

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILES 8672

2395 SCOMM 101 LONG RANGE FINANCIAL PLANNING COMMISSION, 1995

July 7th, 1995
ANCHORAGE DAILY NEWS

Communities look for harbor-upkeep revenue

The Associated Press

JUNEAU — Coastal communities are looking for alternative sources of revenue for harbor upkeep now that Gov. Tony Knowles has vetoed an increase in boating fuel taxes.

The legislation, vetoed by Knowles last week, would have raised the state marine fuel from 5 cents to 8 cents, with the extra proceeds going to local communities for harbor repairs.

Knowles spokesman Bob

King said the governor vetoed the bill because he does not want to raise taxes.

"I know many of those communities do have their needs, but the governor made a pledge in his state of the budget address that there will be no new taxes until we have our house in order," King said.

Knowles said he is awaiting recommendations from his financial planning panel before he authorizes any new taxes.

The higher fuel taxes

would have raised an estimated \$5 million this year, money that could have been used for local communities to take over and repair or replace state-owned harbors.

City officials, especially in Western Alaska, had asked for the higher taxes to raise money for deteriorating docks and harbors.

"We're trying to get some sort of stable maintenance revenue for the ports and harbors in the state," said Dutch Harbor port director Jim Stearns. "We

already put in a lot of local money into our facilities."

Harbors raise considerable cash for the state and deserve more financial support, Stearns said.

In Juneau, harbor master Joe Graham said officials had figured the rise in fuel taxes would not come through and had not counted on the money.

Knowles said he would try to incorporate parts of the boat-fuel bill into future plans for communities to take over state harbors.

TO: Members, Long Range Financial
Planning Commission

From: Staff
258-8165

Legislative Research Agency

Alaska State Legislature



130 Seward Street, Suite 218
Juneau, Alaska 99801-2196

Phone: (907) 465-3991
Fax: (907) 463-3351

March 3, 1994

MEMORANDUM

TO: Representative Mark Hanley

FROM: Gordon S. Harrison, Director 

RE: "Endowment" Method of Using Trust Fund Income
Research Request 94.161

You noted that the fiscal plan advocated by Mr. Roger Cremo relies on an annual withdrawal from the permanent fund of a certain percentage of the fund's assets (measured by market value), and you asked if this technique is used by other, large trust funds. The answer is yes. In fact, it is the method typically used by such funds. We refer to the method here as the "endowment" method or the "payout" method, although I do not know if those are conventional terms used in financial circles.

Ideally, the fixed percentage of a fund's assets withdrawn each year under the endowment approach is equal to the long-term *real* rate of return of the fund. If the annual payout exceeds the real rate of return, the principal of the fund erodes. Thus, if inflation averages 4 percent per year, and the fund's nominal rate of return averages 10 percent per year, then the payout should not exceed 6 percent per year for the fund to stay whole ("inflation proofed" in the parlance of the Alaska permanent fund). Under the endowment approach, managers calculate *total* return, not just cash return. That is, unrealized appreciation or loss is included in the calculation of annual return.

The Alaska permanent fund does not use the endowment method of determining income that may be appropriated annually by the legislature. Rather, it uses a strictly cash method. That is, only cash income generated by the fund during the year is available for use: unrealized capital gains and losses are excluded from the computation of income. A few years ago there was considerable interest on the part of a few permanent fund trustees to switch to an endowment approach. The trustees saw three advantages to it.

One advantage is that the method does not distort investment strategies by requiring that the fund produce a minimally acceptable amount of cash each year. That is, under the current, cash-based system, fund managers may sell securities that they would not otherwise sell at that time in order to have sufficient cash to pay dividends and inflation proof the fund.

Representative Hanley

March 3, 1994

Page 2

Another advantage perceived by the trustees interested in the endowment approach is that it could allow the fund to shift more of its assets into equities (stocks), where higher long-term returns have been the historical experience, in contrast to fixed income securities such as bonds. The problem with equities, from the perspective of the current management regime, is that they do not generate much cash and their returns are volatile from year to year. The trustees thought that the endowment approach would encourage a longer-term investment perspective by diverting public attention from the annual cash performance of the fund. Finally, the trustees were interested because the endowment method is simple and understandable, whereas the current management and accounting scheme of the permanent fund is complex and understood by surprisingly few people.

During the administration of Governor Cowper, analysts in the Alaska Office of Management and Budget interviewed the managers of a number of large, nonprofit, foundation trust funds and university endowment funds. Apparently the federal Internal Revenue Service requires such trust funds to pay out at least 5 percent of assets in order to retain their nonprofit status. The analysts found that the payout from these funds was typically between 5.5 and 6.5 percent. They also found that an overriding goal of these fund managers tended to be financial stability for the programs the fund supported, and in some cases the managers tolerated a payout higher than the long-term average real rate of return of their fund, and thus erosion of principal, in pursuit of this goal. If you are interested in pursuing this matter, you should contact OMB analyst Jack Fagnoli (extension 3568).

I hope this information is what you were looking for. Call if you have questions or want additional information.

FAX COVER SHEET

TO: BRIAN ROGERS
456-2531

14 MAY 1995

BRIAN:

PERHAPS WE SHOULD INVITE DAVID
REAUME TO GIVE HIS POINT OF VIEW TO THE
COMMISSION!!

MAF

**STATE OF ALASKA
LONG RANGE FINANCIAL PLANNING COMMISSION**

716 West Fourth Avenue, Anchorage, Alaska 99501

Phone: (907)258-8165, Fax (907)258-9869

Internet: LRFPC%legis@state.ak.us

Staff: Melissa Aber Fouse

Bob Walsh

05 July 1995

Mr. Mark Eames
PO Box 368
Barrow, Alaska 99723

Dear Mr. Eames:

Attached is the list of commission members you requested. Your first message was cut off by the answering machine and the number left on your second message was not a working number, according to the operator.

I hope this is the information you need. Please feel free to call again if you have any further questions.

Sincerely yours,

Melissa Fouse

STATE OF ALASKA
LONG RANGE FINANCIAL PLANNING COMMISSION
716 West Fourth Avenue, Anchorage, Alaska 99501
Phone: (907)258-8165, Fax (907)258-9869
Internet: LRFPC%legis@state.ak.us
Staff: Melissa Aber Fouse

PLEASE NOTE:

**THE LONG RANGE FINANCIAL PLANNING
COMMISSION OFFICE HAS MOVED TO
ROOM 470 IN THE LEGISLATIVE
INFORMATION OFFICE - 716 WEST
FOURTH AVENUE.**

**THE NEW PHONE NUMBER IS
258-8165**

**THE NEW FAX NUMBER IS
258-9869**

**THE E-MAIL ADDRESS WILL NOT WORK
FOR ABOUT A WEEK**

**PLEASE STAY TUNED FOR FURTHER DEVELOPMENTS. I WILL
KEEP YOU POSTED.**

A handwritten signature in black ink, appearing to be 'M. F.' or similar, written in a cursive style.



STATE OF ALASKA

LONG RANGE FINANCIAL PLANNING COMMISSION

AGENDA
Saturday, 08 April 1995

11:00 am:

Call to Order

Introductions

Speaker Phillips: discussion of HCR 1 and its charge to the
Commission (depending upon session schedule).

Strategy Session: How to Achieve the Goals of HCR 1

1:00 pm:

Break for Lunch (Sandwiches to be sent in)

2:00 pm

Reconvene

Elect Chair

Discussion of Work Plan, Timelines, & Staff Assignments

Budgeting Briefing:

Sources of Revenue/Revenue Projections

Five-Year Projections

MEMORANDUM

30 MARCH 1995

TO: Suzanne Lowell
Chief Clerk, House of Representatives'

FROM: Melissa Fouse
Staff, Long Range Financial Planning Commission

The Long Range Financial Planning Commission will be meeting on April 8th, 1995 in Juneau. The meeting will take place in the Butrovich Room from 11 am to 1 pm and from 2 pm to 5 pm. This meeting will be teleconferenced.

Please include notice of this meeting in the Committee Schedule. If you have any questions, please feel free to call me at 258-8170 in Anchorage.

MEMORANDUM

30 MARCH 1995

**TO: Nancy Quinto
Senate Secretary**

**FROM: Melissa Fouse
Staff, Long Range Financial Planning Commission**

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TONY KNOWLES
GOVERNOR



STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

P.O. Box 110001
Juneau, Alaska 99811-0001
(907) 465-3500
Fax (907) 465-3532

March 24, 1995

Ms. Judy Brady
121 West Fireweed
Anchorage, AK 99503

Dear Ms. Brady:

Judi
Thank you for agreeing to serve on the Long Range Financial Planning Commission. Although the charge of the commission is ambitious and the time frame short, we are very optimistic that the commission can meet its goal of developing fiscal plan recommendations by this fall. The experience and knowledge which you and the other members bring will ensure the success of this effort.

The first meeting of the commission is scheduled for Saturday, April 8th in Juneau. We would like to start with a get-acquainted breakfast that morning. Among the items of business for the meeting will be the election of a chair and vice-chair from among the public members, a review of the draft time line and work plan for the months ahead, and a general discussion of the budgetary issues facing the state and the commission.

Enclosed is a copy of HCR 1 which established the commission and a list of the commission members. Melissa Fouse is providing staff coordination for the commission and will send you additional information on the upcoming meeting, including travel arrangements. Please feel free to call her at (907) 258-8170 if you have any questions.

Again, we wish to express our sincere appreciation for your help on one of the most important issues facing Alaska.

Sincerely,

Tony Knowles
Governor

Sincerely,

Drue Pearce
President of the Senate

Sincerely,

Gail Phillips
Speaker of the House

Enclosures

cc: Senator Georgianna Lincoln
Senator Steve Rieger
Representative Mike Navarre
Representative Sean Parnell
Annalee McConnell, Director, OMB
Pat Pourchot, Legislative Director

Many thanks!

March 24, 1995

FIELD(name/address)

Dear **FIELD**(salutation):

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Drue Pearce
President of the Senate

Gail Phillips
Speaker of the House

Enclosures

cc: Senator Georgianna Lincoln
Senator Steve Rieger
Representative Mike Navarre
Representative Sean Parnell
Annalee McConnell, Director, OMB
Pat Pourchot, Legislative Director

Mr. Robert W. Loescher
Executive Vice President
Sealaska Corporation
One Sealaska Plaza, Suite 400
Juneau, AK 99801-1276 ~~ENDFIELD~~
Mr. Loescher ~~ENDFIELD~~
~~ENDRECORD~~

Mr. Brian Rogers
P.O. Box 80690 College Station
Fairbanks, AK 99708-0690 ~~ENDFIELD~~
Mr. Rogers ~~ENDFIELD~~
~~ENDRECORD~~

Chancellor Lee Gorsuch
c/o University of Alaska Anchorage
3211 Providence Drive
Anchorage, AK 99508 ~~ENDFIELD~~
Chancellor Gorsuch ~~ENDFIELD~~
~~ENDRECORD~~

FIELD NAMES (name/address; salutation) ENDRECORD

Ms. Judy Brady
121 West Fireweed
Anchorage, AK 99503 ENDFIELD
Ms. Brady ENDFIELD
ENDRECORD

Mr. Bruce Ludwig
211 Fourth Street, Suite 406
Juneau, AK 99801 ENDFIELD
Mr. Ludwig ENDFIELD
ENDRECORD

Ms. Mary Nordale
Birch, Horton, Bittner & Cherot
100 Cushman, Suite 311
Fairbanks, AK 99701 ENDFIELD
Ms. Nordale ENDFIELD
ENDRECORD

Mr. Mike O'Connor
4300 B Street, No. 603
Anchorage, AK 99503 ENDFIELD
Mr. O'Connor ENDFIELD
ENDRECORD

Ms. Marie Westfall
P.O. Box 5193
Ketchikan, AK 99901 ENDFIELD
Ms. Westfall ENDFIELD
ENDRECORD

Mr. Hugh Motley
P.O. Box 710
Cooper Landing, AK 99572 ENDFIELD
Mr. Motley ENDFIELD
ENDRECORD

2 of 2

OIL: Industry giants get involved in rare public hostilities

Continued from Page D-1

The most public displays of differences are usually guarded jibes at oil-industry gatherings. Like the time an Arco vice president criticized an unnamed company for backing out of exploration in Alaska to spend its money elsewhere. Anyone in the business knew who he meant: BP.

This time, it's different.

Jeff Lowenfels, president of a company that wants to market Alaska's natural gas, called this week's hearing "the most vicious administrative hearing I've ever sat through. Arco was clearly saying: 'BP you cooked the books ... your people lied.'"

The word "lie" was never uttered, of course. But the accusations were thick and the atmosphere was tense. One day this week, John Donovan, an attorney for Arco, said BP was arguing a case that benefits only its bottom line. "BP's

technical case is a sham," he charged.

When the Prudhoe oil companies produce their oil, they also produce the field's natural gas. Most of that gas gets injected back into the ground to help push more oil from the field. The gas could be sold in world markets later.

But some gas becomes liquid during oil production, and some of this liquid gas gets put into the trans-Alaska oil pipeline and shipped to market.

A few months back, Arco tried to boost the amount of liquid gas that it ships with crude. Trouble is, the pipeline where gas and oil are mixed is on BP's side of the field. Arco says it notified BP that more gas was coming but BP refused to open the valve allowing more blending.

BP says that liquid gas is too important to sell now. The state could lose 200 million barrels of oil and gas over Prudhoe Bay's life if that gas

isn't put back into the ground, BP says. That's the size of a very large oil field.

Arco says BP is overestimating how much extra oil the gas will push up — and that the state's take from gas sales now will outweigh the value of that extra oil.

Refereeing this issue is a little-known but powerful state group called the Alaska Oil and Gas Conservation Commission. The three-man panel is charged with ensuring none of the state's oil and gas is wasted, and it can force the companies to operate differently so the state gets its fair share.

David Johnston, who heads the commission, says he expects to rule on the Arco-BP fight this summer. But that the hearings have raised additional concerns about whether oil companies' separate oil and gas ownership is good for the state.

In the past, he said, the

commission usually let the oil companies do what they wanted in developing the field — with the notion that money-making entities would try to maximize profits, which is good for Alaska's economy.

That was fine when Prudhoe Bay was such a prolific oil producer, because even owners with smaller piece of oil ownership got a lot of crude. Prudhoe still is the nation's biggest oil field. But, as less crude is produced, Johnston fears the field will continue to be run as an oil field to satisfy the more powerful and numerous oil owners. That group includes BP, but also companies like Texaco that own only oil and no gas.

Johnston says the commission might force the companies to add the field's oil and gas together and take a single percentage of the total. But it could take months to reach that decision.

Beard
Pierce
465.
3008

1 of 2

Oil giants grapple over gas

Differences yield rare public hostilities among companies

By KIM FARARO

Daily News business reporter

This week's battle before the state's oil and gas commission wasn't anything like what you'd see on "Geraldo." No overturned chairs, no broken noses. But the argument was as close to a brawl as Alaska's giant oil companies get — at least in public.

