

Hard Choices: Revenue-Raising Options for Alaska

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Alaska is at a fiscal crossroads. In recent months, policymakers have begun to discuss using Permanent Fund earnings to help fund public services. At the same time, the governor and the legislature have each proposed increasing various state taxes—or introducing new broad-based revenue sources. As legislators crafting the fiscal year 2005 budget seek to make up a projected \$291 million in revenues through budget cuts or tax increases, these questions will grow more prominent in the coming weeks.

Alaska is also facing an ongoing tax equity crisis. The state's policy makers have chosen to finance government services with a tax structure that requires low-income taxpayers to pay the highest effective state and local tax burdens—and allows the wealthiest taxpayers to pay the lowest effective tax rates.

These dual crises will force lawmakers to make tough decisions about tax and spending policy in 2004—but also represent an historic opportunity to make the tax system less unfair. This analysis looks at Alaska's current regressive tax structure, and identifies various options available to legislators seeking to solve the state's current fiscal shortfall without worsening the inequities in the current tax structure. The options presented in the analysis include reductions in the Permanent Fund Dividend, increasing the state cigarette tax, and introducing several new taxes that the state does not currently levy, including a broad-based sales tax, a personal income tax, and a \$100-per-worker "head tax." For each option, the analysis shows how much additional revenue the option would bring in if enacted in tax year 2003, and how the option would affect Alaska taxpayers at various income levels. The analysis also briefly discusses the advantages and disadvantages of each option.

Distributional Impact of the Current Alaska Tax System

In January of 2003, the Institute on Taxation and Economic Policy released a report entitled *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*.¹ One of the findings of the study was that in 2002, Alaska had a *regressive* tax structure—in other words, that middle- and low-income Alaskans paid a higher share of income in Alaska state and local taxes than did the better-off. In particular, the study found that:

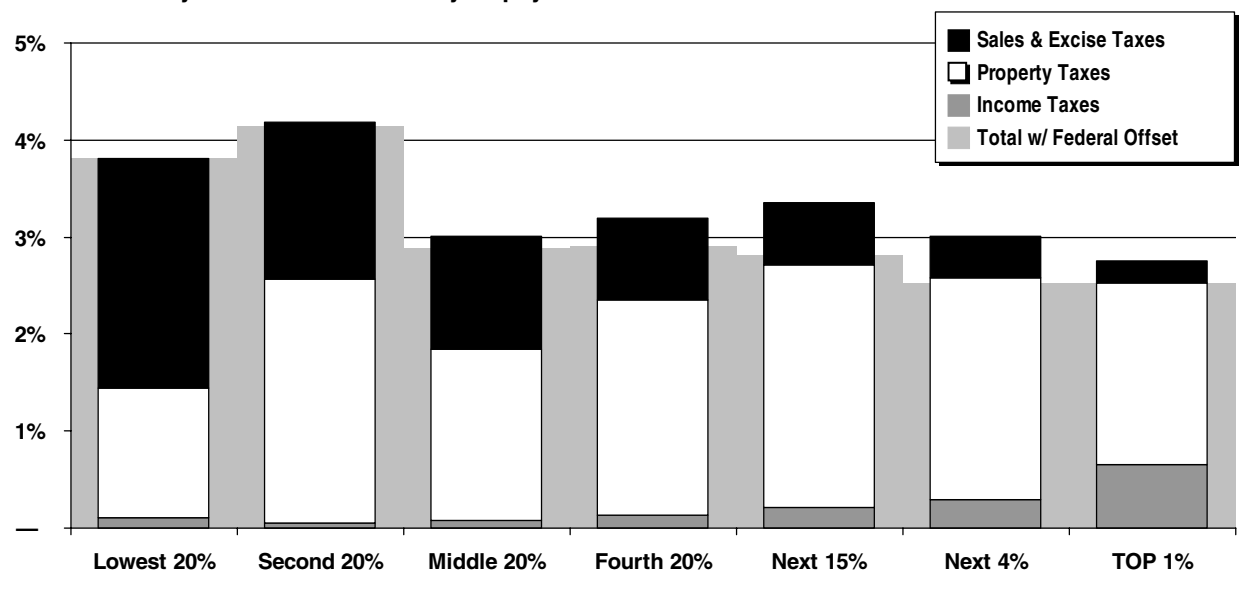
- The poorest twenty percent of Alaskans paid 3.8 percent of their income in Alaska taxes, while the wealthiest one percent of taxpayers paid only 2.8 percent of their income in state and local taxes.
- After taking account of the deductibility of state income and property taxes on federal tax forms, the effective tax rate on the wealthiest Alaskans was 2.5 percent—more than a third lower than the tax burden on the very poorest Alaskans.

