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SUSTAINABLE
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**Potential Fiscal and Revenue Options for the Walker-Mallott
Administration**

Alaska Department of Revenue White Paper

6/4/2015

Potential Fiscal and Revenue Options for the Walker-Mallott Administration

Introduction

The Walker-Mallott administration has tasked the Department of Revenue (Department) with identifying potential short, medium and long-term revenue options in order to help transition Alaska out of its current fiscal situation. Alaska North Slope (ANS) oil prices declined from over \$100 in August 2014, to a monthly average of under \$50 in January 2015, before recently recovering to the \$60 range in early May 2015. The result has been a significant reduction in the near and mid-term revenue forecast for the state of Alaska. In an effort to identify as many options as possible the Department leadership and staff undertook a comprehensive inventory of ideas and concepts that have been proposed and in some cases considered in the past. In addition the leadership encouraged a discussion of potential new ideas as well as an analysis of the range and type of solutions being discussed in the legislature.

In the 2015 State of the Budget Address, Governor Walker clearly expressed the administration's strong desire to avoid introducing new revenue measures during the 2015 legislative session. However he also made it clear that if current or similar revenue conditions were sustained into the coming interim and into the 2016 session that everything, including "traditional revenue increases," would be on the table. His expressed concern was that Alaska and Alaskans were still adjusting to a new budgetary reality, and that the proper first step to fiscal stability was to look to the State budget for cuts and restructuring. Only after the administration had put "theirs" on the table would they look to new or external sources of revenue. This document is produced as a first draft or "blueprint" of the myriad of options to be considered in helping transition and guide Alaska in the direction of long-term fiscal stability.

For purposes of this discussion, revenue is categorized by where it can be spent. Revenue can be either "unrestricted" (available to fund general state activities and capital projects) or "restricted" (required to be used for a specific purpose). Alaska traditionally considers "General Fund unrestricted revenue" any revenue that is not restricted by the constitution, state or federal law, trust or debt restrictions, or customary practice. Most legislative and public discussion centers on this category of revenue, and it is the figure most commonly referenced in budget discussions. Throughout this white paper, unless stated otherwise, revenue and budget numbers refer to the unrestricted General Fund.

As a companion to this report, the Tax Division's Economic Research Group has produced a fiscal model that attempts to compare, quantitatively, the various options available for closing the fiscal gap. The model includes a customizable interface that enables policy makers to adjust multiple revenue items simultaneously. Each change is shown via its impacts to annual budgets, anticipated budget deficits, and over time, savings drawdown. The white paper and fiscal model are intended as companion documents.

For the purpose of organization the options within the white paper has been categorized as follows. The ordering of categories is purely for the purpose of a coherent narrative, and should not be construed to reflect the relative merit or importance of any individual item:

- 1. Continuing restraint in the state budget**
- 2. Options involving Alaska’s financial assets including the Permanent Fund**
- 3. Tax measures related to oil and gas**
- 4. Tax measures targeted to specific portions of the economy other than oil and gas**
- 5. New statewide tax measures impacting individual Alaskans**
- 6. Non-tax measures and miscellaneous**

The current economic reality, borne out by the Department’s fiscal model as well as a model produced by Legislative Finance, is that there is no “magic solution” to solve Alaska’s fiscal crisis. It is going to take several substantial changes working in unison to solve both the short- and long-term budget imbalance.

With this in mind, it is recommended that a policy of shared responsibility be pursued built on a four-legged stool, with the four legs consisting of:

- 1) The Government, through continued budgetary restraint and prudent use of savings;
- 2) The People, through broad based taxes that also collect from our transient and seasonal workforce;
- 3) The Oil Industry, through a fair and stable tax and revenue structure that protects Alaska’s interests at a broad range of prices; and
- 4) The Permanent Fund, through mechanisms that preserve the value and continue to build Alaska’s sovereign wealth savings account

Background

When the FY15 budget passed last year, the deficit was projected at \$1.1 billion and State savings, traditionally understood as the Constitutional and Statutory Budget Reserves, were expected to be in the range of \$10.5-\$11 billion by the end of FY 2015. However, with the downturn in oil prices, Governor Walker actually took office facing a FY15 budget deficit of \$3.5 billion and State savings of less than \$10 billion with an anticipated FY16 deficit of another \$3.2 billion. The clear takeaway is that absent a rebound in oil prices or a massive restructuring the State’s fiscal regime, there is only 3-4 years of savings remaining to preserve government services over the long term, as well as to finance and complete major projects. Knowing this, the administration began a diligent and systematic process of addressing the present and future budget challenges, recognizing the opportunities and constraints provided by the budget reserves.

