# Economic Impact of Revenue Options

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*Discussion of Alaska's multi-billion dollar structural budget deficit typically focuses on the state treasury. While establishing a glide path to a balanced budget is critical to the treasury, the choice of a glide path will affect both individual Alaskans and the economy of the state. Various options to close a budget deficit in excess of $3 billion by reducing expenditures and/or increasing revenue would affect Alaskans to differing degrees. They also differ in how much of the burden would be borne by non-Alaskans and by the federal treasury. In an attempt to frame both public and legislative discussion, this paper discusses the impact of three options that would increase general fund revenue.*

A spreadsheet accessible on the Legislative Finance web site (http://www.legfin.akleg.gov/InformationalPapers/16-2RevenueOptions.xlsx) illustrates the impact of the following revenue options on the incomes of Alaskans:

1. a cap on Permanent Fund Dividends (with the associated Permanent Fund earnings then available to the general fund)
2. an income tax, and
3. a sales tax.

This spreadsheet illustrates one of the many complications that lawmakers and the public may wish to consider in evaluating potential revenue options. That complication is that generating any desired level of revenue can be done in a number of ways, and each option hits different groups of Alaskans in different ways.

The spreadsheet estimates the impact of these options on hypothetical families of two, four, and six at four annual income levels: $25,000, $50,000, $100,000 and $250,000. According to the US Census Bureau, the median household income in Alaska is about $71,000. The projected impacts are rough estimates, and any of the three revenue options could be structured in many different ways.[1]

This simple model illustrates that of the three options, a reduction in dividends would have the greatest relative impact on low-income households and on larger families. A sales tax would also disproportionately impact low-income households, who tend to spend a larger percentage of their

[1] For example, a sales tax could exempt certain purchases, such as groceries, heating fuel, or services. It could also have a higher rate in the summer to shift more of the burden to visitors. An income tax could be structured with a flat rate or a progressive rate structure, and could include any number of deductions or credits.

income on taxable items than higher-income households.[2] An income tax, even a flat tax as modeled in this spreadsheet, would have the greatest impact on high-income households and the least impact on low-income households of the three options. A mix of the options could be used to spread out the effect of the revenue measures.

In addition to the factors illustrated in this spreadsheet, another important consideration is the degree to which a revenue enhancement measure would affect non-Alaskans. The impact of reducing Permanent Fund Dividends (PFDs), which only go to Alaskan residents, would fall fully on residents. However, the federal government includes PFDs as income subject to taxation, so an estimated 20% of PFD payments to Alaskans end up going to the IRS.[3] This means that of the $1.4 billion in dividends paid in 2015, nearly $280 million will go to the federal government. Income and sales tax payments, on the other hand, can be deducted from federal tax liability (although only for taxpayers who itemize) so imposing a state income or sales tax would reduce taxes paid by Alaskans to the federal government.

In addition, sales and income taxes would be paid by non-residents who work in or visit Alaska, while dividends only go to Alaskan residents. A sales tax could be structured to maximize the impact on nonresidents. For example, a sales tax could be applied only during the summer, when tourism is greatest. The Department of Labor and Workforce Development estimates that 15.2% of wages in Alaska were paid to nonresidents in 2013.[4] Depending on the distribution of wages and on the structure of the tax, residents could pay less than 85% of each dollar generated by an income tax.

A complicating factor for a potential state sales tax in Alaska is that 42 municipalities already levy sales taxes, with rates as high as 7% (in Kodiak and Wrangell).[5] The combined impact of a state and local sales tax could hurt local businesses and cause consumers to shift purchasing to online retailers. The highest combined state and local sales tax in the US is in Arkansas and Tennessee, with a rate of 12%, so a 5% state sales tax would make the sales tax in some localities in Alaska the highest in the nation.

**What Tax Rates Are Reasonable?**

[2] In this spreadsheet, the percentage of income spent on taxable items varies only with income, not family size. No data is available with sufficient detail to estimate both variables at once, and plausible reasons could be given for either effect.
[3] See Laurence A. Smith, Note, *A Proposed Solution to the Federal Taxation of Alaska Permanent Fund Dividend Payments,* 11 ALASKA L. REV. 97 (1994). Smith's estimate is based on an earlier estimate by Gunnar Knapp of ISER.
[4] See *Nonresidents Working in Alaska, 2013*. Available at http://laborstats.alaska.gov/reshire/nonres.pdf.
[5] For a full list of municipal tax rates, see Alaska Taxable, available at https://www.commerce.alaska.gov/dcra/dcrarepoext/Pages/AlaskaTaxableDatabase.aspx.