The study showed that the state's regressive tax structure was due to two factors: first, the state relies on regressive taxes such as local sales taxes and excise taxes on cigarettes,

¹*Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. McIntyre, Denk, Francis, Gardner, Hsu and Sims (Institute on Taxation and Economic Policy, 2003).

Alaska State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



alcohol and gasoline. Second, Alaska is one of a handful of states that do not currently levy a personal income tax—the only major progressive tax option available to states.

Revenue-Raising Options

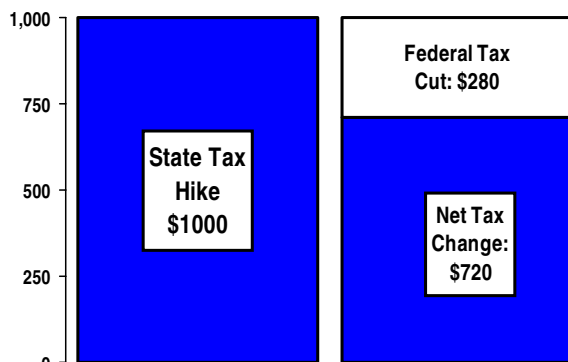
The results of the January 2003 ITEP study have clear implications for revenue-raising in Alaska: if policy makers choose to fund state services by increasing sales and excise taxes, the Alaska tax system will become even more regressive. If, on the other hand, the state chooses to introduce a progressive income tax, the tax system as a whole will become less regressive. This section explores the distributional impact of various alternatives for revenue raising.

For each option described below, the accompanying bar charts show the impact of these options on each Alaska income group, expressed as a percentage of personal income. The solid portion of each bar represents the net tax change (after taking federal tax changes into account) for each income group. The transparent part of the bar shows each proposal's effect on the federal income taxes paid by each group of Alaskans. The entire bar, including both the solid and transparent part, shows the state tax change, before taking account of federal tax changes, for each income group. We have presented our data in this way because for those Alaskans who itemize deductions on their federal tax returns, changes in state and local income or property taxes can produce partially offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of state tax proposals on the *overall* taxes paid by Alaskans, including federal taxes. The simplified graph on the following page shows how to interpret these charts.

Suppose an itemizing Alaska taxpayer in the 28 percent federal tax bracket is subject to a \$1,000 increase in a hypothetical Alaska income tax. The value of her federal itemized

deductions will increase by \$1,000. This means that \$1,000 *less* of this taxpayer's income will be subject to federal tax after the Alaska tax increase. Since this last increment of income was originally taxed at 28 percent, this person's federal tax liability decreases by \$280. So the net *overall* tax hike for this itemizing Alaska taxpayer from a \$1,000 hike in state tax liability is actually \$720, not \$1000. Our distributional analysis of this proposal (the second column in the chart on the previous page) shows that taxpayers do not pay the full \$1,000 tax hike, since \$280 of that hike is directly offset by federal tax cuts.

**How Increases in Federally Deductible Taxes Reduce Federal Tax Burdens:
An Example**

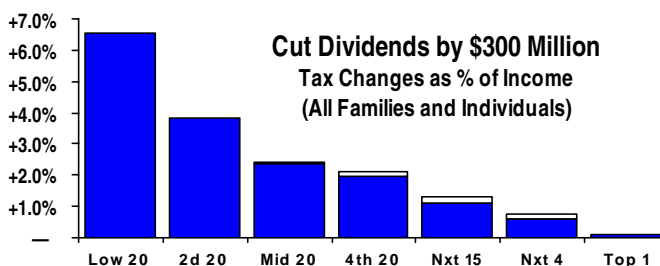


An analysis that looked only at the *state* tax impact of the proposal (the first column in the chart) would overestimate the real tax hike on Alaskans from the proposal.

