

**ALASKA LEGISLATURE**

**2173**

**HOUSE and SENATE FINANCE COMMITTEE FILES,**

**2001 - 2002**

# 2002 vs. 2001 Comparison

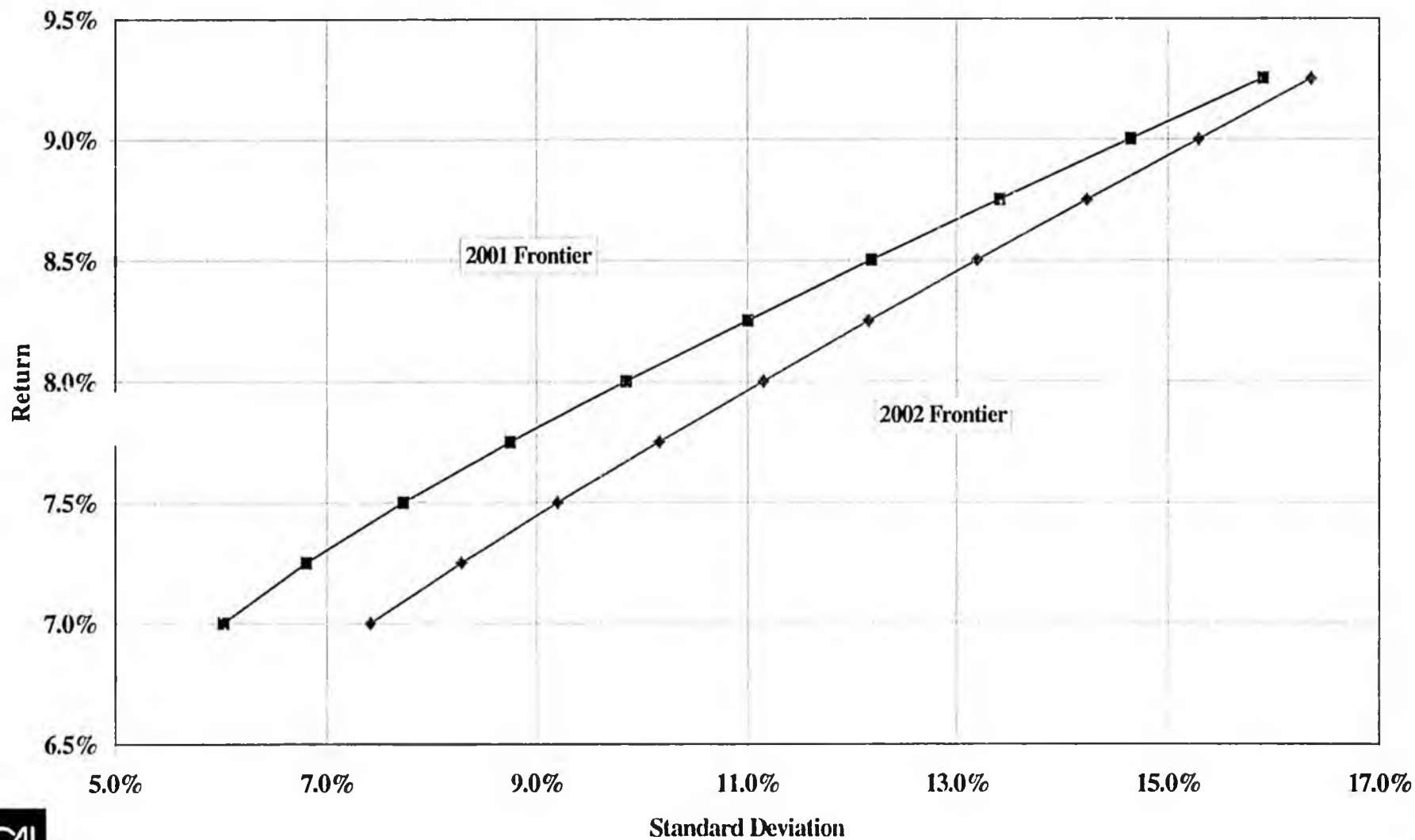
2002 <i>Asset Classes</i>	Limits		Asset Mix Alternatives									
	Min	Max	1	2	3	4	5	6	7	8	9	10
Large Dom Eq	0%	100%	18%	21%	25%	28%	31%	35%	38%	41%	45%	48%
Small Dom Eq	0%	100%	4%	5%	6%	7%	8%	8%	9%	10%	11%	12%
International Eq	0%	100%	8%	10%	12%	14%	16%	18%	20%	22%	24%	26%
Dom Fixed	0%	100%	57%	51%	45%	38%	32%	26%	19%	13%	6%	0%
International Fixed	0%	100%	6%	6%	5%	5%	4%	4%	3%	3%	2%	2%
Real Estate	0%	100%	6%	6%	7%	8%	8%	9%	10%	10%	11%	12%
Cash	0%	100%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Totals			100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Projected Return			7.00%	7.25%	7.50%	7.75%	8.00%	8.25%	8.50%	8.75%	9.00%	9.25%
Projected Risk			7.41%	8.28%	9.20%	10.16%	11.15%	12.16%	13.19%	14.24%	15.29%	16.35%

2001 <i>Asset Classes</i>	Limits		Asset Mix Alternatives									
	Min	Max	1	2	3	4	5	6	7	8	9	10
Large Dom Eq	0%	100%	12%	16%	20%	23%	28%	32%	36%	40%	44%	48%
Small Dom Eq	0%	100%	3%	3%	4%	6%	7%	8%	9%	10%	11%	13%
International Eq	0%	100%	5%	7%	10%	12%	14%	17%	20%	22%	25%	27%
Dom Fixed	0%	100%	65%	64%	56%	48%	40%	32%	24%	16%	8%	0%
International Fixed	0%	100%	6%	6%	5%	5%	4%	3%	2%	2%	1%	0%
Real Estate	0%	100%	4%	4%	5%	6%	7%	8%	9%	10%	11%	12%
Cash	0%	100%	5%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Totals			100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Projected Return			7.00%	7.25%	7.50%	7.75%	8.00%	8.25%	8.50%	8.75%	9.00%	9.25%
Projected Risk			6.03%	6.81%	7.72%	8.75%	9.85%	11.00%	12.19%	13.41%	14.65%	15.90%

2002-2001 <i>Asset Classes</i>	Limits		Asset Mix Alternatives									
	Min	Max	1	2	3	4	5	6	7	8	9	10
Large Dom Eq	0%	100%	6%	5%	5%	5%	3%	3%	2%	1%	1%	0%
Small Dom Eq	0%	100%	1%	2%	2%	1%	1%	0%	0%	0%	0%	-1%
International Eq	0%	100%	3%	3%	2%	2%	2%	1%	0%	0%	-1%	-1%

# Comparison

Efficient Frontier (Alternative Investments Excluded)



# Unconstrained Efficient Frontier

## Optimal Portfolios

Portfolio Component	Target Mx	Limits		Asset Mix Alternatives						
		Mn	Mix	1	2	3	4	5	6	7
Broad	37%	0%	100%	30%	34%	38%	42%	46%	50%	54%
Int'l Eq	16%	0%	100%	13%	15%	17%	19%	21%	23%	25%
LB Agg	35%	0%	100%	45%	39%	33%	27%	20%	14%	8%
NUS Bond	2%	0%	100%	5%	5%	5%	4%	4%	3%	3%
Real Est	10%	0%	100%	6%	7%	8%	9%	9%	10%	11%
T-Bills	0%	0%	100%	0%	0%	0%	0%	0%	0%	0%
Totals	100%			100%	100%	100%	100%	100%	100%	100%
Median	7.95%			7.50%	7.74%	7.97%	8.21%	8.45%	8.69%	8.92%
Std Dev	10.99%			9.22%	10.14%	11.08%	12.04%	13.01%	14.00%	15.00%

# Efficient Frontier with equities constrained to 60%

## Optimal Portfolios

Portfolio Component	Target Mx	Limits		Asset Mix Alternatives						
		Mn	Mx	1	2	3	4	5	6	7
Broad	37%	0%	100%	30%	34%	38%	41%	39%	35%	33%
Int'l Eq	16%	0%	100%	13%	15%	17%	18%	21%	25%	27%
LB Agg	35%	0%	100%	45%	39%	33%	28%	21%	14%	5%
NUS Bond	2%	0%	100%	5%	5%	5%	4%	2%	0%	0%
Real Est	10%	0%	100%	6%	7%	8%	8%	17%	26%	35%
T-Bills	0%	0%	100%	0%	0%	0%	0%	0%	0%	0%
Totals	100%			100%	100%	100%	100%	100%	100%	100%
Median	7.95%			7.50%	7.72%	7.94%	8.17%	8.39%	8.61%	8.83%
Std Dev	10.99%			9.22%	10.08%	10.96%	11.86%	12.81%	13.87%	15.00%

The 60% equity constraint results in huge real estate allocations beyond mix 4 because that is the only choice available to the optimizer that would increase expected returns

**2/19/02**

**AK**

**RAILROAD**

**OVER-**

**VIEW**

**HFIN**

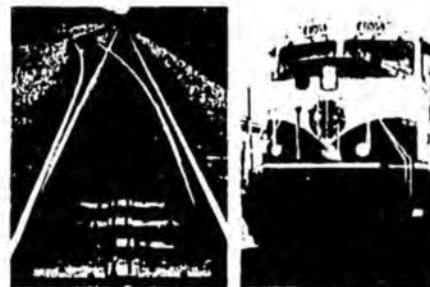
**FILE**



# Alaska Railroad Corporation

## Special Report to the Legislature and Administration State of Alaska

January 2002



2-19-02



## Introduction

January 2002

For the Alaska Railroad, 2001 was marked by solid progress in safety, community relations, revenue growth, environmental response readiness, and modernization.

In 2002, our aim is to continue steady, measurable improvement. To accomplish this goal, our 700-plus employees will continue their focus on safety and excellence on the job. The Railroad is also deeply committed to partnering. Our support to important community and borough initiatives can enhance prosperity along the railbelt, and create conditions for success that enable a more prosperous Alaska.

Essential to our endeavor is the condition of the basic rail infrastructure, and the serviceability of operating and support equipment. To that end, the ARRC Board of Directors approved a five-year capital improvement plan that leverages our modernization priorities. We hope you find the information in this report to be a useful reference throughout the legislative session.

Respectfully,

*general* Patrick K. Gamble  
President & CEO





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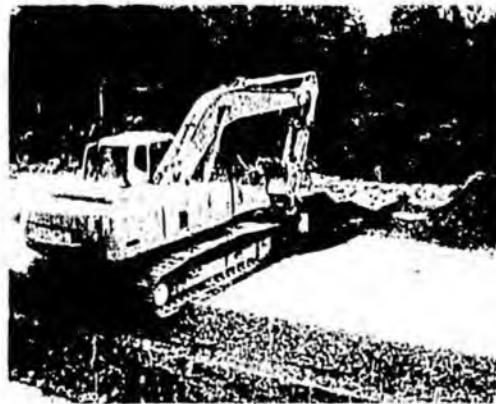
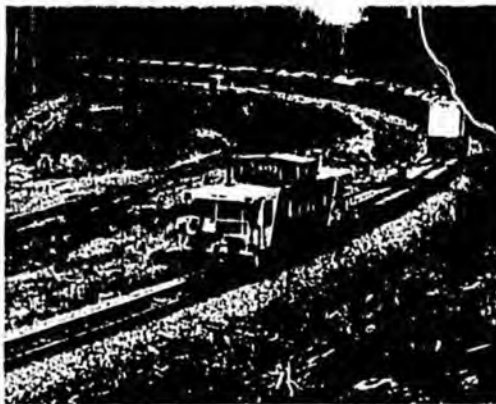
## Guiding Statements

### Vision:

Building a great railroad across the Greatland

### Mission:

To be profitable by focusing on safe, high quality service to our freight, passenger, and real estate customers. To foster the development of Alaska's economy by integrating railroad and railbelt community development plans.





# Alaska Railroad Facts

**PURCHASE PRICE:** (Jan. 5, 1985)

Paid to federal government .....\$22.3 million  
Start-up costs & contributed capital.....\$11.9 million  
Total Investment-State of Alaska.....\$34.2 million

**TOTAL ASSETS:** (Dec. 31, 2001) ..... \$304 million

**FINANCIAL STATISTICS (Preliminary):**

(Jan. 1-Dec. 31, 2001)

Total revenues.....\$104.6 million  
Total expenses .....\$97.9 million  
Net earnings..... \$6.7 million

**OPERATING STATISTICS:**

(Jan. 1-Dec. 31, 2001)

Passenger ridership .....472,275  
Freight tonnage .....7,784,418  
Revenue car loads .....96,488

**OPERATING DATA:**

Miles of main line .....466  
Miles of branch line .....59  
Miles of yards and sidings .....86  
Total miles of track .....611  
Freight cars (owned & leased).....1,672  
Passenger equipment.....43  
Locomotives .....52

**EMPLOYEES:** (December 31, 2001)

Total number of employees.....688  
Average years of service..... 10  
Average age .....42  
Male .....588  
Female ..... 100

**UNION MEMBERSHIP:** (Dec. 31, 2001)

United Transportation Union ..... 156  
Transportation Communication Union ..... 44  
International Association of Machinists ..... 62  
American Federation of Government Employees... 270  
American Train Dispatchers Department ..... 11



# Corporate Organization

## BOARD OF DIRECTORS

Chairman John Binkley

Jacob Adams • Ed Bauer • Jack Burton • Carl Marrs • Commissioner Joe Perkins (DOT) • Commissioner Deborah Sedwick (DCED)

## EXECUTIVE OFFICE

President and Chief Executive Officer, Patrick K. Gamble

External Affairs	Labor Relations	Security	Equal Opportunity
Director Wendy Lindskoog	Director Donald Smith	Chief of Security Dan Frerich	Manager Ouida Morrison

## DEPARTMENTS

Operations	P.E.T.S.	Corporate Affairs	Markets, Sales & Services	Real Estate	Finance	Legal
VP & Chief Operating Officer <b>Matt Glynn</b>  <i>Transportation            Maintenance            Mechanical            Safety</i>	VP <b>Eileen Reilly</b>  <i>Projects            Engineering            Technology            Signals</i>	VP <b>Jim Blasingame</b>  <i>Board            Corporate Analysis            Historical            Corporate Giving</i>	VP <b>Steve Silverstein</b>  <i>Passenger            Freight</i>	VP <b>Jim Kubitz</b>  <i>Leasing            Permitting</i>	VP and Chief Financial Officer <b>Bill O'Leary</b>  <i>Accounting            Human Resources            Procurement</i>	VP & General Counsel <b>Phyllis Johnson</b>  <i>Contractual            Legal</i>



## 2001 Year in Review

### **ARRC prepares to answer the call in state's economic development**

*by Patrick Gamble, President & CEO*

Reflecting back on 2001, the Alaska Railroad Corporation (ARRC) focused time and resources toward bolstering its role as a vital artery for Alaska's economic development. We energetically pursued increasing safe, responsive, and financially sound operations in order to position ourselves as the kind of partner the State, communities and businesses can depend on to support growth and development across Alaska.

