,657
EARNINGS USED	\$1,581	\$1,604	\$1,339	\$1,327	\$1,425	\$1,469	\$1,525	\$1,582	\$1,644
= TOTAL FINANCIAL ASSETS END OF YR	\$28,566	\$27,052	\$27,883	\$28,811	\$29,715	\$30,649	\$31,602	\$32,575	\$33,568
YR END FINANCIAL ASSETS (02\$)	\$28,566	\$28,264	\$26,283	\$26,388	\$28,401	\$26,438	\$26,466	\$26,487	\$26,498
PERMANENT FUND	\$21,900	\$21,491	\$21,083	\$20,621	\$22,678	\$22,717	\$22,849	\$22,971	\$23,081
EARNINGS RESERVE	\$2,013	\$3,004	\$4,151	\$4,730	\$2,860	\$2,797	\$2,732	\$2,665	\$2,597
CBR	\$2,400	\$1,609	\$943	\$915	\$688	\$683	\$687	\$613	\$719
UNREALIZED GAINS	\$203	\$160	\$128	\$99	\$78	\$61	\$48	\$38	\$30
PF + UNREALIZED GAINS	\$22,153	\$21,651	\$21,189	\$20,721	\$22,653	\$22,778	\$22,897	\$23,009	\$23,111
TOTAL EXPENDITURES (02\$)	\$3,448	\$3,190	\$3,007	\$2,873	\$2,843	\$2,828	\$2,803	\$2,737	\$2,672
GENERAL FUND	\$2,408	\$2,379	\$2,344	\$2,310	\$2,276	\$2,276	\$2,276	\$2,276	\$2,276
PERMANENT FUND DIVIDEND	\$1,040	\$907	\$763	\$649	\$652	\$636	\$611	\$543	\$478
PER CAPITA EXPENDITURES (02\$)	\$5,519	\$5,191	\$4,828	\$4,551	\$4,457	\$4,383	\$4,294	\$4,142	\$3,983
GENERAL FUND	\$3,758	\$3,672	\$3,679	\$3,489	\$3,401	\$3,364	\$3,327	\$3,291	\$3,266
PERMANENT FUND PER DIV	\$1,760	\$1,518	\$1,248	\$1,062	\$1,056	\$1,019	\$867	\$852	\$718
JOBS IMPACT									
+ OF SPENDING	42,218	41,703	41,098	40,497	39,908	39,908	39,908	39,908	39,908
+ DIVIDEND	10,788	8,408	7,808	6,729	6,783	6,599	6,330	6,334	4,833
- HOUSEHOLD TAXES	0	(412)	(1,199)	(1,941)	(2,838)	(3,293)	(3,552)	(3,625)	(3,888)
= EMPLOYMENT FROM GOVT	53,006	50,699	47,707	45,285	44,032	43,214	42,685	41,917	41,142
CHANGE FROM 2002	0	(2,308)	(1,801)	(7,721)	(8,874)	(8,782)	(10,326)	(11,089)	(11,884)

**GENERIC FISCAL PLAN (2002 VERSION 1)
TIMETABLE**

SESSION	LEGISLATIVE ACTION	EXISTING BILL (REQUIRING REVISIONS)	ACTION EFFECTIVE FOR BUDGET YEAR										EFFECT	WHAT'S NEW WITH THE BUDGET THIS YEAR	SOURCE FOR BALANCING BUDGET THIS YEAR		
			3	4	5	6	7	8	9	0							
2002	1. FASE SPENDING CAP WITH A SUNSET CLAUSE - CAPS FY 2002, 2004, 2006, 2008 BUDGETS	SJR 22	X	X	X	X							HOLD ON BUDGET GROWTH TO HALF OF INFLATION FOR 4 YEARS		CBR		
	2. FASE 3% ENDOWMENT TO TAKE EFFECT WITH FY 2007 BUDGET	HB 36					X	X	X	X			STABILIZE REVENUES FROM FINANCIAL ASSETS				
	3. INSTITUTE BROAD BASED TAX - PERSONAL INCOME TAX SIMILAR TO KNOWLES PROPOSAL EFFECTIVE CY 2003 WITH 3 YEAR PHASE-IN (\$ 80 MILLION PER CY STEP UP TO \$430 MILLION IN CY 2007) - HB 10 OR HB 188 ARE ALTERNATIVE INCOME TAX MEASURES, HB 300 IS A SEASONAL SALES TAX	HB 413	X	X	X	X	X	X	X				PTT EFF EFFECTIVE JAN 1, 2003 WITH 3 YEAR RAMP UP TO FULL EFFECT				
	4. REALIGN PF CONTRIBUTION RATE TO 25%	HB 3	X	X	X	X	X	X	X	X			ABOUT \$30 MILLION MORE TO GF AND LESS TO PF EACH YEAR STARTING FY 2002				
	5. SUSPEND (BORROW) PF INFLATION PROOFING FOR 3 YEARS (UNTIL IT BECOMES AUTOMATIC WITH ENDOWMENT RULE WITH FY 2007 BUDGET)	NEW	X	X	X								BUILD UP EARNINGS RESERVE BALANCE				
	6. BALANCE FY 2002 BUDGET WITH APPROPRIATION FROM CBR	NEW	X														
2003															OF SPENDING GROWTH CAPPED REVENUES FROM PTT BEGIN ADDITIONAL GF REVENUES FROM OE FINANCIAL RESERVES ACCUMULATE IN ER CBR DRAW DOWN	CBR	
2003	1. INCREASE ALCOHOL TAX BY 10 CENTS PER OUNCE OR TO 8 TIMES CURRENT LEVEL (\$8.8)	HB 229 CR 288		X	X	X	X	X	X	X			BRING AX IN LINE WITH OTHER STATES - ABOUT \$30 MILLION TO GF				
	2. INCREASE GAS TAX BY 10 CENTS/GALLON	HB 401		X	X	X	X	X	X	X			BRING AX IN LINE WITH OTHER STATES - ABOUT \$30 MILLION TO GF				
	3. CRUISE SHIP TAX - \$20 PER PASSENGER	HB 229 CR 288											ABOUT \$20 MILLION TO GF				
	4. IMPOSE HEAD TAX \$100 PER WORKER	HB 229 CR 288 185											ABOUT \$40 MILLION TO GF				
	5. ABOLISH CBR AND USE BALANCE TO CREATE OE REVENUE SHOCK ABSORBER - APPROPRIATE EARNINGS AND USE PRINCIPAL ONLY WHEN OE REVENUES FALL BELOW THE LONG TERM TREND	NEW		X	X	X	X	X	X				FORGIVE LOAN TO GF, APPROPRIATE ONLY EARNINGS, USE BALANCE ONLY FOR OE REVENUE FLUCTUATIONS BELOW TREND	ADDITIONAL GF REVENUES AUTOMATICALLY FLOW TO GF FROM THE ANNUAL EARNINGS OF THE NEW SHOCK ABSORBER FUND CREATED FROM THE CBR			
	6. AMEND DIVIDEND FORMULA TO NET ESTIMATED PTT COLLECTIONS OUT OF DIVIDEND ACCOUNT FOR 3 YEARS	NEW		X	X	X							DIVIDEND CUT BY ESTIMATED AMOUNT OF INCOME TAX COLLECTIONS DURING FY 2003	DIVIDEND CUT BY ESTIMATED AMOUNT OF INCOME TAX			
	7. BALANCE FY 2003 BUDGET WITH APPROPRIATION FROM CBR BEFORE CONVERSION TO SHOCK ABSORBER	NEW		X													
2004															ADDITIONAL REVENUES FROM EXCISE TAX INCREASE	CBR	
2004	1. BALANCE FY 2004 BUDGET WITH FIRST APPROPRIATION FROM ER	NEW			X												
2005	1. BALANCE FY 2005 BUDGET WITH APPROPRIATION FROM ER	NEW				X										ER	
2006																ENDOWMENT RULE TAKES EFFECT THIS SESSION	ER
2006	1. BALANCE FY 2006 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW					X						ALLOCATE PF EARNINGS BETWEEN GF AND DIVIDEND FOR FY2006 BUDGET				
	2. BALANCE FY 2006 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW						X					ALLOCATE PF EARNINGS BETWEEN GF AND DIVIDEND FOR FY2006 BUDGET		PERMANENT FUND EARNINGS SPLIT		
2007	1. BALANCE FY 2007 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW							X				ALLOCATE PF EARNINGS BETWEEN GF AND DIVIDEND FOR 2007 BUDGET		PERMANENT FUND EARNINGS SPLIT		
	2. BALANCE FY 2007 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW								X			ALLOCATE PF EARNINGS BETWEEN GF AND DIVIDEND FOR 2007 BUDGET		PERMANENT FUND EARNINGS SPLIT		
2008	1. BALANCE FY 2008 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW								X			ALLOCATE PF EARNINGS BETWEEN GF AND DIVIDEND FOR 2008 BUDGET		PERMANENT FUND EARNINGS SPLIT		
2008	1. BALANCE FY 2008 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW									X		ALLOCATE PF EARNINGS BETWEEN GF AND DIVIDEND FOR 2008 BUDGET		PERMANENT FUND EARNINGS SPLIT		
2010	1. BALANCE FY 2010 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW										X	ALLOCATE PF EARNINGS BETWEEN GF AND DIVIDEND		PERMANENT FUND EARNINGS SPLIT		

Sales Tax vs. Income Tax
Non-Resident Dollars:

*Total Billions
in economy
DoD
Government*

	<u>Sales Tax</u>	<u>Income Tax</u>
\$ from non-residents	\$ 40 million (tourism)	\$23 million (based on DoR)

*different -
Sales Tax?*

Quick Facts:

~~48~~ States have a state-wide sales tax, 36 of those also have local sales taxes.

42 States collect a personal income tax on wages and salaries.

Objections to Sales/Income Taxes:

Objections to Sales Taxes:

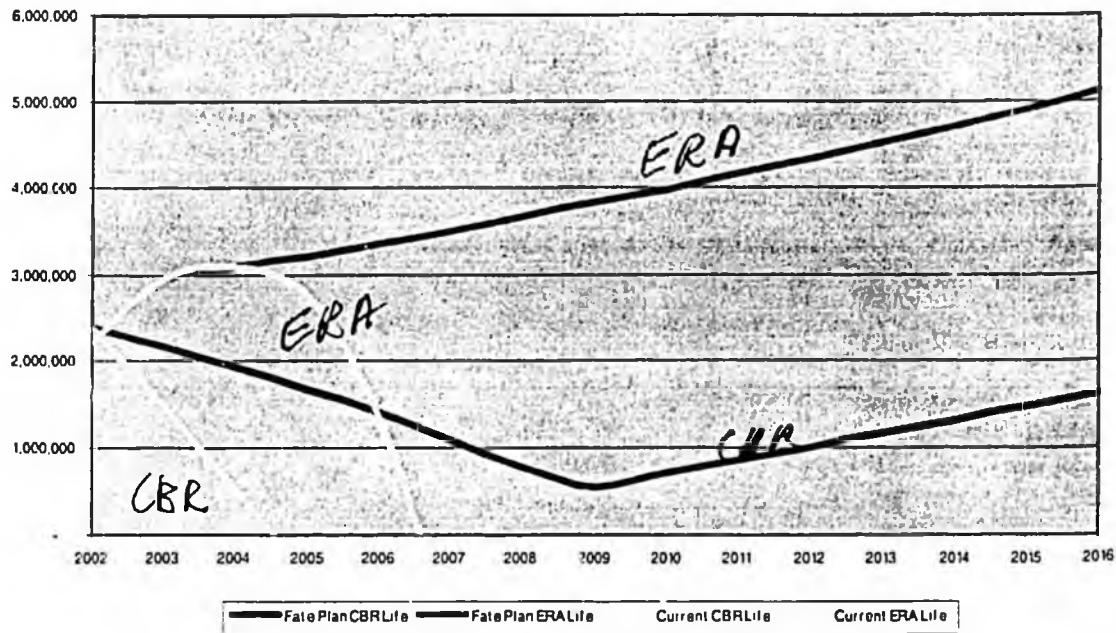
1) sales taxes are regressive, the poor pay a higher percentage of their income than the rich (given no exemptions for essential purchases) 2) the state should not duplicate taxes already being imposed by 97 local governments in the state.