In order to limit the impacts of shrinking government on the economy of Alaska as well as on the lives of Alaskans, the decision was made to resist the “shrink government as small as possible” absolutism that

some have proposed. Although reducing the size of government is part of the fiscal solution, the idea that the right size of government is purely a mathematical exercise is fraught with peril. As an example of this school of thought, a 2012 report from Prof. Goldsmith at the Institute for Social and Economic Research at the University of Alaska calculated a “sustainable” annual revenue level that, without supplement, would limit General Fund spending to \$5.5 billion. This was recently reduced even further to \$4.5 billion because of reduced estimates for the value of the State’s underlying resources. Regardless of the fact that this study has several questionable assumptions including the estimate of the value of the State’s resources, the assumption that the State will only achieve a 4% return on its financial assets and the assumption that the State, despite a declining fiscal position, will continue a \$1.4 billion annual appropriation to the permanent fund dividend program; it nonetheless now underpins much of the debate on the right size of government in the capitol and in the public.

On its face this mathematical debate over the right size of government is founded on making our savings last as long as possible, but in doing so it actually exposes a larger and more important issue: are we going to remain primarily dependent on funding our government from oil, or are we going to make the transition to the mature and sustainable economy envisioned by visionaries such as Jay Hammond?

When Alaskans fought for and earned statehood in the 1950s, it was with the expectation that the State would, over time, be able to support itself with revenue from development of its many natural resources. Since the tapping of the massive Prudhoe Bay field in 1977, the State has relied on Prudhoe Bay and other large oil fields as the primary source of unrestricted revenue to support not only state government and community development but also to maintain extremely low tax rates on smaller oil fields and other resource industries, to attempt to subsidize and attract other economic activity, and of course to minimize taxes paid by individual Alaskans.

In one way or another, Alaska and Alaskans are entering the next era of our history. Oil revenue can no longer independently support the same level of state government that Alaskans have become accustomed to. The question is, how will Alaska and Alaskans adapt to this new fiscal reality?

Summary of Options Discussed in This Paper

The following sections of this paper introduce and discuss a substantial number of the revenue options available for closing the fiscal gap. For simplicity, and as a reference guide, most of the options detailed in the paper are summarized in the table below. In using the table it should be noted that many of these options have multiple variables but for consistency the table provides only a midpoint estimate of additional revenue for a single year in the short term.

In discussing revenue options it is critical to not limit the discussion to the direct revenue impacts but to also consider the impacts of any decision on the broader economy. Many of these impacts are qualitative and thus hard to measure. But it is important to understand that both cuts and taxes will ripple through the economy, and each will do so in unique and different degrees. For example, ISER has estimated that for every \$1 million in state budget cuts costs the state loses about nine jobs. It is also important to note that different revenue scenarios have differing multipliers, creating significantly different spin-off effects. For example, reducing the number of state workers also reduces the income they spend throughout the economy, but cutting contracts to out of state contractors and equipment suppliers has less indirect impacts. Likewise, some revenue measures may create incentives or disincentives that will influence the decisions of individuals and businesses on whether to live and invest here; some add new money to the economy whereas others simply recirculate the money already here; and some measures can be partly offset against other liabilities, for example by reducing a person's federal tax liability.

In estimating the impact of the following options it is important to quantify the budget shortfall in comparison to the revenue potential of the various options. If oil prices stay in the \$60 / barrel range, the estimated budget shortfall for FY16 is about \$3.2 billion.