While ARRC is making an effort to increase revenues, we are working to increase overall capacity as well. We brought new services online. We enhanced environmental protection measures, coordinated community planning, and took many capital projects from the planning stage into construction. We took important steps to assess and redress security weaknesses across the railroad complex.

**Customers & revenue.** Real estate proved to be a star performer. Gross revenues topped \$10 million for the first time — up from \$9.28 million last year. Freight revenue also set a record surpassing \$81 million. Gravel was up and oil field freight exceeded expectations. A record number of fuel cars were hauled from North Pole, exceeding several daily, weekly and even monthly thresholds. Passenger revenue was up. Collectively, these revenue streams provide the cash flow for our work force and our railroad services.

-more-

**New services.** Part of our freight business success is due to a flourishing business relationship established last year with Alaska Railbelt Marine, LLC, a subsidiary of Lynden Transport Inc., to provide barge service between the Lower 48 and our dock in Whittier. On the passenger side, we established the Grandview train to deliver direct Seward-Anchorage service for cruise ship customers. A new web-based passenger reservation system has gone on-line and will soon provide Internet convenience for customers, and global exposure for the Alaska Railroad.

**Environmental measures.** The Railroad significantly enhanced emergency and spill response through the purchase of new equipment, extensive employee training, and an overhaul of our spill response plan. Crafted to meet new state regulations, the plan has been filed with the Department of Environmental Conservation and is available for public review. ARRC also joined Alaska Chadux Corporation, a primary spill response co-op whose considerable experience in Alaska will contribute significantly to our railroad spill response capability.

**Community involvement and planning.** Our people have worked hard this year to better coordinate railroad planning efforts with the communities we serve. We have attended over a dozen municipality meetings. ARRC will soon be named an official member of the Anchorage Metropolitan Area Transportation Study (AMATS) Technical Advisory Committee (TAC), and has also been included in the Fairbanks Metropolitan Area Transportation Study (FMATS) TAC. We are working with several other groups, including the Anchorage and Fairbanks Chambers of Commerce, Anchorage Economic Development Corporation, Seward Centennial Committee, Resource Development Council and the Alaska 20/20 effort, to ensure the Railroad's vision complements and supports the overall plans and strategies developed by our state, municipalities and community groups.

-more-

**Capital Improvements.** Since 1996, federal funding has been laying the financial groundwork for transforming the Alaska Railroad into a safer, more reliable enterprise. In 2001, we saw years of planning materialize as construction began on several capital projects. Some are already completed. The new freight dock in Seward is up and running, track was straightened on Elmendorf Air Force Base, double track is nearly complete in south Anchorage, new sidings were constructed at key locations along the rail line, and a state of the art avalanche detection and prevention system was installed south of Anchorage in slide zones.

**Looking Ahead.** Expect the Railroad to maintain the momentum. New intermodal depots at Denali, Fairbanks and the Anchorage airport will greatly enhance passenger service, security and safety. Ongoing efforts to straighten track and automate train traffic control systems will further increase our efficiency and our speed. We are also continually working on innovative ways to produce better earnings from our real estate holdings. This year we are seeking legislative approval to lease certain railroad real estate lands for up to fifty-five years, going well beyond our current thirty-five year limit. The longer lease is much more attractive to potential customers and their financiers.

As we mature our program to modernize infrastructure and sharpen operations, and as we increase our capacity to take on more business challenges, the Alaska Railroad will grow more valuable as a partner Alaska can depend on.





# 2001 Recap: Health, Safety and Environment

## Recap of major events in health, safety and environment

### 1. *Reductions in derailment risk*

- a. Overhaul of entire GATX tank car fleet of over two hundred cars  
Based on the 2000-2001 Derailment Risk Assessment & Safety Audit, ~150 GATX tank cars had major truck overhauls to eliminate high wedge rise, a condition that often leads to derailment.
- b. Increased targeted track inspection in high risk corridors  
For example, targeted track inspection based on the risk assessment was implemented in the heavily traveled Anchorage to Matanuska corridor
- c. ARRC and federal investment in rail, ties, and ballast is paying dividends – in 2001, for the first time in recent memory, no derailments were caused by a failure in the track structure.



### 2. *Second consecutive year of less than a 2.0 train accident rate*

- a. For the second year in a row, the ARRC showed a rate of less than 2.0 train accidents per million train miles. The 2000 rate was 1.49, and 2001 finished at 1.5. The national average is 3.8 train accidents per million train miles. A train accident, according to the Federal Railroad Administration, is one with more than \$6,600 (\$6,700 as of Jan. 1, 2002) in total damage and repair costs.
- b. The ARRC safely moved 31,000 carloads of refined product from North Pole to Anchorage, a record number of carloads for Williams and the ARRC.

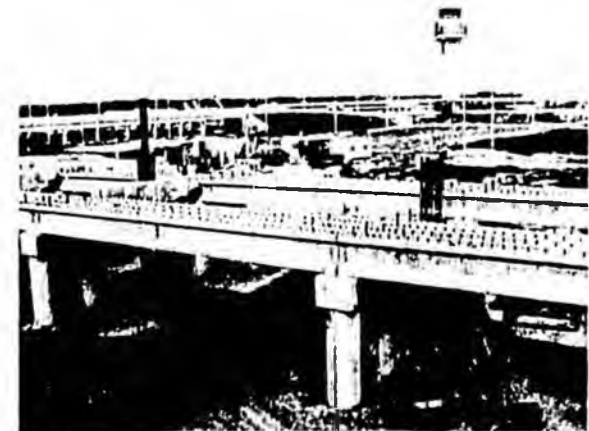
### 3. *New oil spill contingency plan*

- a. The ARRC submitted to the State of Alaska on Oct. 1, 2001, a revised and improved Oil Spill Prevention and Response Plan meeting the requirements of AS 46.040. It is in public review status and expected to be approved on or before May 1, 2002.
- b. The ARRC successfully completed a major tabletop spill response drill with the state and federal governments on Nov. 7, 2001, and a deployment drill on Dec. 18, 2001. More are planned for 2002.



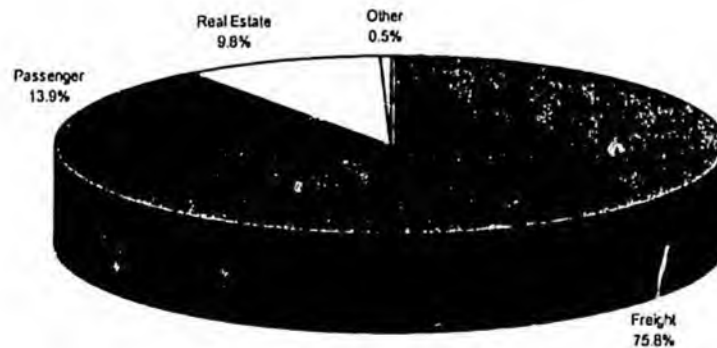
## ARRC Five-Year Objectives

- Reduce employee injuries to achieve an average of no more than 2.0 injuries per 200,000 man hours
- Invest an average of twenty percent of annual revenue in infrastructure maintenance
- Grow overall revenue three to four percent per year
- Successfully complete our federally-funded capital construction program
- Redesign and build Anchorage and Fairbanks yard facilities to meet business, growth, and community requirements
- Consistently reduce running time between Anchorage and Fairbanks to under twelve hours
- Achieve and sustain an annual real estate income of at least \$11 million per year
- Establish a formal railroad recruitment and training program
- Eliminate twenty-five percent of at-grade highway/railroad crossings in Alaska
- Fund and apply technology to train dispatching, signals and switching
- Achieve and sustain a net income, before depreciation and interest expense, of \$20 million

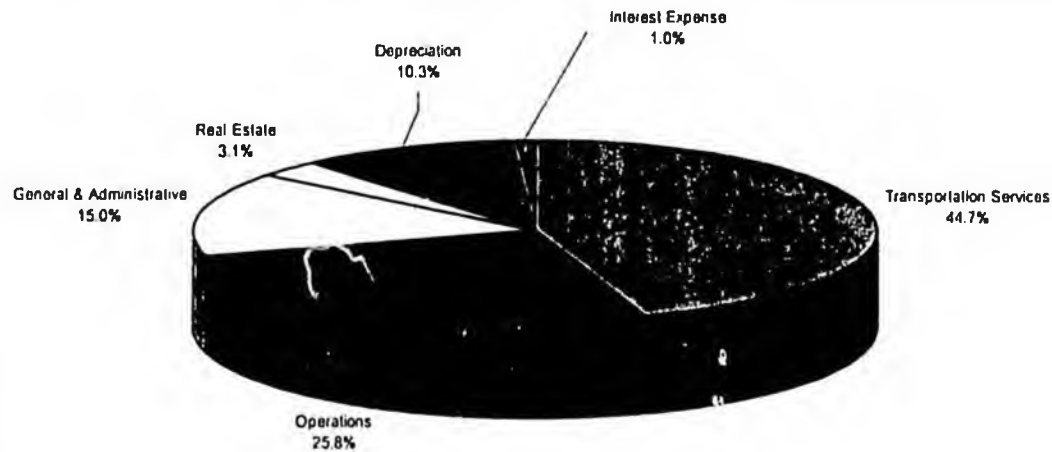




## 2002 Budgeted Revenue and Expenses



Budgeted Revenue  
\$106.9 million



Budgeted Expenses  
\$102.7 million



## 5-Year Forecast – Revenue

<i>(in millions)</i>	<b>2002 Forecast</b>	<b>2003 Forecast</b>	<b>2004 Forecast</b>	<b>2005 Forecast</b>	<b>2006 Forecast</b>
<b>Freight</b>	\$ 81.0	\$ 76.9	\$ 80.4	\$ 83.4	\$ 84.8
<b>Passenger</b>	14.9	15.6	16.3	17.1	\$ 18.2
<b>Real Estate</b>	10.5	11.0	11.3	11.6	\$ 11.9
<b>Other</b>	0.5	0.5	0.4	0.3	\$ 0.3
<b>Total</b>	\$ 106.9	\$ 104.0	\$ 108.4	\$ 112.4	\$ 115.2



## 5-Year Forecast – Summary

<i>(in millions)</i>	<b>2002 Forecast</b>	<b>2003 Forecast</b>	<b>2004 Forecast</b>	<b>2005 Forecast</b>	<b>2006 Forecast</b>
<b>Operating Revenues</b>	\$ 96.1	\$ 92.7	\$ 96.8	\$ 100.5	\$ 102.9
<b>Operating Expenses</b>	87.9	83.7	87.1	90.3	\$ 92.9
<b>Net Income – Operations</b>	8.2	9.0	9.7	10.2	\$ 10.0
<b>Net Income – Real Estate</b>	7.3	7.8	7.9	8.1	\$ 8.4
<b>Other Income</b>	0.4	0.3	0.3	0.3	\$ 0.3
<b>Net Income (before depreciation and interest)</b>	15.9	17.1	17.9	18.6	\$ 18.7
<b>Depreciation</b>	10.6	10.6	10.6	10.6	\$ 10.6
<b>Interest Expense</b>	1.1	1.1	1.1	1.1	\$ 1.1
<b>Net Income</b>	\$ 4.2	\$ 5.4	\$ 6.2	\$ 6.9	\$ 7.0



## 5-Year Forecast – Planned Capital Expenditures

<i>(in millions)</i>	<b>2002 Budget</b>	<b>2003 Budget</b>	<b>2004 Budget</b>	<b>2005 Budget</b>	<b>2006 Budget</b>	<b>TOTAL</b>
<b>ARRC Internally Generated</b>	\$ 12.9	\$ 37.1	\$ 36.2	\$ 34.3	\$ 34.9	\$ 155.4
<b>Federal Railroad Administration</b>	* 32.0	32.0	30.0	20.0	20.0	\$ 134.0
<b>Federal Transit Administration</b>	33.0	24.0	43.7	40.1	7.9	\$ 148.7
<b>Total</b>	\$ 77.9	\$ 93.1	\$ 109.9	\$ 94.4	\$ 62.8	\$ 438.1
* Actual FY02 appropriation received totaled \$30.2 million						



## 5-Year Forecast – Capital Investment Program

<i>(in millions)</i>	<b>2002 Budget</b>	<b>2003 Forecast</b>	<b>2004 Forecast</b>	<b>2005 Forecast</b>	<b>2006 Forecast</b>	<b>TOTAL</b>
<b>Vehicle / Equipment Program</b>	\$ 1.5	\$ 3.8	\$ 2.3	\$ 1.9	\$ 9.3	\$ 18.8
<b>Maintenance Program</b>	3.7	14.5	15.5	18.7	19.1	\$ 71.5
<b>Mechanical Program</b>	1.8	6.4	10.5	1.8	2.4	\$ 29.8
<b>Transportation Program</b>	1.7	4.5	2.5	0.0	0.0	\$ 8.8
<b>Marketing, Sales &amp; Service</b>	1.7	3.5	3.1	2.8	2.4	\$ 13.5
<b>Information Services</b>	1.2	1.3	0.8	0.8	0.4	\$ 4.4
<b>Communications</b>	0.2	0.3	0.5	0.4	0.5	\$ 1.9
<b>Operations</b>	0.1	0.0	0.0	0.1	0.0	\$ 0.2
<b>Real Estate</b>	0.5	2.3	0.7	0.7	0.7	\$ 4.9
<b>Health, Safety &amp; Environmental</b>	0.6	0.6	0.2	0.2	0.2	\$ 1.8
<b>Federal Railroad Administration</b>	* 32.0	32.0	30.0	20.0	20.0	\$ 134.0
<b>Federal Transit Administration</b>	33.0	24.0	43.7	40.1	7.9	\$ 148.7
<b>TOTAL</b>	\$ 77.9	\$ 93.1	\$ 109.9	\$ 94.4	\$ 62.8	\$ 438.1
* Actual FY02 appropriation received totaled \$30.2 million						