Objections to Income Taxes:

1) states should not duplicate taxes that already are being imposed at the federal level; 2) exemptions and deductions assure that a significant percentage of Alaskans pay no -- or very small amounts of -- taxes. Sometimes it's argued that every citizen should pay at least some taxes.

Rep. Fate Plan

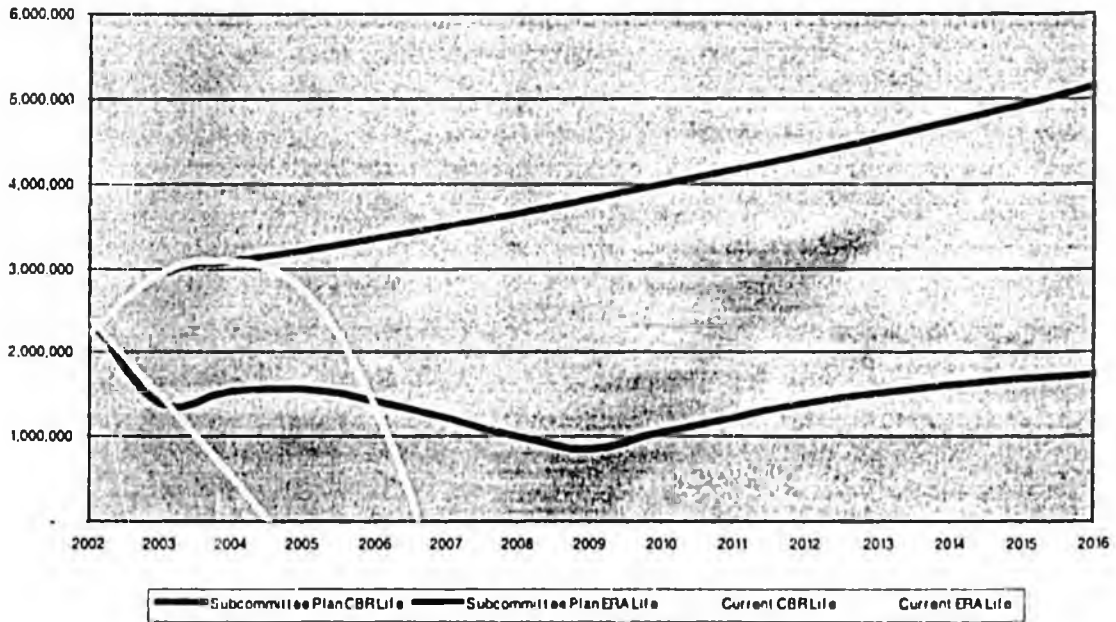
Statewide sales tax of 4%
 Use of \$250 million from ERA
 State Spending Cap:
 adjusted for pop. and inflation



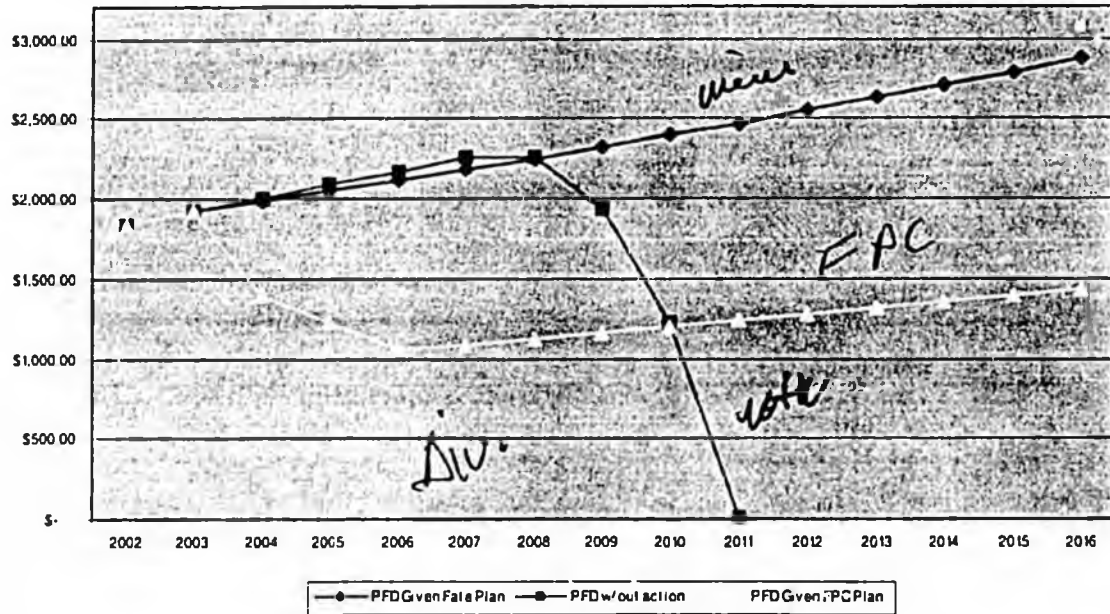
FPC Subcommittee Plan

opm v

Statewide income tax:
 4% of Federal taxable income tax
 POMV Dividend/50% used for GF
 No State Spending Cap



Permanent Fund Dividends



State Job Loss


Given Numbers Presented by Goldsmith

Job Loss Without Action: 16,674 (cut dividend, cut spending)

Job Loss With Fate Plan: 3,256 (slow dividend, sales tax)

Job Loss With FPC Subcommittee Plan: 10,017 (cut dividend, income tax)

*Based on
Goldsmith #5
assump.*



Multistate Tax Commission

REVIEW

444 North Capitol Street, NW, Suite 425, Washington, DC 20001 (202) 624-8699 www.mtc.gov

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Mississippi
New Hampshire
North Carolina
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Oklahoma
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South Carolina
Tennessee
West Virginia
Wisconsin

SSTP: Out of the Great Swamp, But Whither? A Plea to Rationalize the State Sales Tax*

Charles E. McLure, Jr.

Hoover Institution, Stanford University

I. Introduction in the Form of a Dream

Last night I dreamed I was sitting on a promontory watching events unfold below. A group of travelers bound for Salt Lake City entered a clearing, followed by a strange beast that kept nipping at their heels. From the logo on the travelers' sweatshirts, "SSTP 2001," I could see that they were bound for the Inaugural Meeting of the Implementing States of the Streamlined Sales Tax Project, not the Winter Olympics.

The beast looked a bit like the centipede at the annual Bay-to-Breakers race in San Francisco — a creature composed of individuals covered by a common green skin, but it had neither head nor tail. Like the members of the San Francisco centipede, the components of this beast seemed to have their own agendas. Now and then one would break free and whisper something to one of the travelers, while others would shout, "It's not fair." The beast responded to carrots and sticks, but not much else. On its side were emblazoned the words, "US ECONOMY."

The travelers were considering three paths, each leading to alternative policies for the future.

The first continued the trail that brought the group to the clearing. It was marked by a sign that warned, "Great Swamp. Your pack animal must still carry an excessively heavy load if you continue here. Footing is treacherous and there are many pitfalls."

On the right of the clearing, marking the second path, was a sign that proclaimed, "Elegant Simplicity, nine yards.¹ You can remove the excess burdens from your pack animal. Footing is as good as it gets."

The third path, which lay between the other two, was marked by a sign that said, "Lesser bog, just a few steps. You can remove some of the burden from your pack animal, but most will remain. Footing is good, but not great. Rely on technology to get out of a fix."

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*I have made a few additions and minor substantive changes, as well as numerous expositional changes that do not affect the substance, to the "presentation draft" of this address that I delivered in Salt Lake City. I identify the most important additions in the notes. I have benefitted from comments Walter Hellerstein made on an earlier draft of this address.

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Suggesting that the signs had been written by a refugee from a Chinese fortune cookie factory, the travelers seemed puzzled. When they said they thought the passage through the Great Swamp had not been particularly onerous, there were howls of protest from the great beast. The travelers had heard that the Lesser Bog, with all its "gee whiz" technological gimmicks, might be preferable to the Great Swamp, but they had never considered going the full nine yards to reach Elegant Simplicity. Nor had they noticed that their beast of burden was, indeed, excessively laden or that the burden was not evenly spread. They asked whether anyone could help them understand their options. That is when I awoke.

In my remarks today I will describe the Great Swamp, tell you how to achieve Elegant Simplicity by draining the swamp, and comment briefly on the Lesser Bog.

II. Mapping the Great Swamp: the Current Sales Tax

The current sales tax "system" is extraordinarily complex — literally a compliance swamp, especially for vendors who must collect tax on sales to customers located in multiple states. The US Supreme Court has ruled twice — in *National Bellas Hess* in 1967 and again in *Quill* in 1992 — that the sales tax is so complex that states cannot require an out-of-state (remote) vendor to collect the tax unless the vendor has a physical presence in the state.² The purpose of the SSTP is to simplify compliance, especially for multistate sellers, and thereby gain approval (from either the Congress or the Supreme Court) of an expanded duty for remote vendors to collect tax.³

The practical inability to collect tax on many remote sales to individuals implies that revenues are lost or that tax rates must be higher than otherwise. In addition, the sales tax distorts economic decisions, thereby creating burdens that exceed those of a neutral system. As in the dream, the extra burdens created by complexity and discrimination are not borne equally by all parts of the economy.

A. Complexity

The primary purpose of the SSTP is to reduce the complexity encountered by vendors who must collect tax on sales to customers located in multiple

states. But vendors operating in only one state also encounter complexity. It is useful to understand this first level of complexity before considering the complexity multistate vendors face.

1. Complexity for single-state vendors

Exemption of products. Most sales tax states tax most tangible products (goods), by enumerating those that are exempt, and exempt most services, by enumerating those that are taxed; most states implicitly exempt intangible products, including digitized content — the hallmark of electronic commerce, since they are not tangible. (Note that "products" includes services and intangible products, as well as tangible products, also called goods.) While the dividing line between taxed and exempt products is usually clear, this is not always the case. Exemptions for food are notoriously ambiguous, since they typically exclude such ill-defined categories as "candy," "prepared food," and "soft drinks." Thus Kit Kat candy bars — which are chocolate-covered wafer cookies, may be taxable, even though "chocolate-covered wafer cookies" are explicitly exempt, and deodorant and antiperspirants may be treated differently. Also, various states may require that, to be classified as fruit juice, and therefore exempt, a beverage must contain 10, 25, 50, or 100 percent juice. Nor does the result always make sense, as when raw peanuts, salted peanuts, and sugar-roasted peanuts are treated differently. Distinctions such as these inevitably complicate compliance.

Caps and thresholds.⁴ Rather than taxing or exempting all purchases of particular products, some states employ caps and thresholds, exempting only purchases (e.g., of meals and clothing) that do not exceed a cap or taxing only those that exceed a threshold. Besides inviting manipulation (for example, buying pants and a matching coat separately to benefit from an exemption for clothing with a value below the threshold), caps and thresholds create complexity.