Alaska is the only state without either an income or sales tax; most states have both. In addition, Alaskans receive a Permanent Fund Dividend each year, giving Alaskans an effective negative tax burden.

The average broad-based tax revenue in all US states is approximately $2,000 per capita. In Alaska, it is about $350 per capita (from sources such as the motor fuel tax and tobacco taxes) without factoring in the PFD.

If the $2,100 PFD is counted as a "negative tax," then Alaskan's "out-of-pocket" per capita taxes would need to be $3,750 (which translates to about $2.7 billion in total tax revenue) in order to reach the national average of $2,000 in taxes paid per capita.

For discussion purposes, the following rates would need to be implemented to equate to the per capita national average of $2,000, assuming the PFD continues at $2,100 and there are no income tax exemptions:

- An income tax of about 12.5%; or
- A sales tax of more than 26%.

To put this in perspective, the states with the next lowest tax rates (New Hampshire and Texas) have tax burdens two and three times Alaska's, respectively – and both states also rely on unusually high statewide property taxes.

In the 41 states with an income tax, the highest top rate is California's 12.3% and the lowest is Pennsylvania's 3.07%. The median top rate is 6%. Eight states have flat taxes, ranging from Pennsylvania's aforementioned rate to North Carolina's 5.8%. For comparison, each 1% of a flat income tax in Alaska would bring in about $220 million, with no exemptions or deductions. Exempting the first $25,000 of income would reduce revenue by about $50 million for each 1% levied.

Of the 45 states with a sales tax, the lowest rate (not including local taxes) is Colorado's 2.9% and the highest is California's 7.5%. The median rate is 6%. 38 states either exempt groceries or have a reduced tax rate for them.[6] For comparison, each 1% of sales tax with groceries exempted in Alaska would bring in about $105 million.

**Assumptions for Distributional Impact Calculations**

The PFD cap option is not a true "revenue" proposal, but the impact of a change to dividend calculations is comparable enough to a tax that it can be included in this illustration. It uses a projected baseline dividend of $2,100, which is the projected value of the 2018 dividend. The

[6] For a full list of states tax rates and exemptions, see the Federation of Tax Administrators data, available at http://www.taxadmin.org/fta/rate/tax_stru.html

data assumes that each person is eligible for a dividend, and does not factor in the federal tax liability created by the dividend.

The income tax option allows for a flat tax and an optional income exemption. For example, a rate of 3% and an exemption of $25,000 would levy no tax on the first $25,000 of income, and tax income above $25,000 at a 3% rate. The revenue figures for this option come from an adjusted version of the Department of Revenue's (DOR) income tax projection for FY18. These adjustments use 2012 IRS data (the same data source used by DOR for its projection) to translate a projection based on federal tax liability to a tax on adjusted gross income, and then to allow for exemptions of certain amounts based on the brackets reported by the IRS. A bracketed income tax (which is more common in other states) would be more complex than this simple illustration could depict. Likewise, an analysis of a tax based on a percentage of federal liability (like HB 182) would require more information about individual taxpayers than is currently available to the public.

The sales tax impact is based on a tax incidence study by the Minnesota Department of Revenue of its own sales tax.[7] Minnesota's sales tax exempts groceries, so this model's revenue figures reflect DOR's FY18 estimate for a sales tax with exemptions. The Minnesota incidence data was then applied to the income levels in Alaska, assuming an identical tax structure. This data does not differentiate between household sizes; US Census data indicates that larger households pay a higher percentage of their income in sales tax than smaller households, but it does not provide enough data to be applied to this model. To provide a full, accurate estimate of the impact of a sales tax, a more comprehensive analysis would be necessary.

[7] Available at http://www.revenue.state.mn.us/research_stats/research_reports/2015/2015_tax_incidence_study_links.pdf. See page 29 for the source data.