The issues: Who, if anybody, is cheating the state out of millions of dollars. And does

this fight suggest the ownership structure of the giant Prudhoe Bay field will cost the state millions more.

At the heart of both matters is money, and how different oil companies see Prudhoe's money-making possibilities very differently.

Under an agreement set up years ago, companies own one percentage of the oil and a different percentage of the natural gas.

What that might mean, some officials say, is that Prudhoe's majority oil owners are so intent on producing crude that they'll delay gas production too long — possibly losing the state its best chance to market the valuable commodity.

But that's getting ahead of the story.

First the basics. Prudhoe Bay is owned by 11 companies but dominated by three. BP Exploration (Alaska) Inc. owns

51 percent of the oil but only 14 percent of the gas. Arco Alaska Inc. and Exxon USA Inc. each own 22 percent of the oil but 43 percent of the gas.

Arco and Exxon want to produce more gas. BP says that would be a big mistake.

The owners often disagree, and the fights are often ugly. But they're behind closed doors.

Please see Page D-4, OIL

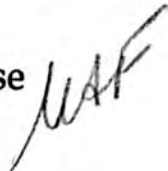
ADN Thurs, June 22, 95

MEMORANDUM

29 March 1995

TO: Members, Long Range Financial Planning Commission

FROM: Melissa Aber Fouse
Staff



The first meeting of the Long Range Financial Planning Commission scheduled for April 8th in Juneau will begin at 11 am in the Capitol Building, Room 205 (Butrovich Room). We plan to have an informal coffee hour beginning at 10 am, also in the Butrovich Room. This meeting will be teleconferenced.

The schedule as it stands now is as follows:

11:00 am to 1:00 pm	Meeting
1:00 pm to 2 pm	Break for Lunch
2:00 pm to 5:00 pm	Meeting

Those members flying from Anchorage can fly down and back the same day if they so desire. Alaska Airlines Flight 62 leaves Anchorage at 7:50 am and arrives in Juneau at 9:29 am. Flight 67 leaves Juneau at 6:55 pm and arrives in Anchorage at 8:35 pm. Members wishing help with their reservations are welcome to call me at 258-8170.

cc:Mail for: Melissa Fouse

Subject: LRFP

From: LHSCMAF 1/30/95 2:56 PM

To: LHSCMM at JNU_CAPITOL

So what is the scoop on the Long Range Financial Planning Commission? Who is carrying the bill for Gail? Staff-wise, I mean. I think there should be a whereas or a section in the "shall" part that talks about maintenance of public facilities, a la Jeanette James HB 81. I think this is a good deal and whatever small thing I can do to help in on its way, please feel free to call on me.

Oil ban falls in House

New measure allows exports

By DAVID WHITNEY
Daily News reporter

WASHINGTON — Oil from Alaska's North Slope, which for 22 years could be sold only in the United States, may be trading on foreign markets early next year under legislation passed by the House Monday.

The Senate passed similar legislation in May, and President Clinton has said he'll sign it.

Ending the export ban will be a financial boon to Alaska and the North Slope's largest producer, British Petroleum, because prices are expected to rise as much as \$3 a barrel.

"We have believed all along that Alaskan crude should be available for export where it will be sold at a price set by the marketplace," Charles H. Bowman, head of BP America, said

Please see Back Page, OIL

QDN
25 July 95

Note: Revenue is sticking by its projections of \$80 million from this

PER ROGER MARKS:

WILL RESULT IN
\$80M YR 1
40M YR 2
20M YR 3

will be updated in fall forecast.

25 July 95

OIL: U.S. House approves export measure

Continued from Page A-1

in a prepared statement after the vote.

According to the U.S. Department of Energy, selling Alaska oil abroad could stimulate oil production in California and Alaska. That could add as many as 25,000 jobs and \$1 billion in state and federal tax receipts by the turn of the century, the agency said. Alaska's share of that would be about \$140 million a year.

But critics warned the move could raise gasoline prices for West Coast motorists. They also charged that the additional industry profits are not likely to be plowed back into domestic production, and that lifting the ban will increase U.S. dependence on foreign imports.

"We're going to create a fire sale and then we'll be completely dependent on the Middle East," said Rep. Sam Gejdenson, D-Conn.

Rep. George Miller, D-Calif., charged that the bill "represents the collapse of the argument that producing oil is vital to American security." But Rep. Don Young of Alaska said that the majority of U.S. oil imports now come from Canada and Mexico and that U.S. dependence on

Middle Eastern oil has declined. And with Alaska oil no longer depressing West Coast prices, he said, domestic production will soar.

Last year, Gejdensen was chairman of the committee overseeing foreign trade and was able to crush oil-export efforts. With Republicans now in charge of the House, however, most Democrats joined them on the export bandwagon as the chamber voted 324-77 to lift the ban.

While there are differences between the the House and Senate versions, those should be ironed out quickly. Alaska Republicans control the committees that wrote the legislation. Sen. Frank Murkowski heads the Senate Energy and Natural Resources Committee and Rep. Young, who pushed the bill on the House floor Monday with only minimal resistance, is chairman of the House Resources Committee.

The administration still would have to complete an environmental analysis before any oil could be exported, but Energy Department officials think that will take less than six months.

Still, there could be rough international waters ahead.

The bill requires the oil to be carried on U.S.-flagged and crewed vessels. The Clinton administration said that the restriction doesn't violate international trade agreements, but many countries hotly disagree.

Last week, European Union officials protested the exclusive shipping arrangement before the World Trade Organization in Geneva. If the organization agrees, the United States may be forced either to pay off the complaining countries or open the exports to foreign tankers, U.S. Trade Representative Mickey Kantor has said.

The North Slope oil export ban has been in force since 1973, when Congress gave the go-ahead to construct the 800-mile trans-Alaska oil pipeline. At the time, the United States was in the midst of an oil crisis created by an embargo on oil shipments from the Middle East. Congress wanted to make sure that Prudhoe Bay's huge reserves stayed in the country.

The consequence is that crude oil which couldn't be refined and sold on the West Coast was shipped down the Pacific to Panama, unloaded into a pipeline, and then pumped to tankers for delivery to

Gulf Coast refineries. Those added transportation costs dampened the oil's value and reduced Alaska's royalties.

Eliminating the West Coast surplus has been the driving economic force behind lifting the export ban. The argument was that if there was no surplus, Alaska oil would trade at higher world market prices. As it turns out, there isn't much of a surplus left. Prudhoe Bay oil production is declining, though it still amounts to about 25 percent of domestic production, and it is now selling at close to world prices.

The major advantage of selling the oil abroad now will be the even lower transportation costs of shipping overseas. According to the Energy Department study, Alaska oil carried on huge supertankers can be delivered at less cost to Japan than to San Francisco.

Export authorization comes as the Alaska delegation is also pushing to open the Arctic National Wildlife Refuge to oil drilling. The refuge's coastal plain is believed to be the best prospect for a giant oil discovery in North America. Any oil pumped from there could be exported.

The Anchorage Times

Publisher: BILL J. ALLEN

"Believing in Alaskans, putting Alaska first"

Editors: DENNIS FRADLEY, PAUL JENKINS, WILLIAM J. TOBIN

The Anchorage Times Commentary in this segment of the Anchorage Daily News does not represent the views of the Daily News. It is written and published under an agreement with former owners of The Times, in the interests of preserving a diversity of viewpoints in the community.

Drip, drip, drip

IN SOMETHING akin to water torture, Alaskans are finding themselves subjected to a subtle but relentless bit of brainwashing. They are being quietly told over and over again — in a drip, by drip, by drip process — that, of course, one day Alaska will have to reinstitute a personal income tax.

They keep hearing in a never-ending variety of ways that if and when the time comes — and it's not really a question of *if*, but of *when* — good-hearted Alaskans will accept a new income tax because, well, it's simply the thing to do.

After, all don't all states have an income tax?

Well, as a matter of fact, not all states do have an income tax. New Hampshire, for one, gets along very well without a levy against personal income. So do six other states, thank you — and others are increasingly in a tax-cutting mood.

In Alaska, however, where the income has been off the books for more than a decade and a half, there are those who can't stand the thought of people not paying taxes — sales taxes, property taxes, income taxes, you-name-it taxes.

Taxes are necessary to support government, you see. And supporting high-paying public sector jobs is crucially important to a big number of people — and that makes the imposition of taxes an issue for a lot of politicians.

The argument in support of the let's-convince-you, drip-drip-drip faction is that the state is facing a huge fiscal crisis, and a personal income tax is the only way to close the gap between declining income and continued high spending.

But of course it isn't the only way — or even the one that will work most effectively.

The state pays out more each year in Permanent Fund dividends than it would collect in personal income taxes set at any sort of reasonable level. Elimination or reduction of the annual Permanent Fund handouts would do the job nicely. Ah, but that's a whole different political hot potato, isn't it?

Furthermore, the imposition of an income tax would mean that a whole new bureaucracy, made up of auditors, enforcement agents, collection clerks and administrators, would have to be created — thus providing more government jobs, complete with rich benefits in the form of vacations, health insurance and pensions. And that's a preferred option to a lot of people.

The state's left hand would continue once a year, under this drip, drip, drip scenario, handing out hundreds of millions of dollars in money to every man, woman and child, workers and non-workers alike, while its right hand would be taking away a big chunk of the earnings of those who happen to be working for a living.

And all the while the Permanent Fund bulges with \$15.5 billion, the ultimate use of which still remains a mystery.

THE
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ADN 11 Aug 95

State fiscal panel nearing end of preliminary findings

By DAVID GERMAIN
The Associated Press

JUNEAU — A grab-bag of money measures — from reducing Alaska's dependence on oil revenue to bringing back the income tax — are under consideration by a panel examining the state's long-term financial troubles.

The Long Range Fiscal Planning Commission this weekend is putting finishing touches on a preliminary report to hold state spending in line with revenue.

Appointed last spring by Gov. Wally Knowles and legislative leaders, the 15-member panel is trying to come up with a business plan to deal with ongoing challenges that are expected to grow worse in the next decade.

The preliminary report, expected to be finalized at a meeting today and Saturday in Anchorage, makes no recommendations. That will come in October, when the panel issues its final report to the Legislature and the governor.

Many of the ideas the panel has discussed are old ones, such as raising the income tax, a politically unpopular proposal that some conservative members feel is inevitable.

Equally unpopular is a proposal to cap payouts to Alaskans from the state's Permanent Fund, using the excess revenues for government services.

Panel members said, no matter what recommendations they make, the message is clear: State government is in a painful bind. "We're in the sort of situation where, if we don't do something, we will be in that position a few years from now."

“We’re not in a crisis situation now. The problem is, if we don’t do something, we will be in that position a few years from now.”

— Annalee McConnell, state budget director

plagues other states.

“We’re not in a crisis situation now. The problem is, if we don’t do something, we will be in that position a few years from now,” said Annalee McConnell, state budget director and a member of the panel.

In recent years, the state has avoided budget deficits only by drawing on reserve funds, money that came largely from tax and royalty lawsuits against oil companies.

This year alone, reserve cash will pay for about one-fifth of the state’s \$2.5 billion budget. That keeps up the reserve fund — now at about \$2.3 billion — could be gone over the next decade.

The state already has begun cutbacks, reducing spending this year. The commission is trying to come up with other spending cuts along with ways to bring in more money.

Oil revenues account for four-fifths of the state’s annual income. But the uncertainty of oil prices, along with declining oil production from the vast Prudhoe Bay field, makes it hard to predict revenues.

While state officials want to develop new businesses to offset the loss of oil money, it will take time to be Alaska’s main source of income.

near future, said Rep. Sean Parnell, R-Anchorage, a commission member.

“There’s no way we can hope to diversify our revenue base enough in the next 10 to 20 years to make up for declining oil revenues,” Parnell said. “Prudhoe Bay is the main source of state government revenue and there’s no way we can replace it.”

That has led to talk of new taxes, such as increasing motor fuel taxes or bringing back the personal income tax enacted in the late 1930s. When the state was founded, it had no new oil cash.

“Everyone in the government financial community is kind of sorry we’re dealing with the income tax,” said Bruce Ludwig, a commission member and business manager of the Alaska Public Employees Association, a union representing 1,500 state workers. “It’s going to be real hard for people to accept it again.”

Parnell and other Republicans who control the Legislature have said that the public will accept any tax increase if the state brings spending under control.

Panel members said they will recommend a mix of measures, including a new income tax, to bring the state’s budget in line with revenue.

A PRACTICAL GUIDE
FOR
DEALING WITH THE FISCAL GAP

Cliff John Groh

April, 1990

I. The Nature of the ProblemA. The Fiscal Gap Is Real, and Is Potentially Very Wide

The biggest question facing Alaska today is how to deal with the difference between income and outgo in the state budget. This "fiscal gap" will be the issue of the 1990s as much as state spending was the issue of the 1980s.

The budget is about \$2.3 billion for fiscal year (FY) 1990. (This figure represents unrestricted General Fund dollars, which is what most people mean when they say "the budget.") The budget faces numerous pressures to grow no matter what the revenues are. One of those pressures is the continuing growth of the state's population; another pressure is the tendency of the federal government to shove off responsibilities on the states.

The revenues, on the other hand, are probably going to go down in terms of what they can actually buy. It's important to factor in the effects of inflation when thinking of future revenues and future expenditures, because \$1 will be worth less--and thus buy less--one year or five years from now than it could buy today. So let's talk about future revenues and future expenditures in terms of "real dollars"--that is, dollars measured on a common yardstick of purchasing power--so that we can account for the effects of inflation.

The following table shows the unrestricted General Fund revenues projected by the Alaska Department of Revenue for four fiscal years--1993, 1997, 2000, and 2010--plus the actual revenues for FY1989. The table shows the revenues projected for each year under each of three scenarios--low, medium, and high. Caution: these scenarios are not gospel. All three are plausible, however, and actual revenues are likely to come in somewhere between the low and the high scenarios.

Unrestricted General Fund Revenues
Real 1989 Dollars ("Purchasing Power")

<u>Fiscal Year</u>	<u>Low Scenario</u>	<u>Mid Scenario</u>	<u>High Scenario</u>
1989	\$2.2 billion	\$2.2 billion	\$2.2 billion
1993	\$1.6 billion	\$2.0 billion	\$2.6 billion
1997	\$1.1 billion	\$1.4 billion	\$2.9 billion
2000	\$0.7 billion	\$1.0 billion	\$2.3 billion
2010	\$0.3 billion	\$0.4 billion	\$0.8 billion

(Source: Alaska Department of Revenue, Revenue Sources Book, Fall, 1989--rounded to the nearest hundred million)

Taxes and royalties from Prudhoe Bay account for about 75 percent of state oil revenues, and thus produce about three out of every five dollars in the state budget. Prudhoe Bay production began dropping in calendar 1989, and the Department of Revenue projects that it will continue to fall by five to 10 percent a year. The falling production at the field means that we are losing the equivalent of one well a week at Prudhoe Bay, without any replacement.

Prudhoe Bay has been an extremely rare gift to Alaska. The oil industry calls it an "elephant"; it is by far the largest oil field in North America and the only world-class field on the continent. It is highly unlikely any field anywhere near its size will be found in Alaska again.