1. Reduce the Permanent Fund Dividend

Plans to devote Permanent Fund earnings to balancing Alaska's budget would have the impact of reducing funds available for the Permanent Fund Dividend. This option shows the impact of reducing the aggregate dollar amount available for the PFD by \$300 million on Alaskans if this change were enacted in tax year 2003.

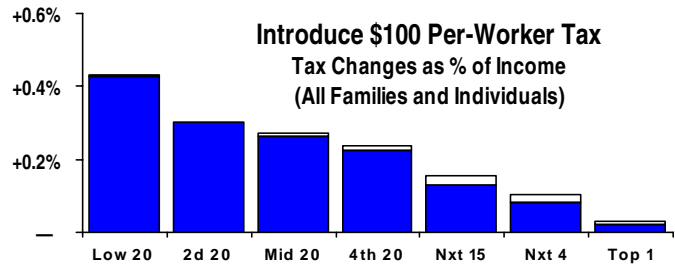
- Because the dividend is a flat per-person amount, the “tax hike” as a share of personal income would be much greater for lower- and middle-income Alaskans than for wealthier taxpayers.
- This proposal would have increased state tax collections by \$300 million in tax year 2003.
- Federal taxes paid by Alaskans would fall by \$20 million under this proposal—offsetting 6 percent of the state “tax hike” from the Dividend cuts. This is because the Dividend is taxable on federal tax returns, so cutting the Dividend will reduce federal taxable income.



2. Enact a \$100-Per-Worker “Occupation Tax”

Personal income taxes are generally a progressive approach to revenue-raising, requiring higher-income taxpayers to pay a larger percentage of their income in tax. However, the \$100-per-worker “occupation tax” shown here has exactly the opposite effect, imposing the highest effective tax burden on the poorest Alaskans and allowing the wealthiest taxpayers to pay the lowest effective tax rate.

- Because wage-earners and self-employed taxpayers at all income levels would pay exactly the same dollar amount of tax (\$100 per earner), this is a regressive tax.

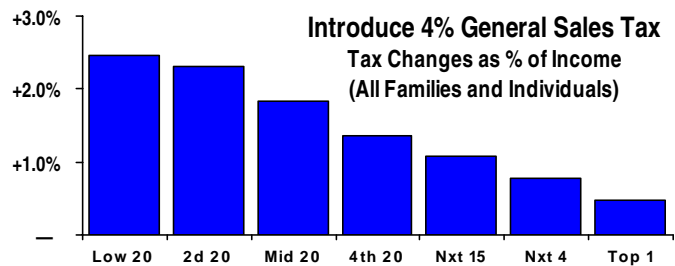


- Alaska tax collections would have increased by about \$31 million in 2003 under this plan.

- Because the lion's share of the tax burden under this plan would be paid by low- and middle-income Alaskans who do not itemize their federal income taxes, relatively little of this state tax hike would be offset by federal tax cuts for Alaska itemizers. Alaskans would see a \$3 million federal tax cut from their plan.

3. Introduce a 4% Statewide General Sales Tax

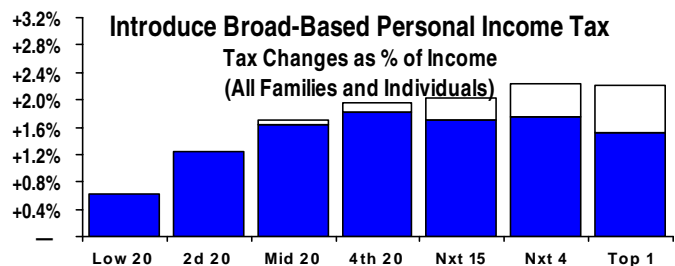
This option would introduce a state sales tax of 4 percent. Sales taxes are the most regressive of the major taxes levied by state governments—and an important contributor to the overall unfairness of the Alaska tax system. By increasing the state's reliance on this revenue source, this plan would make the tax system even more regressive.



