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University of Alaska Anchorage

Who Will Pay For Balancing the Budget?

Alaskans will pay more and get less from state government in the 1990s. But how will the burden of spending cuts and tax increases fall on richer and poorer and urban and rural households? That depends on which policies state officials choose.

Alaska faces big and growing budget deficits because the petroleum revenues that mostly paid for state government in the 1980s are steadily shrinking. When those deficits will start is uncertain, but low world oil prices are erasing the budget surplus state officials had expected as a result of the Middle East war. (See page 16.)

Whenever budget deficits start, state officials will face tough choices—how much to cut spending and how much to raise taxes; which programs to cut; whether to use Permanent Fund earnings; and many others. Those choices will affect all Alaska households, but not in the same way.

This paper assesses how different taxing and spending policies could affect different kinds of households. As a measure of those effects we examine relative losses in disposable household income.

Budget deficits will of course have other effects on households. Some households will be hurt a lot more than others by broad economic losses and reduced government services. Alaskans who lose their jobs will obviously suffer bigger losses than we describe.

But relative household income loss is a good measure of the equity of various fiscal policies. We estimate losses in disposable household income by comparing how various fiscal policies reduce state transfer payments and increase state and local taxes.

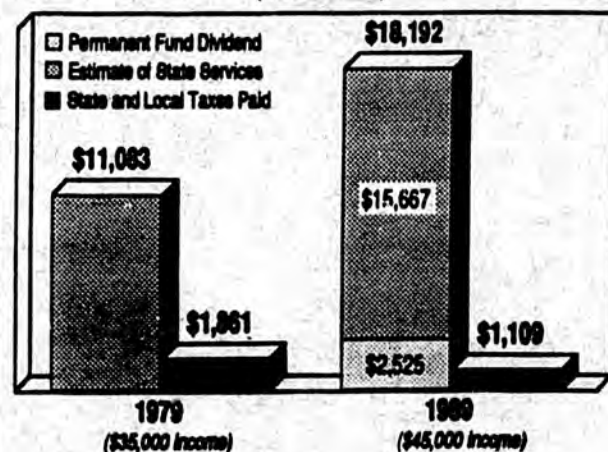
Figure 1 provides perspective by comparing services received and state and local taxes paid by a fairly typical Alaska household in 1979 and 1989. (All numbers are in 1989 dollars, to remove the effects of inflation.) Households generally get more in value of services than they pay

in state and local taxes, because businesses and the federal government help pay government costs. But in Alaska in the 1980s services grew, taxes dropped, and the state government began paying Permanent Fund dividends.

As the figure shows, a couple with one child and a median income in 1979 would have received about six times as much in state services as it paid in state and local taxes. By 1989, the same household with a median income would have collected 17 times as much in Permanent Fund dividends and state services as it paid in just local taxes. (No major state taxes existed in 1989.)

So within 10 years, Alaska households were getting 60 percent more from the state and paying 40 percent less in taxes. We're not suggesting what the relationship between value received and taxes paid ought to be. We're just pointing out that today Alaskans, regardless of income, pay little or nothing for state and local government—because there are no major state taxes and Permanent Fund dividends frequently exceed local taxes.

Figure 1. How Much Does a Typical Household Receive and Pay?
(In 1989 Dollars)



This is the sixth in a series of ISER Fiscal Policy Papers examining state government revenues and spending. We intend the papers to focus the attention of state officials and other Alaskans on the fiscal crisis in Alaska's future. The authors are Alexandra Hill, Matt Berman, Linda Leask, and Scott Goldsmith. Monette Dalsfoist prepared the graphics.

The series is financed by a grant from ARCO Alaska.

But what will happen when the budget ax begins to fall? We can assess the equity of potential fiscal policies by looking at their comparative effects on wealthier and poorer regions of Alaska, or at their comparative effects on wealthier and poorer households within any region.

To analyze how different fiscal policies could affect diverse households—both across and within regions—we developed specific sample households and broad household averages. We then analyzed how various fiscal policies would affect disposable household incomes of the sample households and of Alaska households on average. (Disposable income is defined on page 3.)

The facing page describes our sample households, which are similar to many actual Alaska households. The averages shown in figures throughout the rest of this paper illustrate how different fiscal policies would affect Alaska households, if every household paid the same amount in taxes and collected the same amount in transfer payments. They provide baselines for comparison.

We examine relative household income losses under various measures designed to fill a \$500 million budget deficit. We used a \$500 million gap because that's the magnitude of deficit likely to open sometime in the next five years. We wanted to illustrate the kinds of budget balancing measures that will be necessary in the relatively near future. The size of the gap, and the measures needed to fill it, will increase over time. The gap could be twice as large by the start of the next century, depending on world oil prices and other factors. (See page 16.)

We assess relative losses in disposable household income under individual taxes and under four fiscal packages that in various ways combine budget cuts, tax increases, and use of Permanent Fund earnings to fill a \$500 million budget gap. We also examine whether different kinds of households would lose more by giving up their Permanent Fund dividends or by paying new taxes.

Without advocating particular choices, we tried to cover a range of options open to policymakers. We also recognize that if policymakers in fact decided to implement certain options—like changing the Permanent Fund dividend program, for instance—they'd first have to make statutory changes.

Figure 2 sets the stage for our analysis of household income losses by showing how much our

five sample households and Alaska households on average currently collect in state transfer payments and subsidies and how much they pay in state and local taxes. (Transfer payments and subsidies received by sample households are specified on the facing page. Major transfers included in calculations of the averages are the state portion of public assistance programs and the Permanent Fund Dividend, Power Cost Equalization, and Longevity Bonus programs.)

Three of the households—the single person and the families with median and higher incomes—collect just Permanent Fund dividends, which make up between 3 and 7 percent of their incomes. They pay between 3 and 4 percent of their incomes in state and local taxes.

The single parent's low income qualifies her for day care assistance and other subsidies in addition to Permanent Fund dividends; she depends on those payments and subsidies for a third of her income and pays about 2 percent in taxes. The retired couple qualifies for Longevity Bonus payments and Permanent Fund dividends, which make up nearly 20 percent of its income, and is exempt from property taxes. (That exemption was enacted so that older Alaskans on fixed incomes could afford to stay in their homes as property values increased.)

Pages 4 and 5 show distributive effects on households of imposing state sales, income, and property taxes and eliminating the Permanent Fund dividend. Pages 6 through 13 describe the four fiscal packages and show their distributive effects on disposable household income. The last pages offer conclusions.

Figure 2. Payments To and Taxes From Alaska Households, 1989

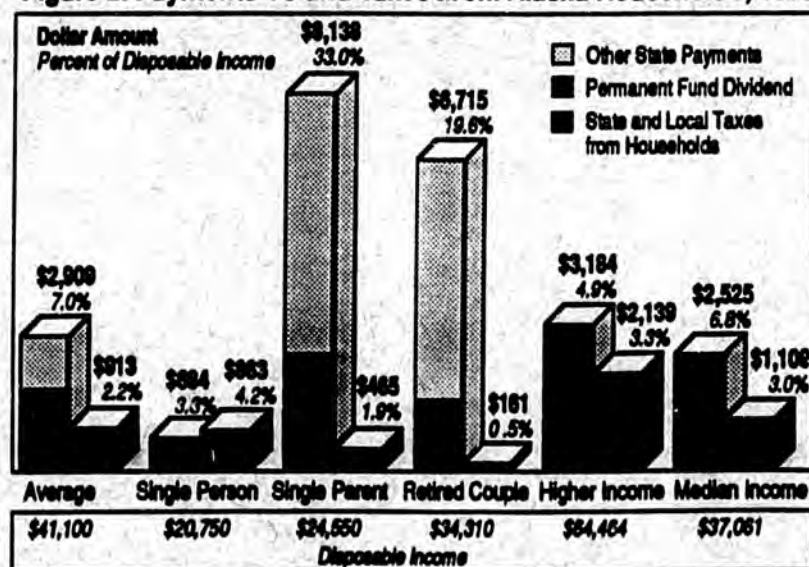


Table 1. Profiles of Sample Households

SAMPLE HOUSEHOLDS: Our five sample households are described in detail below. We chose them in part because each is similar to many actual Alaska households. The overviews of households make it plain that households in different circumstances, or at different phases in their life cycles, have very different tax burdens in relation to income. When we refer to income anywhere in this paper, we mean *disposable* income—which is total income, including subsidies and imputed rent, minus income taxes and Social Security taxes.