New production from smaller fields on the North Slope will probably replace only a fraction of the lost production from Prudhoe Bay. The Trans-Alaska Pipeline is no longer full, and will almost certainly never be full again.

The Department of Revenue's high scenario projects that in less than 10 years, Prudhoe Bay production will be less than half of what it is today. Under the low and mid scenarios, that point is reached in less than seven years.

Unless the real price of oil more than doubles during that period, this fall in production will put a serious dent in the budget. The high scenario says that prices will go almost that high by 2000. The low and high scenarios do not, and forecast a real crunch in the 1990s. Counting on prices to go up as production goes down also puts Alaska on a treadmill; if prices slowed their increase or even dropped, catastrophe would follow.

Maybe this forecast is too pessimistic. Maybe other events not assumed in the forecast will force world oil prices up or increase Alaska's production. Maybe, for example, the recent moves toward free markets in the Soviet Union and Eastern Europe will increase worldwide demand for oil, thereby pushing prices up. Maybe a major field will be discovered in the Arctic National Wildlife Refuge. But even a big find in ANWR would not increase Alaska's oil tax or royalty collections until after 2000, because even the Resource Development Council says that it would take more than 10 years from the time Congress authorized drilling before the first oil could come out. (Carl Portman, "Limited exploration approach in ANWR could impede discovery," Juneau Empire, June 29, 1988, p. 4.)

It seems safest to assume the mid scenario, prepare for the low scenario, and dream of the high scenario.

CORRECTION

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A PRACTICAL GUIDE
FOR
DEALING WITH THE FISCAL GAP

Cliff John Groh

April, 1990

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I. The Nature of the ProblemA. The Fiscal Gap Is Real, and Is Potentially Very Wide

The biggest question facing Alaska today is how to deal with the difference between income and outgo in the state budget. This "fiscal gap" will be the issue of the 1990s as much as state spending was the issue of the 1980s.

The budget is about \$2.3 billion for fiscal year (FY) 1990. (This figure represents unrestricted General Fund dollars, which is what most people mean when they say "the budget.") The budget faces numerous pressures to grow no matter what the revenues are. One of those pressures is the continuing growth of the state's population; another pressure is the tendency of the federal government to shove off responsibilities on the states.

The revenues, on the other hand, are probably going to go down in terms of what they can actually buy. It's important to factor in the effects of inflation when thinking of future revenues and future expenditures, because \$1 will be worth less--and thus buy less--one year or five years from now than it could buy today. So let's talk about future revenues and future expenditures in terms of "real dollars"--that is, dollars measured on a common yardstick of purchasing power--so that we can account for the effects of inflation.

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(Source: Alaska Department of Revenue, Revenue Sources Book, Fall, 1989--rounded to the nearest hundred million)

If the high scenario occurs, the State is in fairly good shape for the next 10 years before facing grim belt-tightening in the first decade of the next century. The news is much worse under the mid and low scenarios. Under the mid scenario, under current law and current policy the State would have to cut the budget by 30 percent by 1997 and by more than 50 percent by 2000. The low scenario is even scarier: the State would have to cut the budget by half by 1997 and by more than two-thirds by 2000.

This analysis becomes more alarming still when you remember that barring a big out-migration caused by a crashing economy, Alaska's population will continue to grow. This means that with the existing sources of revenues, real per capita public spending in Alaska will almost certainly take a sharp fall in the next 10 to 20 years.

B. The Fiscal Gap Is Caused By Falling Oil Production

The fiscal gap exists because most of the money in the Alaska state budget and the Alaska economy comes from oil. The price of oil is liable to sharp swings, and Alaska is running out of oil to sell and to tax.

Almost 85 percent of Alaska's state revenues comes from taxes and royalties on oil production. The dominance of oil revenues in the State's budget will decline, but will continue at least until today's newborns get into high school. The Alaska Department of Revenue forecasts that the state will receive more than half of its revenues from oil and gas until at least 2005.

This heavy reliance on petrodollars to fuel the State budget leaves the state exposed to drops in both the price of oil and the production of oil.

The first problem--price declines--is longstanding and well-known. Oil prices have been up and down a lot during the 1980s, particularly in the last half of the decade. The 16 months between November of 1988 and February of 1990 have seen the market price of Alaska North Slope oil below \$11 a barrel and above \$20 a barrel. Prices around \$20 a barrel--the level in February of 1990--creates a sense of complacency in State policy-makers. Prices around \$10 a barrel trigger fear and panic. The collapse of the oil market to around \$10 for several months in early 1986 brought a substantial cutback in the State budget.

Now the scope of the problem has doubled. The price of oil may bounce up and down, but the new problem is that Alaska's oil production is definitely going down. Just as most of Alaska's revenues come from one source (oil production), most of Alaska's oil production comes from one source: the super-giant Prudhoe Bay field. And the flow from Prudhoe Bay is falling.

Taxes and royalties from Prudhoe Bay account for about 75 percent of state oil revenues, and thus produce about three out of every five dollars in the state budget. Prudhoe Bay production began dropping in calendar 1989, and the Department of Revenue projects that it will continue to fall by five to 10 percent a year. The falling production at the field means that we are losing the equivalent of one well a week at Prudhoe Bay, without any replacement.

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Maybe this forecast is too pessimistic. Maybe other events not assumed in the forecast will force world oil prices up or increase Alaska's production. Maybe, for example, the recent moves toward free markets in the Soviet Union and Eastern Europe will increase worldwide demand for oil, thereby pushing prices up. Maybe a major field will be discovered in the Arctic National Wildlife Refuge. But even a big find in ANWR would not increase Alaska's oil tax or royalty collections until after 2000, because even the Resource Development Council says that it would take more than 10 years from the time Congress authorized drilling before the first oil could come out. (Carl Portman, "Limited exploration approach in ANWR could impede discovery," Juneau Empire, June 29, 1988, p. 4.)

It seems safest to assume the mid scenario, prepare for the low scenario, and dream of the high scenario.

II. Potential Gap Closers

LIST OF OPTIONS

The major ways available to the state to close the fiscal gap are:

1. Cut the budget
2. Raise business taxes
3. Raise individual taxes and fees
4. Settle the disputes over taxes and royalty payments from prior years
5. Invest more successfully
6. Cut or eliminate Permanent Fund Dividends
7. Cut or eliminate Permanent Fund inflation-proofing
8. Cut or eliminate Permanent Fund principal
9. Borrow
10. Sell cash assets
11. Insure against oil revenue declines ("hedging")
12. Engage in entrepreneurial activities

Let's consider these options one by one.

1. CUT THE BUDGET.

This is a popular idea. To decide whether to cut, how much to cut, and how to cut, here are two critical facts which are poorly understood: Alaska's budget is high, but it has always been high; and Alaska's high budget is not primarily caused by paying too much to too many State employees.

BUDGET FACTS

a. Alaska's budget is high, but it has always been high. In 1987, Alaska's state spending per resident was a little more than three times higher than the average of all other states, even after accounting for the higher cost of living here. (We have to account for cost-of-living differences in comparing revenues and expenditures in different places just as we had to account for inflation in comparing revenues and expenditures in different years. Just as \$1 won't buy as much in 1995 as it would in 1990, that same \$1 won't buy as much in Alaska as it would in Arkansas.)

But Alaska's higher-than-average spending did not start with the petrodollar boom. Alaska's per capita spending was almost twice as high on a cost-of-living basis as the national average in 1967--before Prudhoe Bay was discovered. It was still at about the same relative level in 1977--at the end of the pipeline construction boom but before the petrodollar boom of state spending. (Institute of Social and Economic Research, "Facts and Fables of State Spending," ISER Fiscal Policy Paper No. 2, October, 1989, p. 8.)

In the current fiscal year, FY1990, the State is spending a little more than \$4,000 per person in today's dollars. This is about the same level of real per capita spending as in FY1979, before the budget explosion of the early '80s. (Division of Policy, Office of the Governor, "State Spending in Alaska, Fiscal 1979-1990," July 24, 1989.)

There are two big differences between now and 11 years ago. The first difference is that we are more dependent on oil money--85 percent in FY90 versus 73 percent in FY79. (Alaska Department of Revenue, Revenue Sources Book, Fall, 1989, pp. 13 and 53.) The second difference is that now oil money is falling off, not about to take off.

b. The budget is high for a number of reasons, not just because there are a high number of well-paid State bureaucrats. Many people seem to believe that Alaska spends a lot of money mainly because it has too many workers and pays them too much. This is incorrect.

Per capita State employment was about 2.7 times higher in FY87 than the national average, and State employee wages in FY87 were about 25 percent higher than the national average, even after adjusting for the higher cost of living here. (Institute of Social and Economic Research, "Facts and Fables of State Spending," ISER Fiscal Policy Papers No. 2, October, 1989, p. 12.) But State employee salaries, wages, and other compensation account for only about 30 percent of the total State budget.

About 45 percent of the State budget goes for "transfers": a collection of payments of grants and claims to individuals or local governments. This is the biggest and fastest-growing part of the State budget. Also called "entitlements" or "pass-throughs," these programs include five programs for local governments: the school foundation program; school debt reimbursement; revenue sharing; municipal assistance; and pupil transportation. Another four programs aim their benefits at individuals: public assistance; medical assistance; power cost equalization; and the longevity bonus.

Of these nine largest transfer programs, four are not based on need, ~~not even partially:~~ ^{the longevity bonus,} municipal assistance; power cost equalization; ~~and school debt reimbursement~~ (in 1990 legislation changed this from a transfer program and made it part of the capital budget). Two of these programs--municipal assistance and power cost equalization--did not exist before the petrodollar boom of the '80s began, and one--the longevity bonus--existed only in a much cheaper (although unconstitutional) form.

Other reasons exist for Alaska's high per capita spending besides higher transfer program costs and higher State payroll costs. Some are special Last Frontier conditions that are not captured in a cost-of-living adjustment but still drive up the budget. This "Alaska factor" would include the state's huge size, small population, highly dispersed population, heavy reliance on flying, and harsh climate.

More important than the "Alaska factor" is that in Alaska the State government pays for and does many things that in other states are either financed and delivered primarily by local governments. ~~It is~~ ^{the} important still is that in Alaska the State government ~~pay~~ ^{for} and does many things that in other states no government ~~does~~ ^{does} at all. Examples of rare or unique Alaska State expenditures would include municipal assistance, the longevity bonus, the pioneers' homes, and power cost equalization. (Permanent Fund Dividends are also unique to Alaska, although they are not part of the budget because they come out of Permanent Fund earnings.)

To sum up, the State budget is roughly 45 percent transfers and pass-throughs, 30 percent State employee pay and benefits,

and 25 percent everything else. A budget strategy which focuses on the State employees alone misses the big picture.

BUDGET OBSERVATIONS

a. The State budget must be cut, if only because no plan to close the fiscal gap can succeed politically without budget cuts being part of the package. To win public acceptance for an overall plan, the budget must go down in current dollars, which with inflation and population growth means a significant cut in real per capita terms.

b. It will be difficult to cut the budget without also raising taxes, although that will be the first natural reaction in a true fiscal crisis. It will be even more difficult to raise taxes without cutting the budget. Being able to do either in an intelligent manner before the crisis hits will require political leadership of the highest order.

c. A budget can be cut selectively or non-selectively. Non-selective cuts are politically easier, but selective cuts are more responsible.

One example of a non-selective method is to impose across-the-board reductions. This involves picking a number--say seven percent--and ordering all program expenditures to be cut by that amount. This approach is less unpopular with State employees and beneficiaries of the budget than selective methods, because across-the-board cuts leave no one feeling singled out.

Another example is to enforce a policy of attrition. This approach is more popular with union leaders than immediate layoffs, because it makes the cuts voluntary with the employees.

Yet as politically attractive as these cuts sound, they should be avoided as much as possible. Non-selective cuts leave the government doing all the same things, only less well.* The reality is that some programs are important than other programs, and some jobs are more important than other jobs. Leadership requires the setting of priorities.

*

Attrition is particularly hard to implement as a long-term strategy to cut State employment significantly. What does an agency do, for example, if its only accountant quits? Go without? Or take an accountant from another agency, thereby leaving that operation short?

Setting priorities means being selective on the basis of values. The first values to observe are to minimize waste, fraud, and abuse and to generally economize. Saving money by getting the government to spend more honestly and more efficiently is certainly desirable, but will probably not capture substantial budget cuts.

Significant selective budget cuts will come only by deciding what the most important functions of government are, and targeting spending on those functions.

c. Cutting the budget is difficult. The budget as a whole is politically unpopular, but each individual part is important to some interest. Moreover, more than one in every four jobs in Alaska can be traced to State and local government spending. (Institute of Social and Economic Research, "Facts and Fables of State Spending," ISER Fiscal Policy Paper No. 2, October, 1989, p. 14.) There are major splits in Alaska along regional and ethnic lines, and cutting the budget touches those splits where they hurt. It is difficult for the Governor to cut the budget because the Governor's own advisors will recommend against it; they are almost invariably advocates of particular programs or interests. Finally, a Governor's greatest political power to cut the budget comes at the beginning of the term, when the Governor has the least information on which to base the cuts.

2. RAISE BUSINESS TAXES.

SPECIFIC INDUSTRIES

A. OIL. There are two pots of business money to tax in Alaska: oil and everything else. Oil is the big pot. Despite the beginning of the fall in Prudhoe Bay production, oil is still where the big money is in Alaska, at least for the next few years. A 1989 study by Edward B. Deakin, an internationally known petroleum accounting expert, reported that the oil industry made more than \$41 billion in Alaska in after-tax profits between 1969 and 1987. (Edward B. Deakin, Oil Industry Profitability in Alaska--1969 Through 1987, Alaska Department of Revenue, 1989.) More than 90 percent of that profit came from two sources: the Prudhoe Bay field and the Trans Alaska Pipeline System (TAPS).

Overall, the Deakin study showed North Slope oil development at an annual rate of return of more than 29 percent after-tax. And most of this profit is leaving the state: the Deakin study found that oil companies were re-investing in Alaska less than 70 percent of the cash flow made here.

A more recent study financed by ARCO also suggests that the oil industry can afford to pay more taxes in Alaska. The Institute of Social and Economic Research found that the tax rate

for the petroleum industry in Alaska was "just about the same" as the national average--which means that some states have higher tax rates. (Institute of Social and Economic Research, "Alaska's Potential Tax Revenues," ISER Fiscal Policy Papers No.3, February, 1990, p. 2.)

Two methods of raising taxes on the oil industry in Alaska have been recently discussed: (1) changing the method by which oil and gas corporations pay State corporate income tax (from formula apportionment to separate accounting); and (2) "decoupling" the statewide oil and gas property tax from local property taxes on oil and gas.

1. Separate accounting. When thinking about taxes, most people think about the rate; in Alaska the official top tax rate on corporate income is 9.4 percent. This is the rate for the corner grocery store as well as the multinational oil company.

But just as important as the rate is the base--which is the amount of money to which the tax rate applies. If the taxpayer can report a small base, this will lower the effective tax rate the taxpayer actually pays.