Exemption of sales for resale. Recognizing the distortions and inequities caused by pyramiding — levying tax on a product repeatedly as it moves through the production-distribution process — all states exempt sales for resale. States typically also exempt products that are physically incorporated in goods for resale, as well as some other business purchases to be mentioned later. Problems of interpretation abound in this area. For example, does a fast-food restaurant "resell" to its customers the napkins, plastic utensils, and containers that it purchases? Is the coke used to fire a blast furnace

physically incorporated in the steel that is produced, or is it merely a fuel?

Exemptions of sales for resale are, in the first instance, generally administered by having the purchaser provide a resale exemption certificate to each of its suppliers. The supplier is sometimes held liable for tax if the purchaser files a fraudulent exemption certificate or uses the goods purchased for a non-exempt purpose, unless it can demonstrate that it accepted the certificate in "good faith" — an amorphous standard that provides little certainty for the vendor.

Sales to and by tax-exempt organizations. States generally allow tax-exempt organizations to make purchases required for the conduct of the activities for which their tax-exemption has been granted without paying sales tax, utilizing procedures similar to those for sales for resale. In addition, states generally exempt sales such organizations make in the conduct of these activities (e.g., tuition charged by universities); exemption of sales of taxable physical property is not common.

Sales tax holidays. A particularly pernicious form of complexity that has sprung up in recent years is the sales tax holiday — a tax exemption for specified products such as children's clothing and school supplies bought during a specified period, usually just before the commencement of the school year. Holidays raise definitional problems of the type already identified. Exactly what are "children's clothing" and "back-to-school supplies?" Moreover, holidays may be granted only for purchases that do not exceed a cap, creating complexity of the type already identified. Holidays announced without adequate notice impose onerous burdens on merchants, who must reprogram computers on a crash basis to deal with the exemptions.⁵

Local sales taxes. Local governments in about three dozen states levy sales taxes. The existence of local sales taxes generally complicates life only marginally for vendors operating in just one state. Ordinarily local sales taxes take the form of surcharges levied on the same base as the state tax and collected by the state government. Since the vendor knows in which local jurisdictions its outlets are located, it is a relatively simple matter to comply with such "piggybacked" local taxes. An exception to this generalization may occur when a vendor makes a sale to a customer in a different local jurisdiction in the same state. Depending on the state, such sales may be subject to tax in the jurisdiction where the customer is located or in the jurisdiction where the vendor is located. Some states allow local use

taxes (some on a base that differs from the base of the local sales tax), but others prohibit them.⁶

The complexity created by local sales taxes is even greater if local governments can levy tax on a base that differs from that of the state tax or if they can require that taxpayers register and file tax returns with them. Either of these anomalous provisions can considerably increase compliance burdens, even for vendors making sales in just one state.

2. Complexity for multi-state vendors

If a vendor operates in only one state the complexities mentioned thus far can be overcome, if not easily. The real problem arises when a vendor must collect the sales or use taxes of many states. First, it must address each of the problems identified in every state where it operates. Second, it must deal with the legal and administrative systems of each state. The resulting complexity may be overwhelming, especially for small remote vendors — of which there are potentially many in electronic commerce.

Exemption of products. The fact that different states may tax and exempt different products is only the tip of the iceberg of complexity; they may also define particular products differently. Thus, even if the tax base is ostensibly the same, it may actually be quite different. A vendor must know the definitions of tax and exempt products in each state (and in each locality, in some states) where it must collect tax and be familiar with relevant caps and thresholds. (One might liken the tax base of a given state to Swiss cheese. The holes in each of the 45 state systems are different.)

Exemption of sales for resale. Some states are more liberal than others in their exemptions for business purchases. Some exempt only products that are physically incorporated in the production process, in addition to sales for resale. Others exempt materials used or consumed in manufacturing or processing taxable tangible products, even if not physically incorporated in the final product. Still others exempt machinery and equipment used in manufacturing taxable products. Some states also exempt industrial fuels, and some exempt sales of seed and fertilizer to farmers. And, of course, definitions differ from state to state. For example, in some states the exemption for ingredients incorporated in the production process applies only when the "primary purpose" of acquiring the ingredient is to incorporate it into the final product; in others the exemption applies as long as a "substantial

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portion" of the ingredient ends up in the final product; and in still others it applies as long as the ingredient is necessary to production of the final product, regardless of how minuscule the amount of the ingredient in the final product. Similarly, in some states the exemption for machinery used in manufacturing applies only when the machinery or equipment effects a "physical" change in the product or is "directly" used in manufacturing, whereas in other states the exemption applies to any machinery or equipment that is part of an "integrated plant." Multistate vendors must contend with these various definitions.

Sales to and by tax-exempt organizations. A non-profit organization that operates in multiple states must comply with the laws of each regarding its purchases and its sales. Also, a firm selling to a non-profit in another state must know the exemption rules of that state if it has nexus there. As with other aspects of the sales tax considered thus far, there is no uniformity from state to state.

Sales tax holidays. The problems sales tax holidays create for vendors operating in one state are compounded by the need to deal with temporary changes in tax bases of more than one state, including caps on the temporary exemptions, and by the fact that definitions of products that are eligible for the temporary exemption can differ from state to state.

Local sales taxes. Local sales taxes can be particularly burdensome for remote vendors, assuming they have taxable nexus, because vendors must, at the very least, identify the local jurisdictions of destination and collect the appropriate local taxes. Levying a "blended" use tax rate that reflects the average of sales tax rates throughout the state has been found to be unconstitutional, since the blended rate inevitably exceeds the local tax rate in some jurisdictions. Moreover, a blended rate does not solve the problem of "sourcing" sales to local jurisdictions. Standard five-digit zip codes are not adequate for that, because boundaries of zip codes and local jurisdictions need not coincide. (Use of 9-digit zip codes offers more promise.)

If the local tax is collected as a surcharge on the state tax these complications — which can be significant — are the only ones encountered. But in some states it is necessary to determine whether a sale is taxable or exempt when made to a particular locality and/or comply with the administrative requirements of the jurisdictions of destination.

Legal structure and administrative procedures.

Each state has its own statutes, regulations, and interpretations thereof. Moreover, each state also has its own administrative procedures — registration requirements; resale and other exemption certificates; requirements for filing tax returns, making remittances (including vendor discounts), and retaining records; procedures for audit, handling disputes, adjudication, etc. Thus a multistate vendor must know the legal framework and administrative procedures in each of the states where it has a duty to collect tax.

Cumulative effects of state decisions. If a vendor operated in only two states or made remote sales into only one state, it would need to contend with only two state sales tax systems. But if a vendor made sales in a large number of the 45 sales tax states and had to deal with the sales and use taxes of each, the complexity could be overwhelming. The problem would be aggravated by the need to trace sales to local jurisdictions and (in a few states) contend with local deviations from the state sales tax base and/or local administrative requirements.

B. Economic Distortions and Inequities

Complexity creates the Great Swamp and is a significant part of the burden borne by the beast in the dream. But it is not the only burden. The current sales tax system also creates considerable economic distortion.⁷ In reality, as in the dream, all do not bear these burdens equally. Thus the system is also unfair.

1. Consumption choices

Because most goods are taxed and most services are exempt, the sales tax system tilts consumer choices in favor of services, creating an avoidable loss of economic welfare. It also discriminates against low income households, who prefer to consume goods, and favors the more affluent, who prefer services.

2. Production-distribution decisions

The economics of taxation teaches that no legitimate costs of production and distribution should be taxed, whether they be for goods bought for resale, intermediate products that enter the production process, capital equipment, fuel, office supplies, transportation costs, or whatever.⁸ This principle is reflected in the sale for resale exemption mentioned earlier,⁹ but, as indicated, sales tax exemptions for sales to business are far from universal. It has been estimated that as much as 20 to 70 percent of sales tax revenues are

not derived from sales to individuals, depending on the particular state.¹⁰ Thus the problem is not a minor one.

Taxing business purchases has several adverse effects. First, it distorts decisions on techniques of production and distribution away from the most efficient toward those that minimize tax on purchased input.¹¹ The advent of electronic commerce is likely to aggravate these distortions, by making markets for business inputs function more efficiently than before. Second, it is unfair to place unequal burdens on firms that buy from other firms.

Third, the hidden tax costs inherent in the failure to exempt business purchases reduces the ability of American producers to compete, in both foreign and domestic markets. Imports from Europe (and other nations that impose a VAT) bear little or no hidden tax costs, due to the rebate of value added tax on exports.¹² Because they bear hidden tax costs, American exports to Europe or to third countries are at a competitive disadvantage. Eliminating these hidden costs would reduce imports and boost exports.¹³

Fourth, seen from the perspective of producers in an individual state, these hidden sales tax costs are a burden that domestic competitors do not bear. (This point may require some clarification. Competitors from some states may face hidden tax costs that equal or exceed those of the state in question. But, seen from the viewpoint of any one state, those hidden tax costs are no more relevant than any other costs incurred in other states. Competitors from states that have no sales taxes will face few, if any, such hidden tax costs.) A policy of imposing hidden tax costs on in-state producers seems strangely perverse, especially at a time when most states are looking for ways to get a foot up on their competitors.¹⁴

Finally, when business inputs are taxed, part of the cost of government is hidden. Suppose that the sales tax rate is 6 percent, but that 40 percent of sales tax revenues are derived from sales to business. This implies that the real cost of government financed with the sales tax is 10 percent of sales, not 6 percent.

3. Discrimination against local merchants

As noted earlier, the U.S. Supreme Court has ruled that a state can require a remote vendor to collect its use tax only if the vendor has a physical presence in the state. This de facto exemption of remote sales creates incentives for inefficient distribution of products — for example, sending individual packages into a state, rather than sending boxes of products to local stores.¹⁵

Moreover, it is obviously unfair — to both local merchants and their clientele — to exempt remote sales from taxes that are collected on sales by local merchants.¹⁶ No wonder that Main Street components of the beast scream that the system is unfair.

C. How We Got into The Great Swamp

The present sales tax system is not the product of conscious policy; rather it reflects historical evolution. During the Great Depression, when revenues from other taxes were declining, states were casting about to find alternative sources of revenues and hit upon the sales tax. By the beginning of World War II about half the states levied sales taxes, and over time other states adopted the tax, until now all but a handful utilize it.¹⁷

Both the American economy and what we know about the adverse effects of unwise sales taxes were very different 60 years ago. First, goods were far more important than services, and the loss of revenue, economic distortions, and inequities caused by not taxing services were much smaller and received little thought. Second, ignorance of the economic cost of taxing business inputs, demagoguery — the demand that business should pay tax if families do, and the desire to hide the tax led politicians to tax sales to business.

Third, most retail sales were made by local merchants that operated in only one state. Thus complexity for multistate vendors — and especially for remote vendors — was much less of a concern than now. Responding to political pressures that played out differently in various states, each state acted independently in deciding its tax base, establishing its legal structure, and designing its administrative procedures. It is hardly surprising that the exercise of fiscal sovereignty by individual states has created a system that is so complicated that remote vendors cannot be expected to comply with it.

D. A Personal Comment on *Quill*

The physical presence rule of *Quill* produces distortions and inequities that are undesirable — I might even say unconscionable. This does not, however, mean that *Quill* was decided wrongly. The states had had 25 years, since the 1967 decision in *National Belas Hess*, to simplify their sales taxes, by making them more nearly uniform. Instead, they continued to force vendors with taxable nexus in multiple states to trudge

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through the Great Swamp. I have no doubt that we would be stuck in that swamp forever if the Supreme Court had ruled for the state in *Quill*. But the Court provided directions on how to escape the swamp. If the states can simplify their sales taxes enough, either the Congress, acting pursuant to the Commerce Clause, or the Court itself may eliminate the physical presence test.¹⁸ That brings us to the question before the Implementing States of the SSTP: how to drain the swamp.