Sample Households		Annual Income		Annual Expenditures	
	SINGLE PERSON: A single man living alone in a rented two-bedroom apartment and earning \$12 per hour. His major debt is his car payment.	<i>Wages</i>	\$25,000	<i>Federal Taxes</i>	\$5,200
		<i>Perm Fund</i>	950	<i>Food</i>	2,900
		<i>Total Income</i>	25,950	<i>Rent</i>	7,200
		<i>Disp. Income</i>	\$20,750	<i>Transp</i>	3,500
				<i>Other</i>	6,400
				<i>Savings</i>	\$750
	SINGLE PARENT: A low-income single mother with two young children, living in a subsidized apartment. She is employed full-time for \$6.60 per hour. She receives several state and federal subsidies that substantially increase her disposable income—housing, day care, and energy cost subsidies and food stamps.	<i>Wages</i>	\$13,200	<i>Federal Taxes</i>	\$1,664
		<i>Perm Fund</i>	2,850	<i>Food</i>	4,300
		* <i>Food Stamps</i>	1,932	<i>Rent</i>	6,600
		* <i>Housing Sub</i>	2,664	<i>Transp</i>	3,750
		* <i>Day Care Sub</i>	5,400	<i>Day Care</i>	6,300
		* <i>Energy Assist</i>	168	<i>Other</i>	3,600
		<i>Total Income</i>	26,214	<i>Savings</i>	\$0
		<i>Disp. Income</i>	\$24,550		
	RETIRED COUPLE: A retired couple, both over 70. The husband receives a pension; both receive Social Security and Longevity Bonuses. They own their home, so we add to their effective income an "imputed rent"—the amount they save in housing costs which is equivalent to the return on their home equity. As senior citizens they are exempt from property tax on their home.	<i>Social Security</i>	\$9,325	<i>Federal Taxes</i>	\$1,515
		<i>Pension</i>	12,600	<i>Food</i>	4,500
		<i>Longevity Bonus</i>	6,000	<i>Transp</i>	4,000
		<i>Perm Fund</i>	1,900	<i>Misc. Home</i>	4,200
		* <i>Imputed Rent</i>	6,000	* <i>Imputed Rent</i>	6,000
		<i>Total Income</i>	35,825	<i>Health Care</i>	2,000
		<i>Disp. Income</i>	\$34,310	<i>Other</i>	13,600
				<i>Savings</i>	\$0
	HIGHER INCOME: A working couple with two children in elementary school. Both parents earn above-average wages. The family lives in a house valued at \$200,000 and carries a large mortgage.	<i>Wages</i>	\$80,000	<i>Federal Taxes</i>	\$19,836
		<i>Perm Fund</i>	3,800	<i>Food</i>	9,500
		<i>Invest Income</i>	500	<i>Mortgage</i>	21,500
		<i>Total Income</i>	84,300	<i>Transp</i>	12,500
		<i>Disp. Income</i>	\$64,464	<i>Day Care</i>	3,600
				<i>Other</i>	13,200
				<i>Savings</i>	\$4,200
	MEDIAN INCOME: A couple with one child. The husband earns above average wages and the wife cares for the child. Their home is valued at \$85,000 and they have little equity.	<i>Wages</i>	\$42,000	<i>Federal Taxes</i>	\$7,939
		<i>Perm Fund</i>	2,850	<i>Food</i>	5,400
		<i>Invest Income</i>	150	<i>Mortgage</i>	5,450
		<i>Total Income</i>	45,000	<i>Transp</i>	6,100
		<i>Disp. Income</i>	\$37,061	<i>Other</i>	15,100
				<i>Savings</i>	\$2,000

* Indicates subsidies or other forms of in-kind income that households don't receive as direct cash payments but which add to effective buying power of households. The U.S. Department of Commerce also includes these in its definition of personal income.

Sources: ISER households surveys; U.S. Bureau of the Census Consumer Expenditure Surveys and Current Population Survey, P-70, No. 12; State of Alaska, Office of Management and Budget Report #06-55, Welfare Reform and Public Assistance Recipients in Alaska. Details available on request.

Figure 3. Relative Effects of Raising Taxes

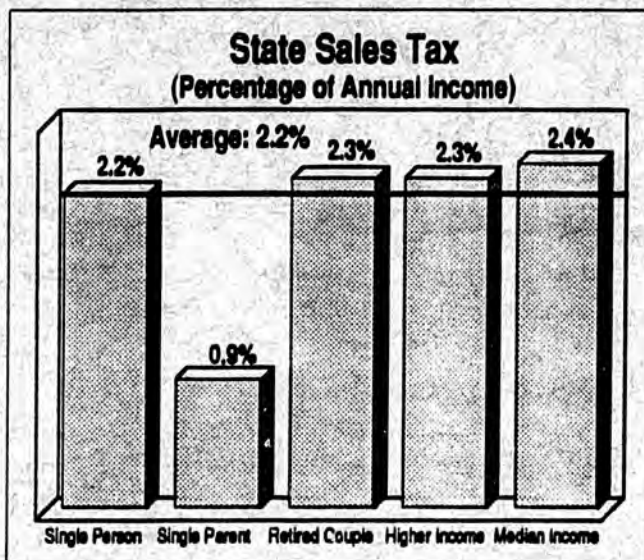
Sales Tax (\$216 million in Revenues)

Assumptions: Six percent state sales tax; food and most services excluded. Local sales taxes would be in addition to the state tax.

General: Proportion of income paid as sales tax is determined by how much of a household's spending is on taxed items. Households with large non-taxed subsidies or high housing costs would pay proportionately less, while households with more discretionary spending would pay more.

Percentage of Income: Because the state tax base excludes many types of spending, the effective tax rate for the average household would be about 2.2 percent of annual income. The single parent would pay relatively little, because much of her income is in subsidies that must be spent on non-taxed items.

Regional Differences: Rural families that rely heavily on subsistence (non-cash income) would pay less in sales taxes if the value of their non-cash income (subsistence food and imputed rent) were included in their disposable income. However, they might pay a larger portion of their



money income in sales taxes because a high proportion of money spent is on taxable items.

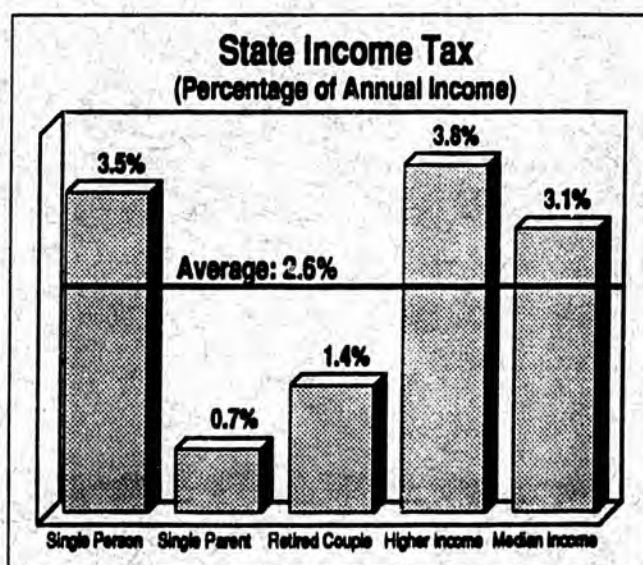
Income Tax (\$210 million in Revenues)

Assumptions: Adjusted gross income taxed at 3.2 percent for the first \$30,000 and 5.6 percent above that. Per person exemption of \$3,000. Tax bills of the median- and the higher-income families are net of the reduction in federal income tax that would result from deducting state taxes on federal returns.

General: The income tax is structured to tax higher incomes at a higher rate, but actual payments depend on deductions, amount of non-taxable income, and subsidies that effectively increase income but aren't taxed.