The base issue is particularly important in taxing corporations that operate in more than one state or country, and there are several methods for defining the base in this situation. The two methods most discussed in Alaska are "formula apportionment" (which we have now for all corporations) and "separate accounting" (which between 1978 and 1981 we had for oil and gas corporations).

Formula apportionment is based on a corporation's worldwide income. It thus allows deductions for expenses which have nothing to do with Alaska.

The formula apportionment method is not designed for oil production activities, and seriously understates the amount of income in an oil-producing state like Alaska. By averaging all profits into worldwide operations, the phenomenal profits made at Prudhoe and from the pipeline largely escape taxation. Detailed analyses have showed that under the formula apportionment method the big oil companies producing at Prudhoe Bay pay an effective tax rate of only 3.7 percent--not the 9.4 percent paid by the corner grocery store.

Formula apportionment also has the inequitable effect of imposing different tax levels on producers with the same profits in Alaska. Oil companies with identical holdings in Alaska pay vastly different rates.

Recognizing these problems with formula apportionment, in 1978 the Alaska Legislature adopted separate accounting as the

method for taxing the income of oil companies operating in Alaska. Separate accounting might be called "all-Alaska accounting" because it only looks at the profits and losses of a corporation inside Alaska, and does not collect taxes on income or allow deductions for expenses paid outside of the state.

The major oil producers sued after the separate accounting law was passed, claiming it was unconstitutional. Alaska won this lawsuit all the way to the United States Supreme Court, which ruled in Alaska's favor in 1986.

While the lawsuit was pending, the Legislature moved to protect the people of Alaska from having to pay back a lot of money if the State lost in court. These concerns led the Legislature to repeal the separate accounting law in 1981, returning to a form of formula apportionment.

A number of people have supported the reinstatement of separate accounting for oil companies, particularly since it was upheld by the U.S. Supreme Court.

ARGUMENTS FOR SEPARATE ACCOUNTING:

a. Separate accounting makes a lot of money. Putting separate accounting back on the books would most likely produce \$100 million to \$400 million in additional revenue each year, according to estimates by the Department of Revenue. The revenues gained by separate accounting would go up as oil prices went up, and go down as oil prices fell. At very low oil prices, separate accounting could raise slightly less than the current system of formula apportionment.

b. Separate accounting is more fair than current law. Current law lets big oil companies get out of paying income taxes on most of the profits they make here in Alaska. Under Alaska's tax law now, the oil companies can write off a share of the cost of dry holes in Indonesia or Texas against profits made here in Alaska. As a result, the tax law now lets the oil companies shift their profits so that they end up paying Alaska income tax on less than half of the profits they earn from Alaska oil. By contrast, separate accounting is a fair tax system because it only allows deductions for costs related to Alaska income, and only collects taxes on income earned in Alaska.

c. Separate accounting does not discourage marginal production. Separate accounting more accurately taxes profits of oil production and oil transportation, so it focuses on the two big profit centers in Alaska: the Prudhoe Bay field and TAPS. Less profitable operations are not hit with higher taxes.

d. Separate accounting has significant political support. This position is particularly popular in Fairbanks, and has been one of the two issues promoted by the Committee to Repeal the ELF. The Railbelt Coalition has passed a resolution in favor of separate accounting. The Coalition is a group of local governments which includes the Fairbanks North Star Borough, the Municipality of Anchorage, the Matanuska Susitna Borough, and the Kenai Peninsula Borough.

ARGUMENTS AGAINST SEPARATE ACCOUNTING:

a. Separate accounting is more difficult to administer than formula apportionment. The disadvantage of a formula is that it can be distorting in a particular case; the advantage is that it is easy to plug in numbers and come up with a tax bill. The difficulty of administering separate accounting can lead to delays in collections. The problem of delay can be partially addressed by having the State change its procedures in tax administration.

b. Separate accounting leads to more unstable revenues than formula apportionment. Separate accounting is more sensitive to profits made in Alaska than is formula apportionment. This means that separate accounting is also more sensitive to swings in the price of oil than is formula apportionment. Thus revenues could be more unstable. Policy-makers need to balance that against the high likelihood of higher revenues under separate accounting under almost all future price scenarios.

c. Separate accounting faces significant political opposition, particularly from the oil industry. British Petroleum, the major lease-holder at Prudhoe Bay, is especially strong in this sentiment.

2. "De-coupling" the statewide oil and gas property tax from local property taxes. Alaska law provides for a 20-mill State tax on oil and gas production and pipeline transportation property. (Twenty mills equals two percent.)

There are two problems with this tax. The tax base is shrinking because the value of oil and gas property is falling. And the State's collections are being gobbled up by local governments, because all property taxes paid by oil companies to local governments are a credit against the State's take.

The State cannot do anything about the shrinking tax base except encourage further oil development in Alaska. The State can do something about the second problem by eliminating the credit for local governments.

The total tax base for this tax is more than \$16 billion. With a 20-mill tax, this means that total tax collections equal about \$350 million. But because the State allows a credit for taxes paid to local governments, the State is receiving only about five mills, or about \$80 million. The local governments with oil and gas property in their jurisdictions are receiving more than 15 mills, or more than \$250 million. The North Slope Borough and the City of Valdez receive most of the revenue.

The credit means that every time that any local government with oil and gas property raises its tax rates, the State's take is reduced. The local governments have such a great effect on the State's collections that in one year the tax base increased in value and the State's take still went down because of local property tax increases.

The effect of the credit in reducing the State's take means that the State could cut its 20-mill tax rate to 10 mills and double the State's revenues if the credit for local taxes were also eliminated. This proposal would "de-couple" the State tax from the local governments' taxes, and would allow the local governments to continue to tax up to the 20-mill ceiling they face now before they go past the protection of the State tax.

De-coupling would raise the maximum potential tax burden on oil and gas property in Alaska from 20 mills to 30 mills.

ARGUMENTS FOR DE-COUPLING:

a. De-coupling will raise substantial revenues. If the credit for local taxes were killed and the State's rate were cut to 10 mills, the State's collections will double. Initially this would raise the State's take from about \$80 million to about \$160 million.

b. De-coupling would make the State's collections from the oil and gas property tax more stable. Now three percent of the State's revenues are at the mercy of local governments with oil and gas property. Each time the local governments raise their taxes, the State's take goes down. Killing the credit would remove this instability.

c. De-coupling could provide a way to eliminate legal uncertainty caused by the current system. There have been repeated legal questions raised about the operation of the present system of local governments' oil and gas property taxation. De-coupling could provide a legislative framework to get out of this continuing controversy.

ARGUMENTS AGAINST DE-COUPLING:

a. De-coupling would leave the local governments on their own against the oil companies. Now the local governments can raise taxes on oil and gas property up to 20 mills with impunity. The availability of the credit means that local government tax hikes only cut into the State's take, and do not increase the oil companies' overall tax bill.

This argument appears weak in the face of the political skill and sophistication shown today by the local governments with oil and gas property. They seem to be able to take care of themselves.

b. De-coupling would effectively raise taxes on the oil industry.

B. FISHING. The most important thing to remember about the revenue potential of the commercial fishing industry is that there is a lot less money there than in oil. In the last fiscal year, taxes on the fishing industry raised less than \$40 million for the State--and an aggressive estimate of the amount available from greater taxation would be another \$40 million a year. (Memorandum from Commissioner of Revenue Hugh Malone to Rep. Al Adams, "State Revenue Options Discussion Paper," November 14, 1988, p.2.)

This estimate of \$40 million would be for a new five percent tax on the landing of all processed fisheries resources within State jurisdiction, including transshipments that occur within Alaska's three-mile limit. Assuming that the boom in bottomfish does not fizzle out, enacting a fisheries resource landing tax is the only way to capture a good portion of the resource value to compensate for the impact the industry has on communities such as Unalaska.

We should explore the enactment of such a fisheries resource landing tax.

An approach with more political appeal would be to stop eroding the fish taxes we already have and devote more resources to enforce them. Tax credits now give away more than a third of all the potential tax collections on the raw fish tax, Alaska's ^{primary} fish tax. The great majority of these credits go to Outside-based corporations who employ mostly non-residents. We should really consider whether this credit program is helping the State.

The bottomfishing industry has grown rapidly in Southwest Alaska, and our tax compliance efforts have fallen behind. There are millions--maybe even tens of millions--to be raised by hiring more fish tax auditors.

C. MINING. Like bottomfishing, mining is growing rapidly in Alaska. Like fishing, compliance efforts on taxing this industry have not kept up with this growth. Mining could probably also support some tax increases, but any tax hike on mining would bring in very little compared to raising more money from oil.

D. TIMBER. Unlike fishing and mining, timber has not been growing rapidly in Alaska. The tax potential for this industry is lower than the other resource industries.

GENERAL OBSERVATIONS

Some have suggested paying for activities in the budget aimed at regulating certain industries by charging "user fees" from those regulated industries. This may be a good and relatively politically acceptable idea, but it is important not to overstate the revenues that can be generated in this way. Adding up the FY1990 budgets for the agencies in the Departments of Natural Resources, Commerce and Economic Development, and Fish and Game primarily concerned with regulating oil and commercial fishing produces less than \$75 million.

3. RAISE INDIVIDUAL TAXES AND FEES.

There is one central fact about individual taxes in Alaska: people here pay about the lowest taxes in the United States.

Study after study shows this. A study of the state and local tax burdens faced by a family of four in the largest city in each state shows Anchorage residents as having the lowest taxes in each of four income categories. An article in Money magazine named Alaska one of the country's "tax havens." The survey in Money shows that its average reader in Alaska has lower taxes than readers in every other state except Florida and New Hampshire. This comparison obviously understates the good deal available in Alaska, because neither Florida nor New Hampshire has a Permanent Fund Dividend program. (Department of Finance and Revenue, Government of the District of Columbia, Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison, June, 1989, pp. 10-13; and Teresa Tritch, "The Taxes You Can No Longer Ignore," Money, January, 1990, pp. 81, 82.)

Alaskans are not overtaxed. If national averages mean anything, Alaskans are grossly undertaxed for the amount of government they get.

Nor are the residents of Alaska's two largest cities--despite their complaints--taxed the most severely within the state. A 1988 House Research Agency study estimated the local taxes which would be paid by a family of four with a home and a

boat. The analysis of the local taxes levied in 12 Alaska communities showed that taxes ~~were higher~~ in Haines, Wrangell, Ketchikan, and Juneau were all higher than in Anchorage or Fairbanks. (Karen Oakley, "Local Taxation: Variation Among Communities and Effect on Receipt of State General Funds," Research Request 88.126, House of Representatives Research Agency, February 12, 1988, p. 3.)

Higher taxes are inevitable. Let's look at what kind those could be.

GENERAL CONSIDERATIONS

We can measure the desirability of different types of individual taxes and fees in Alaska by four general considerations: revenue potential; progressivity; administrative feasibility; and political acceptability.

Revenue potential is obvious. All other things being equal, the best tax is the one that raises the most money.

Progressivity is a common goal of taxation. It is based on the idea that richer people should pay a higher percentage of income to support government than should poorer people. Even those who reject the concept of progressivity should at least avoid the opposite; taxes should be at least proportional, because it cannot be right for the poor person to pay a greater percentage of his or her income in taxes than a rich person.

Administrative feasibility is a dull subject in theory, but a critical one in government. It's generally easier to raise money by hiking an existing tax than enacting a whole new tax. Start-up costs should be factored in to any discussion of the relative potential of different taxes.

Political acceptability is tricky. Alaskans have gotten used to not paying taxes. The most popular tax would be either invisible or paid only by non-residents. Given that we cannot attain much revenue from either kind of tax, let's look at ways to make taxes more or less acceptable.

One facet of the political acceptability of a tax is its visibility. It is easier to get people to pay taxes if they don't notice it. This is a big problem for the income tax, which requires taxpayers to send in very obvious annual checks.

Another aspect of political acceptability is the visibility of the benefit received for the tax or fee. The most politically acceptable revenue raisers are those linked to a specific and tangible benefit--like an increase in the gasoline tax earmarked for highway repair. Similarly, the idea of a "user fee" is more

popular than a tax because the "user fee" seems to cut out the bureaucratic middleman and directly finance a useful activity.

There are obvious limits to this "fee for service" concept. One big one is that there is no way to charge for welfare. Society has a floor below which it does not want anybody to fall, regardless of ability to pay.

A final test of political acceptability for a tax in Alaska is how much it will hit residents versus non-residents. Alaskans resent people who live somewhere else coming in and making money here. The anger is particularly aimed at the oil, fishing, and construction industries. Fishing and construction work is often seasonal, making it easy for non-residents to come in and get it. Work in all three industries in Alaska often occurs at remote sites unsuitable for permanent habitation. The individual income tax is the only tax that can hit significantly at non-residents. (But it is constitutionally and administratively impossible to get only non-residents to pay it.)

SPECIFIC TAXES AND FEES

A. INDIVIDUAL INCOME TAX. Alaska had an individual income tax before 1980, but eliminated it that year in the first surge of petrodollar euphoria. Bringing back the income tax would raise \$250 million annually (assuming a 3.27 percent effective rate, the plan proposed by Governor Cowper in 1987). (Memorandum from Commissioner of Revenue Hugh Malone to Representative Al Adams, "State Revenue Options Discussion Paper," November 14, 1988, p. 2.)

Alaska is one of only seven states with no individual income tax. The proposed effective rate of 3.27 percent would give Alaska one of the 10 highest income tax rates of any state in the nation.

The major arguments for the income tax are that it raises a significant amount of money, it is progressive, and it is the only tax that hits at non-residents to any significant degree. The major arguments against an income tax are that it is hard to start up, and that its high visibility unlinked to any obvious specific benefits makes it highly unpopular with a large segment of the public.

B. GENERAL SALES TAX. Alaska has never had a statewide sales tax. The State has traditionally reserved the general sales tax for local governments--although the biggest local government--Anchorage--does not impose one. A broad-based State general sales tax could raise \$57 million per one percent of tax, so a three percent tax could raise \$171 million. This estimate

assumes that the tax would cover all retail sales (including residential and commercial customers.

Alaska is one of only five states with no statewide sales tax. (Alaska is the only state without either an individual income tax or a sales tax.) A three percent rate would put Alaska among the top 15 states in sales taxes.

Federal tax law currently makes state sales taxes non-deductible against the federal income tax, while state income taxes remain deductible. This means that Alaskans would fare worse with a sales tax.

Enacting a statewide sales tax also raises the question of how the State will treat sales in areas that already have local sales taxes. The revenue estimate assumes that the State will neither allow a credit against the State sales tax for local governments which have their own local sales taxes, nor will it share revenues with those local governments. If the State takes this approach, businesses within those jurisdictions will be forced to assume a double filing burden. This increases the potential for errors and non-compliance, and substantially increases the political opposition.

The start-up^{costs} on a general statewide sales tax would be very high, in part because we have never had one.

This tax is regressive, and will hit particularly hard at low-income Alaskans. Non-residents and seasonal workers will largely escape this tax, because they do not buy much here.