ALASKA RAILROAD CORPORATION  
Five-Year Federal Funding Capital Plan

Project ID		2002	2003	2004	2005	2006	Total
<b>Vehicle/Equipment Program</b>							
<u>1</u>	Vehicle purchase	867,000				867,000	1,734,000
<u>23</u>	H.E. Lease Equipment Buyout	133,000	120,000	120,000	120,000	493,000	986,000
<u>24</u>	Certified Rebuild 988 Loader (2)	520,000				520,000	1,040,000
<u>44</u>	Grader		250,000	250,000		500,000	1,000,000
<u>45</u>	D-6 Cat		300,000	300,000	300,000	900,000	1,800,000
<u>46</u>	Snow blower		350,000			350,000	700,000
<u>47</u>	Speed Swing		200,000	200,000		400,000	800,000
<u>48</u>	Front End Loaders (5 yd)		300,000		300,000	600,000	1,200,000
<u>49</u>	Hi Rail Boom Truck (Tundra type)		250,000		250,000	500,000	1,000,000
<u>50</u>	Locomotive Crane Rebuilds		500,000	500,000		1,000,000	2,000,000
<u>51</u>	Hydraulic Track Equipment Trailer		200,000			200,000	400,000
<u>52</u>	Jet Blower		200,000			200,000	400,000
<u>53</u>	15 Passenger Hy-Rail Bus		90,000			90,000	130,000
<u>54</u>	Grove Crane (80 Ton)				500,000	500,000	1,000,000
<u>58</u>	Strengthen Cat Cabs		50,000	50,000		100,000	200,000
<u>59</u>	Snowcat				50,000	50,000	100,000
<u>37</u>	Tampers			450,000		450,000	900,000
<u>42</u>	Pile Driver Assembly		225,000			225,000	450,000
<u>20</u>	Ballast Regulator		300,000	300,000	300,000	900,000	1,800,000
<u>142</u>	Hostler/Yard Tractors			60,000	60,000	120,000	240,000
<u>154</u>	Car mover for U.A.F. - used			75,000		75,000	150,000
<u>31</u>	Rail Profile/Geometry Vehicle		225,000			225,000	450,000
<u>215</u>	Snow machine: remote site access (Signal/Telecom)		20,000	20,000			40,000
<u>219</u>	Signal Maintainers Truck		35,000				35,000
<u>212</u>	Hyrail boom truck w/man lift (Signal/Telecom)		175,000				175,000
	Subtotal	1,520,000	3,790,000	2,325,000	1,880,000	9,265,000	18,780,000
<b>Maintenance</b>							
<u>220</u>	Light Plant @ Hurricane		60,000				60,000
<u>2</u>	MOW Lodging Facilities & Section Improvements	200,000	300,000	300,000	300,000	300,000	1,400,000
<u>3</u>	Equipment Shed at Tunnel	50,000					50,000
<u>5</u>	Equipment Shed @ Hurricane	50,000					50,000
<u>6</u>	Equipment Shed to FBX Roundhouse		200,000				200,000
<u>7</u>	Electric System Rehabilitation - Anch & Fbks shops	600,000	750,000	750,000	750,000	750,000	3,600,000
<u>8</u>	Premium rail for worn curves		1,125,000	1,020,000	1,020,000	1,020,000	4,185,000
<u>10</u>	Bridge - Renewal, upgrade or elimination	500,000	1,250,000	1,250,000	1,250,000	1,250,000	5,500,000
<u>11</u>	Ballasted Surfacing		1,800,000	1,800,000	1,800,000	1,800,000	7,200,000
<u>12</u>	Crossties	385,000					385,000
<u>13</u>	Switches & Curve Ties - System-wide		322,500	322,500	322,500	322,500	1,290,000
<u>14</u>	Brush cutter Purchase			375,000			375,000

ALASKA RAILROAD CORPORATION  
Five-Year Federal Funding Capital Plan

Project ID		2002	2003	2004	2005	2006	Total
	<b>Maintenance - continued</b>						
15	Rip Rap Placement	100,000	150,000	150,000	150,000	150,000	700,000
16	Build shoulders		62,500				62,500
17	Hydraulic Tools for MOW Sections	80,000	80,000	80,000	80,000	80,000	400,000
18	Roofs - Anch Shops	400,000	500,000	500,000	250,000	250,000	1,900,000
19	Loco Fueling Facility		1,000,000	1,000,000			2,000,000
21	Switch Rehabilitation - Anch & Fbks Yards		150,000	150,000	150,000	150,000	600,000
204	Anch Yard 6,000' track	1,000,000					1,000,000
287	Portage Door #4 gas installation	20,000					20,000
22	Yard Tracks Relays Upgrades		750,000	750,000	750,000	750,000	3,000,000
27	Anchoring						
28	Install pre-built switches @ Nenana						
29	Ballast Cleaning		450,000	450,000	450,000	450,000	1,800,000
30	Drainage Improvements		750,000	750,000	750,000	750,000	3,000,000
32	Yard Paving - Anch/Fbks	100,000	100,000	100,000	100,000	100,000	500,000
280	Utility relo & demo of Warehouse 3	150,000	680,000				830,000
33	Slide Zone Detection/Mitigation				250,000	250,000	500,000
34	Install Larger Tie Plates		400,000	400,000	400,000	400,000	1,600,000
35	Lap Top w/Track Database Programs		10,000	20,000	20,000		50,000
36	MOW Work Tracks			200,000	100,000	100,000	400,000
38	Purchase Ballast Cars			700,000	700,000	700,000	2,100,000
39	Crossings			75,000	75,000	75,000	225,000
40	Eielson Branch Upgrade			250,000	250,000	250,000	750,000
41	Switch & Crossing Grinder			2,500,000			2,500,000
43	HE Repair Shop Tools/EQ - Continued purchase of shop tools	30,000	30,000	30,000	30,000	30,000	150,000
55	Heavy Equipment Shop Relocation				7,000,000		7,000,000
56	Locomotive Heavy Repair Rehabilitation/Relocation					7,000,000	7,000,000
60	Geographical Information System				60,000		60,000
61	<b>Bridges &amp; Tunnels</b>						
62	Tunnels		100,000	110,000	110,000	110,000	430,000
63	Steel Bridges - Foundation Rehabilitation		500,000	540,000	625,000	585,000	2,250,000
64	Resurrection River Bridge Extension		2,300,000				2,300,000
65	<b>Facilities North</b>						
66	Fbx Mechanical Shops Electrical Upgrade		75,000	75,000	50,000	25,000	225,000
67	Fbx Freight House Doors		20,000				20,000
68	Automatic Static Scale Track-Remote Display		10,000				10,000
69	Fbx Yard Heat System Conversion				350,000	850,000	1,200,000
70	Fbx Scale Rehab			25,000			25,000
71	Section - Cantwell Garage			40,000			40,000
72	<b>Facilities South</b>						
73	Anchorage Shop Sprinklers		75,000	175,000	75,000	75,000	400,000

ALASKA RAILROAD CORPORATION  
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Project ID		2002	2003	2004	2005	2006	Total
<b>Maintenance - continued</b>							
74	Diesel Repair Shop - Roof drains, windows etc		50,000	75,000	50,000	150,000	325,000
75	General Repair Shop - Roof drains, windows, etc		50,000	75,000	50,000	150,000	325,000
76	Fencing		50,000	50,000	50,000	50,000	200,000
77	Car and Coach Shop - Roof drains, windows, heat etc		25,000	25,000	75,000	25,000	150,000
78	Yard Lighting - Fixture Upgrade/Replacement - Anch		10,000	10,000	10,000	10,000	40,000
79	Whittier - Electrical Distribution and Lighting		40,000	135,000	120,000	40,000	335,000
80	Sanitary Sewer - trunk extensions - Anchorage		50,000	50,000	50,000	50,000	200,000
81	Storm Drains - Rehabilitation and extensions - Anchorage		50,000	50,000	50,000	50,000	200,000
82	Anchorage Shop Water systems upgrade/meters		50,000				50,000
83	Boiler Plant - Stack Monitoring System		75,000				75,000
84	Mechanical Offices - Siding Replacement		25,000				25,000
85	Nose Stall Shed, Foundation Rehabilitation - Anchorage		15,000	15,000			30,000
86	Wheel Shop - Heating Improvements			40,000			40,000
87	Water Tower Fencing			15,000			15,000
88	Warehouse #3 - Freeze Protection			60,000			60,000
	Subtotal	3,665,000	14,490,000	15,487,500	18,672,500	19,097,500	71,412,500
<b>Mechanical</b>							
89	P-30 Overhaul	122,000					122,000
90	Wheel garden			300,000			300,000
91	Wheel shop work flow (carryover 2001)	161,000		327,000			488,000
93	FBX 5 ton overhead crane (carryover 2001)	89,500					89,500
95	Armature Oven (carryover 2001)	25,000					25,000
96	Fall Protection (carryover 2001)	20,000					20,000
282	Psgr car bearing conversion (carryover 2001)	30,000					30,000
97	Overhaul Trucks for 6 locomotives	138,000	140,000	140,000	140,000	140,000	598,000
98	General Locomotive Overhauls	722,500	1,000,000	800,000	800,000	800,000	4,122,500
208	Reposition derrails and blue light equip						
99	Install 8 digital fuel gauge systems/year	32,500	32,500	32,500	16,250		113,750
100	Install toilets, insulation, and heat in 8 locomotives	87,500	175,000	175,000	175,000	175,000	787,500
101	Send 8 locomotives outside for repainting	122,000	245,000	245,000	245,000	245,000	1,102,000
102	Modify / Purchase wheel boring machine	60,000		550,000			610,000
209	Modernize electrical systems in diesel shop/genl repair		600,000				600,000
104	Small power tool replacement	20,000	20,000	20,000	20,000	20,000	100,000
105	Purchase floor cleaning machine	25,000					25,000
106	Purchase/install Timken rail friction management system		25,000	25,000	25,000	25,000	100,000
107	Construct pole barn w/lights FBX wheel garden	30,000					30,000
103	Design/install paved locomotive power testing pad			140,000			140,000
108	Purchase 6 pair HOT/EOT devices	60,000	60,000	60,000	60,000	60,000	300,000
109	Purchase/apply pass car trucks for bag cars 110 & 111		150,000				150,000
210	Install Psgr Train and Locomotive Wash Facility		1,300,000				1,300,000

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Project ID		2002	2003	2004	2005	2006	Total
<b>Mechanical - continued</b>							
110	Purchase/install air dryers for locomotives and RDCs		136,000	136,000	136,000	136,000	544,000
111	Convert 38 MOW friction bearing cars to roller bearing trks		200,000	200,000	200,000	778,000	1,378,000
114	Purchase replacement boom for 290 Hoesch truck						
113	Improve overhead lighting in all Mechanical Dept shops						800,000
116	Install locomotive shutdown heating/starting system						1,120,000
112	Convert aux generators on 8 locomotives from DC to AC						572,000
115	Pave employee parking/roads by bldgs 26,27, & 63						50,000
117	Install one lateral load detection and reporting system						500,000
119	Purchase replacement band saw for Boiler Shop		40,000				40,000
120	Equip 4 SD70 MACs for distributive power operation			450,000			450,000
118	Rebuild/remodel offices in General Repair Shop		200,000				200,000
122	Anchorage Locomotive Service Facility Design		200,000				200,000
127	Construct new Anchorage locomotive service facility			5,500,000			5,500,000
128	Locomotive Inspection and Repair Facility Design			200,000			200,000
129	Locomotive Inspection and Repair Facility				7,000,000		7,000,000
	Subtotal	1,745,000	4,523,500	9,300,500	8,817,250	2,379,000	29,807,250
<b>Transportation Projects</b>							
131	Head in Williams Loop	1,316,106					1,316,106
132	New Yard Office/Operations Center Upgrade	200,000	1,000,000	2,000,000			3,200,000
133	Automatic Low Banner Switch	20,000	20,000	20,000	20,000	20,000	100,000
221	Seward End Ramp Off Track 1	20,000					20,000
217	Teaming Area with Track	150,000					150,000
155	Whittier yard improvements		500,000	500,000			1,000,000
134	Distributed Power		1,000,000				1,000,000
135	Coal Interchange		2,000,000				2,000,000
	Subtotal	1,706,106	4,520,000	2,520,000	20,000	20,000	8,786,106
<b>Markets, Sales &amp; Services</b>							
136	Wheelchair lifts	15,000	15,000				30,000
137	Whittier freight dock improvements	1,600,000					1,600,000
146	Container cars		600,000	400,000	400,000	400,000	1,800,000
145	Baggage bins	10,000		10,000		10,000	30,000
148	Finish electrification of TOFC cars		25,000				25,000
150	Spreader bar for Fairbanks	30,000					30,000
149	Electrify container cars		25,000	25,000	25,000	25,000	100,000
147	Chain tie-down cars		150,000	150,000			300,000
141	Restroom Upgrade to 6 DHI cars		60,000	60,000			120,000
156	Seward Freight Dock Crossover		400,000				400,000
261	Fbks Pipe Yard Track			170,000			170,000

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Project ID		2002	2003	2004	2005	2006	Total
<b>Markets, Sales &amp; Services - continued</b>							
138	Low level dome seating			150,000	150,000		300,000
139	Seat Replacement DM cars			160,000	160,000		320,000
140	Steel Hopper Acquisition - Leased and retired car replacement		1,800,000	1,800,000	1,800,000	1,800,000	7,200,000
151	Magnet controls for 2nd forklift		20,000				20,000
152	New (used) general service flats		150,000	150,000	150,000	150,000	600,000
153	New Scale for Anchorage & Fairbanks		130,000		130,000		260,000
211	Dining car kitchen upgrades		150,000				150,000
	Subtotal	1,655,000	3,525,000	3,075,000	2,815,000	2,385,000	13,455,000
<b>Information Services</b>							
<b>Infrastructure</b>							
157	Network Server Upgrades	130,000	125,000	50,000	100,000	100,000	505,000
158	Wide Area Network	95,000	120,000	30,000	70,000	100,000	415,000
159	Tape Library System	270,000	83,200	50,000	25,000	15,000	443,200
160	Disaster Recovery		50,000	10,000	50,000	100,000	210,000
161	Network Printer Upgrade Program	8,000	8,000	8,000	8,000	8,000	40,000
<b>Corporate Applications</b>							
162	Grant Application - NEPA/Permit Tracking	12,000	10,000	6,000	6,000	6,000	40,000
163	Preventative Maintenance System	500,000	500,000	250,000	200,000		1,450,000
164	Plotter replacement - REO		7,000				7,000
165	Wireless handheld development - Transp	60,000	70,000	30,000	30,000	30,000	220,000
166	Signal Reporting DB		8,000		20,000		28,000
167	GIS Track and Watershed DB		16,000	100,000	20,000	20,000	156,000
260	GIS Strategic Plan and Implementation	75,000					75,000
168	Locomotive Fuel Tracking	20,000	10,000				30,000
169	Online Freight Quotes		20,000	5,000			25,000
170	Financial System HW Upgrade			20,000	200,000		220,000
281	Automated Time & Attendance		250,000	80,000	50,000		380,000
171	OIS System HW Upgrade			200,000			200,000
	Subtotal	1,170,000	1,277,200	839,000	779,000	379,000	4,444,200
<b>Telecom and Signaling</b>							
172	Replace Yard & Radio Telephones	31,000	30,000	30,000	30,000	30,000	151,000
173	Type "D" dragging equip detectors	38,500	77,700	66,600	38,500		221,300
175	Battery Plant Replacement	20,000	20,000	20,000	20,000	20,000	100,000
176	Hot Wheel/Hot Bearing/Clearance/Dragging Detector	31,571	31,571	31,571			94,713
177	Test Equipment		40,000	20,000	20,000	20,000	100,000
178	Type "C" hot bearing detectors	18,000	18,000	18,000	106,000	106,000	266,000
179	Type "A" dragging equip detectors			22,200	22,200	22,200	66,600
213	Crossing signal batter replacement		50,000	50,000	50,000	50,000	200,000