Percentage of Income: Average cost to Alaska households would be about 2.6 percent of annual income. The single parent and the retired couple would pay less than average, because their incomes are below the median and portions are not taxed. The single person would pay about the same percentage as the median and higher income families, even though his income is much lower. That's because the families have more exemptions and can itemize deductions (including state taxes) on their federal income tax returns, while the single person can't.

Regional Differences: Rural incomes are generally lower than urban, so many rural households would pay



less income tax. However, some rural jobs pay more than equivalent urban jobs, since rural living costs are higher—so rural residents with higher wages would pay higher taxes and lose more buying power.

and Eliminating Permanent Fund Dividends

Property Tax (\$120 million in Revenues)

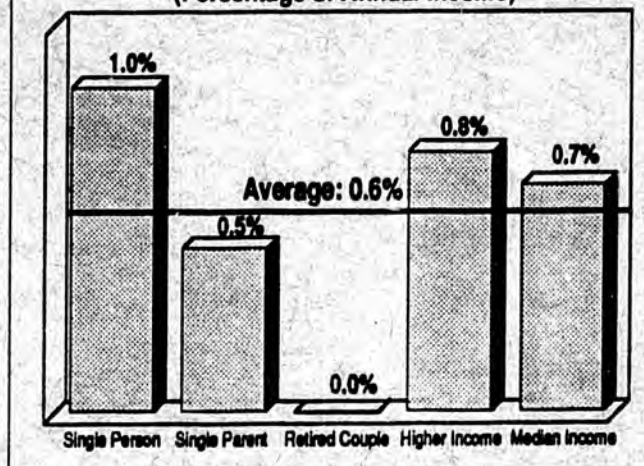
Assumptions: State property tax of 20 mills, with local property taxes (frozen at 1989 levels) deductible. The effective state tax rate is the difference between the existing local rate and 20 mills. Households that do not own property pay indirectly through increased rent.

General: The figures show potential additional property tax for Anchorage households, which we are using as a benchmark. Figures would differ for every community. Current local property tax rates vary considerably across regions; this measure would equalize mill rates statewide.

Percentage of Income: Average cost to Anchorage households would be about 0.6 percent. The single person would bear a relatively high burden, because he lives in an apartment that is more valuable than average while his income is below average. Those who live in mobile homes, by contrast, would pay a lot less. Alaskans over 65 are exempt from property tax.

Regional Differences: Areas which now have the lowest local property taxes would see the biggest increase under a combined state and local tax of 20 mills. Sitka, for instance, could see property taxes triple. Many rural areas

State Property Tax, Anchorage
(Percentage of Annual Income)



currently have no local property tax, so the increase would be large—but offsetting that increase would be the generally lower value of rural property.

Eliminate Permanent Fund Dividend (\$439 million in Revenues)

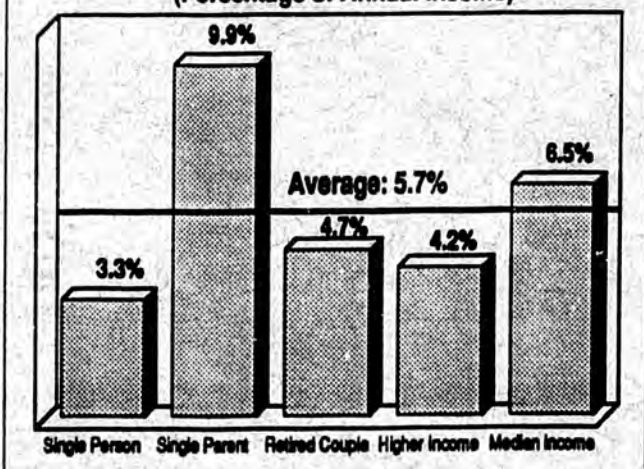
Assumptions: Permanent Fund dividend program eliminated.

General: Eliminating the dividend would cost larger, lower-income families a bigger share of income, since each member of every household is paid equally.

Percentage of Income: On average households would lose 6 percent of income. The single parent would lose nearly twice the average, because her household would lose three dividends and her income is low. The single person would lose less than average, because he has a moderate income and loses only one dividend. The higher income family would also lose less than average, even though they give up four dividends, because their income is so much higher than average.

Regional Differences: Rural households on the whole tend to be bigger and to have smaller incomes than urban households—so in general rural income losses would be larger.

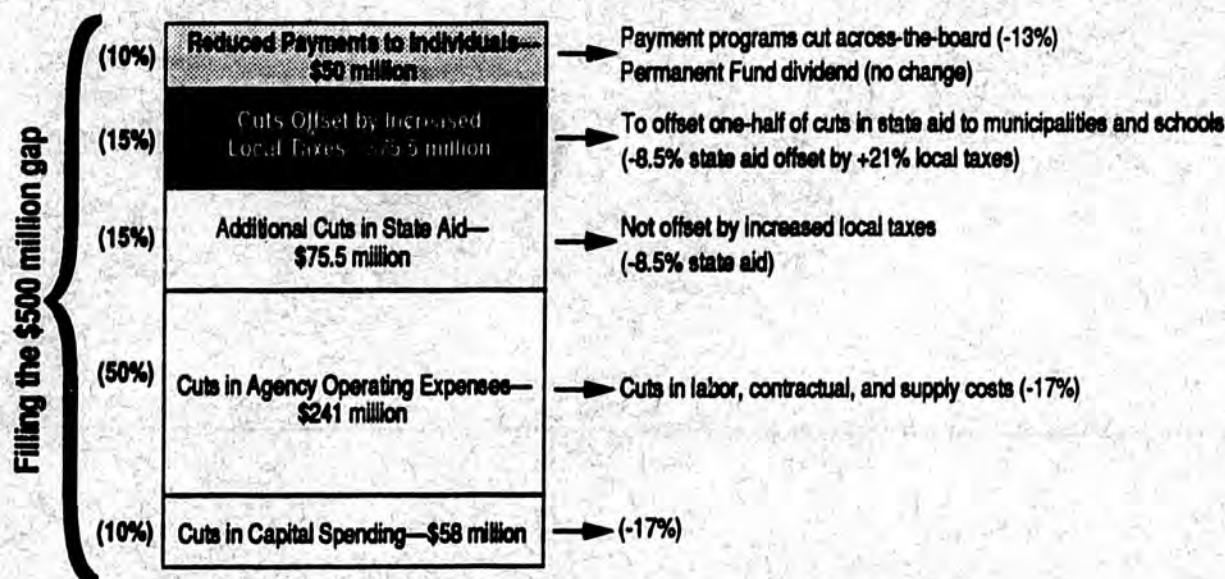
Eliminate Dividend
(Percentage of Annual Income)



Fiscal Package 1. Cut Budget Across-the-Board • Fiscal Package 1. Cut

ASSUMPTIONS: State general fund spending of \$2.5 billion (in 1990 dollars)
 Fiscal gap (the difference between current spending and expected revenues from existing sources) of \$500 million (in 1990 dollars)
 No new state taxes; cut most spending across-the-board; leave Permanent Fund dividend program intact
 Local governments make up half the cuts in state aid through increased local taxes

DESCRIPTION: This package illustrates the approach of balancing the budget by cutting all kinds of spending equally. It would close a \$500 million gap entirely through deep budget cuts across all operating and capital programs, with a few exceptions. The figure below shows how a \$500 million gap would be filled under this approach. The percentages at the left show how much of the gap would be filled by each category of cuts. The percentages at the right show how much each type of spending would be cut, or how much state and local taxes would be increased.



BROAD ECONOMIC AND SERVICE EFFECTS: Cuts of this magnitude would cost the economy tens of thousands of jobs and millions of dollars of income, as described in *Fiscal Policy Paper No. 5*. State and local services would be reduced. The cuts would be reflected in things like fewer new schools and other public facilities; poorer maintenance of existing roads, schools, and other public buildings; higher local taxes; larger class sizes; less police and fire protection; fewer regional offices for state agencies; and slower responses from state and local agencies.