Despite the unfairness of this tax, it is less unpopular than an income tax, because the sales tax is paid in nickels and dimes all year long instead of in a lump-sum check.

C. RAISE FUEL TAXES. Alaska levies sales taxes on specific commodities. One of these "excise" taxes is on fuel. Alaska's taxes on fuel are very low compared to other states. Alaska is third from the lowest on its gas tax and second from the lowest on its diesel fuel tax. Doubling the motor fuel tax from 8 cents to 16 cents a gallon would raise \$34 million and put Alaska at the national average on state taxes.

This tax is somewhat regressive. A tax hike is relatively easy to implement, and is a good revenue raiser for the effort.

Governor Cowper's proposal to double the motor fuel tax is going nowhere during the 1990 legislative session. An increase can best be sold politically if it is linked to highways. Supporters should consider a constitutional amendment which would allow a dedicated highway fund for this purpose.

For all these excise taxes, remember that increasing the tax will almost certainly lead to decreased consumption. This decreased in consumption will necessarily hold down ~~on~~ the revenues gained, although for some commodities--such as the next two discussed--this drop in use is all to the good.

(All excise tax rates come from Federation of Tax Administrators, "State Excise Tax Rates Are Rising," FTA Bulletin, February 9, 1990.)

D. INCREASE TOBACCO TAXES. Alaska increased its tobacco tax in 1989, and now has the 13th highest tax on cigarettes in the U.S. Note that excise tax hikes do not raise all that much money; an 80 percent tax increase only brought in \$4 million.

Just because we can't balance the budget on the backs of smokers doesn't mean that we shouldn't try to raise money to help fight the health costs of the use of this commodity. Alaska could raise another \$3 million or so if it raised cigarette taxes to the highest level in the country, and we should consider it.

E. EQUALIZE THE ALCOHOL TAX ON A PER OUNCE OF ALCOHOL BASIS. There is a different tax rate for the three major kinds of alcohol. The tax per gallon of distilled spirits is \$5.60, the tax per gallon of wine is \$0.85, and the tax per gallon of beer is \$0.35.

Alcoholic beverages are not all ethyl alcohol, although that is what people are buying the stuff for. One proposal would be to equalize the tax rates based on alcohol content, with the tax rate for distilled spirits being used as the standard. This proposal would raise the tax rate on wine to \$1.82 per gallon and raise the rate on beer to \$0.58 per gallon. Enacting this proposal would raise \$4 million annually.

Alaska's alcohol taxes are now in the mid to high range. Alaska's tax on distilled spirits would remain the third highest in the country for states which allow that liquor to be sold outside State-run stores. Alaska's tax on wine would be the highest in the country, and the tax on beer would be the third highest.

This proposal to equalize the tax based on alcohol content has three justifications. One rationale is that tax collections are dropping, and one cause of the decline is that people are shifting away from distilled spirits towards wine and beer--which are more lightly taxed. A second rationale is that what we should be taxing is the stuff people are buying it for. A third justification is that no state has more problems with alcohol

than Alaska, and anything that discourages consumption is probably desirable.

The public understands this third rationale, but the liquor lobby has stopped this proposal. A slick effort killed this idea in the Senate in 1989.

F. INCREASE USER FEES. Perhaps another \$30 million could be raised by doubling driver's license, motor vehicle registration, and fish and game license fees. Another \$30 million could come from doubling fees on the Alaska Marine Highway System.

4. SETTLE THE DISPUTES OVER TAXES AND ROYALTY PAYMENTS FROM PRIOR YEARS.

The State is claiming more than \$4.4 billion in disputes with oil and gas producers and purchasers over taxes, royalties, and pipeline tariffs. This figure does not count estimates for recent years whose audits are not yet complete, and also excludes Exxon Valdez oil spill litigation and a dispute with the Federal government over revenue sharing (the Dinkum Sands case). Adding those figures in could add another several billion dollars to the total claimed. (Richard A. Fineberg, Oil and Gas Revenue Disputes: Status Report and Recommendations, prepared for the Alaska State Legislature, February 1, 1990, p. 7; and Memorandum from Commissioner of Revenue Hugh Malone to Representative Al Adams, "State Revenue Options Discussion Paper," November 14, 1988, p.3.)

Two points about this disputed oil money: 1. The State will not get as much as it has claimed; and 2. The more we feel we have to have this money in any particular year, the less we will ever get. Taken together, these two facts mean that the State cannot count on settlements to save the budget.

Counting on settlements of these disputes to fill the budget gap on a continuing basis would be like announcing that you have to sell your car today and your house tomorrow to keep food on the table. Settlements will bring in some money over the next 10 years, but we can't rely on any particular amount in any particular year unless we want to give away the farm.

5. INVEST MORE SUCCESSFULLY.

As Prudhoe Bay production falls, the amount of money in State hands happens to be growing. The General Fund sometimes has \$1 billion or more sitting in it, and the Permanent Fund now has about \$10 billion.

The State does fairly well in the management and investment of its funds now, but it could do better. If the State could raise its return from the General Fund by one percentage point--from, say, 15 percent to 16 percent--the State could earn an extra \$10 million on its \$1 billion. The payoff from greater returns is much greater in the Permanent Fund, because it's bigger; each additional one percent added to the Permanent Fund's total return adds another \$100 million to its earnings. This suggests that the State ought to make it a high priority to get the greatest total return from its money, consistent with safety. Greater diversification of investments could be one key to greater returns.

6. CUT OR ELIMINATE PERMANENT FUND DIVIDENDS.

About half of the Permanent Fund's income each year goes for Permanent Fund Dividends. This unique Alaska program will put more than \$500 million into the Alaska economy in 1990, with each Alaskan getting a check of about \$1,000. The entire Alaska economy has about \$10 billion of personal income, so for every \$20 bill you see, about \$1 of it is a dividend dollar.

The program was born during the petrodollar surge of the early '80s, and it has several rationales.

a. Permanent Fund Dividends build a political constituency for the Permanent Fund itself. Special-interest pressure for Permanent Fund investment in shaky Alaska development schemes would be irresistible without the provision of direct and tangible benefits for individual Alaskans. PFDs provide that direct and tangible benefit, and give the public a powerful incentive to increase the size of the Fund and protect it against special-interest raids.

b. PFDs are more fair than many of the other uses of the oil money. Subsidized loan programs have been a particularly egregious example of the inequity of other uses. Loans only go to those who can pay them back--thus cutting out many people--and subsidized loans provide big grants of "subsidy welfare" to those fortunate enough to receive them.

c. To the degree that government expenditures in Alaska are justified because of the economic effects, PFDs stimulate the economy more efficiently than do operating expenditures, capital expenditures, or loan programs. Using a dollar to pay a PFD increases personal income more than using that dollar to pay for the operating budget, the capital budget, or a loan program. Permanent Fund Dividends provide a significant portion of the incomes of many Alaskans, particularly village Natives. In 1988, more than 12 cents of every dollar of income in the Wade Hampton census area around Bethel came from PFDs. Using a dollar to pay

a PFD creates more jobs than using that dollar to pay for the capital budget or a loan program.

d. PFDs deliver benefits more efficiently to the PFDs' targeted population than these other methods of using money deliver benefits to their own targeted populations. Significant chunks of the money distributed in other ways leak out to "middlemen." PFDs allow each Alaskan to receive benefits undiluted by State employees, construction contractors, or bankers.

e. The payment of PFDs decentralizes decision-making. Individual decisions can often be better than collective decisions. Some Alaskans believe that the money distributed as PFDs in the 1980s was better spent than it would have been if the legislature had had that money available to spend.

Some say that these rationales for PFDs mark the program as an antidote for a disease--too much money coming into public hands--which is now gone, and that the antidote itself is no longer necessary and perhaps even harmful. Some say it's time for the State to return to the core functions of government, which do not include per capita direct distributions. And some will say that it would be crazy to restore the individual income tax as long as the PFD survives.

There may be merit to these arguments against PFDs, but Alaskans should be wary. Permanent Fund Dividends have helped protect the Permanent Fund from low-return investments, and they have been a big boon to lower-income Alaskans with large families who were not so poor as to qualify for public assistance. Eliminating the PFD would hurt low-income residents, and keeping the Dividend should be considered whether or not the income tax comes back.

7. CUT OR ELIMINATE PERMANENT FUND INFLATION-PROOFING.

This is where the other half of Permanent Fund income goes annually: to keep the real value of the Fund from eroding each year from the ravages of inflation. No matter what you plan to use the Permanent Fund for, you need to maintain inflation-proofing to be able to do it. Reducing inflation-proofing cuts into the size of both the principal and the income in the future.

8. CUT OR ELIMINATE PERMANENT FUND PRINCIPAL.

Spending any of the corpus of the Permanent Fund would require a constitutional amendment. Soon--within a couple of years--the Permanent Fund will be the number one revenue producer for the State. Whatever you want to do with the Permanent Fund, it would be nigh-impossible politically and unwise to try to spend it.

9. BORROW.

The State could borrow, but this is of course a short-term strategy. Besides the obvious necessity of paying the money back, there are constitutional restrictions on any long-term strategy of rolling the debt to pay for the operating budget.

10. SELL ASSETS.

The State has significant assets which have some value on the open market. These assets include the Alaska Housing Finance Corporation, the Alaska Power Authority, and the Alaska Railroad Corporation. The catch is that the State is unlikely to get a good deal by immediately selling any of them. The amount and liquidity of these assets and the amount of the liabilities remain undetermined.

11. INSURE AGAINST OIL REVENUE DECLINES ("HEDGING").

The State can insure against getting hit hard by oil price declines and production drops the same way a person can insure against getting hurt in a car accident: by buying insurance. The problem is that the risk of the bad outcome is so great here that the insurance will carry a heavy price tag--say, in the hundreds of millions.

12. ENGAGE IN ENTREPRENEURIAL ACTIVITIES.

The State has gotten involved in the private economy before, often with less than favorable results--Delta barley and Matanuska Maid come to mind. Perhaps the State's problem has been that it has gotten into the ^{wrong} businesses. Instead of agriculture, perhaps the State needs to invest in more likely fields: gambling and oil.

If the State ran a lottery, one--perhaps low--estimate of the potential proceeds is \$10 million; legalized gambling operated by private interests could produce \$5-10 million in State amusement taxes and local property taxes. (Institute of Social and Economic Research, "Alaska's Potential Tax Revenues," ISER Fiscal Policy Papers, No. 3, February, 1990, pp. 12, 14.) There are obvious moral objections to either course.

A more promising venture could be found in oil. The State gets almost all of its oil money from taxes and royalties on production--the "upstream" end of the oil business. Often, however, the big money in oil is "downstream," in the transportation, refining, and distribution of oil and oil products. Some have suggested that the State buy into TAPS, but it is probably too late for that to work. It does make sense, however, for the State to explore the acquisition of an interest

in a refinery. This could allow the State to reap the profits available in processing its in-kind royalty oil. This course could be risky, but prudence might dictate diversification away from the strict reliance on the price of oil at the wellhead the State currently depends upon.

SCOMM

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SUBCOMMITTEE MEETING ANNOUNCEMENT
LONG RANGE FINANCIAL PLANNING COMMISSION

WEDNESDAY 19 JULY , 8:30 AM TO 10:30 AM

REVENUE SOURCES SUBCOMMITTEE:

Identify potential sources of state revenue, estimate their impacts.
Examine earnings of the permanent fund.

Mary Nordale, Chair 452-1666/Fax 452-5055
Pat Pourchot 269-7450/Fax 269-7461
Mike Navarre 283-7223/Fax 283-3075
Lee Gorsuch 786-1437/Fax 786-6123
Marie Westfall 225-3561/Fax 225-8731

Please dial teleconference bridge #1-800-478-7612 from outside of Anchorage or 700-222-1000 if from inside Anchorage. (if not on Alascom dial access code 10866)

Also on line:

Brad Pierce, 465-3008
Jim Kelly, 465-2059

FAX COVER

TO:
REVENUE SOURCES SUBCOMMITTEE
MEMBERS
LONG RANGE FINANCIAL PLANNING
COMMISSION

FROM:
MELISSA FOUSE
STAFF, LONG RANGE FINANCIAL PLANNING
COMMISSION

PHONE: 258-8165
FAX: 258-9869

FOLLOWING IS MATERIAL FROM MARY
NORDALE FOR TOMORROW MORNING'S
TELECONFERENCE.

CC: Brad Pierce
Jim Kelly

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**Fax Log Report for
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Pourchot	OK	09/09	Sent	Jul-18	11:56A	00:06:39	002465030022
Gorsuch	OK	09/09	Sent	Jul-18	12:03P	00:07:44	002165230020
Nordale	OK	09/09	Sent	Jul-18	12:12P	00:06:39	002565030022
Westfall	OK	09/09	Sent	Jul-18	12:19P	00:10:29	002564030022
Brady	OK	09/09	Sent	Jul-18	12:30P	00:05:14	002566030022
Pierce	OK	09/09	Sent	Jul-18	12:35P	00:05:15	002566030022

19 JUNE 95, MONDAY

FROM: MELISSA FOUSE

TO: REVENUE SOURCES SUBCOMMITTEE:

Identify potential sources of state revenue, estimate their impacts.
Examine earnings of the permanent fund.

Mary Nordale, Chair 452-1666/Fax 452-5055

Pat Pourchot 465-4021/Fax 465-3147

Lee Gorsuch 786-1437/Fax 786-6123

Marie Westfall 225-3561/Fax 225-8731

Staff: Melissa Fouse/Bob Walsh-Anchorage LIO

Brad Pierce 465-4677

**THERE IS A TELECONFERENCED MEETING OF THE
REVENUE SUBCOMMITTEE SCHEDULED FOR 8:30 TO 10:30
AM, THURSDAY, 22 JUNE 95.**

**IF YOU ARE LOCATED OUTSIDE OF ANCHORAGE , CALL
1-800-478-7612**

**IF YOU ARE LOCATED IN ANCHORAGE, EITHER COME
TO THE LIO OR CALL 700-222-1000. IF YOU ARE NOT
CONNECTED WITH ALASCOM, YOU WILL NEED TO DIAL THE
ACCESS CODE 10866 FIRST.**

CC: Chairman Rogers

Fax 456-2531

CC: Vice Chair Brady

Fax: 279-8111

CC: Brad Pierce, OMB

1-907-465-3008

FAX Cover Sheet

State of Alaska
Long Range Financial Planning Commission
716 W. 4th Avenue, Suite 470
Anchorage, Alaska 99501
(907) 258-8165
Fax: (907) 258-9869

To: Lee Gorsuch, Commissioner
Mary Nordale, Commissioner
Marie Westfall, Commissioner

From: Bob Walsh, Staff

Note: This is the first report dealing with model boroughs and the feasibilities of each. Although this was completed in the late 80's, I don't think it would take much to update the numbers. I also requested the copy of the model borough boundary study, this second one doesn't have the economics attached. It only identifies areas that would be compatible. Please let me know if you wish further information and I'll pass this along.