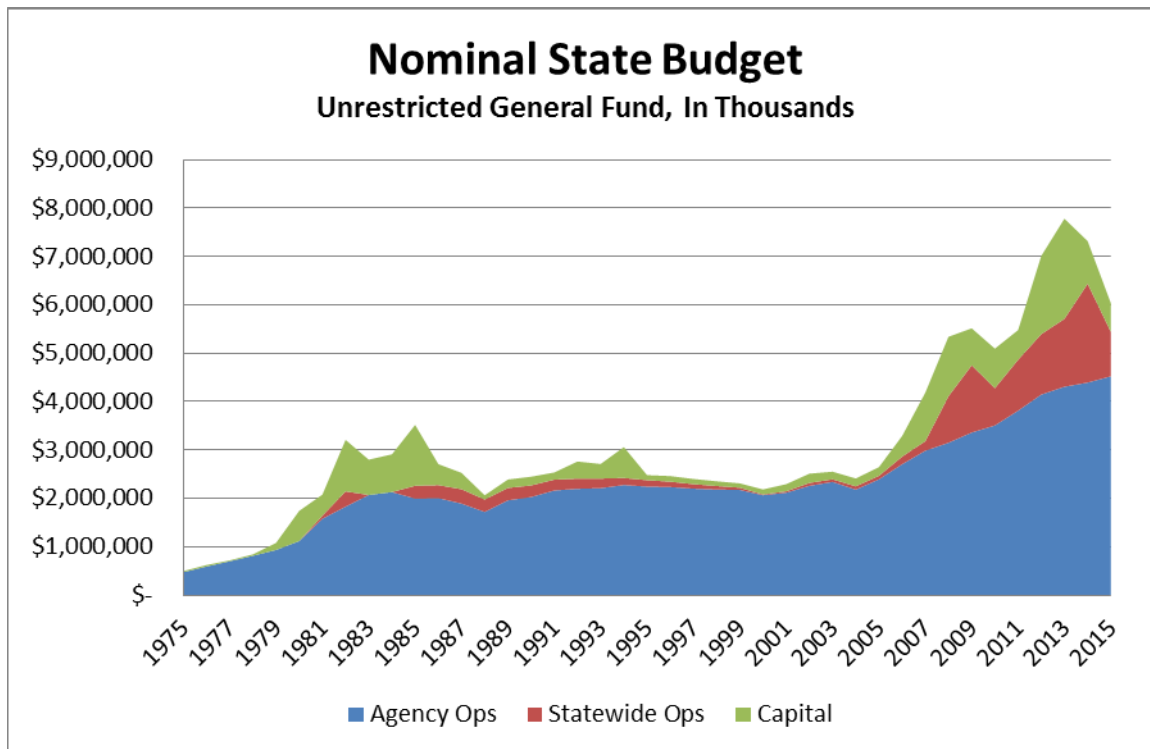
Item	Description (example proposal)	Potential Annual Revenue	Note	Impact-Pro and Con	Page Ref.
Permanent Fund					
Endowment Model (i.e. Percent of Market Value)	4.5% of average market value over past five years (HJR2)	\$2.5 billion	Revenue includes amount available for dividends	New money into economy. But could slow growth of fund	11
Dividend Cap	Assume \$1,200 cap	\$600 million	Disproportionate impact on low-income Alaskans		12
Royalty Diversion	Amount above 25% to GF (similar to HB11 from 2003)	\$80 million			13
Royalty / Earnings Swap	Per SB114	\$1.4 billion			13

Oil and Gas					
Minimum Tax	Increase to 10%	\$500 million	New revenue only at low prices	New money in economy, and potential for significant additional revenue. But revenue is unpredictable and it could discourage investment	15
Per-Barrel Credit	Cut in half (SB192)	\$300 million	Most impact at prices between \$80-\$110		15
Gross Value Reduction (GVR) Sunset	Revert to full tax after 5 years	\$25 million	Number will grow substantially over time		15
Interest Rates	Revert to 11%	\$25 million			16
Cook Inlet Credits	Replace ACES-type spending-based credits with SB21-type production-based credits	\$165 million			16
Progressivity	10% surtax bracket above \$60 / bbl in profits	Indeterminate	\$0 below \$110 oil; \$1 billion at \$150		17
Separate Accounting	Oil & Gas Corporate Income Tax (HB 191)	Indeterminate	Would have raised \$220 million in past		17
Gas Reserves Tax	3 cents / mcf	\$1 billion	Creditable after production begins		18
Non-Oil and Gas					
Alcohol	5 cents / drink	\$20 million			19
Fisheries	Increase by 50%	\$16 million	Net to state after municipal sharing		19
Mining	Additional 3% of net	\$19 million			20
Motor Fuel	Double (highway rate goes from 8 to 16 cents)	\$40 million			20
Tobacco	Cigarettes from \$2 to \$3; Other Tobacco from 75% to 100%	\$27 million			20
Tobacco (E-cigarettes)	Currently untaxed	Unknown			20
Health Care Provider	6%	\$59 million			20