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Project ID		2002	2003	2004	2005	2006	Total
<b>Telecom and Signaling - continued</b>							
214	Crossing signal electronic upgrades			20,000	20,000		40,000
218	Replace Battery In Crossing Signal	50,000	50,000	50,000	50,000	50,000	250,000
180	Telephone Switch			200,000		200,000	400,000
	Subtotal	189,071	317,271	528,371	356,700	498,200	1,889,613
<b>Operations Division</b>							
181	Print Shop Copier	80,000			50,000		130,000
182	Records Retention Program	30,000	10,000	10,000			50,000
	Subtotal	110,000	10,000	10,000	50,000		180,000
<b>Real Estate</b>							
183	Delong Dock	150,000					150,000
187	Plaza Project - gate mode, fence ext, (carryover 2001)	34,000					34,000
190	Utility Projects	200,000	200,000	200,000	200,000	200,000	1,000,000
191	Freight House - Ph 1 Improvements	100,000	1,500,000				1,600,000
192	Depot - sidewalk/landscape/GOB improvements						
193	Street Lights. N side of Ship Creek Ave.						
195	Leasehold Improvements		500,000	500,000	500,000	500,000	2,000,000
196	Ship Creek sidewalk/landscape/depot improvements						
205	Chena Pond	50,000					50,000
286	GOB/Depot Building		50,000				50,000
	Subtotal	534,000	2,250,000	700,000	700,000	700,000	4,884,000
<b>Health, Safety and Environmental</b>							
285	Emergency Response (carryover 2001)	30,000					30,000
197	Safety Committee Funding	150,000	200,000	200,000	200,000	200,000	950,000
198	HSE Database Overhaul	25,000	10,000		10,000		45,000
199	POL Soil Decanter	15,000					15,000
201	Anchorage Terminal Fuel Facility Compliance	200,000	140,000				340,000
202	Fairbanks Terminal Fuel Facility Compliance	100,000	100,000				200,000
203	Remote Fuel Facility Compliance Upgrades	50,000	70,000				120,000
200	Fuel Storage Best Practice Upgrades		50,000				50,000
	Subtotal	570,000	570,000	200,000	210,000	200,000	1,750,000
	<b>Total</b>	<b>12,864,177</b>	<b>35,272,971</b>	<b>34,985,371</b>	<b>34,300,450</b>	<b>34,923,700</b>	<b>155,388,669</b>

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Project ID		Prior Year Capital Amount	2002	2003	2004	2005	2006	Total
	<b>FRA Track Program</b>							
<u>R-01</u>	<b>Base Line Changes</b>							
	Appropriations Received	20,000,000						20,000,000
	*** 2002 Appropriation		12,000,000					12,000,000
	Future Funding Requests			12,000,000	10,000,000			22,000,000
	Subtotal	20,000,000	12,000,000	12,000,000	10,000,000			54,000,000
<u>Siding</u>	<b>Siding Access Program:</b>							
<u>R-02</u>	Susitna - New		1,850,000					1,850,000
<u>R-04</u>	Eklutna - extend		114,900					114,900
<u>R-07</u>	Summit - extend/relay		650,000					650,000
<u>R-08</u>	Hunter - relay		139,000					139,000
<u>R-09</u>	Houston - relay		85,000					85,000
<u>R-15</u>	Manley - relay		135,000					135,000
<u>Track</u>	<b>Track Rehab Program:</b>							
<u>R-20</u>	GEHH Signal Equipment		2,000,000					2,000,000
<u>R-21</u>	Signal Install		3,363,875					3,363,875
<u>R-22</u>	Gold Creek - heat		332,000					332,000
<u>R-39</u>	Indian - relay		150,000					150,000
<u>R-26</u>	Rail		2,537,000					2,537,000
<u>R-27</u>	Ties		2,913,000					2,913,000
<u>R-28</u>	Bridge		2,325,000					2,325,000
<u>R-29</u>	Drainage Improvements		250,000					250,000
<u>R-32</u>	Healy Canyon Stabilization/Realignments		500,000					500,000
<u>R-38</u>	Ballast/Surfacing South End		868,125					868,125
<u>R-38</u>	Ballast/Surfacing		1,787,100					1,787,100
	<b>Siding Access and Track Rehab Program:</b>							
	Future Funding Request			20,000,000	20,000,000	20,000,000	20,000,000	80,000,000
	Subtotal		20,000,000	20,000,000	20,000,000	20,000,000	20,000,000	100,000,000
	<b>FTA 5309 Earmark Projects</b>							
	<b>Fairbanks Intermodal</b>							
<u>T-01</u>	Fairbanks Intermodal/Depot	8,771,458						8,771,458
<u>T-02</u>	Fairbanks Loop Track : Pending 2002 Appropriation		1,293,750					1,293,750
<u>T-03</u>	Fairbanks Passing Track : Pending 2002 Appropriation		737,500					737,500
<u>T-04</u>	Fairbanks Maint Inspection Pil : Pending 2002 Appropriation		718,750					718,750
<u>T-08</u>	Whittier Underpass	2,284,894						2,284,894
<u>T-09</u>	Wasilla Intermodal Facility	1,250,000						1,250,000
<u>T-10</u>	Denali Depot	3,713,681						3,713,681

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Project ID		Prior Year Capital Amount	2002	2003	2004	2005	2006	Total
<u>T-11</u>	<b>Ship Creek Intermodal</b>							
	Appropriations To Date	5,334,688	6,189,467					11,524,155
	Future Funding Request			4,300,000	6,218,696	15,000,000	7,957,149	33,475,845
<u>T-32</u>	<b>Seward Passenger Transit Improvements:</b>							
	2002 Appropriation		3,500,000					3,500,000
	Subtotal	21,354,721	12,439,467	4,300,000	6,218,696	15,000,000	7,957,149	67,270,033
	<b>FTA 5309 New Start</b>							
	<b>Track Program - Wasilla to Girdwood</b>							
<u>T-05</u>		11,305,180						11,305,180
<u>T-06</u>	Eagle River - Knik	12,505,563						12,505,563
<u>T-07</u>	So Anchorage Double Track	7,027,300						7,027,300
<u>T-12</u>	<b>Wasilla Rail Realignment</b>							
	2002 Appropriation		3,250,000					3,250,000
	*** Future Funding Request			30,000,000	30,000,000			60,000,000
	Subtotal	30,838,043	3,250,000	30,000,000	30,000,000			94,088,043
	<b>FTA 5309 Fixed Guideway Modernization Projects</b>							
<u>T-13</u>	<b>DMU Acquisition</b>							
	Future Funding Request		5,495,628					5,495,628
	Future Funding Request			2,000,000	2,000,000	2,000,000	2,000,000	8,000,000
<u>T-14</u>	NEPA OVL to N leg wye AIA : Pending 2002 Appropriation		1,000,000	500,000	500,000	500,000	500,000	3,000,000
<u>T-15</u>	Campbell Creek Bridge and CTC So Anch:							
	2002 Appropriation		4,800,000					4,800,000
	Subtotal		11,295,628	2,500,000	2,500,000	2,500,000	2,500,000	21,295,628
	<b>FTA 5307 Projects</b>							
	<b>Planning</b>							
<u>T-16</u>	• Chester Creek: NEPA	144,453						144,453
<u>T-41</u>	• NEPA / Planning		126,295					126,295
<u>T-17</u>	• Transit Security	144,850	48,151	48,151				241,152
	<b>Construction</b>							
<u>T-19</u>	• Anch Car Shop Design and Eng	730,740	986,440	3,983,974				5,701,154
	• Standby Electric / Potable Water	525,000	20,000					545,000
<u>T-10</u>	• Denali Depot	763,967						763,967
<u>T-31</u>	• Ship Creek Trail Construction			1,500,000				1,500,000
<u>T-23</u>	• Whittier Transit Shed Demolition	975,000						975,000
<u>T-24</u>	• Whittier Maintenance Shed Replacement	1,225,000	1,000,000					2,225,000
<u>T-40</u>	• Whittier: Multimodal planning	512,500						512,500
<u>T-33</u>	• Talkeetna Access		510,000					510,000
	• Anchorage Depot & Annex Improvements							
<u>T-34</u>	• Anc Depot -sidewalk/landscape/GOB Improvements		50,000					50,000

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Project ID		Prior Year Capital Amount	2002	2003	2004	2005	2006	Total
	<b>Transit Security Construction - continued</b>							
<u>T-35</u>	Street Lights - N side of Ship Creek Ave		50,000					50,000
<u>T-36</u>	Ship Creek Sidewalk/landscape/depot improvements		400,000					400,000
	<b>Equipment</b>							
<u>T-37</u>	Restroom upgrade 6 DHI		60,000					60,000
<u>T-25</u>	Overhaul RDC 712 & 701	1,370,000						1,370,000
<u>T-27</u>	Remodel 3 ARRC passenger cars	500,000	500,000	500,000				1,500,000
<u>T-29</u>	** FT 40s - Includes In Kind Match	1,216,371	2,206,239					3,422,610
<u>T-38</u>	RDC - Phase 2 rebuild engine and gallery 600 generator		75,000					75,000
	Amtrack Domes/Diners	3,949,590						
	<b>Completed Section 5307 Projects</b>	16,018,054						16,018,054
	<b>Future Funding Request</b>				6,032,125	6,032,125	6,032,125	18,096,375
	Subtotal	24,125,935	6,032,125	6,032,125	6,032,125	6,032,125	6,032,125	54,286,560
	<b>Total</b>	96,318,699	65,017,220	74,832,125	74,750,821	43,532,125	36,489,274	390,940,264

**Notes:**

- Reconciliation of prior year capital budget
- \*\* Change funding source
- \*\*\* Actual appropriation received totaled \$30.2 million
- \*\*\*\* See Page 29



## Program of New (2002) Capital Projects

The Alaska Railroad continues to pursue a comprehensive program of capital improvements. The railroad is investing heavily in rail, ties, bridges and ballast to completely renovate its infrastructure. Safety and efficiency upgrades include projects to straighten the main track between Anchorage and Wasilla, build longer sidings (railroad "passing" lanes) and add automated and heated switches. The railroad is also capitalizing on opportunities to better serve Alaskans through new depots, passenger services and equipment. Detailed descriptions of these projects are available on the Railroad's website: [www.alaskarailroad.com](http://www.alaskarailroad.com).

Funding for much of the capital projects program comes from more than \$246 million in federal grants received since 1996. Funds have come from the Federal Railroad Administration (FTA), Federal Transit Administration (FTA), Federal Highway Administration (FHWA) and Congressional earmarks through various agencies, such as the U.S. Forest Service. FTA-funded projects require 20% - 40% matching funds, which are drawn from railroad net earnings. In addition to the local funding match, ARRC is investing an additional \$12 million of internally generated capital funds in numerous other projects.

### Projects Under Construction/Design in 2002

#### 137 Whittier Barge Slip Side Unloading Facility

Design is complete on a project to accommodate unloading from the side of the Railroad's existing barge dock. Construction on two 34-by-60-foot elevated platforms and associated trackage is scheduled to begin in spring 2002. Funded 100% by the Railroad, the \$1.6 million project will significantly improve safety and efficiency of barge operations.

#### R-28 Bridge Program

The Alaska Railroad's 500-plus miles of mainline track includes 169 bridges that cross barriers ranging from trickling streams to plunging gulches. The Railroad's 2002 Bridge Program of \$2.325 million in major maintenance, overhaul and replacement projects needed to maintain Railroad integrity, safety and efficiency. The program is funded with \$1.825 million from the FRA and \$500,000 from the ARRC.

#### Siding Siding Improvements

In 2000, the Railroad developed a five-year Siding Access Plan to place remote control power switches and heaters at about 40 sidings between Seward and Fairbanks, to extend 13 existing sidings and to build seven new sidings. The FRA has earmarked \$10 million to fund 2002 siding projects.

**T-01 Fairbanks Intermodal Facility and Depot**

Preliminary design and engineering is complete on an intermodal facility and depot in Fairbanks. Proposed plans are to locate the new Fairbanks Intermodal Facility on a 32-acre site adjacent to the Alaska Railroad (ARR) operations yard, near the intersection of Johansen Expressway and Danby Road. Funded 80% by FTA and 20% by the Railroad, the \$11.5 million project will begin construction in 2002, with completion in 2003.

**T-05 Anchorage to Wasilla Track Realignment**

Efforts to straighten the track from Anchorage to Wasilla are underway, which will increase train speeds, increase efficiency and improve safety along this stretch. Funded by FRA, the \$54 million Anchorage to Eagle River phase started construction in 2001 and should be complete in 2004. Funded 80% by FTA and 20% by the Railroad, the \$23.8 million Eagle River to Wasilla phase should enter construction in 2002, with completion in 2004.

**T-07 South Anchorage Double Track**

Construction is underway on a project to add about five miles of new mainline and signalized main track between 120<sup>th</sup> Avenue (Near Klatt Road) and the Minnesota Drive overpass, within the Railroad's right of way. The second track will improve efficiency and safety along the currently congested mainline through Anchorage. Funded 80% by FTA and 20% by the Railroad, the \$11.8 million double track project will be complete in Winter 2003.

**T-08 Whittier Pedestrian Underpass**

Construction is nearly complete on a 300-foot-long, 10-foot-in-diameter pedestrian underpass traversing the rail yard, which lies between the town of Whittier and the waterfront. Funded 80% by FTA and 20% by the Railroad, the \$2.285 million project will be completed by Summer 2002.

**T-10 Denali National Park Rail Station**

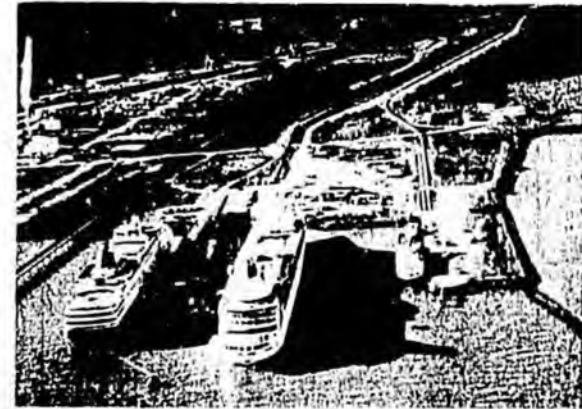
Design and engineering got underway in 2001 to improve the passenger depot and surrounding facilities at Denali National Park. Construction on the \$5.0 million project begins in spring 2002, with completion expected in 2003. Funding comes 80% from FTA and 20% by the Railroad.