TONY KNOWLES, GOVERNOR

**DEPARTMENT OF COMMUNITY AND
REGIONAL AFFAIRS****MUNICIPAL & REGIONAL ASSISTANCE DIVISION**

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FAX: (907) 842-5140

June 15, 1995

The Honorable Representative Mike Navarre
Legislative Long Range Planning Committee
Room 521, State Capitol
Juneau, AK 99801-1182

Dear Representative Navarre:

You have asked my office to address the issue of the possibility of the State levying a statewide ad valorem property tax. In particular, you have asked for estimates of revenue which might be generated and any problems that may be involved from administering this undertaking.

The Office of the State Assessor currently calculates a Full Value Determination (FVD) annually for 16 boroughs and 27 cities located in the unorganized borough. This could not be accomplished without the cooperation of the assessors around the state assisting with those municipalities which levy a property tax. At the present time, there are 11 boroughs and 13 cities located in the unorganized borough which levy a property tax and those values are provided to me making the calculation of the FVD relatively easy for those municipalities. The values in the remaining 4 boroughs and 14 cities located in the unorganized borough are calculated by this office. As of January 1, 1994 the total Full Value Determination for those 16 boroughs and 27 cities was \$43,829,908,630. This figure includes a value of \$15,934,252,630 for all oil and gas property which is assessed by the Dept. of Revenue. This results in a value of \$27,895,656,000 for those 43 municipalities, excluding oil and gas properties.

There is no doubt that the majority of the municipalities in the rural area of the state would contain little value which would be taxable under our property tax laws. This is mainly due to mandatory exemptions, i.e., ANCSA and native allotment property, and the local economics of a region. The majority of the value would most likely rest along the road systems, Parks, Glenn and Richardson Highways, and in the areas of the state which have a good commercial fishing industry.

The Honorable Mike Navarre

June 15, 1995

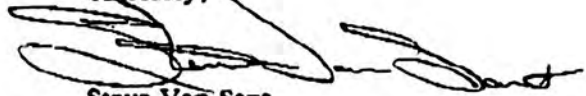
Page Two

The other areas of the state may have taxable value, but certainly not to the extent of these areas. Regardless of this fact, however, the data would have to be collected, analyzed, property record cards would have to be created and assessment rolls would have to be finalized and the appeal process would have to be in place. This entire process would be extremely expensive to set up and maintain. The initial set up process could take up to three or four years to complete, depending on the amount of revenue allocated and the total number of personnel hired or contracted for the project.

Based upon the values currently in the Full Value Determination process, the state would realize about \$28 million annually for each mill of tax levy. This amount excludes the oil and gas property, as the state already has a 20 mill levy against that property. If the state were to complete assessments on all other property which might be subject to a property tax, in my opinion, the state would probably receive no more than a total of \$30 million annually for each 1 mill of tax levy.

I hope this information is of help to you and your committee. If further information is needed, please feel free to call upon me and I will do what I can to gather it for you.

Sincerely,

A handwritten signature in black ink, appearing to read "Steve Van Sant", with a long horizontal flourish extending to the right.

Steve Van Sant
State Assessor

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Fax Log Report for
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<u>Identification</u>	<u>Result</u>	<u>Pages</u>	<u>Type</u>	<u>Date</u>	<u>Time</u>	<u>Duration</u>	<u>Diagnostic</u>
Rogers	OK	02/02	Sent	Jun-21	03:04P	00:01:46	002164230020
Pourchot	OK	02/02	Sent	Jun-21	03:14P	00:01:44	002064230020
Gorsuch	No answer	00/02	Sent	Jun-21	03:07P	00:00:00	002060000000
Nordale	OK	02/02	Sent	Jun-21	03:07P	00:01:08	002565030022
Westfall	OK	02/02	Sent	Jun-21	03:09P	00:01:33	002564030022
Brady	OK	02/02	Sent	Jun-21	03:16P	00:00:53	002566030022
Pierce	OK	02/02	Sent	Jun-21	03:11P	00:00:53	002566030022

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Navane

Agenda

BIRCH, HORTON, BITTNER AND CHEROT
A PROFESSIONAL CORPORATION

facsimile

TRANSMITTAL

to: Melissa Aber Fouse and Bob Walsh
fax #: 907-258-9869|
re: Perm. Fund work session
date: July 5, 1995
pages: 1, including cover sheet.

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MESSAGE:

Unless something really goes haywire, the July 19 meeting is still scheduled. When you send out the notices, please make sure that all members of the commission are invited to participate.

Thanks.



From the desk of...

Mary A. Nordale
Of Counsel
Birch, Horton, Bittner & Cherot
100 Cushman Street, Suite 311
Fairbanks, Alaska 99701

907-452-1666
Fax: 907-456-5055

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PLEASE CONTACT SENDER AT (907) 452-1666 or, in Alaska only, (800) 478-1666.**

DISCUSSION PAPER: This paper is prepared in anticipation of the teleconference meeting of July 19. All Commission members and staff participating should have with them the papers presented by the Alaska Permanent Fund Corporation, Senator Rieger and Roger Cremo. The purpose of the meeting is to consider whether or not the Permanent Fund should be included as a source of funding to close the fiscal gap. As the presentation of the APFC demonstrates, the existing statutes applicable to management of the Fund would not yield excess income that could be used. It is, therefore, essential to a long-range plan that the crucial decision regarding the Fund be made early enough to allow preparation of the plan in accordance with the Commission's determination.

THE ALASKA PERMANENT FUND

Background of Fund

The Alaska Permanent Fund was established by a constitutional amendment adopted in 1976 which allowed the dedication of at least twenty-five percent (25%) of mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses to a permanent fund (Article IX, Sec. 15). The principal of the fund is required to be invested in income-producing investments and the income is required to be deposited in the General Fund.¹

In 1977 the legislature established the Alaska Permanent Fund Corporation to manage the Permanent Fund. In 1980, the legislature established the practice of issuing dividends to Alaskans who apply for them annually. In order to do this, the legislature has adopted definitions of income and has created allocations of income for the purpose of the dividend program and to permit a portion of the income to be deposited in the principal of the Fund to compensate for the erosion of value of the Fund by inflation, so-called inflation proofing. Earnings in excess of amounts for dividends and inflation proofing are held in what is called an "earnings reserve account." The sums held in the earnings reserve account are invested in the same manner as the principal of the Fund.

At the present time, the allocation of income is as follows:

1. AS 37.13.140. Net income includes income of the earnings reserve account. It is computed as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding unrealized gains and losses.² Net income available for distribution equals 21 percent of the net income over the last five years, including the fiscal year just ended, but may not exceed net income for the fiscal year just ended plus the balance in the earnings reserve account.

¹Sec. 7 of the Alaska constitution originally prohibited the dedication of any state tax or license to a specific purpose. With adoption of Sec. 15, Sec. 7 continues to prohibit dedicated funds with the sole exception being the Permanent Fund.

²"Unrealized gains and losses" are those gains and losses on investments that are calculated according to market prices. They are "unrealized" because the investments have not been sold, so the market value of the investments has no effect on income.

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2. AS 37.13.145. Fifty percent (50%) of the income available for distribution is transferred to the dividend account. The balance is used to inflation proof the Fund and, if there is a remainder, it is held in the earnings reserve account.

At the end of FY 1995 (June 30, 1995), the sum to be allocated to dividends was estimated to be \$556 million and the amount required for inflation proofing was estimated at \$344 million.

Allocation Issues

Since its creation, the Permanent Fund has been the subject of much commentary--about its purpose, about the use of its income--what role it should play in the fiscal management of Alaska. Nearly every witness appearing before the Commission included the Permanent Fund as a portion of his or her recommendations. A number of specific plans were presented and the purpose of this document is to compare the various proposals. Before doing so, however, it is important that certain concepts with respect to the Fund be understood.

Income: Article IX, Sec. 15, refers to "all income" as being required to be deposited in the General Fund. The constitution does not distinguish between ordinary income such as dividends and interest and capital gains which accrue by reason of the increase of value over the purchase price of an investment.

AS 37.13.140 does not mention income, but defines "net income" as including income earned by the earnings reserve account, but excluding unrealized gains and losses. AS 37.13.145 provides for the disposition of the net income. Net income is first deposited in the earnings reserve account. At the end of the year, sums necessary for the payment of dividends and for inflation proofing are required to be transferred and any balance remaining in the earnings reserve account is held there subject to appropriation.

Sums used to pay dividends and to provide inflation proofing include both ordinary income and capital gains as AS 37.13 does not, for these purposes, distinguish between the two classes of income.

Inflation proofing: AS 37.13.145 requires that the inflation rate determined as directed by the statute be applied "to the value of the principal of the fund on the last day of the fiscal year just ended." The term, "value," is not otherwise defined and the practice of the Alaska Permanent Fund Corporation has been to value the principal of the fund at its market value, not at cost.

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Thus the investments of the principal are inflation proofed not only against the depreciation of the dollars that originally purchased them, but also for the dollars that represent any appreciation in value. As inflation proofing occurs every year, both the original purchase value of each investment is sustained and the appreciated market value is protected.

Issues: Some of the issues that the statutory definition or treatment of income raise are:

1. Should capital gains be segregated from ordinary income and only ordinary income be used for the purpose of dividend distribution? If that were done, what would be the consequences?
2. Should capital gains be treated as appreciation of the value of the principal rather than as income available for dividends and inflation proofing? If that were done, what would be the consequences?
3. Should the principal of the Fund be calculated at cost or market for the purpose of determining the amount of money necessary to inflation proof the Fund? If that were done, what would be the consequences?

Subcommittee Scenarios

The Alaska Permanent Fund Corporation was asked by the Subcommittee on Revenue to prepare charts and graphs based on possible changes in allocations and classifications of income. The Subcommittee on Revenue appreciates the cooperation of APFC in helping to clarify the significance of a number of ways to manage the Fund and utilize its income, if necessary, for the purpose of closing the fiscal gap. None of the possible changes have been endorsed by APFC and it should be understood that the proposals were developed to explore the potential of the Fund.

Most of the scenarios proposed that the dividend fund be capped at \$500 million. Although this represents a departure from present practice, it was devised because of the concern that has been evidenced by the Commission on the consequences of population driven expenditure programs. In 1992, the dividend fund was \$488 million. By 1995, the dividend fund had risen to \$556 million. These sums represented annual dividends in amounts of approximately \$900 per applicant, give or take \$50. Capping the dividend fund would mean that a dividend of nearly the same amount would be distributed annually, slightly diminished each year because of population growth.

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All of the scenarios used the same base case based upon information at hand that has been used by the Commission in analyzing expenditures and revenues. Although the base case will be adjusted, it is unlikely that the scenarios would be altered significantly by using the revised base case adopted by the Commission. The APFC uses a different model for estimating revenues, inflation and earnings so a difference appears between the estimates based on the current statutory requirements and the same model applied to the preliminary base case used by the Commission.

Scenario No. 1

This scenario uses the base case and, instead of depositing surplus earnings in the earnings reserve account, transfers those earnings directly to the General Fund. Graphs explaining the result are attached. The amounts of money that would go to the General Fund in 1998, \$268 million; 2000, \$255 million; and in 2005, \$660 million.

Scenario No. 2

This scenario, using the base case, caps the dividend fund at \$500 million and would transfer to the General Fund all earnings in excess of inflation proofing and the dividend. This results in there being available to the General Fund in 1998, \$376 million; in 2000, \$453 million; and in 2005, \$670 million.

Scenario No. 3

This scenario departs significantly from existing law. All of the royalty and rental income received by the state would be deposited in the Fund. All of the realized gains would be added to the principal of the Fund and that amount would be deducted from the amount determined to be required to inflation proof the Fund. Unrealized gains would be excluded from the inflation proofing requirement and the dividend fund would be capped at \$500 million. This results in there being available to the General Fund in 1998, \$310 million; in 2000, \$446 million; and in 2005, \$830 million.

This scenario causes the principal of the fund to grow dramatically to slightly over \$30 billion by the end of FY 2005. However, although by 1998 the General Fund would be receiving \$310 million, it would have lost approximately \$700 million because of the loss of the royalty, rents and other mineral resources income presently being directly deposited in the General

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Fund. It appears that this would not only not make up a portion of the fiscal gap, but would increase the gap by approximately \$700 by 1993.

Scenario No. 4

This scenario is identical in its assumptions to Scenario No. 3 except that only 25 percent of the royalty and rental income would go to the Permanent Fund. This causes the principal of the Permanent Fund to grow slightly more than it would under present law, and would result in there being available to the General Fund in 1998, \$275 million; in 2000, \$339 million and in 2005, \$519 million.

Scenario No. 5

This scenario proposed a dramatic change in the structure of the Permanent Fund. Under this scenario, all rent and royalty income would be deposited in the Permanent Fund. All earnings from investments would be considered part of the principal and, as in an endowment, four percent of the total fund would be made available for dividends and for transfer to the General Fund. There would be no need for inflation proofing. Under this scenario, there would be available to the General Fund in 1998, \$305 million; in 2000, \$459 million; and in 2005 \$900 million. The principal of the Fund would grow to nearly \$34 billion by the end of FY 2005.

Scenario No. 6

This scenario is identical to Scenario No. 5 except that only 25 percent of the rent and royalty income would go to the principal of the Permanent Fund. This results in the growth of the principal of the Fund to nearly \$25 billion by 2005 and would make available to the General Fund in 1998 \$215 million; in 2000, \$296 million and in 2005, \$527 million.

Rieger Plan (SB 51)

Senator Steve Rieger introduced Senate Bill 51 in 1997. SB 51 would incorporate the concept of "real" earnings rather than "nominal" values for determining the value of the Fund and the earnings as a basis for dividend calculation. This would shift the burden of inflation from the Fund to the dividend applicants. Another aspect of SB 51 is that the amount required to inflation proof the fund would be calculated as a percentage of the average annual balance of the fund. SB 51 would not change the existing allocation formula for dividends. SB 51 would eliminate the

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need to have an earnings reserve except for a relatively small amount to insure that the dividend commitment would be met.

SB 51 would convert the Permanent Fund to an annuity fund for Alaska dividend applicants, rather than providing sums that would be available to the General Fund for the operation of government. Adoption of the SB 51 proposal would have no effect on the projected fiscal gap.

The Roger Cremo Plan

use "Base Case"

Roger Cremo has developed a proposal for use of natural resource revenue as a permanent endowment to be used to fund government. The plan relies on the existence and increase in other revenues, such as taxes, as the Cremo plan does not propose that all state spending be funded by the funds generated through his proposal.

Cremo proposes that all revenues from natural resources, the Permanent Fund and reserves be placed in a single fund, to be established, and the fund then invested aggressively to reap a ^{nominal} "real" return of about 10 percent. The legislature could withdraw up to 20 percent of the fund the first year and the amount of permitted withdrawal declines geometrically each year thereafter until it reaches the base withdrawal rate of 6 percent in 2006.

The Cremo plan would significantly reduce present revenues available for appropriation from natural resources and the decline would continue until about 2008. Thereafter, increasing amounts would be available for appropriation. In the period between 1996 and 2008, the Cremo plan requires an increase in other revenues or dramatically reduced expenditures of other revenues cannot be found.