BROAD HOUSEHOLD EFFECTS: *The household disposable income losses we discuss in these fiscal packages are just the result of increased taxes (either local tax increases in response to cuts in state aid or new state taxes) and reduced state transfer payments. The effects of lost government services are not reflected. Income losses among households that lost jobs would be much higher.*

Deep across-the-board cuts would take the most from households that rely more on transfer payments or subsidies—poor working parents, older people, and many rural residents, for instance. Households with higher incomes would lose less, because they don't rely as much on state payments—and the only new taxes they'd have to pay would be any increases in local taxes that municipalities and boroughs imposed to make up for reduced state aid.

Note: Certain categories of operations spending are protected from cuts by law. The state must pay debt service on its general obligation bonds. Welfare and medical assistance programs are federally mandated and only certain optional expenses can be cut.

Budget Across-the-Board • Fiscal Package 1. Cut Budget Across-the-

MEASURING HOUSEHOLD INCOME LOSSES: Below we assess comparative effects of Fiscal Package 1 on our sample households and on Alaska households on average. The figure immediately below shows percentages of disposable income households would lose through reduced transfer payments and increased local taxes. (There are no state tax increases under this package.) The figure at the bottom of the page shows how Fiscal Package 1 would change transfer payments households receive and state and local taxes they pay; these can be compared with the existing balance of payments and taxes shown on page 2.

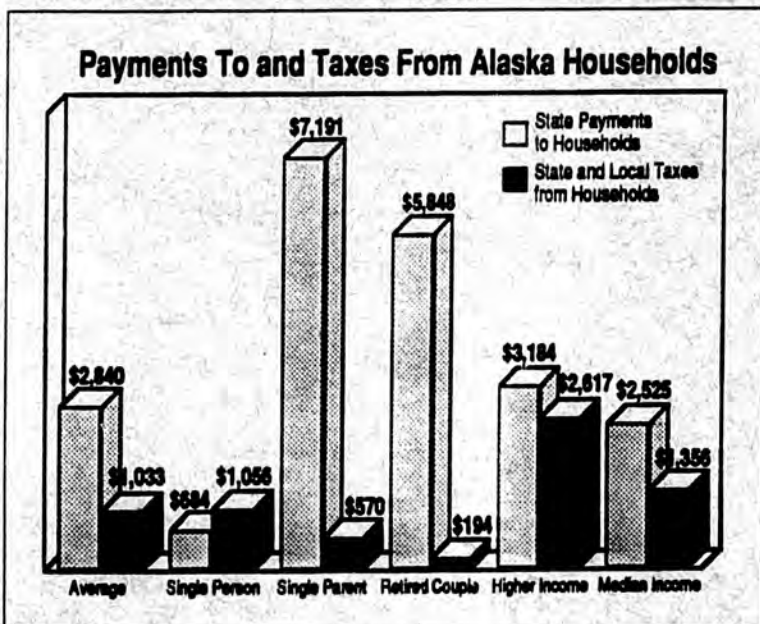
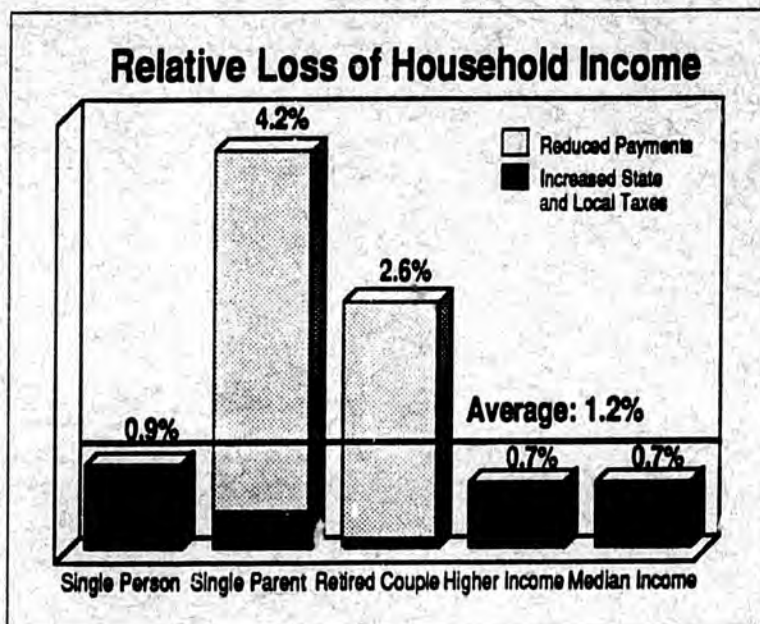
RELATIVE HOUSEHOLD INCOME LOSSES:

Alaska households on average would lose about one percent of their incomes as a result of reduced transfer payments and increased taxes. The retired couple and the single parent would lose much more, because Longevity Bonus payments and day care subsidies would be cut sharply. The other households would lose less than average—because they receive only Permanent Fund dividends (which wouldn't be cut under this package), and they would pay just local tax increases.

PAYMENTS AND TAXES: All households except the single person would still receive considerably more in state payments than they pay in state and local taxes. However, the retired couple and the single parent would each lose close to 12 percent of their transfer payments. The single person would end up paying more than he receives because he gets only one dividend.

RELATIVE HOUSEHOLD LOSSES BY REGION:

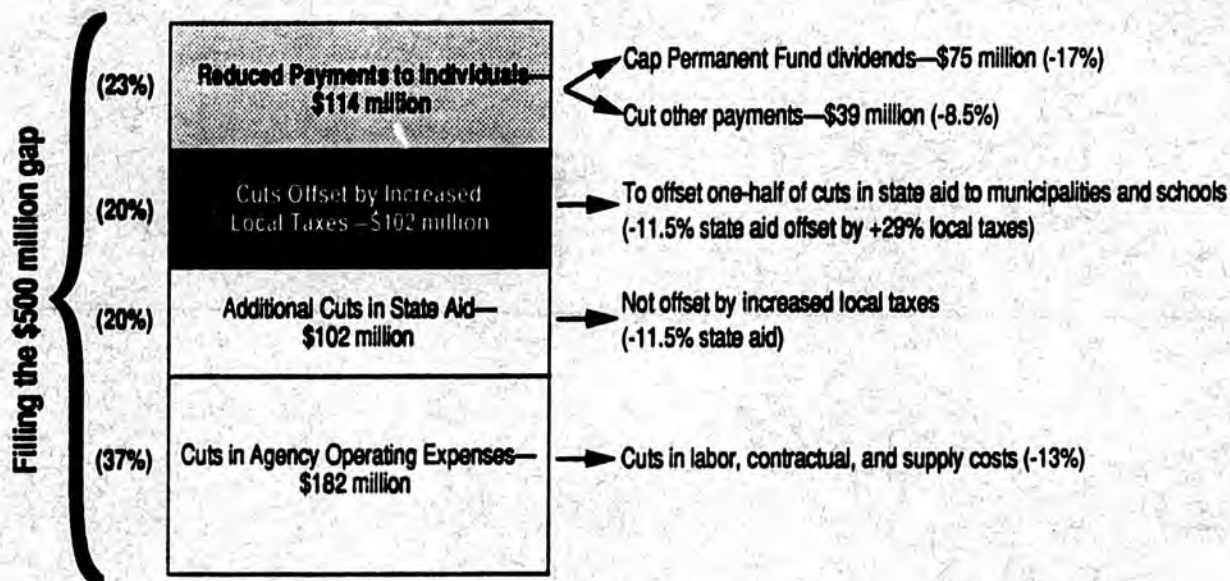
(Not shown) Households in rural regions are frequently larger and poorer than urban households. So they typically receive more in transfer payments—and therefore stand to lose more under deep cuts in transfer payments. Rural communities also generally receive higher per capita state payments for education and general government. So if rural governments chose to make up at least a portion of cuts in state aid by raising local taxes, households in rural regions would have to make up proportionately more than urban households. Exceptions would be households in communities with virtually no tax bases, which don't have the capacity to pay much tax, and communities with extremely large commercial tax bases (like the North Slope Borough) which take much of the tax burden off households.



Fiscal Package 2. Preserve Capital Budget • Fiscal Package 2.