III. Draining the Sales Tax Swamp: Starting from First Principles

The best way to make massive improvements in tax policy — which is what the SSTP will need to accomplish if either the Congress or the Supreme Court is to ratify its work — is to start with a clear picture of the conceptual ideal. A conceptually principled retail sales tax, which might be described as an “economically neutral and compliance-friendly system,” would follow several simple rules:¹⁹

If a product is sold to consumers, it is subject to tax.

If a product is sold to a business, it is exempt.²⁰ States would administer local sales and use taxes, using procedures that would allow vendors to identify the local jurisdictions of destination (e.g., based on zip codes).

These rules would apply equally to local merchants and to remote vendors, subject to *de minimis* rule. That is, remote vendors would be required to collect tax if its sales to customers in a given state exceeded a *de minimis* amount.²¹

The legal framework and administrative procedures of all states would be identical. (Many of these features, which I cannot discuss in detail, might follow the outlines of the SSTP proposals.)

Multi-state “one-stop” administrative procedures (e.g., for registration, filing tax returns, payment of tax, and audit) should be employed to the extent possible.

Under this approach *states would retain full sovereignty over the choice of state sales tax rates* and could allow local autonomy over local rates. Differences in tax rates, even among localities, is not what causes complexity; it

is differences in tax bases between states (and within states in a few cases) and the need to determine the local jurisdiction of destination of remote sales. (Of course, as noted above in the discussion of sales tax holidays, changes in rates made frequently or without adequate notice can cause complexity.)

A. Curtailing Complexity

The proposed system is “compliance-friendly” and would achieve Elegant Simplicity. It addresses a concern heard repeatedly in discussions of the SSTP, that “the devil is in the details,” by simply eliminating many of the needless details that complicate compliance and create the current sales tax swamp.

There would be no need to define products, since liability for tax would depend solely on the nature of the buyer, not on the nature of the product. (If products such as prescription drugs and medical services are to be exempt, exemptions and definitions of exempt products should be identical in all states.)

All sales to business purchasers would be exempt; it would not be necessary for the vendor to inquire into the intended use of the product.²²

Nexus would depend on the volume of sales in a state, not the fuzzy standard of physical presence.²³

Businesses and tax exempt organizations that are eligible to make tax-exempt purchases would be identified in a central registry, which could use digital certification and digital signature technology to certify eligibility.

State and local sales tax bases would be identical.

Vendors would need to deal with only one tax administration in each state. Indeed, they would conduct many transactions with the multi-state “one-stop” administrative shop.

Being based on sound principles, instead of expediency, the system would minimize the “sacred cow” problem (states holding out for retention of pet provisions), increasing the likelihood of agreement on a common system within two years, and there would be no need to change it in responses to future changes in the economy.

Under this “elegantly simple” system a vendor located in any state, by knowing the sales tax law of its own state,

the nature of the buyer (consumer, business, or tax-exempt organization), and the location of the buyer, could comply with the law of any other state or local government. Compliance software would presumably be employed to implement the system, but it could be vastly simpler than that needed to implement the SSTP proposal described in the next section, let alone current law.

B. Eliminating Distortion and Inequities

This system is not only compliance-friendly; it is economically neutral and fair.

All consumption would be treated identically.

No business purchases would be taxed. There would be no pyramiding.

Local merchants and remote vendors would be treated identically.

Hidden taxes would not place local producers at a competitive disadvantage in either domestic or foreign markets.

The cost of government would be more transparent.

C. Loss of State Fiscal Sovereignty

Achievement of the economically neutral and compliance-friendly system would entail some loss of state sovereignty (and of local autonomy) over tax policy. The question, then, is whether this loss of sovereignty is acceptable. I believe that it is.

First, recall that the basic outline of the present chaotic system — taxation of business inputs, exemption of services, and mind-numbing complexity — which results in the constitutional inability to require remote vendors to collect tax — is the result of historical evolution that began in a world that no longer exists. Fighting to retain elements of that antiquated system that are undesirable (or even unconscionable) is hardly a responsible exercise of fiscal sovereignty.

Second, not all decisions on sales tax policy are equally important. *The most important decision is the choice of tax rates*; that is basically what determines the amount of revenue a tax yields. *States (and local governments) should retain control over tax rates.*

The second most important choice is whether or not to tax or exempt certain broad categories of products, such as food and clothing. While the desire to exempt these products on social grounds is perhaps understandable, sales tax exemptions are an incredibly blunt instrument to use for this purpose. Loss of

sovereignty in this area would not be much of a loss.

Supposing that some products are to be exempt, definitions that are uniform across (and within) states are required to minimize complexity. For example, food should be defined the same way in all states. The inability of a state to define food in one of 45 different ways is really a small loss of sovereignty. Similar comments can be made about many of the other sources of complexity in the current sales tax, such as differential treatment of specific products (e.g., candy and soft drinks), legal structure, and administrative procedures. These secondary elements of sovereignty come at too high a price: needless complexity, unfair competition local merchants experience, and loss of revenues.

Before leaving the subject of fiscal sovereignty it is worthwhile to note briefly the experience of the European Union (EU). Under the Treaty of Rome, the “constitution” of the EU, agreement on tax matters requires unanimous approval of all members; it is hard to imagine more fiscal sovereignty than that. Yet, in order to create a single market, the members of the EU long ago ceded the sovereignty implied in this veto power to create a sales tax system (the value added tax or VAT) that is much more nearly uniform in important respects than that found in the United States, as well as being more nearly economically neutral.²⁴ (Members retain the power to set tax rates.) If the nations of Europe, which have repeatedly been engaged in wars against each other, are willing to accept mutual limits on their sovereignty in order to achieve this level of uniformity, why cannot the American states do so?

IV. SSTP: Must a Lesser Bog Be the Destination?

The Streamlined Sales Tax Project has made amazing progress in achieving simplification. Its proposal would substantially drain the sales tax swamp.²⁵ Yet it would not achieve either Elegant Simplicity or economic neutrality because of unwillingness to go the full nine yards.

There are two variants of draft legislation emanating from the Project, the “SSTP draft” approved by the SSTP in December 2000 and the “NCSL draft” approved by the executive committee of NCSL in January 2001. What I call “the SSTP approach,” which involves simplifying just enough to pass muster in the Congress or the Supreme Court, without rationalizing the system, underlies both.

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A. Simplification

I cannot comment on all the simplifications proposed by the SSTP.²⁶ Rather, I will comment only on the features that most markedly distinguish the SSTP approach from the economically neutral and compliance-friendly system described earlier. This does not, however, mean that the SSTP simplifications that I do not discuss are unimportant; indeed, they are required to drain the swamp. Also, some reforms that are important in their own right, such as the elimination of tax on sales to business, might not be required to persuade the Supreme Court or the Congress to approve an expanded duty of remote sellers to collect tax, even though they would contribute to simplification.

Exemption of products. Rather than adopting the conceptually correct approach, in which all products would be treated the same and taxation or exemption would depend solely on the status of the purchaser, the SSTP draft would maintain the present approach, in which some products are taxed and some are exempt. It would simplify compliance by providing uniform definitions of broad categories of products from which each state could construct its tax base, by taxing or exempting the category. The NCSL draft follows the same approach, but would not achieve even this degree of simplification.

Exemption of sales to business. The SSTP and NCSL drafts would also maintain the present approach to the treatment of business inputs, in which only selected business purchases are exempt. They would eliminate the "good faith" requirement for acceptance of certificates of exemption for resale, but would not otherwise simplify the determination (by the buyer) of whether or not a purchase made by a business in a given state is exempt.

Local taxes. The SSTP draft requires uniformity of the state and local tax bases in each state; by comparison, the NCSL draft would allow local tax bases to deviate from a state base. While software companies are confident that they can handle local differences in tax rates (and the need to channel revenue to the right local jurisdiction), they are understandably less sanguine about their ability to handle local differences in tax bases.²⁷

B. Remaining Distortions and Inequities

Many of the important distortions of economic decisions and inequities that characterize the current system would remain under the SSTP approach. In

particular, sales taxes would continue to punish producers, sellers, and purchasers of taxable products and reward producers, sellers, and purchasers of exempt ones. They would continue to distort decisions on production and distribution and to discriminate against producers who must pay tax on their purchases. I believe that these are major shortcomings of the SSTP. On the other hand, if something like the SSTP draft were adopted the existing de facto discrimination against local merchants might be eliminated. I address that issue now.

V. The Political and Judicial Future

Less than two weeks ago the Congress voted to extend the Internet Tax Freedom Act for two years. It did not provide any assurance that it would eliminate the physical presence test of nexus if the states simplified their sales taxes. The question, then, is whether simplification is worth the candle.

The answer, it seems, is a resounding "Yes." First, even if there were no question of nexus for remote vendors, it is unconscionable that there is so little uniformity in the state sales taxes. The existing diversity creates overwhelming complexity, with little real gain in state sovereignty. I would urge the Implementing States of the SSTP to simplify the system because it is the right thing to do.

But there is a question of nexus for remote vendors. Here I would argue that the issue is not so much one of revenue, although revenue losses may become more important with the maturation of electronic commerce. Rather, I believe that the primary issue is one of economic neutrality and fairness. It is neither sensible nor fair to place Main Street merchants at a competitive disadvantage, relative to remote vendors.²⁸ If the distortions and inequities created by the physical presence rule are to be eliminated, state and local sales taxes must be simplified.

There are two ways the physical presence rule might be overturned: by an act of Congress or by the Supreme Court reversing *Quill*. There is no way of predicting how much simplification is enough for either of these bodies. Prediction is difficult in the case of the Congress because it involves weighing the relative influence of representatives of state and local governments and of lobbyists for the various business groups that reform would affect differently. In the case of the Supreme Court the key question is the relative weight the Court would place on eliminating artificial influences on interstate trade and on *stare decisis* (let the decision

stand), the doctrine that seems to have been so important in the *Quill* case — and, of course, the extent to which simplification had been achieved.

Though one cannot be sure, I believe that the Court would find the “economically neutral and compliance-friendly system” described earlier would provide enough simplification that it would choose neutrality and fairness over blind allegiance to *stare decisis*. I am less confident that it would reach the same decision if confronted with the SSTP draft. If it did, we might be out of the Great Swamp, but we would not have reached Elegant Simplicity. (It probably would not — and should not — find that the NCSL draft provided enough uniformity.)

This leaves the question of how to achieve multi-state agreement on a more uniform sales tax system. I would, of course, hope that I have made a case for the economically neutral and compliance-friendly system that is so convincing that all the sales-tax states would immediately sign on and proceed directly to Elegant Simplicity. It is probably more realistic to hope that a core group of states will form a nucleus around which other states will coalesce.²⁹ Once enough states have agreed on a common system that is more nearly uniform, and thus simpler, “tipping” may occur, as other states join. (Congressional or judicial sanction of a system, indicated by allowing an expanded duty of

remote vendors to collect the use taxes of states adopting the common system, would almost certainly create tipping.) In that case, I hope the core group will see the light and choose Elegant Simplicity over the Lesser Bog.