The 40-30-30 Plan

The 40-30-30 Plan was proposed in 1987 by Sen. Jan Faiks and was incorporated in a resolution for a constitutional amendment that would have, in addition to amendment of the Permanent Fund provisions, established a constitutional appropriations limit and created a budget reserve fund. The plan would have allocated 40 percent of the Permanent Fund income to dividends, 30 percent to inflation proofing and 30 percent to a budget reserve fund. The plan was amended in 1989 to propose the allocation of Permanent Fund income 50 percent to dividends, 30 percent to inflation proofing and 20 percent to a budget stabilization fund.

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SUMMARY

The Alaska Permanent Fund must be considered in any long-range financial plan, either as a contributor to closing the gap or as a source of funds available for the generation of funds to pay for government. If the Commission determines that the Alaska Permanent Fund must contribute to closing the gap, legislative or constitutional changes must be enacted to create the revenue stream necessary to make the Fund's contribution meaningful.

LONG RANGE FINANCIAL PLANNING COMMISSION

Report of Subcommittee on Revenues

The Long Range Financial Planning Commission is charged under House Concurrent Resolution No. 1 with a number of tasks related to the revenues that are or could be available to the state to support state government at the present or at either a reduced or increased level. The Subcommittee on Revenues, composed of Mary A. Nordale, chairman, Pat Pourchot, Legislative Director in the Office of the Governor, Rep. Mike Navarre (D, Dist. 9, Kenai), Lee Gorsuch, Chancellor of the University of Alaska Anchorage, and Marie Westfall, retired Gateway Borough Finance Director, has prepared this preliminary report to present information on revenue sources and to suggest on a preliminary basis the advantages and disadvantages of existing sources and new sources.

The Long Range Financial Planning Commission is charged with, among other duties, the following:

- (2) identify and evaluate all current state income sources and assets, including recurring revenue, reserves, physical resources, and investments;
- (3) identify and prioritize systemic changes to stabilize the state's revenue stream;

- (6) identify and prioritize new sources of revenues;

- (9) consider the division of responsibility for providing services and raising revenue between the state and local governments and evaluate the effect of the long-range financial plan on local governments;

EXISTING REVENUE SOURCES

The identification of sources of revenues, while not difficult, is somewhat complicated. Some revenues are paid directly into the General Fund, such as corporate income and severance taxes. Other state revenues are not accounted for as General Fund sources, such as interest on the 4-Dam Pool which funds the Power Cost Equalization Program and repayments on mortgages received by the Alaska Housing Finance Corporation. Likewise, revenues to the Alaska Permanent Fund Corporation are not generally treated as available for appropriation in the same sense as tax receipts. The Commission must adopt a policy for the purpose of determining

Preliminary Report
Subcommittee on Revenues

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revenue sources of considering such fund earnings as revenue sources, considering such fund earnings as not available for appropriation or distinguishing among the various funds and accounts to specify which funds should be accounted for as revenue sources to the General Fund and which should not be considered as sources for the purposes of achieving a long-term revenue stream.

Recommendation: All funds carried as separate accounts in the General Fund that are not dedicated, the earnings of which are usually appropriated to fund specific programs, be considered General Fund reserves and the earnings classed as available for appropriation for any purpose.

Recommendation: Earnings received by Alaska Housing Finance Corporation and Alaska Industrial Development and Export Authority should not be considered as General Fund revenues but at least a portion of those earnings should be considered available for payment to the General Fund as a dividend or return of capital.

Recommendation: The earnings of the Alaska Permanent Fund Corporation should be considered as General Fund revenues, subject to existing statutory allocations.

Recommendation: All revenues required by federal law or the Alaska Constitution (including dedicated revenues carried over from territorial government) should be identified as dedicated and the program or programs for which the dedications have been made or are required should be stated explicitly in each budget document.

At the present time, the major sources of revenue to the state are oil and gas rents, royalties and bonuses; oil and gas properties tax; severance taxes; and corporate income taxes. The state has a number of small sources of revenue, generally excise taxes or charges and fees for services¹, that generate approximately \$300 million annually.²

¹Fees and charges for services are generally termed "program receipts." Federal law requires, for example, that the Alaska Department of Environmental Conservation generate enough funds through fees and charges to support the costs of administration of the state's clean air program. Other services, for example, the Recording Offices, charge fees, but the revenue received does not fully support the services. All funds from such fees are deemed revenues to the general fund and are available for appropriation for any budget category.

²An excise tax is a tax applied directly to a commodity used or consumed within the taxing jurisdiction. Examples in Alaska are: alcohol taxes, motor fuel taxes and cigarette taxes.

The Commission has adopted for its use a base-case revenue sources and projections. A copy of the base case, in both nominal and real³ terms is attached to this report. In FY 1996, the amount of revenue estimated to be received by the General Fund is as follows:

Petroleum	\$1,473.4
Other Sources	301.3
Nonrecurring Sources	197.1
Total	\$1,971.8

The base case has projected a fiscal gap, that is, a difference of \$498.3 million between revenues and expenditures, for FY1996. This fiscal gap has been filled by appropriations from the Constitutional Budget Reserve fund. The base case also projects fiscal gaps, in nominal dollars, of \$709.9 million in FY 1997 to \$1,713.9 million in 2005. The base case projects that these gaps cannot be filled entirely from the Constitutional Budget Reserve after FY 1999 and that starting in FY 2000, the amount that must be made available by expenditure cuts and new revenue sources, again in nominal dollars, will be \$390.1 million, rising to \$1,713.9 million in FY 2005.

The Subcommittee on Revenue has not, for the purposes of its work, considered expenditure cuts as a revenue source. The Subcommittee has proceeded on the basis that its responsibilities are to identify existing and new revenue sources and that the full Commission will, in the preparation of its plan, make recommendations as to what new sources of revenue will be needed if expenditure cuts alone cannot fill the budget gap.

NEW REVENUE SOURCES - TAXES

The Subcommittee on Revenues examined revenue sources utilized by other states that Alaska does not use. Most prominent among these sources are statewide property taxes, statewide sales taxes and individual income taxes. Alaska repealed its individual income tax in 1979 and has traditionally allocated to local government units use of property and sales taxes. At the same time, the state funds certain programs, notably education, that have been traditionally considered to be a local responsibility. The subcommittee noted that many states use a statewide real property tax as the primary source of revenue to fund statewide education support.

The Subcommittee considered taxes of various sorts as potential sources of revenue to fill the budget gap. In doing so, the Subcommittee recognized that taxes impose burdens on both individuals and businesses. Economic burdens on individuals and businesses can impair economic

³"Real terms" or "real dollars" means, in this report, the amount of revenue received adjusted for inflation, using FY 1996 dollars as the measure. The purpose of using "real dollars" is to portray the relative purchasing power of the amount of dollars received as compared to the FY 1996 purchasing power.

development, although it is widely known that most businesses and individuals accept the necessity of paying taxes and ask only that the burdens be imposed fairly and for important services. With respect to large economic developments, taxes generally are not a deterrent, unless they are deemed confiscatory.

In considering taxes, tax efficiency should be considered. Taxes may be efficient, neutral or inefficient. Efficient taxes are those that generate more revenue than the costs of collection. Neutral taxes collect revenue equal to the cost of collection and inefficient taxes are those that cost more to collect than the revenue received. The Subcommittee considers that if new taxes are necessary to fill the budget gap, the taxes should be efficient and should not be imposed to accomplish social engineering purposes rather than to raise revenue.

This preliminary report considers only three major new taxes, all of which are considered to be efficient to one degree or another. They are a statewide real property tax, a statewide sales tax and an individual income tax.

Statewide Real Property Tax

Local government units do not exist throughout vast areas of the state. The urban areas are organized into home rule first and second class boroughs. Some boroughs have been formed in the so-called bush areas after introduction of a property base of sufficient size to support local government. In those areas where economic development has not occurred to such a degree, local government formation is weak or nonexistent.

The Department of Community and Regional Affairs publishes a report annually entitled, "Alaska Taxable." This report attempts to set forth the real property values of all parts of the state, within organized boroughs and cities as well as within the unorganized borough. This report reveals that substantial values would appear to exist in the rural areas to support in part local government functions such as education. Closer examination reveals, however, that vast areas of the state could not support a local, let alone a statewide, property tax. In these areas, although values in property exist, incomes of property owners are insufficient to bear the burden that the payment of real property taxes would cause. Moreover, a number of people in rural areas who can place their real property in restrictive titles⁴ have done so, so that any real property tax levied would be paid only by those who are ineligible for such protective status.

The Subcommittee requested the assistance of Mr. Steve Van Sant, the State Assessor, in determining the availability of a statewide real property tax. Attached is a copy of his response which more clearly sets out the difficulty a statewide real property tax would pose in those areas

⁴Alaska Natives may place legal title to their real property in the federal government, while retaining beneficial or equitable title. When the federal government holds legal title, the property is not taxable.

of the state where job opportunities and employment are limited and, consequently, where cash income for the payment of such taxes is very limited. After concluding that the major values in real property that would support a statewide real property tax lie along the road system and in Southeastern Alaska, he pointed out that:

The other areas of the state may have taxable value, but certainly not to the extent of these areas. Regardless of this fact, however, the data would have to [be] collected, analyzed, property record cards would have to be created and assessment rolls would have to be finalized and the appeal process would have to be in place. This entire process would be extremely expensive to set up and maintain. The initial set up process could take up to three or four years to complete, depending on the amount of revenue allocated and the total number of personnel hired or contracted for the project.

Notwithstanding the difficulties, Mr. Van Sant stated that the state could expect to receive approximately \$28 million annually based on a real property tax levy of one mill in addition to the amount the state receives presently from the real property tax levied on oil and gas properties.

AS 29.45.090 presently limits local governments to a property tax of not more than three percent (3%) of value. This is the equivalent of 300 mills.⁵ A tax of 300 mills levied against a residence valued at \$100,000 would yield \$3,000 in revenue. A tax of one mill levied against the same residence would yield \$100 in revenue. AS 29.45.090 further limits the tax levy to \$1,500 per person if more than one taxing entity can levy a tax on the same property. Alaska Taxable shows that millage rates vary among Alaska's taxing jurisdictions, from *** to ***.

The Subcommittee considered the real property tax as a potential new source of state revenues on the basis that each one-mill levy would yield \$28 million in revenue. In order to fill the fiscal gap solely on the basis of state real property taxes, a levy of 30 to 100 mills would be necessary. In doing so, the Subcommittee considered the advantages and disadvantages as follows:

⁵A mill is one one-hundredth of a cent. Real properties are traditionally taxed at rates of mills instead of percentages: the millage rate.

Advantages

Real property values are generally stable and the calculation of anticipated revenue is relatively easy.

Taxation of real property would spread the tax burden throughout the state.

Real property taxes could be used to offset the rising cost of education, especially in the K-12 schools.

Disadvantages

Payment of real property taxes must be made by individuals with cash incomes. In periods of recession, lowered family income make payment of such taxes difficult. For property owners with little or no cash income, real property taxes pose an insurmountable problem.

Collection of real property taxes in many areas would be so difficult that it is likely that statewide real property taxes would be collected primarily in those areas in which real property taxes are already imposed.

Local governments already levying real property taxes use all or a portion of the tax revenues to support education. A statewide tax as an additional tax might weaken the local effort to support education.

The foregoing chart of advantages and disadvantages is not exhaustive, but is set forth to illustrate the types of considerations the Subcommittee gave to the subject and to set forth a basis for its recommendation.

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Recommendation: A statewide real property tax should not be considered as a reasonable new source of revenue because: (1) the cost of collection would be extraordinarily high; (2) collection would require the establishment of a sizable bureaucracy to administer the tax; and (3) local governments rely upon real property taxes as a major source of revenue to fund local government.

Statewide Sales Tax

Sales taxes are a popular form of taxation in other states as well as among Alaska's units of local government. Some local government units, Anchorage for example, have steadfastly resisted the imposition of a sales tax. Fairbanks had a sales tax at one time, but repealed it. Juneau imposes a four percent sales tax. In contract, the State of Washington imposes a sales tax of over 13 percent.

There are two broad arguments for a sales tax. One is that it is easy to collect because the seller, in effect, is the tax collector. The other is that it spreads whatever tax burden there is widely to all purchases of goods and services.

At the present time, the state does not impose a sales tax, but in AS 29.45.650 et seq. authorizes local government units to impose sales and use taxes. Sales taxes are useful in those areas in which real property taxes are unrealistic because it enables local government units to generate revenues based on the community's ability to pay.

There is one broad argument against sales and use taxes and this is that the tax is regressive. A regressive tax is a tax that creates the largest burden for those who have the least ability to pay. In recognition of this, many jurisdictions exempt food and other categories of essential goods and services. The federal government requires, and the state has adopted such legislation, that items purchased by food stamps be tax exempt.

Commissioner Wilson L. Condon of the Department of Revenue has supplied the Subcommittee with the department's estimate of revenue from a statewide sales tax. A copy of the report is attached. In summary, the department has estimated that for every one percent of sales tax imposed, the state would receive approximately \$40 million in revenue. This estimate is based on the proposition that the tax would be imposed on all sales and uses, with no exemptions. If exemptions are created, revenues per one percent of tax would, of course, be less.

Advantages

Revenues are easily calculated.

Collection is easy and relatively inexpensive.

Sales taxes spread the burden widely.

Sales taxes would create new revenue from the tourists and other non-permanent residents of the state.

Disadvantages

Revenues are dependent on the general economic health of the state and should, therefore, be considered volatile.

Auditing sales tax returns from sellers would be expensive, requiring hiring of a number of personnel to conduct audits and requiring large amounts of travel.

Sales taxes would impose an additional burden on purchasers and might reduce other local government revenues.

Sales taxes might create a greater tax rivalry between communities than already exists.

Advantages

The percentage of additional cost that a sales tax would represent is not a burden.

Disadvantages

Sales taxes of any amount create burdens for the economically disadvantaged, especially for those whose cash incomes are limited.

The Subcommittee considered the role sales taxes play at the present time and probably in the future in funding local government. The Subcommittee considered the impact on buyers of goods and services in those communities in which sales taxes are imposed and also considered that the ability to impose sales taxes may offer a powerful incentive to areas in the unorganized borough to organize into units of local government. As a consequence, the Subcommittee makes the following:

Recommendation: Sales and use taxes should remain exclusively within the taxing jurisdictions of units of local government and should not be considered as a means to fill the fiscal gap.

Individual Income Tax

From 1949 to 1979 Alaska imposed an individual income tax that, until the advent of oil and gas revenues, was the single largest source of revenue to the Territory and then to the State. The citizens of the Territory of Alaska were originally persuaded that an income tax was necessary because of the increasing costs of territorial government and the fact that employment in Alaska, other than government, was seasonal and an income tax was a method of capturing a portion of individual income earned in Alaska before it was exported to other states. When it became clear that oil and gas revenues were going to be greater than the state's requirements, the individual income tax was repealed.