ASSUMPTIONS: State general fund spending of \$2.5 billion (in 1990 dollars)
 Fiscal gap (difference between current spending and expected revenues from existing sources) of \$500 million (in 1990 dollars)
 No new state taxes; preserve capital budget; deep cuts in aid to local governments and schools and across-the-board cuts in other operating expenses; cap Permanent Fund dividends at 1990 expenditure per recipient
 Local governments make up half the cuts in state aid through increased local taxes

DESCRIPTION: This package illustrates the approach of maintaining capital spending and putting more of the burden of government operating costs on local governments. It would leave capital spending intact and make across-the-board cuts in most operating expenses, but with deeper cuts in aid to municipalities and schools. It would also cap Permanent Fund dividends at the 1990 level and shift the savings to the General Fund. The figure below shows how this approach would fill a \$500 million fiscal gap. The percentages at the left of the figure show how much of the gap would be filled by each category of cut. The percentages at the right show how much each type of state spending would be cut or how much state and local taxes would be increased.



BROAD ECONOMIC AND SERVICE EFFECTS: Deep cuts in the operating budget could cost the economy tens of thousands of jobs and millions of dollars in income, as described in *Fiscal Policy Paper No. 5*. Government services would be broadly reduced, but local programs would be hit especially hard.

BROAD HOUSEHOLD EFFECTS: Household income losses discussed in these packages are just losses resulting from reduced transfer payments and increased taxes (either local tax increases in response to cuts in state aid or new state taxes). Not reflected are effects of reduced services. Losses among household that lost jobs would be much larger.

Households that rely most on transfer payments would lose the most under this package—poor households, households with older people, and many rural households. The cap on Permanent Fund dividends would cost all households some income, but bigger, poorer households would be hurt more. Households would have to pay higher local taxes to help offset sharp cuts in aid to schools and local governments.

Preserve Capital Budget • Fiscal Package 2. Preserve Capital Budget

MEASURING HOUSEHOLD INCOME LOSSES: Below we assess comparative effects of Fiscal Package 2 on our sample households and on Alaska households on average. The figure immediately below shows percentage losses in disposable household income; those numbers show proportional losses among different kinds of households. The figure at the bottom of the page shows how Fiscal Package 2 would change state payments households receive and state and local taxes they pay. These numbers can be compared with the existing payments and taxes shown on page 2.

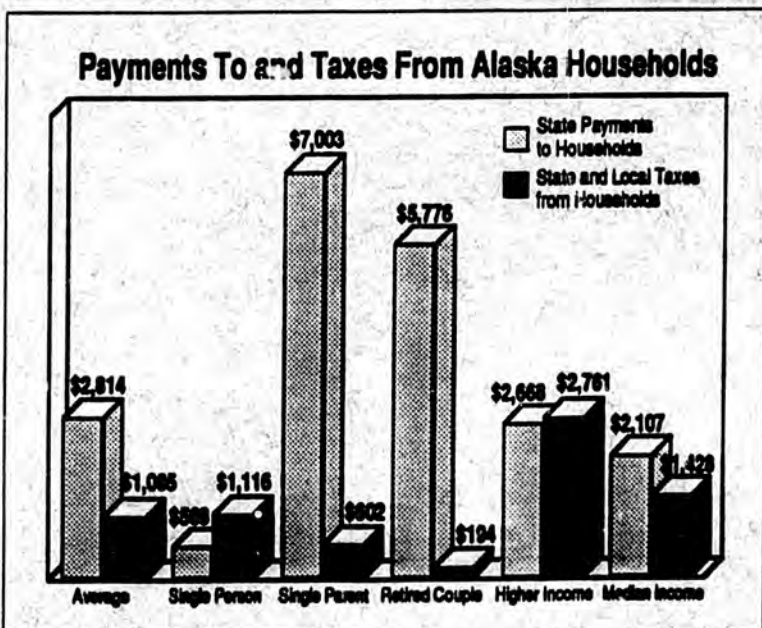
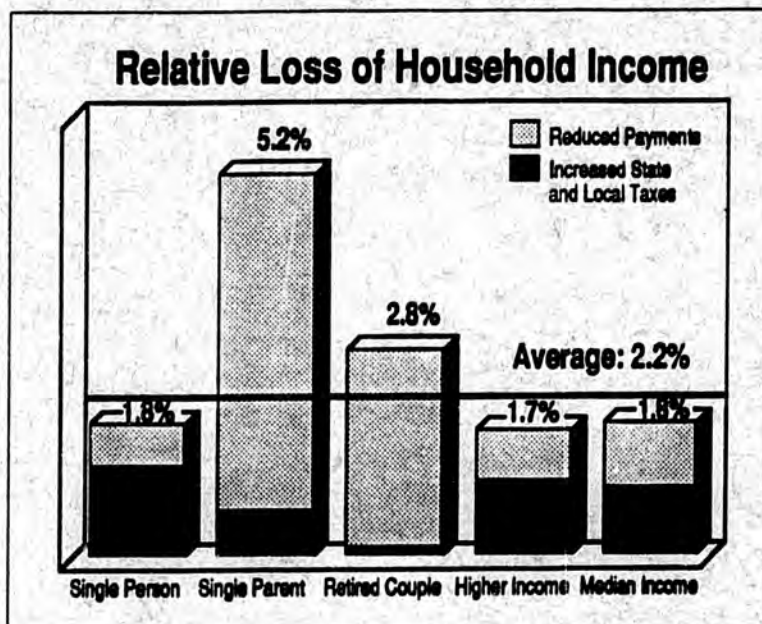
RELATIVE HOUSEHOLD INCOME LOSSES:

Alaska households on average would lose 2.2 percent of their incomes under this package, mostly in reduced transfer payments. The single mother and the retired couple would lose much more, because day care subsidies and Longevity Bonuses would be cut.

PAYMENTS AND TAXES: Three of the five households would still receive more than they paid, but the retired couple and the single mother would both lose close to 15 percent of their transfers because of cuts in day care subsidies and Longevity Bonuses and a cap on dividends. The single person would pay almost twice as much in state and local taxes as he would receive under the capped dividend program, and the higher income family would pay slightly more than they receive.

RELATIVE HOUSEHOLD LOSSES BY REGION:

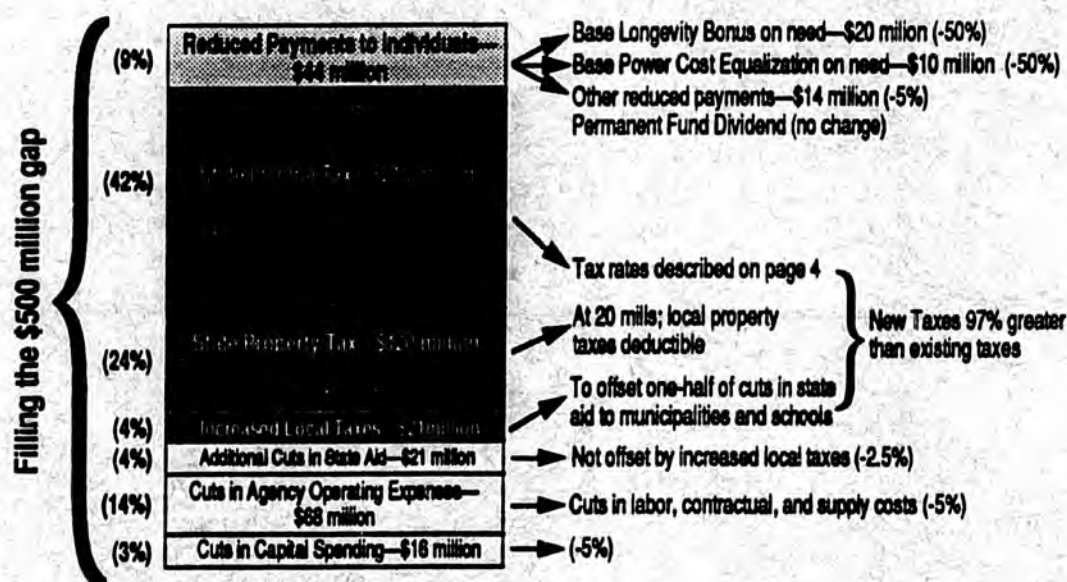
(Not shown) Comparative regional household losses under this package would be similar to those described under Package 1, except that in all regions both cuts in transfer payments and increases in local taxes would be larger. That's because dividends would be capped under this package, and local government aid would be cut more. Areas that have very limited local tax capacity would lose the most services, since they couldn't raise local taxes to make up for cuts in state aid, especially education aid.