- This option makes the tax system more regressive. The largest tax hike, as a share of income, would be borne by the poorest Alaskans.
- This option would have increased Alaska tax revenues by \$300 million in 2003. Since sales taxes are not deductible on federal income tax forms, there is no offsetting federal income tax cut from this change.

4. Introduce a Broad-Based Personal Income Tax

Alaska is one of only seven states that do not currently levy a broad-based personal income tax. This option would introduce a flat-rate personal income tax of 2.75 percent. The tax base is federal taxable income, which includes federal personal and dependent exemptions and the federal standard and itemized deductions.



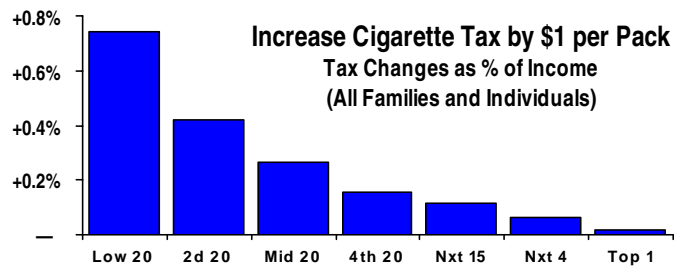
- This option makes the tax system less regressive. The largest tax increase, as a share of income, is paid by the very wealthiest Alaskans.

- This plan would have increased state revenues by \$300 million in 2003.
- Because state income taxes are deductible on federal income tax forms, 14 percent of the new state taxes paid by Alaskans under this plan would be offset by federal tax cuts. Overall, Alaskans would pay about \$42 million less in federal income tax.

5. Increase the State’s Cigarette Tax by \$1.00 per Pack

This option would increase the Alaska cigarette tax from \$1 to \$2 per pack. Cigarette taxes are among the most regressive taxes levied by state governments—and one of the principal reasons for the overall unfairness of the current Alaska tax system. By increasing the state’s reliance on this revenue source, this plan would make the tax system even more regressive.

- Excise taxes are generally the most regressive taxes. This tax hike would impose the greatest burden on the poorest Alaskans.
- This option increases Alaska tax revenues by \$35 million. Since



cigarette excise taxes are not deductible on federal income tax forms, there is no offsetting federal income tax cut from this change. Moreover, the state revenue gain from this plan is uncertain, since higher cigarette taxes may encourage a decline in smoking.

Conclusion

Alaska faces a short-term fiscal challenge. State policymakers must decide how best to modify the state’s tax structure to make up the state’s projected \$291 million revenue shortfall, while ensuring the long-term adequacy of the tax structure.

Alaska also faces a tax equity crisis: ITEP’s *Who Pays* study found that Alaska’s tax system is regressive, applying the very highest effective tax rates to the poorest Alaskans.

This analysis has shown that some revenue-raising options currently available would address both of these problems, increasing Alaska tax revenues in a way that does not worsen the inequities of the current tax structure. In particular, a personal income tax would have a progressive impact on the state tax system—and would be partially paid for by the federal government due to the federal deductibility of state income taxes.

The analysis has also shown that using sales or excise taxes to balance Alaska’s budget—or further depleting the Permanent Fund by reducing the annual Dividend—would make the state tax system even more unfair, and that a \$100-per-worker “head tax” would also make the tax system more regressive.

We hope this analysis will be useful to policy makers as they make important decisions about the future of Alaska’s fiscal structure.

APPENDIX: ABOUT THE ITEP MODEL

The data presented in this report were drawn from the Institute on Taxation & Economic Policy (ITEP) Microsimulation Tax Model. ITEP has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue yield and incidence of current state and local

property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Addendum: Data Sources

The ITEP model is a “microsimulation model.” That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets:

IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey; Consumer Expenditure Survey; U.S. Census, 1990.

Partial List of Aggregated Data Sources:

Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

A more detailed description of the ITEP Microsimulation Tax Model can be found on the ITEP Internet site at www.itepnet.org.