VI. Concluding Remarks: Still Dreaming

As I return to my perch above the clearing I see a group of men and women who have an opportunity — and a challenge — that few have had in our nation's history. They have the opportunity to lay the groundwork for an “elegantly simple” sales tax system that is appropriate for the 21st century. In a sense they are being asked to create a miniature “economic constitution” that will free the American economy from the burden of complexity and economic distortion under which it has long labored because of the chaotic and illogical structure of the sales tax — and to strike a blow for fairness in the bargain — much as the European Union did almost 40 years ago when it decided to adopt the VAT. But they will need to resist the temptation merely to tinker that is inherent in “politics as usual” and go the full nine yards. I hope they are up to the challenge.

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ENDNOTES

¹In the presentation draft this trail was marked "Terra Firma." I have renamed it in response to Governor Mike Leavitt's plea for a plan that is "elegantly simple."

²I will generally use the generic term "sales tax," instead of the technically more accurate term "sales and use tax," but will use "use tax" where context requires it. Strictly speaking, states can impose sales tax only on sales that occur within the state. They can impose use tax on the use of products bought outside the state for use in the state, to compensate for the constitutional inability to levy sales taxes on such transactions. Under the typical state statute a vendor doing business in the state has an obligation to collect sales or use tax due with respect to products sold to in-state purchasers, with liability imposed on the purchaser if the vendor fails to collect the tax. Because such vendors will almost always have constitutional "nexus" with the state when sales occurs within the state, the state can ordinarily require the vendor to collect the sales tax on sales to local purchasers. As noted in the text, however, the U.S. Supreme Court has ruled that a state cannot require an out-of-state vendor to collect the tax imposed with respect to the sale — technically the "use" tax — unless the vendor has a physical presence in the state. In principle, the state could collect use taxes directly from local consumers, who are legally liable for the tax. It is, however, generally infeasible (or at least not cost-effective) for states to collect use taxes directly from purchasers, except in the case of business purchasers (who are subject to audit) and goods that must be registered to be used, such as automobiles. The only potentially effective way to collect use taxes on most remote sales to individuals is for vendors to collect them.

Under current law "vendors who must collect tax on sales to customers located in multiple states" would be only those that have a physical presence where their customers are located. But in reading these words from the text it is useful to consider the hypothetical situation in which remote vendors who do not have a physical presence are required to collect the tax of the states where their customers are located.

³Acting pursuant to the Commerce Clause of the Constitution, i.e. Congress could eliminate the physical presence requirement. Or the Supreme Court could rule that the system has been simplified enough that the physical presence rule is no longer appropriate.

⁴This point does not appear in the presentation draft.

⁵See Cline and Neubig (2000).

⁶See Due and Mikesell (1994).

⁷For further discussion, see McLure (1998a), (1998b).

⁸The obligatory reference is Diamond and Mirrlees (1971).

⁹The principle is also respected in the income tax. It would be rare to find someone arguing that deductions should not be allowed for all legitimate business expenses.

¹⁰See Ring (1999).

¹¹The most obvious example occurs when a firm provides its own supplies instead of purchasing them — a form of vertical integration. Beginning in the late 1960s the members of the European Union replaced their taxes on gross receipts, which were levied every time a product was sold (thus the term "turnover tax"), with value added taxes, which provide a credit for tax paid on purchases. Before that textbooks commonly decried the distortions such taxes created, including the tendency toward vertical integration.

Although the exemption of sales for resale greatly reduces these distortions, extant state sales taxes nevertheless contain an important element of turnover taxation. For evidence that this problem has been recognized in American undergraduate textbooks for at least 40 years, see Hellerstein and McLure (2001).

¹²Those unfamiliar with the mechanics of the VAT might consult McLure (1987).

¹³Over time this effect might be mitigated by changes in exchange rates. But exchange rates reflect many influences. Elimination of the hidden tax, even if combined with a change in exchange rates, would leave those sectors that are currently most adversely affected by the hidden tax in an improved position, relative to others. This implies that producers in states that currently impose the greatest hidden tax burden have the most to gain from rationalization of tax policy in this area.

¹⁴States often resort to techniques of attracting business that are patently unconstitutional under the Commerce Clause; see Hellerstein (1996). By comparison, encouraging in-state production by eliminating sales tax on business purchases is a clearly constitutional.

¹⁵To illustrate the point, consider the following particularly mindless and fallacious argument for exempting sales by remote vendors — that drivers of UPS and FedEx delivery trucks would create economic activity, for example, by buying lunches. (Purchases of trucks, tires, and fuel could have been added to the list to swell the supposed economic benefits.) Carrying that argument to the extreme, we would simply ban all sales by local merchants, so that everything would be delivered directly to consumers from out-of-state. Of course, doing so would entail enormous economic costs. Deliberately imposing a tax penalty on local merchants (except as required to avoid an unconstitutional burden on interstate commerce) is merely a less extreme form of this madness. For refutation of other fallacious arguments see McLure (2000).

¹⁶Another fallacious argument is that remote vendors should not be required to collect tax because they do not benefit from services provided by the states and localities where their customers are located. (This argument is sometimes combined with an argument for “no taxation without representation.”) But remote vendors merely collect the tax; they do not “pay” it. Their customers, who do benefit from public services (and do have representation), pay the tax.

¹⁷For more on the evolution of the sales tax, see Due and Mikesell (1994).

¹⁸It is important that the Court based its decision in *Quill* on the Commerce Clause. If it had based it on the Due Process Clause, Congress could not eliminate the physical presence test.

¹⁹I describe this system in greater detail in McLure (2000).

²⁰A similar approach would be used for exempt purchases by non-profit organizations, which would properly be exempt;

whether made for use in the activities for which the organization is granted exempt status or for business purposes.

²¹This point does not appear in the presentation draft. Nexus in a state would create nexus in all local jurisdictions in the state.

²²It would, of course, be necessary to prevent the diversion to consumption of products bought on a tax-exempt basis. Under a single-stage sales tax this can be achieved only through audits of the purchaser, which would involve verification of the business purpose of exempt purchases. A basic difference between the RST and the VAT is that, in the first instance, the purchaser need only lie to its supplier to evade the RST on “business inputs” intended for personal use, whereas it must lie to the tax authorities to evade the VAT; see Shoup (1969). It would be possible to construct a hybrid “RST with credits” that would combine the features of the current RST and the VAT. Thus some business inputs could continue to be taxed, as now, but business purchasers could be allowed credit for tax on inputs, as under the VAT. Such a scheme could be used to ease the revenue cost of transition to exemption of all business purchases, by allowing only partial credits for taxes on business purchases.

²³This point does not appear in the presentation draft.

²⁴Services are taxed, businesses are allowed credit for tax paid on purchases, and remote sales of tangible products to households in excess of a threshold are subject to the VAT of the destination state. The primary conceptual defect in the VATs levied in the EU is the treatment of remote sales of services, which includes digital content; see McLure (forthcoming, b).

²⁵See the SSTP Website, <http://www.geocities.com/streamlined2000/>, for valuable references, including the texts of the two variants of the legislation. See McLure (forthcoming, a) for an early appraisal of the draft legislation and Rosen and Haffield (2001) for a current analysis.

²⁶See, however, McLure (forthcoming, a).

²⁷See Rosen and Haffield (2001).

²⁸To see this, consider the outcry that would ensue if there were a national sales tax that did not apply to imports from abroad. Yet that is exactly analogous to the *de facto* situation that prevails under state sales taxes, because of the *Quill* decision.

²⁹In one sense this is what happened in Europe. The original members of the European Common Market (the precursor of the EU) adopted the VAT and any new members were required to adopt that system as a condition of membership. The obvious and important difference is that the various states are already part of the United States and will not be booting out of the Union simply because they do not adopt a sales tax system that is adopted by other states. But they may be denied the right to impose an expanded duty to collect use tax.

GENERIC FISCAL PLAN [2002 VERSION 1]

NOTES

A. INTRODUCTION

The absence of a plan for dealing with the fiscal gap is negatively impacting the economy and the state's ability to finance activities through borrowing.

This Generic Plan demonstrates both the nature of the state's fiscal problem and how it can be solved

The fiscal gap—the difference between annual general fund expenditures and revenues—is currently about \$1 billion. It will continue to increase as inflation and population growth drive up the cost of delivering public services and oil production, the primary source of state revenues, continues to decline. By the end of this decade the difference between a maintenance budget (growing with inflation and population) and revenues from current sources could reach \$2 billion.

Any solution to the fiscal gap problem must include the 2 most powerful tools in the arsenal—broad based taxes and use of Permanent Fund earnings. These must be augmented by budget restraint, excise and other less powerful taxes, and judicious use of the Constitutional Budget Reserve.

Many versions of a plan could be crafted based on use of these tools. This Generic Plan could be put into place through legislation and other actions in a multitude of ways.

Our inability to forecast future oil prices, investment returns, economic development, public sector demands, inflation, and other factors that define the size of the fiscal gap require that our fiscal plan remain as flexible as possible.

Any solution to the fiscal gap problem must spread the burden of paying the costs of government fairly among all Alaskans, and no group should be singled out or asked to go first. To this end the Generic Plan calls for simultaneous imposition of a broad based tax (Income tax), reduction of the PF dividend, and budget cuts from the maintenance level.

Any method of solving the fiscal gap will take jobs out of the economy. Staging over several years the introduction of new revenue producing measures and budget reductions (including the PF dividend) will minimize the "drag" on the economy from closing the fiscal gap.

Implementation of a fiscal plan today maximizes future flexibility in the use of our fiscal tools and delay reduces our options.

B. CRITERIA FOR A FISCAL PLAN

FAIR – spread the burden fairly and equitably among Alaskans and across industries

SUSTAINABLE – preserve financial assets and endowment funds (AHFC, etc.)

REALISTIC – close the gap with real measures based on real assumptions

INCREMENTAL – phase in measures gradually over several years

COMPLETE – show the complete plan and timetable

POSITIVE – minimize short term economic impact and long term disincentives to development

FLEXIBLE – maximize capability to adjust to changing circumstances

EFFICIENT – minimize administrative cost

STABLE – maximize revenue predictability

TRANSPARENT – keep it simple, logical, and politically possible

C. GENERIC PLAN FEATURES

1. CONVERT PERMANENT FUND TO ENDOWMENT
2. USE ENDOWMENT EARNINGS TO FUND GOVERNMENT AND DIVIDEND
3. INTRODUCE BROAD BASED TAXES [PERSONAL INCOME TAX] INCREMENTALLY
4. STEP DOWN DIVIDEND IN PARALLEL WITH GROWTH OF PERSONAL INCOME TAX REVENUES
5. IMPOSE SPENDING DISCIPLINE IN PARALLEL WITH DIVIDEND REDUCTION
6. INTRODUCE EXCISE TAXES INCREMENTALLY
7. REDUCE ROYALTY CONTRIBUTION RATE TO PERMANENT FUND TO 25%
8. CONVERT CONSTITUTIONAL BUDGET RESERVE TO OIL REVENUE "CUSHION"
9. RETAIN EMERGENCY FUND IN EARNINGS RESERVE AS FINANCIAL EARNINGS "CUSHION"

D. THE TARGET

When all its features are in place, the Generic Plan solves the fiscal gap problem through a combination of use of Permanent Fund earnings, revenues from broad based taxes, and revenues from other new sources. The legislature retains the authority to determine the levels of both traditional government expenditures and the dividend, and how they will be financed—how permanent fund earnings will be allocated and the mix of taxes and tax rates.

The Generic Plan closes the fiscal gap, spreads the burden fairly across Alaskans, retains maximum flexibility, and minimizes damage to the economy.