Fiscal Package 3. Impose Ability to Pay • Fiscal Package 3. Impose

ASSUMPTIONS: State general fund spending at \$2.5 billion (in 1990 dollars)
 Fiscal gap (difference between current spending and expected revenues from existing sources) of \$500 million (in 1990 dollars)
 Impose state income and property taxes; base some transfer programs on need; make up remaining deficit through across-the-board cuts in operating and capital spending
 Local governments make up half the cuts in state aid through increased local taxes

DESCRIPTION: This package illustrates an approach that would close the gap through a number of measures based on Alaskans' ability to pay: a new state income tax; a property tax that would equalize property tax rates statewide; and changes that would impose need criteria on the Longevity Bonus program and the Power Cost Equalization program. (We recognize that such changes would require statutory changes.) Permanent Fund dividends would be left intact. The figure below shows how this approach would fill a \$500 million fiscal gap. The percentages at the left show how much of the gap each category of cut would fill. The percentages at the right show how much each type of spending would be cut or how much state and local taxes would be increased.



BROAD ECONOMIC AND SERVICE EFFECTS: Economic losses would be smaller under this package than under packages 1 and 2, because state spending cuts would be smaller; but tax increases also cost the economy some jobs and income (see *Fiscal Policy Paper No. 5*). Loss of government services would be only about a third as large under this package.

BROAD HOUSEHOLD EFFECTS: Household income losses discussed in these packages are just the result of reduced transfer payments and increased taxes (either local tax increases in response to cuts in state aid or new state taxes). Not reflected are effects of reduced services. Income losses among those households that lost jobs would be much higher.

Older Alaskans with moderate or higher incomes stand to lose the most under a policy that ties Longevity Bonus payments to need. Some rural households would lose their subsidies for electric bills if the Power Cost Equalization Program were tied to need; how many would be affected would depend on what income level was designated as needy. Moderate and higher income households would pay more than average income taxes.

Ability to Pay • Fiscal Package 3. Impose Ability to Pay • Fiscal

MEASURING HOUSEHOLD INCOME LOSSES: Below we assess the effects of Fiscal Package 3 on our sample households and on Alaska households on average. The figure immediately below shows percentage losses in disposable household income, illustrating proportional losses among households. The figure at the bottom of the page shows how Fiscal Package 3 would change state payments households receive and state and local taxes they pay. These numbers can be compared with the existing payments and taxes shown on page 2.

RELATIVE HOUSEHOLD INCOME LOSSES:

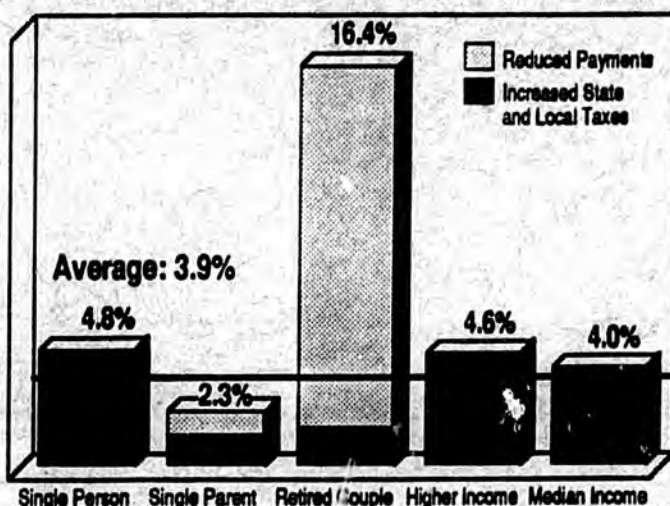
Alaska households would lose on average about 4 percent of their incomes under this package, mostly as a result of new state taxes. The retired couple would lose four times that much, because we assume their income level would make them ineligible for Longevity Bonus payments based on need. The single person would pay higher than average income taxes, because he has no dependents and because he would be unable to reduce the impact on his tax bill by deducting state taxes from his federal return.

PAYMENTS AND TAXES: Households that are able to pay—the single person, the median income family, and the higher income family—would pay more than they receive under this package. The single person would pay three times as much as he receives, because he collects only one Permanent Fund dividend (and he loses more of that dividend to federal taxes than any other household). But the higher income family would also pay substantially (50 percent) more than it collects. The retired couple would lose 75 percent of state payments in losing Longevity Bonus payments. The single parent's transfers payments would remain mostly intact.

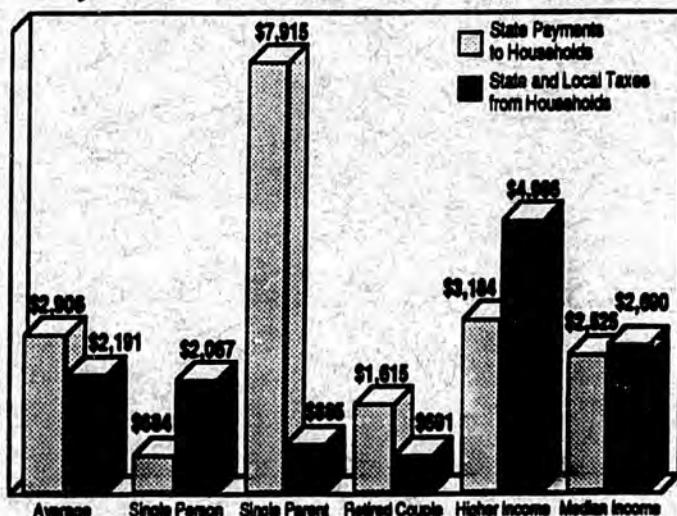
RELATIVE HOUSEHOLD LOSSES BY REGION:

(Not shown) Of course average household tax bills would be higher in all regions under this package, because it adds new taxes. But the relative new tax burden would fall more on urban regions, which generally have higher incomes. However, it is income of individual households and not their location that makes the big difference—rural households that have high incomes would also pay relatively high taxes. Also, areas—both urban and rural—that currently have low mill rates because their commercial tax bases are large would see larger increases than areas where existing property taxes are higher.

Relative Loss of Household Income



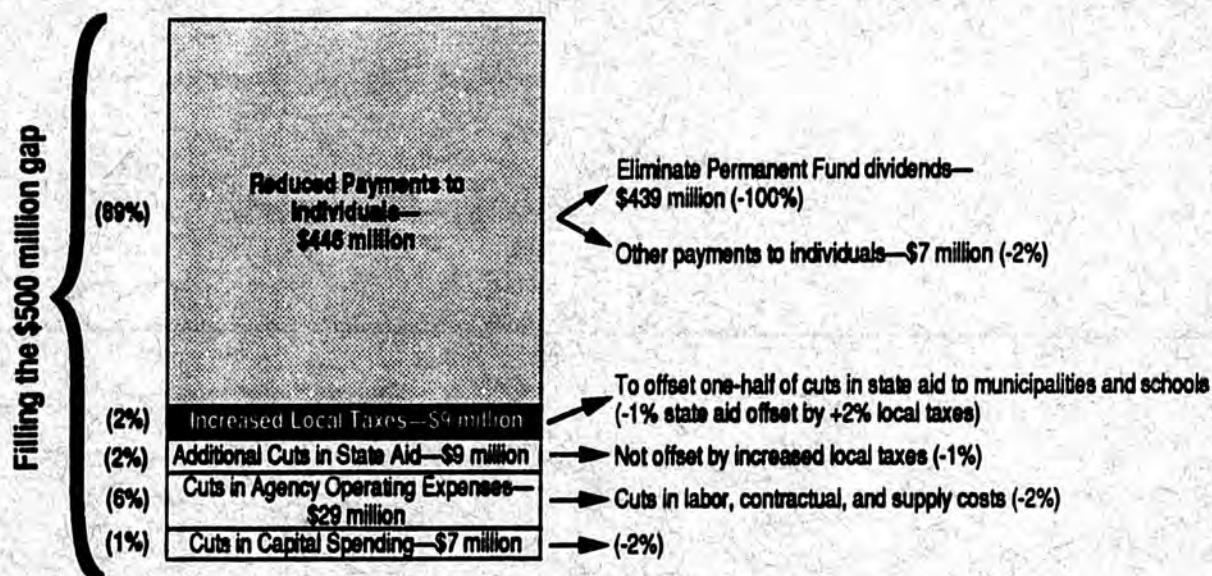
Payments To and Taxes From Alaska Households



Fiscal Package 4. Eliminate Permanent Fund Dividends • Fiscal

ASSUMPTIONS: State general fund spending at \$2.5 billion (in 1990 dollars)
 Fiscal gap (difference between current spending and expected revenues from existing sources) of \$500 million (in 1990 dollars)
 No new state taxes
 Eliminate Permanent Fund dividend program; make up balance of gap through across-the-board cuts in operating and capital spending
 Local governments make up half the cuts in state aid through increased local taxes.