The Subcommittee requested and received assistance from the Department of Revenue in estimating the potential of an individual income tax to generate enough revenue to close the fiscal gap in the present as well as in the future, at least until 2005. The department estimates that if an individual income tax were imposed using the same formula that was in effect in 1978, the amount of revenue that would be generated would be approximately \$450 million per year.

The Subcommittee also had available to it the studies performed by the Institute of Social and Economic Research (ISER) covering a number of subjects, but principally ISER's studies of the fiscal gap and sources of revenue to close the gap. A number of ISER studies compare the tax burdens borne by Alaskans with those borne by citizens of other states. Those studies make it clear that on an individual or per capita basis, the tax burden borne by Alaskans is very light, less than one-half of the U. S. average.

The Subcommittee, therefore, considers that the individual income tax represents a significant and, probably, essential new source of revenue to close the fiscal gap. However, it

believes that imposition of an individual income tax cannot be undertaken without reference to other major sources of both state and individual income. However, an individual income tax reaches all income earned in Alaska and, therefore, imposes the burden of funding state government on all of those who take advantage of work and investment opportunities here who have not contributed to the cost of government over the past nearly 20 years.

The Subcommittee has heard representations that an individual income tax should not be imposed as long as the state pays to each citizen who applies a dividend from the Permanent Fund earnings. The Subcommittee does not consider an individual income tax to be an alternative to the annual dividend, but recognizes that in the minds of most Alaskans, it is. Notwithstanding the political linkage, the Subcommittee considers that imposition of an individual income tax is probably necessary if expenditure cuts and other revenues cannot close the fiscal gap.

The Subcommittee considers the method of calculation of the income tax that was in effect in 1978 may now not be appropriate. The Subcommittee believes that the Department of Revenue should be requested and funded to develop models of an individual income tax system that would be fair, efficient and reasonably simple for people to calculate.

NEW REVENUE SOURCES - NON-TAX

Alaska Permanent Fund

The Alaska Permanent Fund was established in 1977 by a constitutional amendment adopted in 1976. It is designed to act as a savings account to capture a portion of the revenue received by the state from state and federal mineral rents, royalties and bonuses. At the beginning of FY 1996 (July 1, 1995), it is estimated to have a principal value of approximately \$13.5 billion.

The constitution requires that the principal of the Fund be "used only for...income-producing investments...designated by law..." and that the income be deposited in the General Fund unless otherwise provided by law. At the present time, instead of depositing the income into the General Fund, AS 37.13 requires that the income be used to inflation proof the fund and to pay to each citizen applying for it a dividend. Any surplus that exists after these purposes have been satisfied is retained in an account designated as the "earnings reserve account." As of the end of FY 1995 (June 30, 1995), the earnings reserve account holds \$1.138 billion.

Since 1980, the Permanent Fund Dividend has become imbedded in the culture and economy of the state. The amount of the annual dividend has risen from approximately \$300 per applicant to approximately \$950 per applicant. Surveys conducted by the Alaska Permanent Fund Corporation, the state entity that manages the Fund, indicate that recipients of dividends use the money for a variety of purposes including payment of bills, education, travel and investment. Since issuance of the dividend commenced, approximately \$5 billion in dividends has entered the Alaska economy.

GUEST FACSIMILE

To:
KAREN HAMMERFacsimile Number:
(907) 786-6123Phone Number:
(907) 786-1437Date: 7/24/95THE
CHARLES
HOTEL

COVER PAGE

From:
LEE GORSUCHHotel Facsimile Number
(617) 864-5715Guest Room:
539Page 1 of 1

REGARDING:

Karen,

Please call Melissa Fouse @ Leg. Info. Ofc. & ask her to request Jim Kelly of the Ak Perm. Fund to prepare a spreadsheet which assumes: 1) a real rate of return of 6 percent; 2) dividends capped at \$500m and declining @ 1.5% per year 3) all but \$1b of "transition" funds deposited into the Ak Perm Fund; 4) \$80m of real earnings of the Permanent Fund go to G.F., compounding by \$80m each year for 5 years i.e. total of a \$400m payout to G.F.; 5) reduce inflation proofing by the % of the Fund's portfolio that is in equities; and 6) move % of Fund portfolio in equities to 70 percent over 5 years. (Ask Jim to make certain not to double count either inflation proofing if it is already reflected in the unrealized capital gains or calculations of real rates of return if they already account for adjustments to unrealized capital gains.

Also, please give my best wishes to Jonett Tr. Hatch and send me telephone #'s for Jim Kelly and Brad Pierce (@ OMB).

For Questions Regarding the Transmission of this Facsimile, Please Call the Concierge
at The Charles Hotel in Harvard Square.
(617) 864-1200 ext. 4

Mark
Lee

Guest: Please refer to price information on reverse.

TO: Jim Kelly

FM: Melissa Fouse

SCOMM

101:30

TUES
✓ RESERVES

State of Alaska Fund Balances (millions of dollars)

<u>Fund</u>	<u>Current Balance</u>	<u>Purpose and Limits on Use/ Impacts of Spending</u>
Constitutional Budget Reserve Fund	\$1,965.3	Purpose: to save windfall revenues and cushion longer term declines in revenues. Fund can be used to offset revenue shortfalls by majority vote under certain conditions; other appropriations require 3/4 vote of legislature. Appropriations from fund are required to be repaid from surplus revenues. Impact of spending from the fund is to reduce the state's ability to offset future revenue shortfalls.
Permanent Fund Earnings Reserve Account	\$818.0	Projected balance as of June 30, 1996. Purpose: to offset potential shortfalls in funds available for inflation-proofing the Permanent Fund. No limits on appropriations for other purposes except for public pressure to protect the Fund. Impact of spending from the ERA is to potentially create a shortfall in inflation-proofing funds. However, this will depend on future earnings of the Permanent Fund and the impact is uncertain.

What is an appropriate level of reserves for Alaska?

Revenues for the next year's state budget are based on the mid case projection of oil prices and production. In any given year there is a substantial chance that oil revenues will be hundreds of millions of dollars less than the mid case projection. The consequences to the state's economy of addressing such a large shortfall exclusively with budget cuts in a single year would be to severely aggravate an already difficult economic downturn. In 1986-87, the combination of low oil prices and sharply curtailed state spending threw the state into a severe recession, with the following impacts:

- Alaska lost 22,000 jobs — 10 percent of the work force;
- Anchorage's population dropped by 29,000 residents (about 9 percent);
- Over 10,000 residential properties were foreclosed on statewide; and
- At the worst point there were over 90 bankruptcies per month in Anchorage.

One potential policy for use of reserve funds is: if anticipated revenues drop more than a predetermined percentage from the mid case projection, a combination of budget cuts

and use of reserves should be put into place. The appropriate mix will depend on several factors, such as how late in the fiscal year the revenue drop occurs, private sector economic conditions, the amount of cuts already budgeted for the year and the expected duration of the problem.

How much insurance against oil price declines should the state maintain in the form of reserve funds? One reasonable benchmark would be for the state to be prepared to offset a drop in oil prices from the mid case projection for a given year, to the historical low point in oil prices over the last ten years. This ten-year low point was reached in FY 94 in terms of inflation-adjusted oil prices, with an average for the year of \$14.22 per barrel.

If this benchmark were applied to the FY 96 budget, about \$275 million in reserves would be necessary to insure against a potential drop in oil prices from the mid-case revenue forecast to the \$14.22 level. Since lower-than-forecast oil prices could occur in two consecutive years, it may be prudent to maintain about twice this amount, or approximately \$500 million, in reserves to offset oil price fluctuations. This amount would also be sufficient to provide cash necessary to handle a major natural disaster or other emergency requiring immediate and extensive state action.

In addition to providing insurance against oil price fluctuations, reserve funds are also an important element of cushioning the state's adjustment to lower long-term revenues. While reserves cannot fill the fiscal gap indefinitely, if appropriately used, they can smooth this transition to lower revenues and help to avoid excessive impacts to the Alaska economy and work force.

Other reserve fund issues

To ensure that reserves are replenished, a repayment mechanism is required. The commission believes that the repayment provision of the current Constitutional Budget Reserve (CBR) is not as clear and workable as it should be. For instance, it does not make sense to completely drain capital replacement funds (for highways, ferries, state equipment, etc.) at the end of the year in order to pay back the CBR. The very purpose of these funds is to provide a rational, planned source of funds to replace aging equipment and facilities.

An alternative approach would be to repay reserves with year end balances in the general fund and future oil revenue increases. As oil revenues are restored, any amount over the mid case projection should be returned to reserves at year end along with any balances from the general fund appropriation. Any settlement income or other "windfall" should also be deposited in reserves.

A number of other issues have been raised concerning the operation and effectiveness of the Constitutional Budget Reserve, including the 3/4 vote requirement, and the uncertainty regarding the definition of the term "amount available for appropriation," which sets the threshold for use of the Reserve.

The commission has yet to determine whether the CBR is the best long term strategy for implementing the state's reserves policy. At this point, the commission is focusing its

efforts on the development of an effective reserves policy. When this step is complete, the commission will then turn to a more detailed review of the CBR issues discussed above, and address possible solutions to these issues. It should be noted that any changes to the Constitutional Budget Reserve provisions will require a constitutional amendment.

Another potential reserves policy would be that if reserves build up to a level which is more than 1.5 times the amount required under the general rule, the legislature should consider depositing the excess in the corpus of the Permanent Fund. However, an automatic deposit may not be advisable, because under the circumstances it may be more fiscally prudent to build up somewhat larger reserves.

Our experience from the years of dramatic oil price increases tells us that it is absolutely critical that the state not increase spending just because revenues have taken an upturn. This only leads to a level of spending which cannot be sustained when prices return to their more accustomed level, let alone when they drop below the mid case level. Additional revenues from price spikes should be used to replenish reserves or as an addition to the corpus of the Permanent Fund.

Melissa, Annalee also wanted to add a bullet on dedicated funds to the end of the Budget Process section:

- *Review the issue of dedicated funds to determine whether such funds would help or hinder the process of closing the fiscal gap.*

Melissa - Here are some minor revisions to the Reserves and Budget Process sections requested by Annalee McConnell. I've put the new or reworded sections in italics.

Thanks -- Jack Kreinheder

Post-It™ brand fax transmittal memo 7671		# of pages > 4
To Melissa Fouse	From Jack Kreinheder	
Co.	Co.	
Dept.	Phone #	
Fax # 758-9869	Fax #	

DRAFT: 7/25/95

JF

What is needed, therefore - - both as a means of concretely dealing with the fiscal gap, and as a means of not unnecessarily contributing to it - - is for the fiscal gap to be operationalized, or operationally defined. That is, it needs to be given a particular size and shape. Once that is done, and not before, it can be fitted with a specific strategy (or set of strategies) for solving it.

For example: If the Budget Reserve Fund were to be capitalized to yield a scheduled stream of investment income for the general fund for a set number of years, operating and capital budget expenditures were ratcheted down over the same period via a separate schedule, and a mix of tax provisions adjusted to yield yet a different scheduled flow of tax revenue in the same time period, the remaining "fiscal gap" (if any) would thereby have been imparted a specific size and shape, "X" dollars high and "Y" years long. It would no longer be something vague, or constantly changing. In short, to the degree that these fiscal flows were scheduled (agreed upon, enacted, appropriated, etc.) - - i.e., stabilized - - the gap would, in effect, have been defined, at least over the period. The defined gap might be small for the first year or two, small in the middle several years, and very large in the last few out years; or vice versa; or whatever. The point is, stabilization of revenues and expenditures would prove to be the key to developing the strategy, and to achieving and maintaining a consensus for implementing it.

This is an important point: until the fiscal gap is operationally defined, it will be difficult if not impossible to develop and settle upon a strategy or plan for dealing with it. So long as our sense of the fiscal gap remains vague and shifting, it will be very difficult to either lay out a strategy or plan of action, or to obtain (and maintain) agreement on it.

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The key to developing an operational definition of the fiscal gap, as shown in the example, is to approach it through stabilization of the State's revenue and expenditure streams. The reason for this is that stabilization will provide the one thing currently missing that is indispensable for solving the problem of the fiscal gap: it will impart a size and shape to the gap that does not keep changing; and which, therefore, is amenable to a continuing solution strategy that itself need not change from year to year.

This will provide two crucial things, in particular: (1) a solution strategy that can be applied gradually, over a number of years; and, (2) a basis for achieving and maintaining public support for - - and a political consensus for - - that strategy. In addition, it will allow a measured assessment of our needs and problems, and thus establishment of a good "fit" between our needs and our resources. In the broader scheme of things, it will also contribute mightily to overall economic stability in the state, insofar as Alaska's economy is affected hugely by State fiscal policy decisions.

To achieve this operationalization of the fiscal gap, many approaches are possible. The Commission is exploring all of them. Under review at present are the following:

- *Development of a Reserves Policy*

Approaches for employing existing and future reserve funds not just as a "shock absorber" (e.g., for dealing with sudden or short-term revenue decreases), but also as a "stabilizer" (e.g., to enhance program planning and economic development through provision of a steady year-to-year level of expenditures.

NOTE: CHECKED
SECTION 11

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or capital investment; i.e., through capitalization of reserves).

- **Application of Permanent Fund Earnings**

Approaches for using portions of the Fund's earnings to augment budget revenue,

- **Petroleum Hedging**

Investment banking approaches for reducing risk and maximizing income through the use of security and commodity futures, options, etc.

- **Economic Development Initiatives**

Approaches to further development of North Slope oil and gas resources, oil and gas exports, etc.

- **Oil and Gas Settlements**

Approaches for striking a balance between current use and deferred use of oil litigation settlement funds.

*Summarize
discussion
further
study*

*Harry
Lindal
WAF*

Revenue Section

*What OTHER fields to come on
line, any royalty relief*

*direct
hands, etc.*

What about Reserves?

Why do we need reserves?

- To absorb the shock of extraordinary drops in the price or production of oil, the source of 78 percent of our state revenues. Alaska is much more vulnerable to fluctuations in the price of a single commodity — oil — than any other state. Reserves can be used in combination with budget cuts so that the state's economy doesn't suffer as badly as it did in the oil price crash of 1986.
- To provide a "surge tank" for windfall revenues from oil tax settlements and oil price spikes, in order to avoid the spending spree that might result if these windfall revenues flowed directly into the general fund.
- To have funds available for immediate state response to extraordinary disasters and emergencies.
- To reassure the state's bond market that the state has adequate resources to pay bond debt in the event of a major change in revenues or expenditures as described above.
- In the past, the state has used reserve funds for all of these purposes. However, there has not been a consistent policy for using reserve funds from year to year, and the use of reserves has not been as effective in closing the long-term fiscal gap as it might have been.
- While reserve funds have been used to temporarily fill the fiscal gap for several years, over the long term, this is not a viable use of reserves, because the reserves will soon be depleted.
- If the state adopted a proposal to use a portion of the 5-year average earnings of the Permanent Fund to support government services, reserve funds could be used to offset years of low Permanent Fund earnings, to avoid any reduction in the principal balance of the Fund.

What reserves does Alaska have now?

Alaska's major liquid reserve accounts are the following:

X

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