E. IMPLEMENTATION AND TRANSITION

The TIMETABLE and SPREADSHEET describe one possible method for implementation of the Generic Plan, largely based upon proposed legislation. It is similar, in its main features, to many of the ideas put forward by the Fiscal Policy Caucus.

The Generic Plan would be fully in place for the FY 2007 Budget.

a. TRANSITION: THE SIZE OF THE BUDGET

A temporary spending cap that sunsets with the FY 2007 budget is one way to impose budget discipline during the transition. After that time budget discipline would come from the annual determination, made by the legislature and administration, of the share of PF earnings used to fund the budget vs pay the dividend.

b. TRANSITION: BALANCING THE BUDGET

The budget in each year would be balanced as follows:

FY 2002 – CBR Draw
 FY 2003 – CBR Draw
 FY 2004 – CBR Draw

FY 2005 – Earnings Reserve Draw
 FY 2006 – Earnings Reserve Draw

FY 2007 and beyond – Earnings Reserve Draw

c. TRANSITION: THE DIVIDEND

The existing dividend formula would remain in place through the FY 2006 dividend payment (made in the fall of 2006), except that it would include a deduction equal to the projected personal income tax revenues for the year. Starting in FY 2007 the legislature would determine the size of the dividend as the share of PF earnings not used to fund regular state programs.

d. TRANSITION: BROAD BASED TAXES

A progressive personal income tax (the rate increasing with income) would be established with collections beginning in CY 2003. The rates would start low and gradually increase over 5 years to the target rates in CY 2007 at which time the tax would generate about \$450 million.

e. TRANSITION: EXCISE TAXES

Other taxes and revenue generating measures that might be implemented might include: reduction of the contribution rate to the Permanent Fund down to the constitutionally mandated 25 %, increase in the alcohol tax, increase in the fuel tax, cruise ship tax, employment tax.

f. TRANSITION: THE CBR

The CBR continues to fill the shrinking fiscal gap through the FY 2004 budget, after which time about \$1 billion would. After that only the earnings of the CBR contribute to general fund revenues. The balance of the fund is used as a "cushion" to smooth out fluctuations in oil revenues around their downward TREND—the original idea for the CBR.

g. TRANSITION: THE EARNINGS OF THE PERMANENT FUND

Calculation of the earnings of the Permanent Fund is unchanged until FY 2007 when the endowment rule goes into effect. Starting in that year the earnings are 5 % of the trailing moving average of the market value of the fund.

h. TRANSITION: THE EARNINGS RESERVE

Permanent Fund earnings are deposited into the Earnings Reserve through FY 2006. After that time the earnings go directly to the general fund. Permanent Fund inflation proofing is deferred for the FY 2003 through FY2005 budgets with the cash deposited in the Earnings Reserve. This reserve cushion ensures our ability to fund government and the dividend during the transition in the event of a series of years of poor Permanent Fund earnings. In FY 2006 the deferred inflation proofing is repaid

After FY 2006 the Earnings Reserve earnings contributes to general fund revenues, but the balance becomes an emergency fund which remains unspent.

F. SENSITIVITY TO CHANGING CONDITIONS

HIGHER INFLATION – With a cap on spending, higher inflation puts a tighter squeeze on real expenditure growth and since the Permanent Fund is protected from inflation, the fiscal gap is smaller.

HIGHER OIL REVENUES – Higher oil revenues would allow revenues to remain in the CBR and Earnings Reserve and this in turn would permit tax rates to be lower, dividends to be higher, and expenditures to be higher.

LOWER OIL REVENUES – The cushion in the Earnings Reserve would be used in the event of lower than anticipated revenues.

LOWER PERMANENT FUND EARNINGS – The cushion in the Earnings Reserve would be used in the event of lower than anticipated fund earnings.

HIGHER GF SPENDING – In the short term this would increase the draw from the CBR and Earnings Reserve. In the long run it would reduce the dividend.

G. GRAPHICS [illustrating methods to describe and evaluate a fiscal plan]

GENERAL FUND BASICS – The general fund maintenance budget grows with inflation and population. General fund revenues from current sources, dominated by oil, will continue to fall.

THE SIZE OF THE DEFICIT – The deficit is the difference between the general fund maintenance budget and general fund revenues from current sources. The deficit is increasing over time. Its exact size depends upon the size of the budget and revenues which fluctuate with the price of oil.

GENERAL FUND REVENUES FROM CURRENT SOURCES – General fund revenues from oil will continue to fall. Non-oil revenues are not growing.

BUDGET BALANCING MEASURES – Initially the measures to close the fiscal gap are dominated by use of the CBR, but after the transition period the earnings of the Permanent Fund, broad based taxes, other revenue measures, and budget restraint all play a role.

REAL PER CAPITA SPENDING – Both general fund spending and the dividend fall in real dollars.

FINANCIAL ASSETS AT YEAR END – The real value of state financial assets is sustained.

JOB GROWTH COMPARED TO "DO NOTHING" – The "do nothing" scenario is to spend down the CBR and then cut the budget.

NET IMPACT ON HOUSEHOLDS – Households of 3 at different income levels (\$20 to \$100 thousand) receive more from state government (dividend) than they pay in income tax in 2002. In 2010 that would also be true given the assumptions of the Generic Plan.

GENERIC FISCAL PLAN [2002 VERSION 1]

TOTAL FISCAL GAP [MILLION \$]

BUDGET CUTS BELOW MAINTENANCE
 BROAD BASED TAX (INCOME TAX)
 PF EARNINGS
 MISC EXCISE TAXES
 CONSTITUTIONAL BUDGET RESERVE

	\$884	\$1,032	\$1,062	\$1,290	\$1,502	\$1,579	\$1,880	\$2,037	\$2,221
\$0	\$67	\$123	\$192	\$288	\$305	\$347	\$381	\$457	\$457
\$0	\$46	\$135	\$225	\$315	\$405	\$450	\$473	\$487	\$487
\$0	\$0	\$0	\$750	\$800	\$832	\$881	\$1,002	\$1,119	\$1,119
(\$0)	\$30	\$54	\$67	\$85	\$91	\$116	\$116	\$116	\$111
\$884	\$900	\$750	\$56	\$56	\$58	\$58	\$58	\$58	\$58

PLAN EXPENDITURES =

GENERAL FUND
 PF DIVIDEND

\$3,448	\$3,388	\$3,286	\$3,233	\$3,298	\$3,377	\$3,447	\$3,488	\$3,488	\$3,488
\$2,408	\$2,458	\$2,487	\$2,524	\$2,502	\$2,629	\$2,718	\$2,798	\$2,883	\$2,883
\$1,040	\$935	\$799	\$709	\$734	\$738	\$729	\$688	\$603	\$603

PLAN REVENUES =

GENERAL FUND
 GF CURRENT SOURCES
 OIL
 NON-OIL
 GF NEW SOURCES
 PF DIVIDEND

\$3,448	\$3,388	\$3,286	\$3,233	\$3,298	\$3,377	\$3,447	\$3,488	\$3,488	\$3,488
\$2,408	\$2,450	\$2,487	\$2,524	\$2,502	\$2,639	\$2,718	\$2,798	\$2,883	\$2,883
\$1,544	\$1,475	\$1,548	\$1,428	\$1,328	\$1,285	\$1,205	\$1,153	\$1,100	\$1,100
\$1,191	\$1,152	\$1,223	\$1,100	\$989	\$936	\$877	\$825	\$772	\$772
\$253	\$223	\$325	\$328	\$327	\$329	\$328	\$327	\$327	\$327
\$864	\$873	\$839	\$1,098	\$1,236	\$1,374	\$1,513	\$1,648	\$1,783	\$1,783
\$1,040	\$935	\$799	\$709	\$734	\$738	\$729	\$688	\$603	\$603

DIVIDEND AMOUNT

PC GF SPENDING

\$1,780	\$1,584	\$1,322	\$1,181	\$1,189	\$1,182	\$1,156	\$1,047	\$904	\$904
\$3,758	\$3,782	\$3,797	\$3,812	\$3,827	\$3,899	\$3,973	\$4,047	\$4,123	\$4,123

PERMANENT FUND START OF YEAR

+ OIL REVENUES
 + INFLATION PROOF
 - IN FROM EARNINGS RESERVE & CBR
 = BAL END OF YEAR

\$21,047	\$21,980	\$22,138	\$22,346	\$22,534	\$25,408	\$26,335	\$27,283	\$28,251	\$28,251
\$223	\$188	\$210	\$188	\$185	\$157	\$151	\$144	\$134	\$134
\$880	\$0	\$0	\$0	\$884	\$770	\$797	\$825	\$853	\$853
\$0	\$0	\$0	\$0	\$2,025	\$0	\$0	\$0	\$0	\$0
\$21,950	\$22,138	\$22,346	\$22,534	\$25,408	\$26,335	\$27,283	\$28,251	\$29,238	\$29,238

UNREALIZED GAINS START OF YEAR

+ EARNINGS
 - OUT TO EARNINGS RESERVE
 = BAL END OF YEAR

\$1,383	\$203	\$185	\$134	\$108	\$88	\$71	\$58	\$47	\$47
(\$1,180)	\$17	\$13	\$11	\$9	\$7	\$6	\$5	\$4	\$4
\$203	\$185	\$134	\$108	\$88	\$71	\$58	\$47	\$38	\$38

EARNINGS RESERVE START OF YEAR

- IN FROM UNREALIZED GAINS
 - EARNINGS (PF-ER)
 - PF INFLATION PROOF
 - OUT TO DIVIDEND (PAID AFTER FY)
 - OUT TO GF SPEND
 - OUT TO PF
 = BAL END OF YEAR

\$2,384	\$2,013	\$3,094	\$4,404	\$5,169	\$3,219	\$3,243	\$3,262	\$3,278	\$3,278
\$0	\$35	\$46	\$38	\$29	\$24	\$18	\$18	\$13	\$13
\$1,349	\$1,981	\$2,085	\$2,188	\$2,284	\$2,340	\$2,417	\$2,495	\$2,575	\$2,575
\$880	\$0	\$0	\$0	\$884	\$770	\$797	\$825	\$853	\$853
\$1,040	\$835	\$799	\$709	\$734	\$738	\$729	\$688	\$603	\$603
\$0	\$0	\$0	\$750	\$800	\$832	\$881	\$1,002	\$1,119	\$1,119
\$2,013	\$3,094	\$4,404	\$5,169	\$3,219	\$3,243	\$3,262	\$3,278	\$3,290	\$3,290

CBR START OF YEAR

+ REVENUES
 + EARNINGS
 - SPENT
 = BAL END OF YEAR

\$2,985	\$2,400	\$1,858	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
\$100	\$45	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
\$168	\$113	\$82	\$58	\$58	\$58	\$58	\$58	\$58	\$58
\$884	\$800	\$750	\$38	\$58	\$58	\$58	\$58	\$58	\$58
\$2,400	\$1,858	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000

TOTAL \$\$\$ ASSETS START OF YR

TOTAL EARNINGS
 NEEDED TO INFLATION PROOF
 EARNINGS NET INFLATION PROOFING
 EARNINGS USED
 = TOTAL FINANCIAL ASSETS END OF YR

\$27,807	\$28,888	\$27,052	\$27,883	\$28,811	\$28,715	\$30,648	\$31,602	\$32,575	\$33,586
\$238	\$2,080	\$2,171	\$2,254	\$2,329	\$2,402	\$2,478	\$2,558	\$2,636	\$2,636
\$834	\$797	\$812	\$838	\$864	\$891	\$919	\$948	\$977	\$977
\$1,581	\$1,604	\$1,339	\$1,327	\$1,425	\$1,489	\$1,523	\$1,582	\$1,644	\$1,644
\$28,588	\$27,052	\$27,883	\$28,811	\$28,715	\$30,648	\$31,602	\$32,575	\$33,586	\$33,586