DESCRIPTION: This package illustrates an approach that would require neither deep budget cuts nor new taxes because it would fill most of a \$500 million gap with Permanent Fund earnings. The Permanent Fund dividend program would be eliminated and the money shifted to the general fund. (This change would require statutory changes.) The figure below shows how this approach would fill a \$500 million gap, with the percentages on the left showing how much of the gap would be filled with Permanent Fund earnings and other sources, and the figures on the right showing how much each type of spending would be cut or how much state and local taxes would be increased.



BROAD ECONOMIC AND SERVICE EFFECTS: This package would take several hundred million dollars from private hands and shift it to government, causing loss of private jobs and income. But the broad economic losses under this package would be less than under deep budget cuts, because government spending tends to create more jobs than household spending. (See *Fiscal Policy Paper No. 5*.) Government services could be maintained at close to their current levels.

BROAD HOUSEHOLD EFFECTS: Household income losses discussed in these packages are just the result of reduced transfer payments and increased taxes (either local tax increases in response to cuts in state aid or new state taxes). Not reflected are effects of reduced services. Income losses among those households that lost jobs would be higher.

Effects of this package are straightforward: bigger households with smaller incomes would lose a bigger percentage of income if Permanent Fund dividends were eliminated, because each member of every household collects equal dividend payments.

Package 4. Eliminate Permanent Fund Dividends • Fiscal Package 4

MEASURING HOUSEHOLD INCOME LOSSES: Below we assess the distributive effects of Fiscal Package 4 on our sample households and on Alaska households on average. The figure immediately below shows percentage losses in disposable household income; those numbers show which kinds of households stand to lose the most under this package. The figure at the bottom of the page shows how this package would change state payments households receive and state and local taxes they pay. These numbers can be compared with the existing payment and tax levels shown on page 2.

RELATIVE HOUSEHOLD INCOME LOSSES:

Alaska households on average would lose 6 percent of their incomes under this package, with most of that loss the result of losing Permanent Fund dividends. The single parent would lose the most, because her income is low and she would give up three dividend payments. The median income family would also lose somewhat more than average—because of the size of the dividend payments it loses in relation to its income.

PAYMENTS AND TAXES: Those households whose only state payment is the Permanent Fund dividend—the single person and the families with median and higher incomes—would have no payments left to weigh against taxes if dividends were eliminated. The retired couple would still collect Longevity Bonuses and the single parent would still collect day care and other subsidies. But losing the dividend would cost the single parent 33 percent of her transfer income and the retired couple 25 percent of their transfer income.

RELATIVE HOUSEHOLD LOSSES BY REGION:

(Not shown) This package would cost Alaska households on average \$ 2,400. The biggest households would lose the most, because they would give up the most payments. Rural households on average are significantly bigger than urban households, and also typically have lower incomes—and so depend more on dividends.

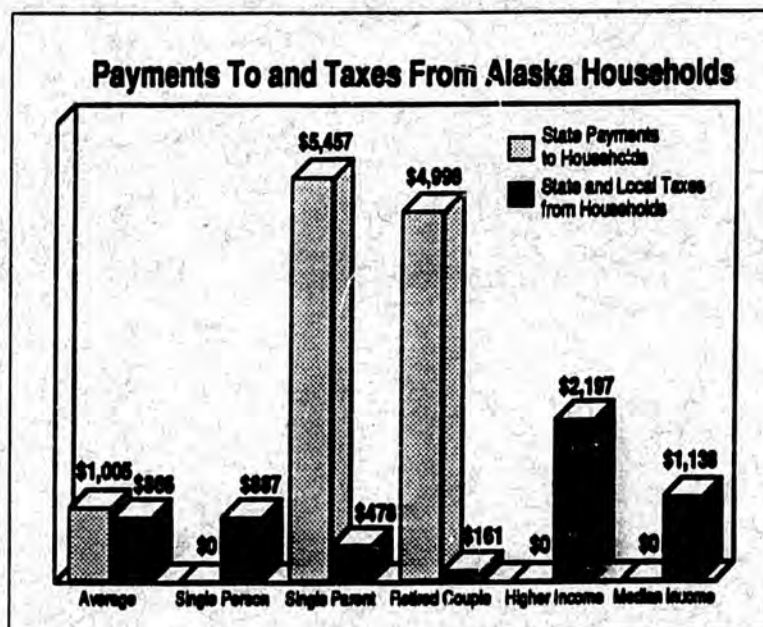
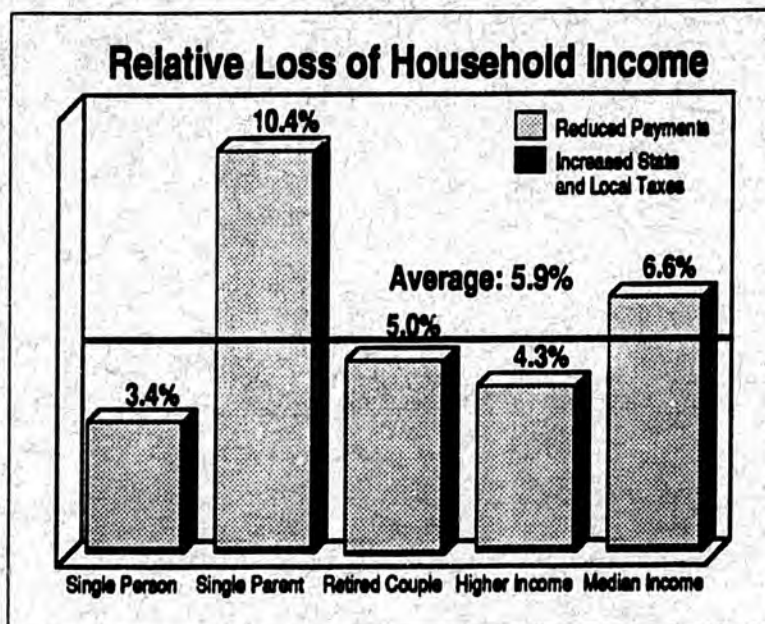


Table 2. Who Will Pay to Fill a \$500 Million Fiscal Gap?

Annual Income Losses of Sample Households (Dollars and Percent of Disposable Income)						
Fiscal Package	GF* Spending (billions of 1989 \$)	Single Person	Single Parent	Retired Couple	Higher Income	Median Income
1. Cut Budget Across-the-Board	\$2.00	\$193 0.9%	\$1,041 4.2%	\$891 2.6%	\$478 0.7%	\$247 0.7%
2. Preserve Capital	\$2.08	\$370 1.8%	\$1,255 5.1%	\$954 2.8%	\$1,090 1.7%	\$670 1.8%
3. Impose Ability to Pay	\$2.33	\$989 4.8%	\$566 2.3%	\$5,630 16.4%	\$2,985 4.6%	\$1,496 4.0%
4. Eliminate PFD	\$2.44	\$708 3.4%	\$2,548 10.4%	\$1,718 5.0%	\$2,794 4.3%	\$2,451 6.6%

*As compared with a base of \$2.5 billion general fund spending.