**T-24 Whittier Maintenance Facility**

Design is complete on a new equipment maintenance building in Whittier. Located in the southeast corner of the rail yard, the 4,793-square-foot building will store and maintain heavy equipment, such as graders and bulldozers. Funded 80% by the FTA and 20% by the Railroad, the \$2.225 million project will be constructed in 2002.

### **T-32 Seward Passenger Dock**

In conjunction with the freight dock project in 2001, the Railroad overhauled the existing dock to serve as a passenger-only facility. This greatly improves safety and efficiency, and brings the existing facility into compliance with State and Federal regulations. Funded by FRA, FHWA and the Railroad, the project included \$2.7 million spent to improve the passenger dock, including connection to the city sewer service. Another \$3.5 million is budgeted to complete the renovation in 2002-2004.



### **T-33 Talkeetna Access / Depot Improvements**

The Railroad has allocated funding from its Sec 5307 FTA program to pursue a Talkeetna passenger facility improvements including: a) extending the existing platform 200 feet to accommodate load/unload of longer passenger trains; b) widening and paving the platform; c) adding a small, gravel long term parking area; and d) constructing a two-way, paved driveway to connect to the Talkeetna Spur Road. The proposed budget is \$510,000.

### **Track Track Rehabilitation**

The 2002 track rehabilitation program calls for replacement of rail, ties and ballast in areas of critical need. The Railroad's \$9.415 million 2002 budget for rail, tie and ballast is funded primarily by the FRA, with additional funds from the Railroad:

- \$2,537,000 (FRA) + \$300,000 (ARR) for rail and joint elimination
- \$2,913,000 (FRA) + \$1,010,000 (ARR) for cross ties and switch ties
- \$2,655,225 (FRA) for ballast and surfacing

## Projects in the Planning Phase

### **R-32 Healy Canyon Safety & Reliability Study**

The Railroad has requested federal funding to execute a \$74 million program to completely redress numerous safety and structural conditions through Healy Canyon. The 10-mile stretch lies between Denali Park (MP 348) and Healy (MP 358).

### **T-09 Wasilla Intermodal Transit Facility**

The Railroad is considering an intermodal transportation facility in the Wasilla area. The bulk of environmental research and documentation, and public involvement activities, are projected for 2003, with construction to take place in 2004. The \$1.2 million budget is funded 80% by FTA and 20% by the Railroad.

### **T-11 Ship Creek Intermodal**

Planning is underway to conceptualize a Ship Creek area transportation hub that provides bus and rail facilities, pedestrian improvements, new rail platforms, bus/van stops, retail development, airport accommodations and visitor information. In 2002, the Railroad plans to pursue preliminary concept work, organize public and agency scoping meetings, and conduct pre-NEPA studies and documentation. The \$4.5 million budget for these initial steps is funded 80% by FTA and 20% by the Railroad. The intermodal design could be significantly influenced by a decision to place the Anchorage Convention Center down in Ship Creek.

### **T-12 Wasilla Rail Relocation**

In September 2000, the City of Wasilla commissioned a study to develop alternatives and estimate costs for relocating the Alaska Railroad around the community. The City of Wasilla commissioned LCMF Incorporated to perform the reconnaissance study. Entitled *Wasilla Alaska Railroad Relocation Reconnaissance Study*, the draft document reviews six options, including a "no build" option and five different rail relocation routes. Congress appropriated \$2.5 (requiring at least a 20% local match by ARRC) to pursue track upgrades, relocations and signalization including an environmental impact study and further planning in the Wasilla area. However, due to the costs identified in the reconnaissance study and a recent change in funding match language for larger projects like this one from twenty percent to forty percent, Wasilla and the ARRC mutually agreed the relocation project was unaffordable. Both organizations, along with ADOTPF, are working together to identify alternative rail safety improvements in the Wasilla area.

**T-14 Anchorage Yard-to-Airport Capacity**

The Railroad is investigating alternatives to increase capacity along the mainline track from the Anchorage Rail Yard to the Anchorage International Airport Spur. Alternative analysis in 2002 will entail preliminary engineering, various environmental studies required for National Environmental Policy Act (NEPA) documentation, and public involvement activities. Funded 80% by FTA, the \$1 million project will set the stage for future design and construction.

**T-19 Anchorage Yard Passenger Car Shop**

Preliminary design got underway in 2001 for a new passenger car shop in the Anchorage Yard. The facility is needed to accommodate the Railroad's expanded fleet of passenger trains. Funded 80% by FTA and 20% by the Railroad, the \$2.32 million design and engineering effort will be complete in 2002. Construction timing and cost will depend on the design selected and funding availability.

**T-40 Whittier Intermodal Planning Study**

The Railroad contracted an Intermodal Planning Study focused on improving passenger-related amenities to facilitate tourism growth in Whittier. Goals include better passenger and pedestrian safety, increased passenger service, segregated passenger and freight operations and construction of new passenger and maintenance facilities. Due for completion in 2002, the \$282,500 study and conceptual design is funded 80% by FTA and 20% by the Railroad.



# Program of New (2002) Capital Projects Project Timeline

Project ID	Legend	2001				2002				2003				2004	2005
		1 <sup>Q</sup>	2 <sup>Q</sup>	3 <sup>Q</sup>	4 <sup>Q</sup>	1 <sup>Q</sup>	2 <sup>Q</sup>	3 <sup>Q</sup>	4 <sup>Q</sup>	1 <sup>Q</sup>	2 <sup>Q</sup>	3 <sup>Q</sup>	4 <sup>Q</sup>		
137	Whittier Barge Slip Unloading Facility									C					
R-28/10	Bridge Program														
Siding	Siding Improvements														
T-01	Fairbanks Intermodal Facility and Depot												C		
T-05/06	Anchorage to Wasilla Track Realignment														C
T-07	South Anchorage Double Track													C	
T-08	Whittier Pedestrian Safety Access							C							
T-10	Denali National Park Rail Station												C		
T-24	Whittier Maintenance Facility									C					
T-32	Seward Passenger Dock													C	
T-33	Talkeetna Access											C			
Track	Track Rehabilitation														

**Projects in the Planning Phase**

		2001				2002				2003				2004	2005
		1 <sup>o</sup>	2 <sup>o</sup>	3 <sup>o</sup>	4 <sup>o</sup>	1 <sup>o</sup>	2 <sup>o</sup>	3 <sup>o</sup>	4 <sup>o</sup>	1 <sup>o</sup>	2 <sup>o</sup>	3 <sup>o</sup>	4 <sup>o</sup>		
R-32	Healy Canyon Safety & Reliability Program Study				<b>C</b>										
T-09	Wasilla Intermodal Transit Facility														
T-11	Ship Creek Intermodal														
T-12	Wasilla Rail Realignment														
T-14	Anchorage Yard to Airport Capacity												<b>C</b>		
T-19	Anchorage Yard Passenger Car Shop														
T-40	Whittier Intermodal Planning Study								<b>C</b>						



## 2002 Legislative Requests

### **Lease Term Lengths for Certain Railroad Lands**

*An Act Relating to legislative approval of certain land leases by the Alaska Railroad Corporation.*

#### **Companion Bills**

SB 209 by Senator Loren Leman • HB 298 by Representative Lisa Murkowski

#### **Purpose of Legislation**

SB 209 and HB 298 extends the length of time the Alaska Railroad Corporation (ARRC) can lease lands within its Anchorage, Fairbanks, Seward and Healy Terminal Reserves from the current 35 years to 55 years.

#### **Background**

Under federal ownership, the Alaska Railroad could lease land for up to 55 years (similar to the Department of Natural Resources and the University of Alaska). When the State of Alaska purchased the Railroad, a decision was made to limit the Railroad's lease lengths to 35 years. In addition, ARRC was given the ability to extend leases beyond 35 years subject to a termination clause that states ARRC can terminate any lease with a term in excess of 35 years in the event the land is needed for railroad purposes after the initial 35 years.

#### **The Problem**

While the 35-year lease limit is adequate for most of ARRC's tenants, it is an obstacle in leasing lands to large commercial and residential developers who need to secure long-term financing for their investments. Financial lenders are reluctant to invest in large-scale projects requiring substantial equity participation when there is no guarantee land will be available beyond 35 years.

For example, Anchorage Neighborhood Housing, Inc. is working on the development of a 20-unit senior housing complex on ARRC property located in the Government Hill area. Housing for this project would be developed using Housing and Urban Development (HUD) 202 senior housing funds. However, HUD requires a 50-year lease period.

#### **Benefits of Legislation**

Changing the statute to allow for 55-year lease lengths increases financing options and, therefore, investor interest. It is an important step toward promoting economic development in railbelt communities where certain high value Railroad lands are currently underdeveloped.

**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

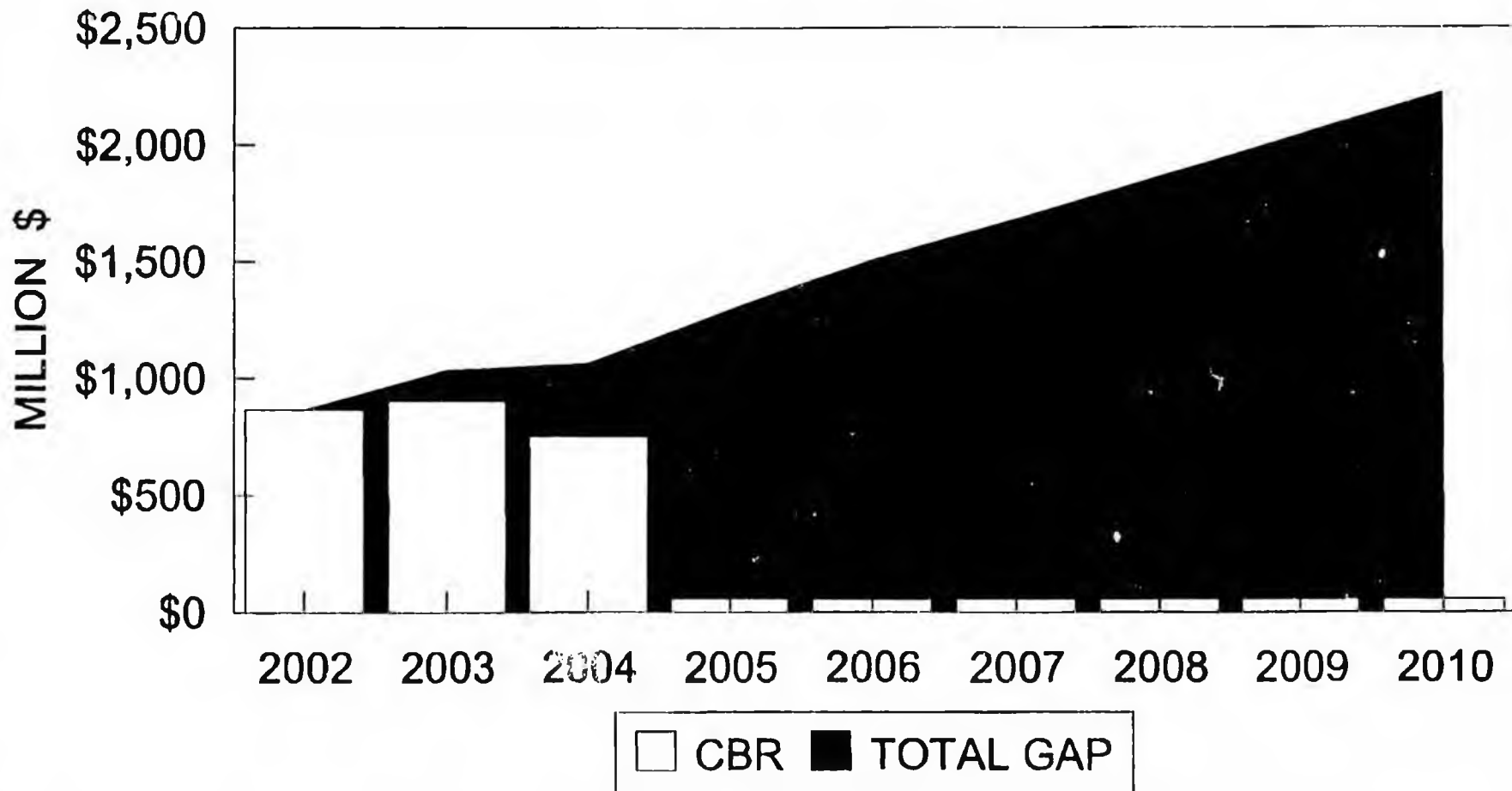
**FLEXIBLE** -- maximize capability to adjust to changing circumstances