YR END FINANCIAL ASSETS (028)

PERMANENT FUND
 EARNINGS RESERVE
 CBR
 UNREALIZED GAINS
 PF - UNREALIZED GAINS

\$28,588	\$28,284	\$28,283	\$28,368	\$28,401	\$28,438	\$28,468	\$28,487	\$28,488	\$28,488
\$21,850	\$21,481	\$21,083	\$20,821	\$22,575	\$22,717	\$22,849	\$22,971	\$23,081	\$23,081
\$2,013	\$3,004	\$4,151	\$4,730	\$5,800	\$6,797	\$7,732	\$8,683	\$9,597	\$10,481
\$2,400	\$1,808	\$943	\$915	\$884	\$883	\$837	\$813	\$788	\$788
\$203	\$180	\$128	\$88	\$78	\$81	\$48	\$38	\$30	\$30
\$28,153	\$21,801	\$21,188	\$23,721	\$22,853	\$22,778	\$22,807	\$23,008	\$23,111	\$23,111

TOTAL EXPENDITURES (028)

GENERAL FUND
 PERMANENT FUND DIVIDEND

\$3,448	\$3,190	\$3,007	\$2,873	\$2,843	\$2,828	\$2,803	\$2,737	\$2,672	\$2,672
\$2,408	\$2,378	\$2,344	\$2,310	\$2,278	\$2,277	\$2,278	\$2,278	\$2,278	\$2,278
\$1,040	\$807	\$753	\$688	\$682	\$678	\$671	\$643	\$618	\$618

PER CAPITA EXPENDITURES (028)

GENERAL FUND
 PERMANENT FUND PER DIV

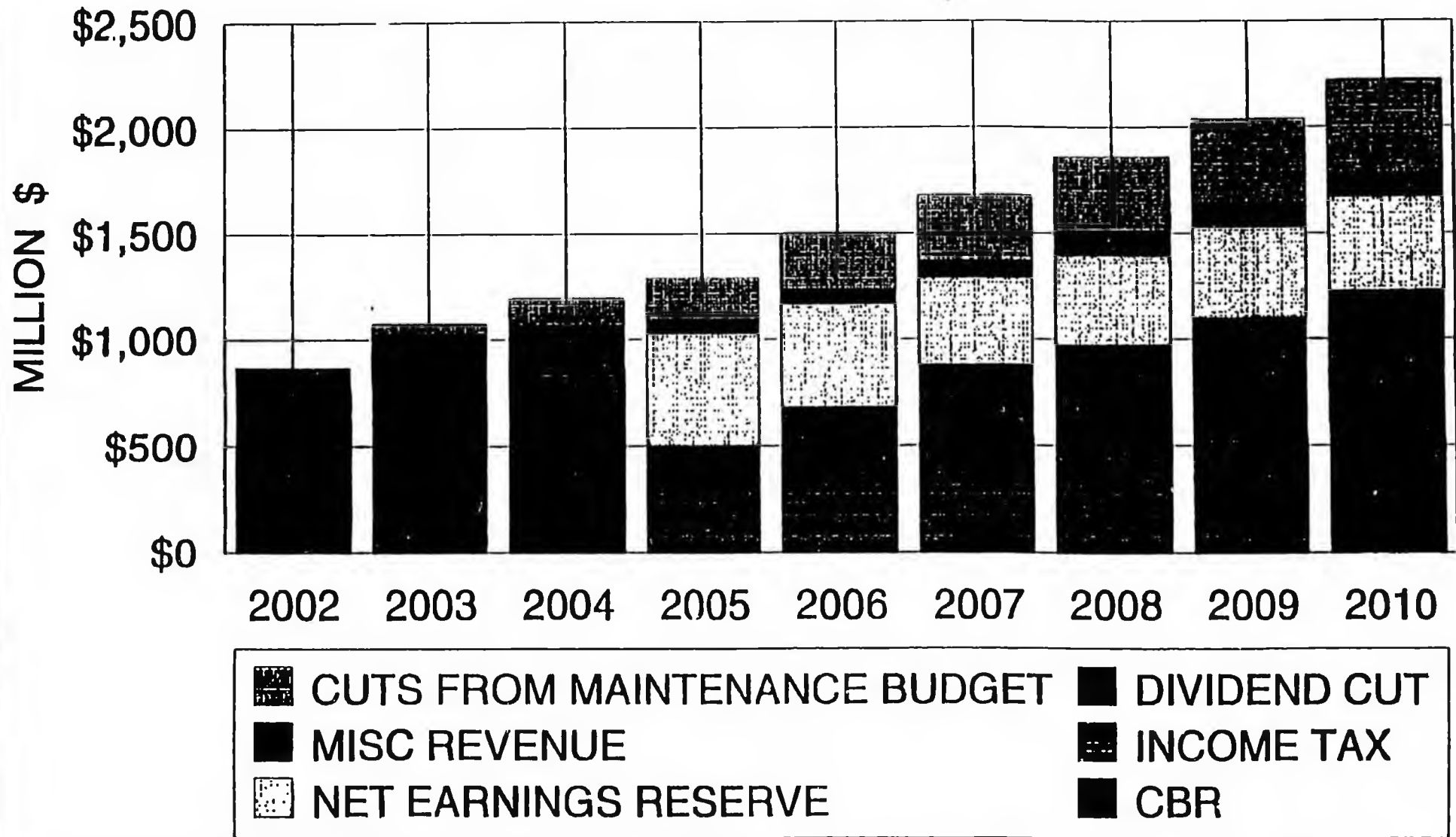
\$8,518	\$8,181	\$8,828	\$8,581	\$8,487	\$8,313	\$8,294	\$8,142	\$8,083	\$8,083
\$3,758	\$3,872	\$3,578	\$3,488	\$3,401	\$3,314	\$3,327	\$3,291	\$3,255	\$3,255
\$1,780	\$1,518	\$1,249	\$1,082	\$1,068	\$1,019	\$987	\$892	\$798	\$798

JOBS IMPACT

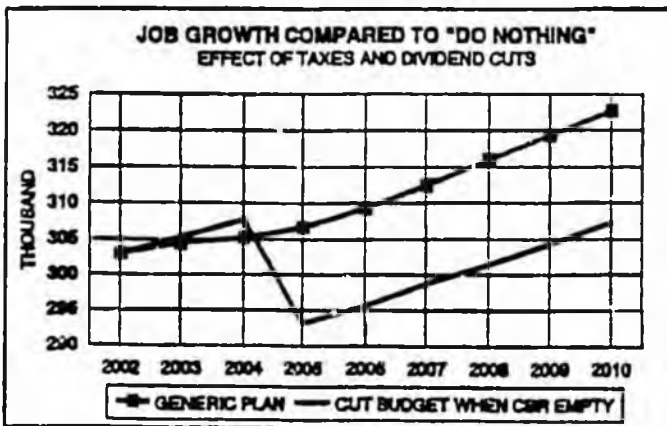
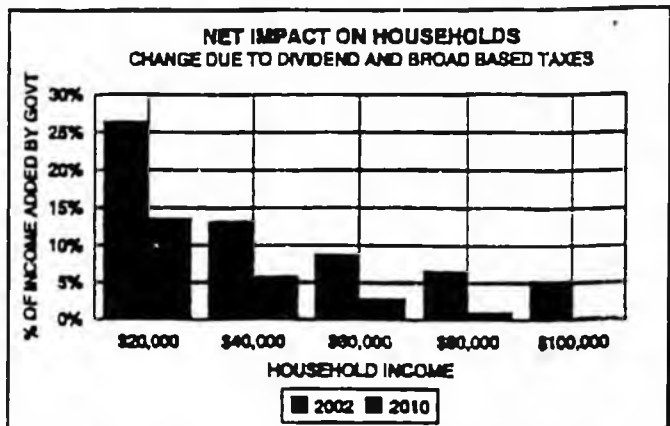
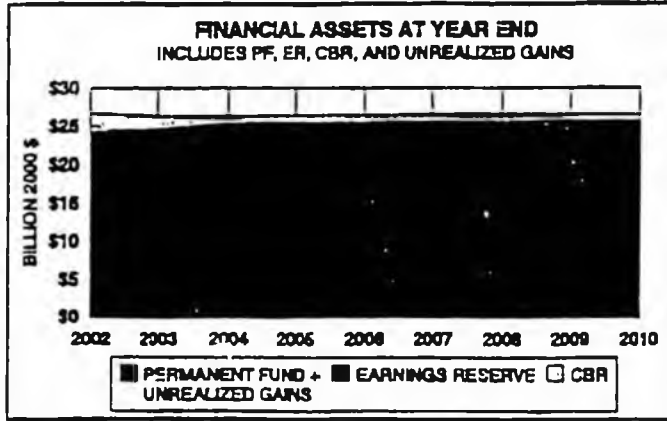
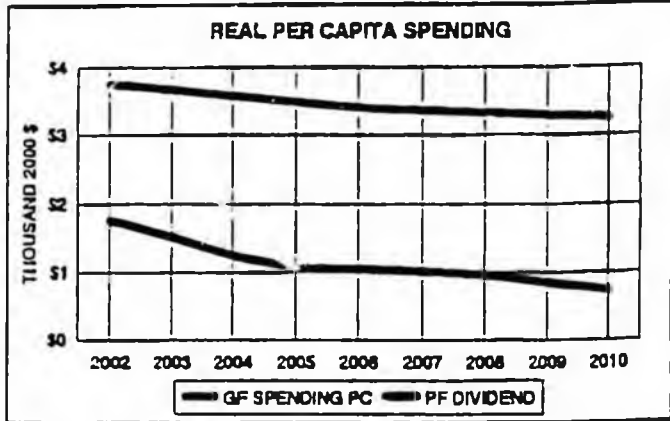
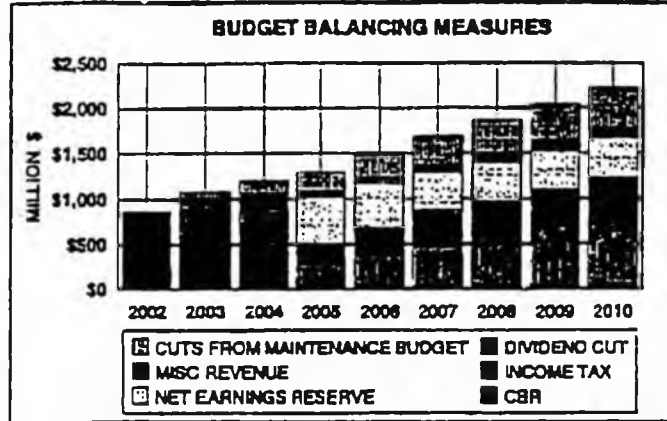
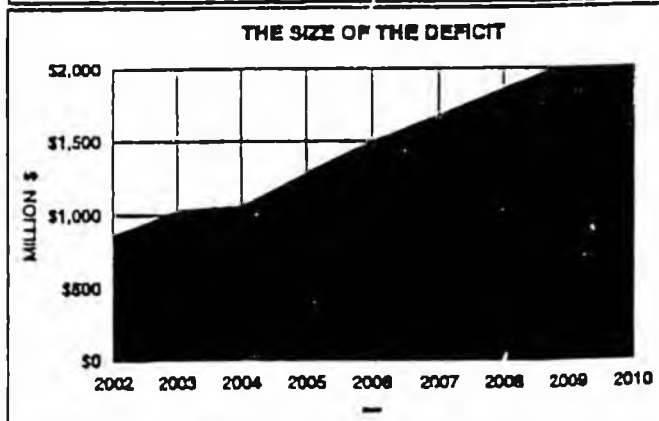
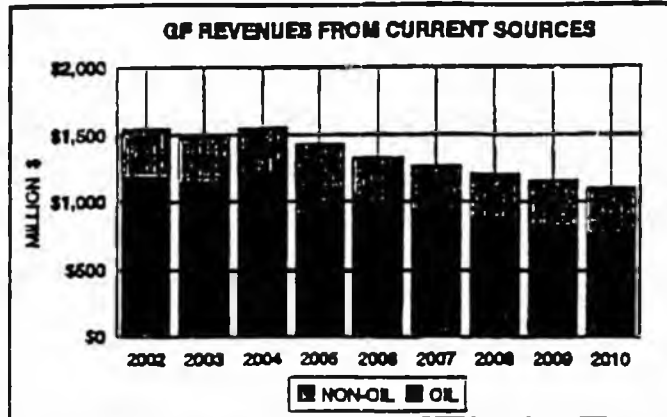
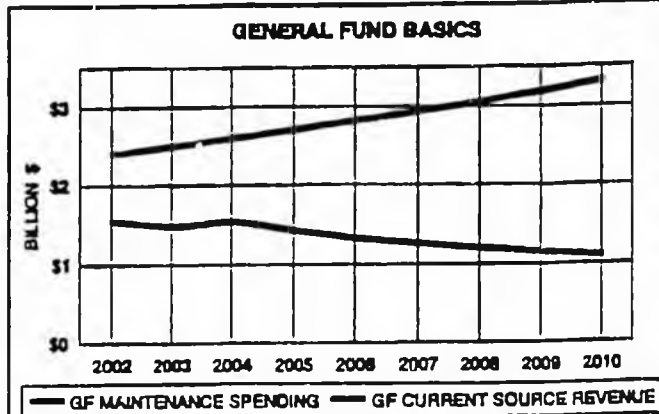
+ GF SPENDING
 + DIVIDEND
 - HOUSEHOLD TAXES
 = EMPLOYMENT FROM GOVT
 CHANGE FROM 2002