Summary and Conclusions

No matter how the state government balances its budget in the coming years, all households will pay in one way or another—in higher taxes, in smaller transfer payments, in reduced government services, in lost jobs. It will be up to state officials to determine what combination of budget cuts and tax increases to use in filling the fiscal gap, and to decide whether and how to shift any of the earnings of the Permanent Fund into general government spending. In making those decisions lawmakers need to be aware of how different measures affect different kinds of households.

In our analysis we looked at four combinations of measures for filling a fiscal gap of \$500 million—the magnitude of gap that might open sometime within the next few years. As the figures on page 16 make clear, whenever the gap starts it will grow over time, requiring more and more to fill it. The fiscal packages in this paper are intended to show how different kinds of taxes and budget cuts and use of Permanent Fund earnings would affect households. If the gap were larger than the \$500 million we use, then deeper cuts or higher taxes would be required to fill it—but the relative effects on households would be similar to what we describe.

We're not advocating the combinations in our four fiscal packages, but are rather using them to show the kinds of choices lawmakers have—and to make it clear that what they choose can make a big difference to Alaska households.

The table above summarizes the decline in government spending and the relative loss of household income under the four fiscal packages we profiled. A number of points are clear from the table and from our analysis:

- The larger a budget Alaskans chose to maintain, the more they will have to pay. The unresolved questions are how much state spending Alaskans want, and how much they are willing to pay.

- The less state officials ask Alaskans to pay, the more government services will decline. Hundreds of millions of dollars in budget cuts would cost the average household relatively little in direct income losses—but they would cost everyone a great deal in lost education, police and fire protection, road maintenance, and other services we expect from state and local government.

- Eliminating Permanent Fund dividends and shifting the money to general government spending would cost Alaska households the most income but would require the smallest cuts in government services—because the dividend money alone would nearly fill a \$500 million budget deficit.

- The more state officials balance the budget through across-the-board spending cuts, the less it will directly affect the incomes of most Alaska households—but the more it will cost poor and elderly households. That's because most households don't receive the transfer payments and subsidies poorer and older households rely on and which would be reduced under across-the-board budget cuts.

- Households on average would lose less income if the state balanced its budget by raising taxes rather than by eliminating Permanent Fund dividends. That's true because businesses would pay a part of new taxes, while households would bear the entire cost of losing dividend payments.

- Smaller, more affluent families and most single Alaskans would probably prefer to see Permanent Fund dividends eliminated rather than pay major new taxes—because they would likely lose less in dividends than they would pay in new taxes.

- Large, poor households could lose several times more than smaller, wealthier households if Permanent Fund dividends were eliminated. Among our sample households, for instance, the single parent with two children could lose 10 percent of her income, as compared with about 4 percent for the higher income family of four. Obviously the difference would be even bigger for larger low-income households. Many larger, poorer families live in rural areas.

- Cutting the Longevity Bonus program across-the-board would take some income from all Alaskans over 65, while basing the program on need would take the entire bonus away from some but protect the payments of those with lower incomes. Our sample retired couple, for instance, has an income near the Anchorage median for those over 65. Under cuts sufficient to save \$20 million, they would lose close to 6 percent of their income; obviously lower-income households would lose more. If the state saved the same \$20 million by making half the current recipients ineligible, our retired couple would lose 15 percent of their income—but older Alaskans with lower incomes would still receive the bonus intact.

- If property taxes were equalized statewide (through a state property tax), residents of areas with low local property taxes relative to their tax bases would pay the biggest increases. Areas that already have higher property taxes, and areas that have little or no tax base, would see more limited increases. (If property tax rates were equalized statewide, that would not equalize the entire tax burden, since sales taxes vary by community.)

- If local governments make up at least part of reduced state aid through increased local taxes, then rural cities would have to make up the most. That's because current per capita state payments for education and general government are higher in rural areas.

- Big budget cuts would hit incomes of rural Alaskans in general harder than incomes of urban residents, because they receive more transfer payments and subsidies.

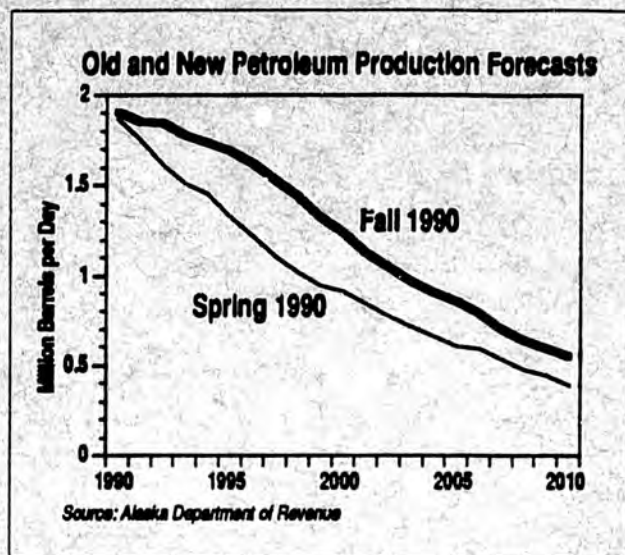
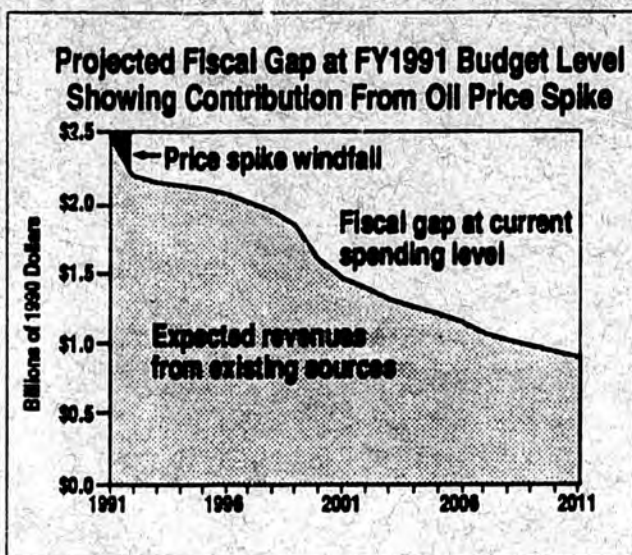
Today Alaskans—whether poor, in the middle, or at the top—pay little or nothing for state and local services, because there are no major state taxes and Permanent Fund dividends exceed local taxes for most households. The dividend program makes annual cash payments to virtually all Alaskans, and the Longevity Bonus program makes monthly payments to Alaskans over 65, regardless of income. Those programs were designed to share with individual citizens the state's oil wealth that is now fading.

Many needy families and older people have come to depend on those transfer programs, although they were not intended as aid programs. In deciding how to balance the budget, lawmakers need to consider the dependence these programs have fostered.

And there are many other issues of equity state officials will have to face as they deal with budget deficits. We've seen, for instance, that deep budget cuts would fall hardest on those poorer households and regions that depend most on state subsidies. Which subsidies should the state maintain in an era of declining revenues?

The equity of government policies didn't concern Alaskans much in the last decade, because oil wealth meant there was plenty for all and individual citizens didn't have to carry the burden of state government. But now lawmakers will have to make tough decisions about who will pay for Alaska's government in the 1990s.

The Alaska Fiscal Gap



We've heard a lot lately about the likely size of the state revenue windfall associated with the Middle East war. The best current information suggests the windfall will be much smaller than previously anticipated, and will be able to provide a cushion against declining revenues for no more than one year (graph at left above).

A more significant development influencing the perceived size of the fiscal gap is the Alaska Department of Revenue's recent upward revision of its petroleum production projections. The revision adds on average 300 thousand barrels per day in production through the year 2000 (graph at right above). Our latest fiscal gap graph

reflects this revision, and shows that if the higher production is sustained, it will cushion the decline in revenues, particularly in this decade.

Although the shape of the latest fiscal gap graph is altered by this new assumption, its message is unchanged. Revenues from existing sources will decline and a significant and growing fiscal gap will open this decade. The shape of the gap will continue to change as information on petroleum prices and production, settlement windfalls, and the budget level change over time. But a gap will remain. Alaska needs to plan now to minimize the fiscal and economic problems it will bring. □

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