**EFFICIENT** -- minimize bureaucratic costs

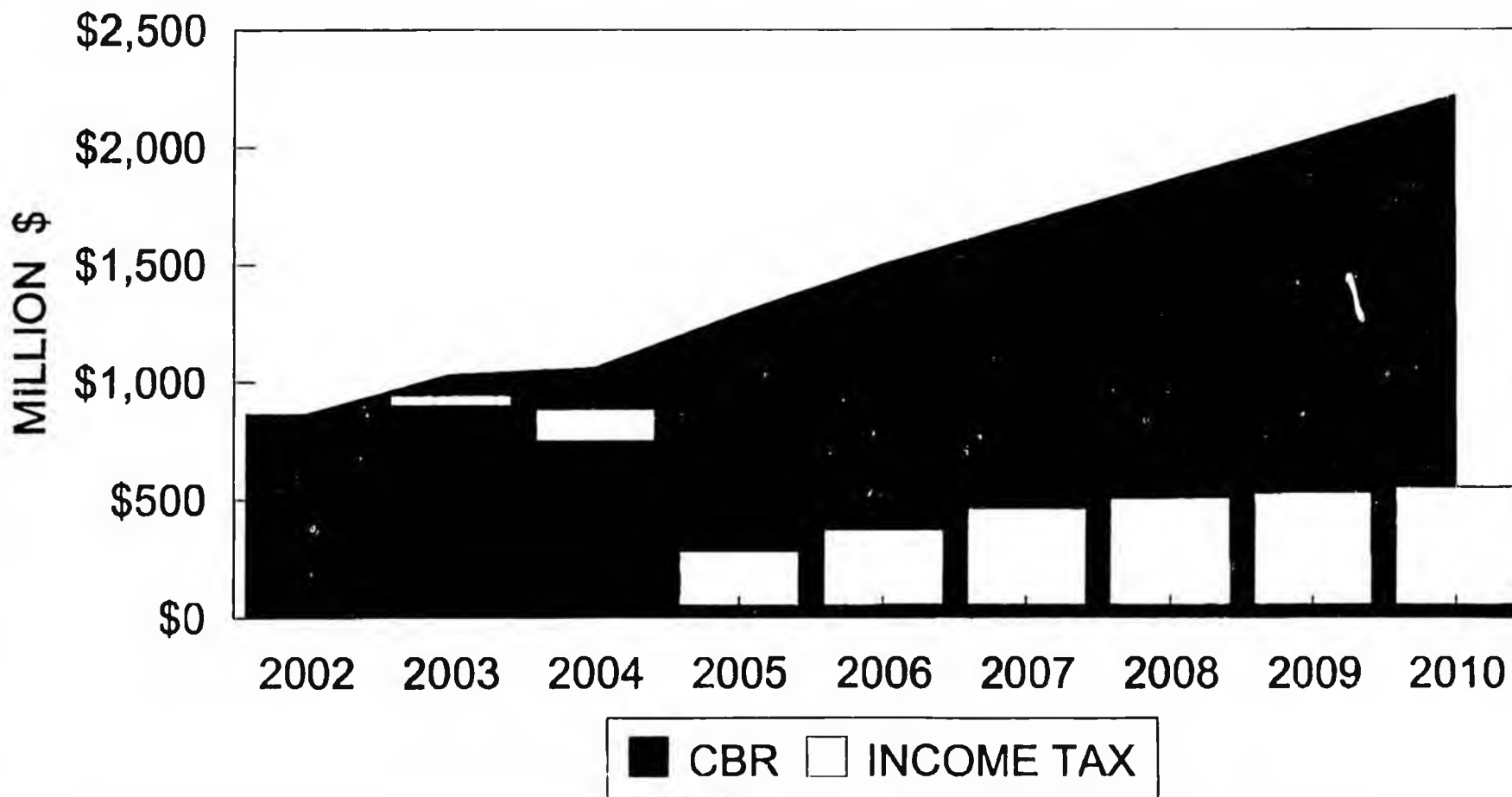
**STABLE** -- maximize revenue predictability

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

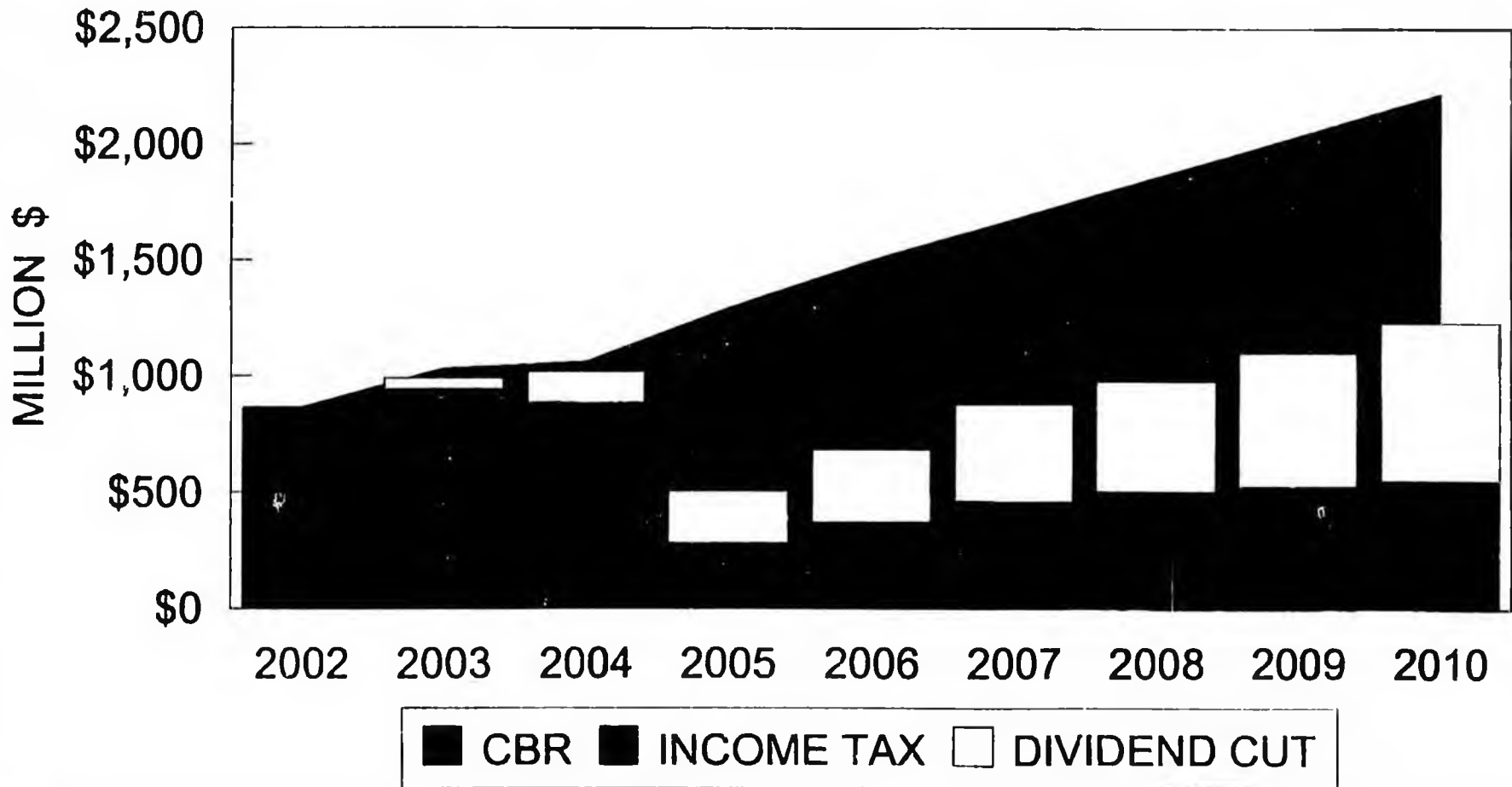
# GENERIC FISCAL PLAN: PART 1 CBR



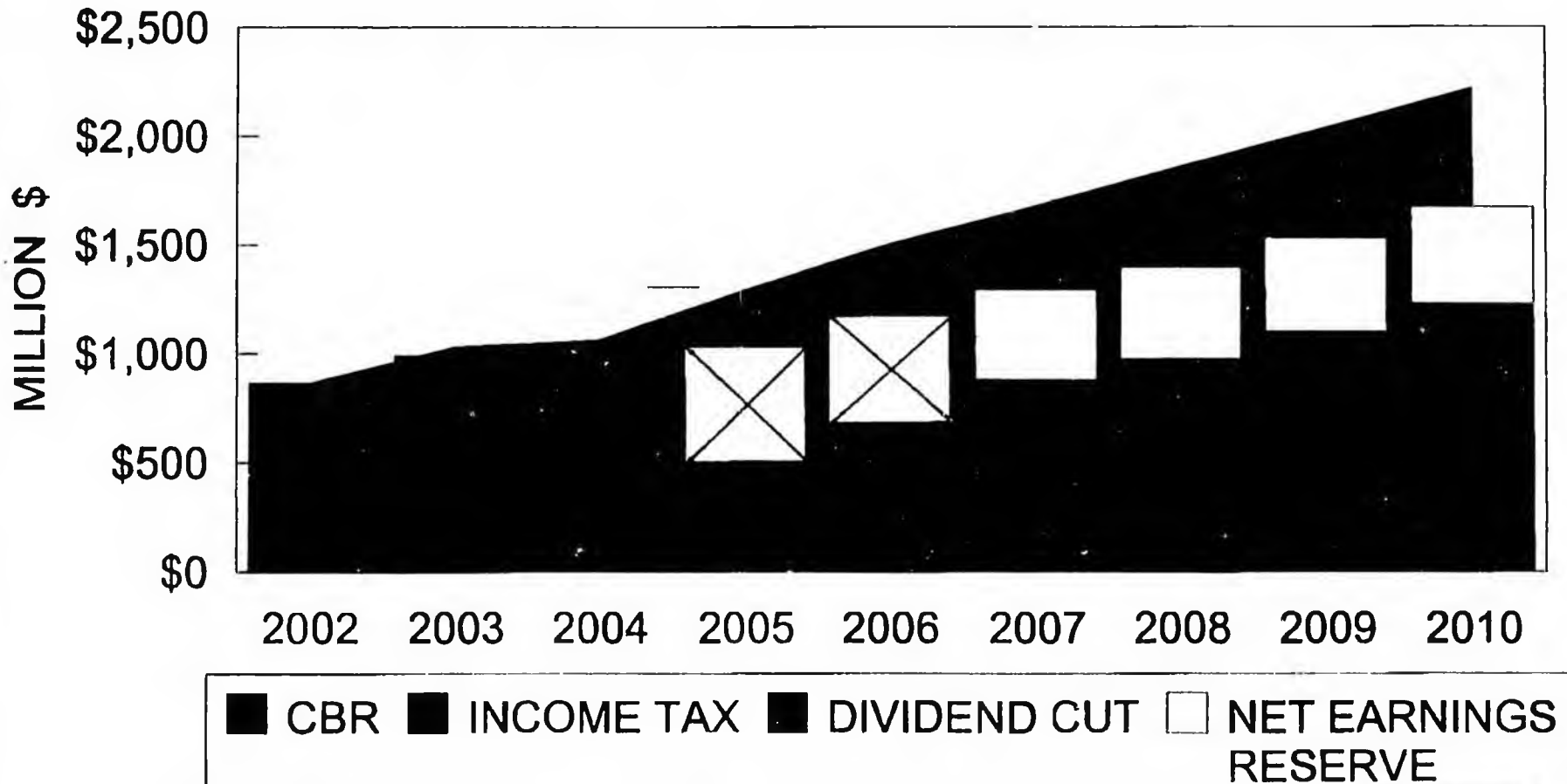
# GENERIC FISCAL PLAN: PART 2 BROAD BASED TAX



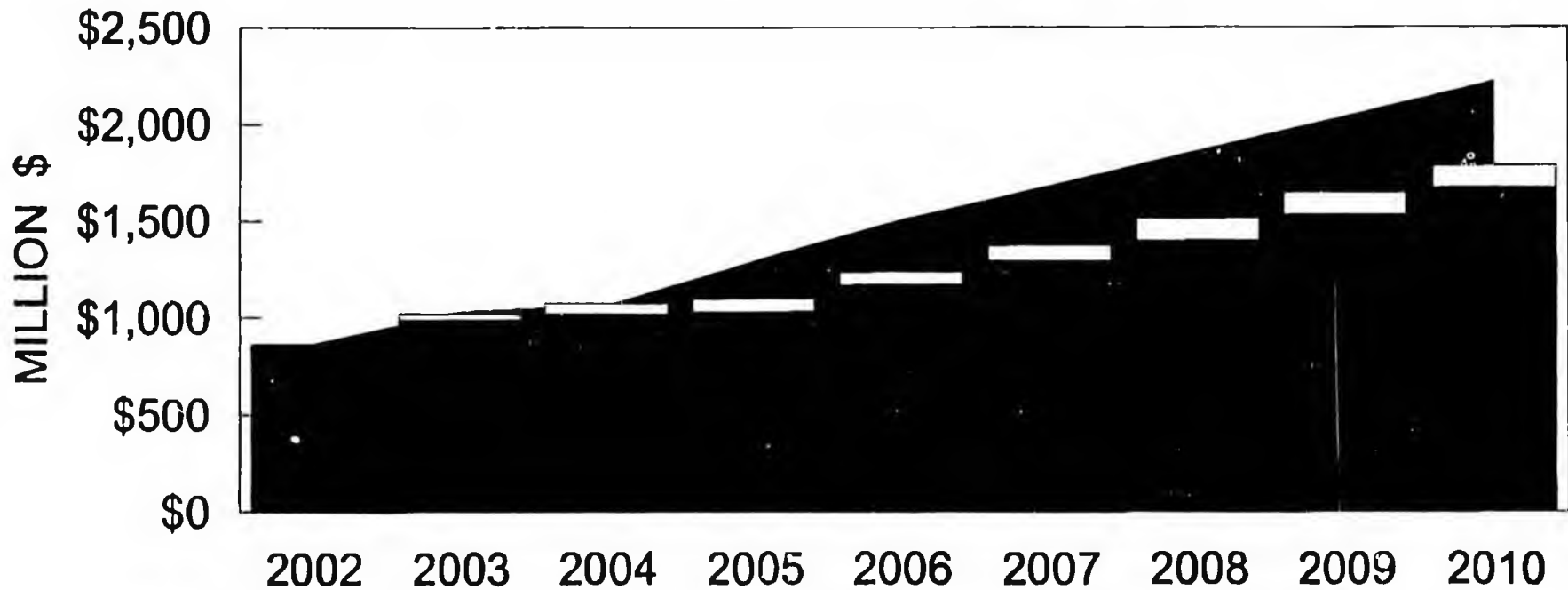
# GENERIC FISCAL PLAN: PART 3 DIVIDEND CUT