48,218	41,703	41,088	40,487	38,908	38,908	38,908	38,908	38,908	38,908
10,788	8,408	7,908	6,728	6,783	6,588	6,330	6,034	5,803	5,803
0	(412)	(1,189)	(1,841)	(2,638)	(3,288)	(3,832)	(4,823)	(5,888)	(6,888)
\$3,008	\$3,888	\$7,708	\$4,288	\$4,038	\$8,214	\$8,886	\$1,917	\$1,148	\$1,148
0	(2,308)	(8,881)	(7,721)	(8,974)	(9,782)	(10,228)	(11,688)	(13,664)	(15,864)

BUDGET BALANCING MEASURES



GENERIC FISCAL PLAN [2002 VERSION 1]



GENERIC FISCAL PLAN [2002 VERSION 1] TIMETABLE

SESSION	LEGISLATIVE ACTION	EXISTING BILL (REQUIRING REVISIONS)	ACTION EFFECTIVE FOR BUDGET YEAR										EFFECT	WHAT'S NEW WITH THE BUDGET THIS YEAR	SOURCE FOR BALANCING BUDGET THIS YEAR	
			3	4	5	6	7	8	9	0						
2002	1	PASS SPENDING CAP WITH A SUNSET CLAUSE—CAPS FY 2002, 2004, 2006, 2008 BUDGETS	HR 28	X	X	X	X							HOLD QF BUDGET GROWTH TO HALF OF INFLATION FOR 4 YEARS		CBR
	2	PASS PF ENDOWMENT TO TAKE EFFECT WITH FY 2007 BUDGET	HR 36					X	X	X	X			STABILIZE REVENUES FROM FINANCIAL ASSETS		
	3	INSTITUTE BROAD BASED TAX—PERSONAL INCOME TAX SIMILAR TO IOWA'S PROPOSAL EFFECTIVE CY 2002 WITH 8 YEAR PHASE-IN (300 MILLION PER CY STEP UP TO \$400 MILLION IN CY 2007) (HR 10 OR HR 188 AND ALTERNATIVE INCOME TAX MEASURES, HR 208 IS A SEASONAL SALES TAX)	HR 413	X	X	X	X	X	X	X	X	X		PF EFFECTIVE JAN 1, 2002 WITH 8 YEAR RAMP UP TO FULL EFFECT		
	4	REALIGN PF CONTRIBUTION RATE TO 2%	HR 3	X	X	X	X	X	X	X	X	X		ABOUT \$30 MILLION MORE TO QF AND LESS TO PF EACH YEAR STARTING FY 2008		
	5	SUBSID (BORROW) PF INFLATION PROOFING FOR 3 YEARS (UNTIL IT BECOMES AUTOMATIC WITH ENDOWMENT RULE WITH FY 2007 BUDGET)	NEW	X	X	X								BUILD UP EARNINGS RESERVE BALANCE		
	6	BALANCE FY 2008 BUDGET WITH APPROPRIATION FROM CBR	NEW	X												
2003														OF SPENDING GROWTH CAPPED REVENUES FROM PF BEGIN ADDITIONAL OF REVENUE FROM OIL FINANCIAL RESERVE ACCUMULATE IN ER CBR DRAW DOWN		CBR
	1	INCREASE ALCOHOL TAX BY 10 CENTS PER QUART OR TO 8 TIMES CURRENT LEVEL (\$80 IN)	HR 231 OR SB 8		X	X	X	X	X	X	X	X		BRING AX IN LINE WITH OTHER STATES—ABOUT \$30 MILLION TO QF		
	2	INCREASE GAS TAX BY 10 CENTS/GALLON	HR 401		X	X	X	X	X	X	X	X		BRING AX IN LINE WITH OTHER STATES—ABOUT \$30 MILLION TO QF		
	3	CRUISE SHIP TAX—\$30 PER PASSENGER	HR 228											ABOUT \$20 MILLION TO QF		
	4	IMPOSE HEAD TAX \$100 PER WORKER	HR 228 OR SB 165											ABOUT \$40 MILLION TO QF		
	5	ABOLISH CBR AND USE BALANCE TO CREATE OIL REVENUE SHOCK ABSORBER—APPROPRIATE EARNINGS AND USE PRINCIPAL ONLY WHEN OIL REVENUE FALL BELOW THE LONG TERM TREND	NEW		X	X	X	X	X	X	X	X		FORGIVE LOAN TO QF, APPROPRIATE ONLY EARNINGS, USE BALANCE ONLY FOR OIL REVENUE FLUCTUATIONS BELOW TREND		ADDITIONAL OF REVENUES AUTOMATICALLY FLOW TO QF FROM THE ANNUAL EARNINGS OF THE NEW SHOCK ABSORBER FUND CREATED FROM THE CBR
	6	AMEND DIVIDEND FORMULA TO NET ESTIMATED PF COLLECTIONS OUT OF DIVIDEND ACCOUNT FOR 3 YEARS	NEW		X	X	X							DIVIDEND CUT BY ESTIMATED AMOUNT OF INCOME TAX COLLECTIONS DURING FY 2003		DIVIDEND CUT BY ESTIMATED AMOUNT OF INCOME TAX
7	BALANCE FY 2004 BUDGET WITH APPROPRIATION FROM CBR BEFORE CONVERSION TO SHOCK ABSORBER	NEW		X												
2004														ADDITIONAL REVENUE FROM EXCISE TAX INCREASE		CBR
1	BALANCE FY 2008 BUDGET WITH PFBY APPROPRIATION FROM ER	NEW			X											
2005																ER
1	BALANCE FY 2008 BUDGET WITH APPROPRIATION FROM ER	NEW				X										
2006														ENDOWMENT RULE TAKES EFFECT THIS SESSION SPENDING CAP SUNSETS THIS LEG SESSION DIVIDEND DETERMINED BY ALLOCATION OF PF EARNINGS		ER
	1	BALANCE FY 2007 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW					X						ALLOCATE PF EARNINGS BETWEEN QF AND DIVIDEND FOR FY2007 BUDGET		
2007	1	SWEEP ER BALANCE INTO THE PERMANENT FUND TO REPAY BORROWING	NEW													PERMANENT FUND EARNINGS SPLIT
	2	BALANCE FY 2008 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW						X					ALLOCATE PF EARNINGS BETWEEN QF AND DIVIDEND FOR FY2008 BUDGET		
2008														FULL EFFECT OF PERSONAL INCOME TAX REACHED WITH FY 2008 BUDGET		PERMANENT FUND EARNINGS SPLIT
	1	BALANCE FY 2009 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW							X				ALLOCATE PF EARNINGS BETWEEN QF AND DIVIDEND FOR 2009 BUDGET		
2009																PERMANENT FUND EARNINGS SPLIT
1	BALANCE FY 2010 BUDGET AND DETERMINE THE SIZE OF THE DIVIDEND A SPLIT OF THE ANNUAL EARNINGS OF THE PERMANENT FUND (% ALLOCATION)	NEW									X		ALLOCATE PF EARNINGS BETWEEN QF AND DIVIDEND			
2010																PERMANENT FUND EARNINGS SPLIT

ASSUMPTION NOTES

FINANCIAL RATE OF RETURN

PF 98 ANNUAL REPORT

AVERAGE ANNUAL TOTAL RETURN FOR ALL YEARS BEFORE INFLATION 16.35%

GIVEN 50% STATUTORY LIMITATION ON EQUITIES, THE ASSET ALLOCATION OF THE FUND IS EXPECTED TO PRODUCE AN AVERAGE ANNUAL TOTAL RETURN OF 8.1% WHICH, AFTER NETTING OUT INFLATION IS 4.7%

THIS TARGET IS MODEST BUT REALISTIC CONSIDERING HISTORICAL MARKET RETURNS AND THE CEILING ON EQUITIES

OIL REVENUES

ANNUAL CHANGE SINCE PRODUCTION PEAKED IN 1988

PRODUCTION -4.0%
 REAL PRICE -2.0%
 REAL REVENUES (EXCLUDING SETTLEMENTS) -6.0%

INFLATION (CPI-W)

ALTHOUGH THE INFLATION RATE HAS LAGGED THE US AVERAGE OVER THE LAST 20 YEARS, THE RATES HAVE BEEN ALMOST IDENTICAL IN THE LAST 10 YEARS

	ALASKA	US
AVG 79-88	3.3%	4.7%
AVG 89-98	3.0%	2.9%
AVG 79-98	3.0%	3.8%

POPULATION

AVG 79-88	3.6%
AVG 89-98	1.4%
AVG 79-98	2.0%

DOR POPULATION GROWTH PROJECTION FALL 1998 ANNUAL AVERAGE GROWTH THRU 2025 1.1%

NON-OIL GF REVENUES

REAL ANNUAL GROWTH RATE 1980 TO 1998 EXCLUDING GF INTEREST 1.0%

WAGE AND SALARY JOB GROWTH NET OF STATE GOVERNMENT

NUMBER OF WAGE AND SALARY JOBS NET OF STATE GOVT & DIVIDEND 1.5%
 250

EMPLOYMENT MULTIPLIERS

	JOBS PER MILLION \$ (REAL) OF SPENDING	1999 \$
GF SPENDING	18.6	
DIVIDEND	11	
HOUSEHOLD TAXES	10	
CONVERSION FACTOR TO 2002\$	0.943	