# GENERIC FISCAL PLAN: PART 4 EARNINGS RESERVE / PF EARNINGS



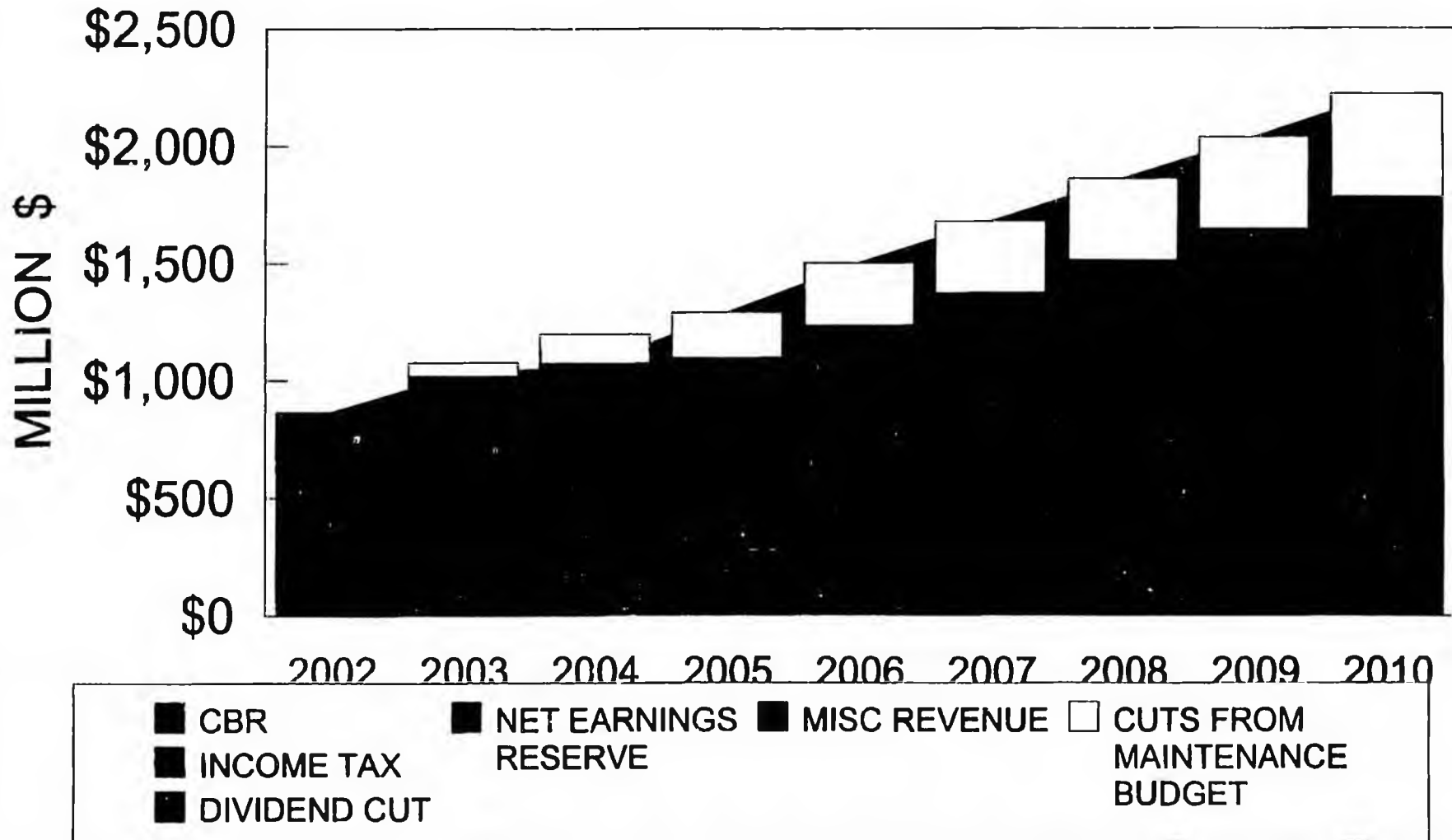
# GENERIC FISCAL PLAN: PART 5 MISC REVENUE



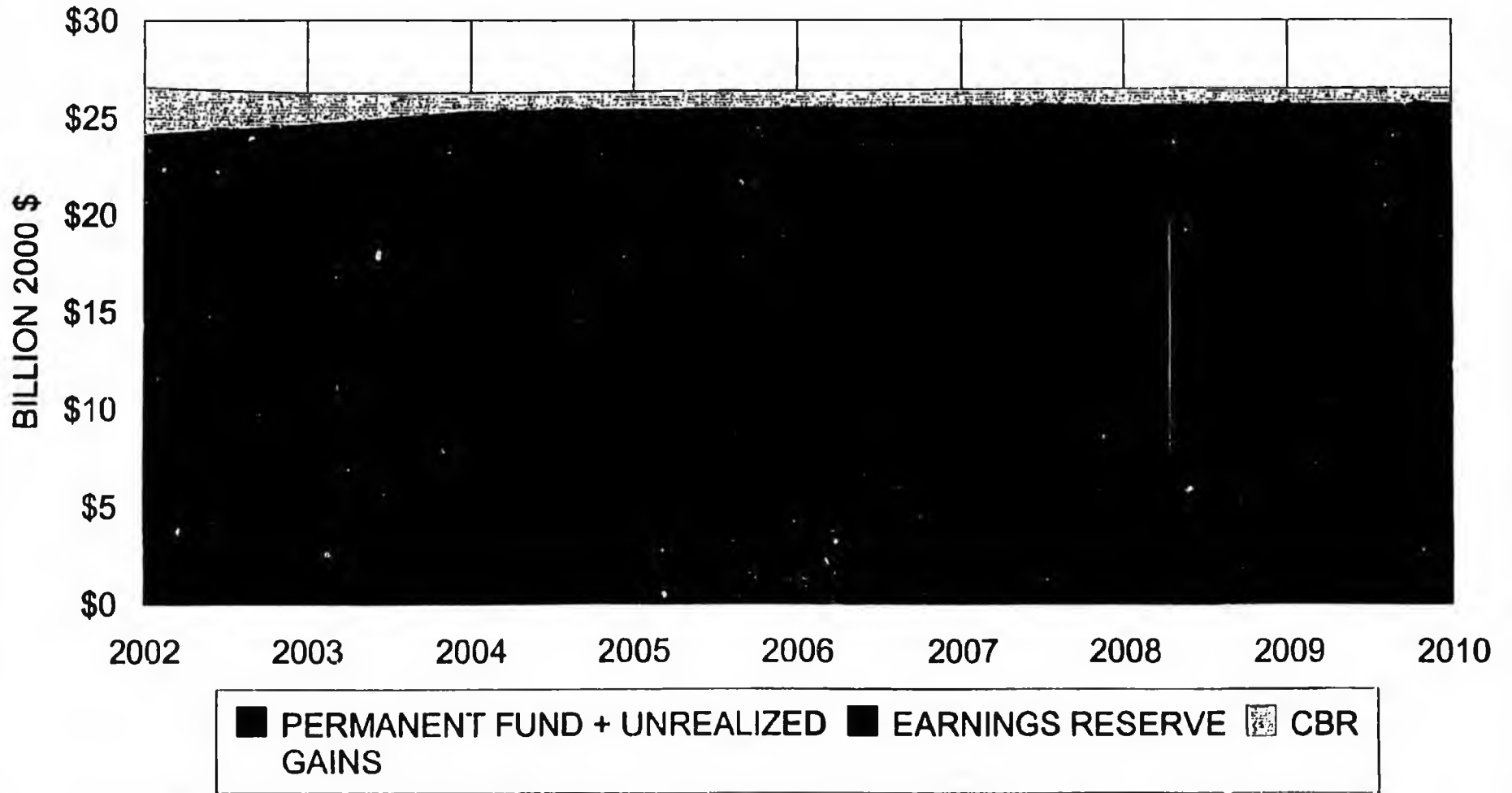
CBR
  NET EARNINGS RESERVE
  MISC REVENUE

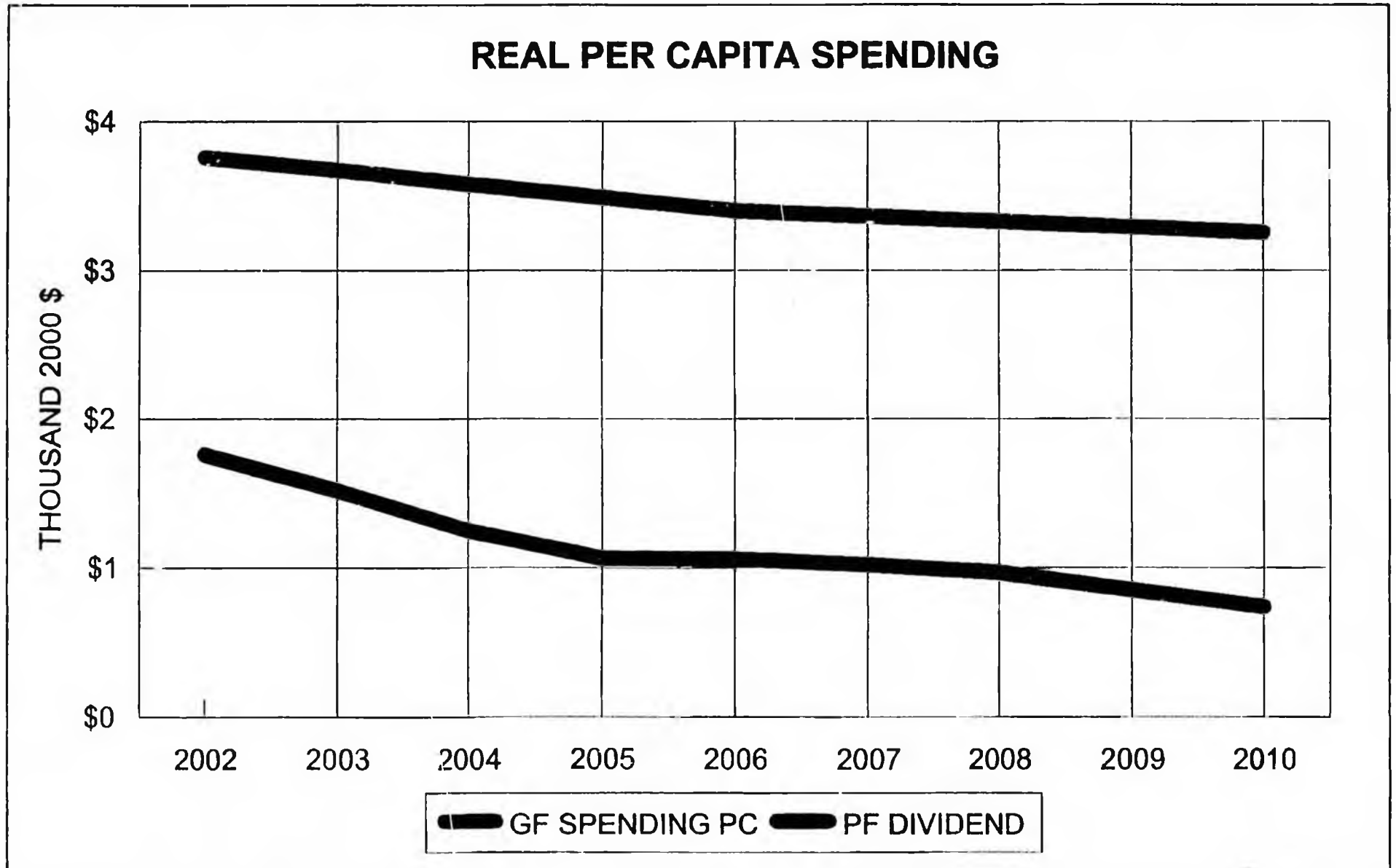
INCOME TAX
  DIVIDEND CUT

# GENERIC FISCAL PLAN: PART 6 BUDGET CUTS

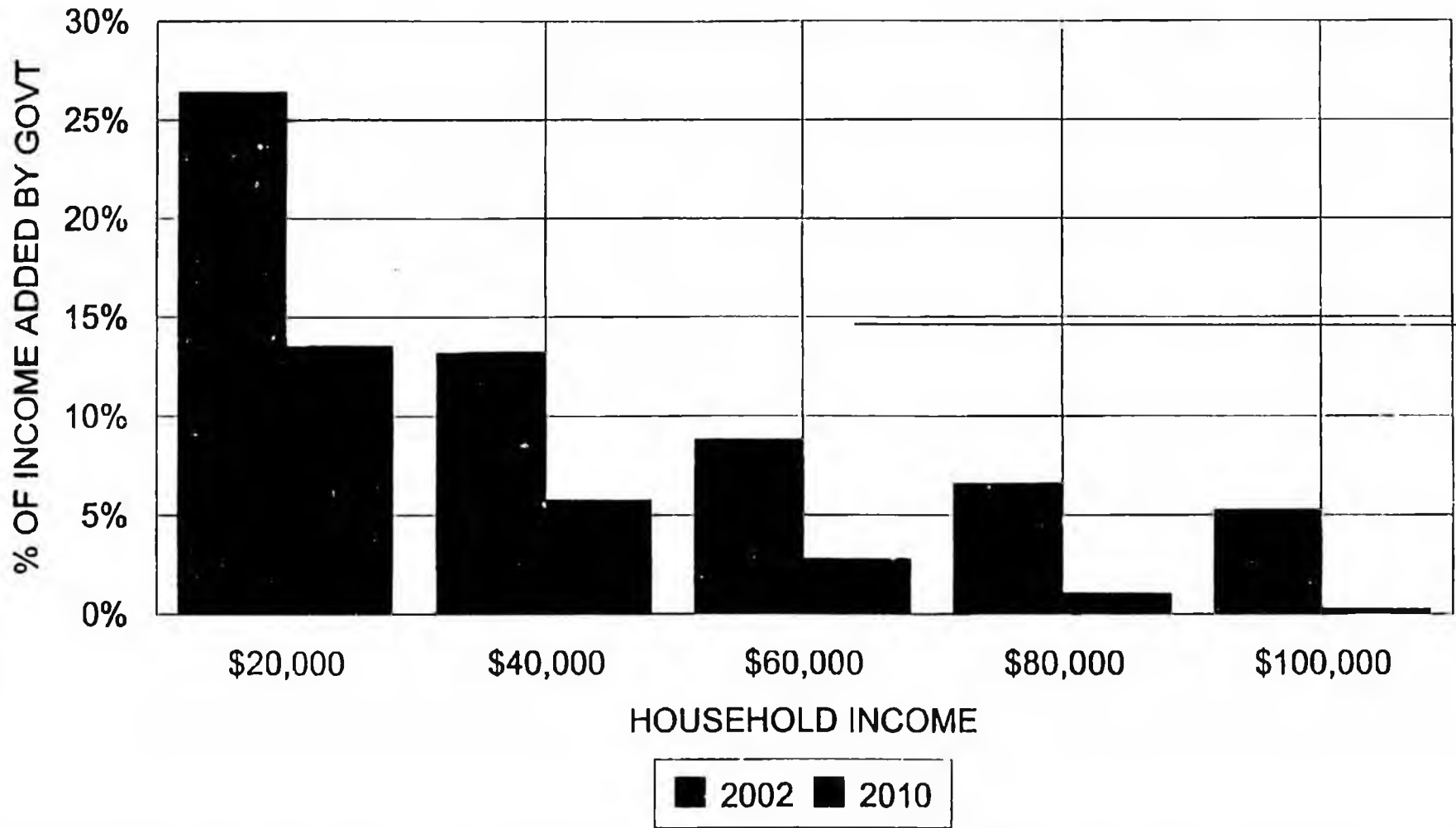


### FINANCIAL ASSETS AT YEAR END INCLUDES PF, ER, CBR, AND UNREALIZED GAINS

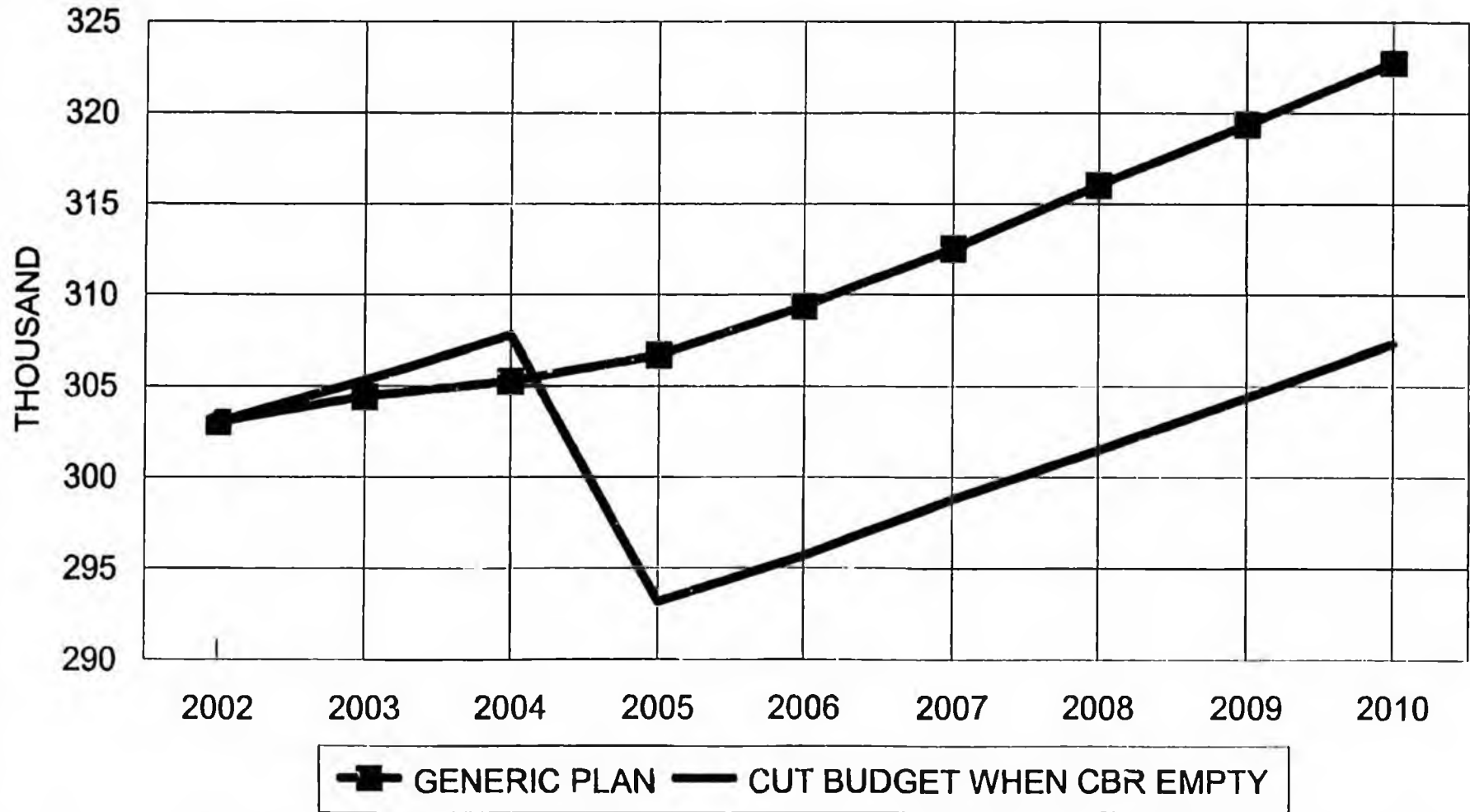




### NET IMPACT ON HOUSEHOLDS CHANGE DUE TO DIVIDEND AND BROAD BASED TAXES



### 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
<b>TOTAL FISCAL GAP [ MILLION \$ ]</b>	\$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
<b>PLAN EXPENDITURES =</b>	\$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
<b>PLAN REVENUES =</b>	\$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
<b>PERMANENT FUND START OF YEAR</b>	\$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	\$22,348	\$22,534	\$25,408	\$26,335	\$27,283	\$28,251	\$29,238
<b>UNREALIZED GAINS START OF YEAR</b>	\$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
<b>EARNINGS RESERVE START OF YEAR</b>	\$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
<b>CBR START OF YEAR</b>	\$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
<b>TOTAL \$\$\$ ASSETS START OF YR</b>	\$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	\$26,566	\$27,052	\$27,883	\$28,811	\$29,715	\$30,649	\$31,602	\$32,575	\$33,568
<b>YR END FINANCIAL ASSETS (02\$)</b>	\$28,968	\$28,264	\$26,283	\$26,388	\$28,401	\$26,438	\$26,466	\$26,487	\$26,498
PERMANENT FUND	\$21,900	\$21,491	\$21,063	\$20,821	\$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	\$888	\$883	\$887	\$813	\$779
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
<b>TOTAL EXPENDITURES (02\$)</b>	\$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
<b>PER CAPITA EXPENDITURES (02\$)</b>	\$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
<b>JOBS IMPACT</b>									
+ 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	6,034	5,833
- HOUSEHOLD TAXES	0	(412)	(1,199)	(1,941)	(2,838)	(3,293)	(3,552)	(3,625)	(3,888)
+ EMPLOYMENT FROM GOVT	53,008	50,899	47,705	45,285	44,032	43,214	42,085	41,917	41,142
CHANGE FROM 2002	0	(2,306)	(1,801)	(7,721)	(8,974)	(8,792)	(10,326)	(11,089)	(11,984)

**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	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	X	X	X	X	X	X	X					ABOUT \$20 MILLION TO GF		
	4. IMPOSE HEAD TAX \$100 PER WORKER	HB 229 CR 288 185	X	X	X	X	X	X	X					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	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 FY2007 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	
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  
DO 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:

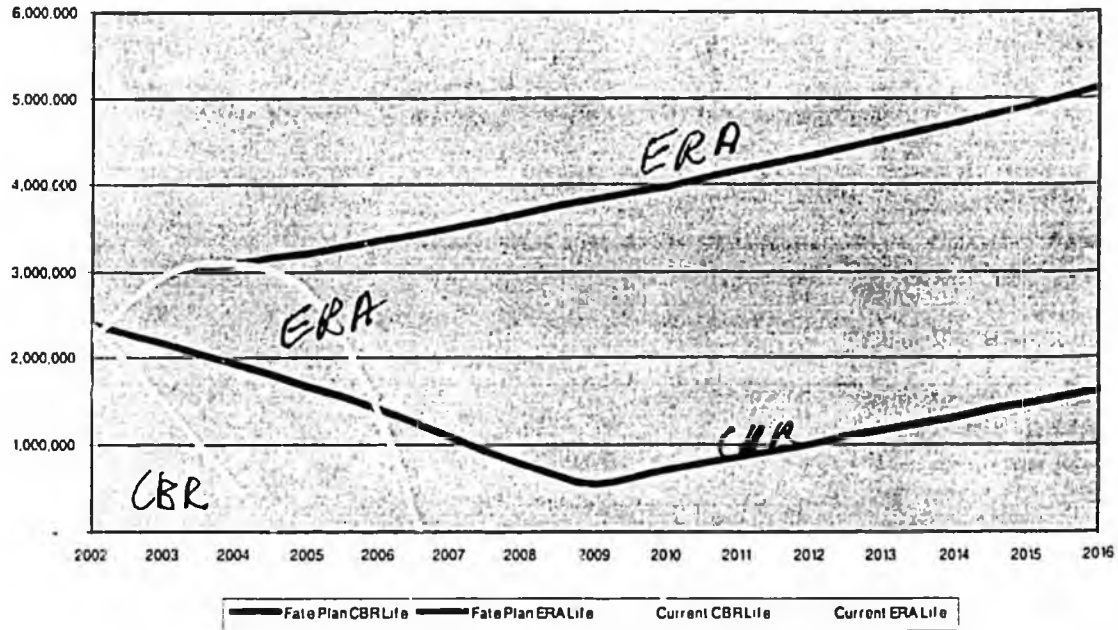
1) sales taxes are regressive, the poor pay a higher percentage of their income than the rich (given no exemptions for essential purchases) 2) the state should not duplicate taxes already being imposed by 97 local governments in the state.

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

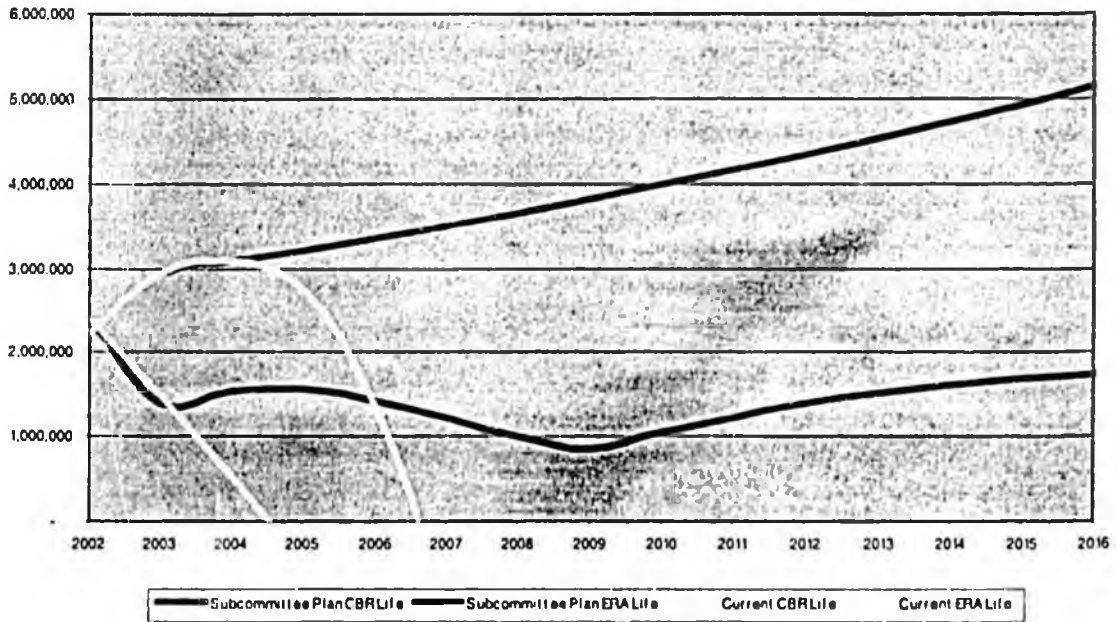
Statewide sales tax of 4%  
 Use of \$250 million from ERA  
 State Spending Cap:  
 adjusted for pop. and inflation



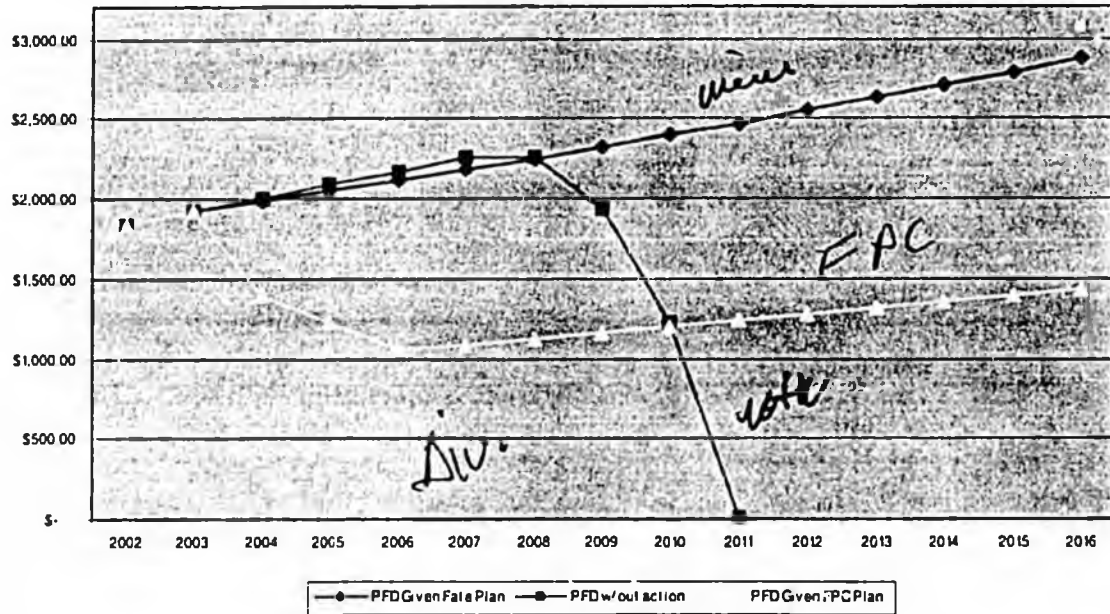
FPC Subcommittee Plan

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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## 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.<sup>1</sup> 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."

*Continued on page 4*

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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.

Continued from page 1

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.<sup>2</sup> 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.<sup>3</sup>

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.**<sup>4</sup> 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.<sup>5</sup>

**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.<sup>6</sup>

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.<sup>7</sup> 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.<sup>8</sup> This principle is reflected in the sale for resale exemption mentioned earlier,<sup>9</sup> 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.<sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup>

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.<sup>15</sup>

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.<sup>16</sup> 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.<sup>17</sup>

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

*Continued on page 8*

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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.<sup>18</sup> 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:<sup>19</sup>

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

If a product is sold to a business, it is exempt.<sup>20</sup> 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.<sup>21</sup>

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.<sup>22</sup>

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

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.<sup>24</sup> (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.<sup>25</sup> 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.<sup>26</sup> 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.<sup>27</sup>

### 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.<sup>28</sup> 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.<sup>29</sup> 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 21<sup>st</sup> 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

<sup>1</sup>In 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."

<sup>2</sup>I 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.

<sup>3</sup>Acting 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.

<sup>4</sup>This point does not appear in the presentation draft.

<sup>5</sup>See Cline and Neubig (2000).

<sup>6</sup>See Due and Mikesell (1994).

<sup>7</sup>For further discussion, see McLure (1998a), (1998b).

<sup>8</sup>The obligatory reference is Diamond and Mirrlees (1971).

<sup>9</sup>The 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.

<sup>10</sup>See Ring (1999).

<sup>11</sup>The 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).

<sup>12</sup>Those unfamiliar with the mechanics of the VAT might consult McLure (1987).

<sup>13</sup>Over 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.

<sup>14</sup>States 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.

<sup>15</sup>To 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).

<sup>16</sup>Another 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.

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

<sup>18</sup>It 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.

<sup>19</sup>I describe this system in greater detail in McLure (2000).

<sup>20</sup>A 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.

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

<sup>22</sup>It 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.

<sup>23</sup>This point does not appear in the presentation draft.

<sup>24</sup>Services 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).

<sup>25</sup>See 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.

<sup>26</sup>See, however, McLure (forthcoming, a).

<sup>27</sup>See Rosen and Haffield (2001).

<sup>28</sup>To 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.

<sup>29</sup>In one sense this is what happened in Europe. The original members of the European Common Market (the pre-cursor 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 booted 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.