Business License Tax (gross receipts)	0.25% => 0.5% based on sales	\$60 million			21
Statewide Taxes					
Income Tax	of fed liability + 10% of capital gains (HB182)	\$655 million	20% is new money from non-residents. Little impact on low-income Alaskan.	Deductible from federal income tax	22
School Tax	\$100 - \$500 (SB97)	\$100 million			23
Sales Tax	3%	\$418 million	About 15% less if food excluded. Brings in money from nonresidents	Affects low-income Alaskans more	23
Property Tax	2.65 mils	\$280 million			23
Misc					
Lottery	Interstate plus AK-specific	\$15 million		Could impact current charitable gaming	25

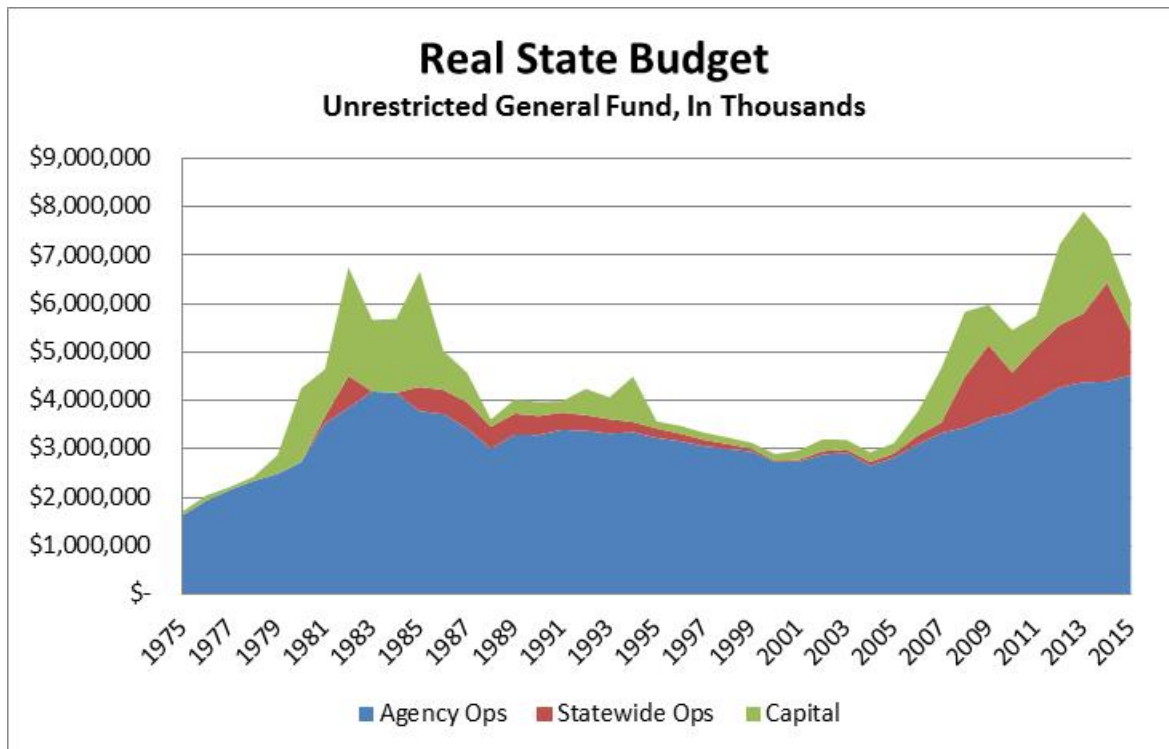
#1: Continued Restraint on Spending

It is generally believed that Alaska's budget is larger than it has ever been, and is considered by many to be "bloated." And, it is true that in nominal terms, the General Fund budget has increased steadily over time and steeply since the mid-2000's:



The above graph makes intuitive sense to people who are familiar with state government spending: the operating budget available to agencies has grown at a relatively even pace, showing a more rapid increase during the "boom" times when oil prices were higher and the state budget was in surplus. Conversely, spending was much flatter from year to year during times when oil prices were lower and the state budget was in deficit. In a similar although more volatile fashion, capital spending has tracked with revenue supply, with large spikes in spending during the periods of surplus and significant reductions during reduced revenue years. The third category, statewide operations, presents a different pattern due to its historic concentration in municipal revenue sharing which was gradually eliminated during the 1990's. However since 2006 this category has grown to record levels with the reintroduction of revenue sharing as well as large direct state contributions to the public employee and teachers' retirement systems, and the growing reliance on reimbursable tax credits in targeting at attracting increased activity in the oil and gas industry.

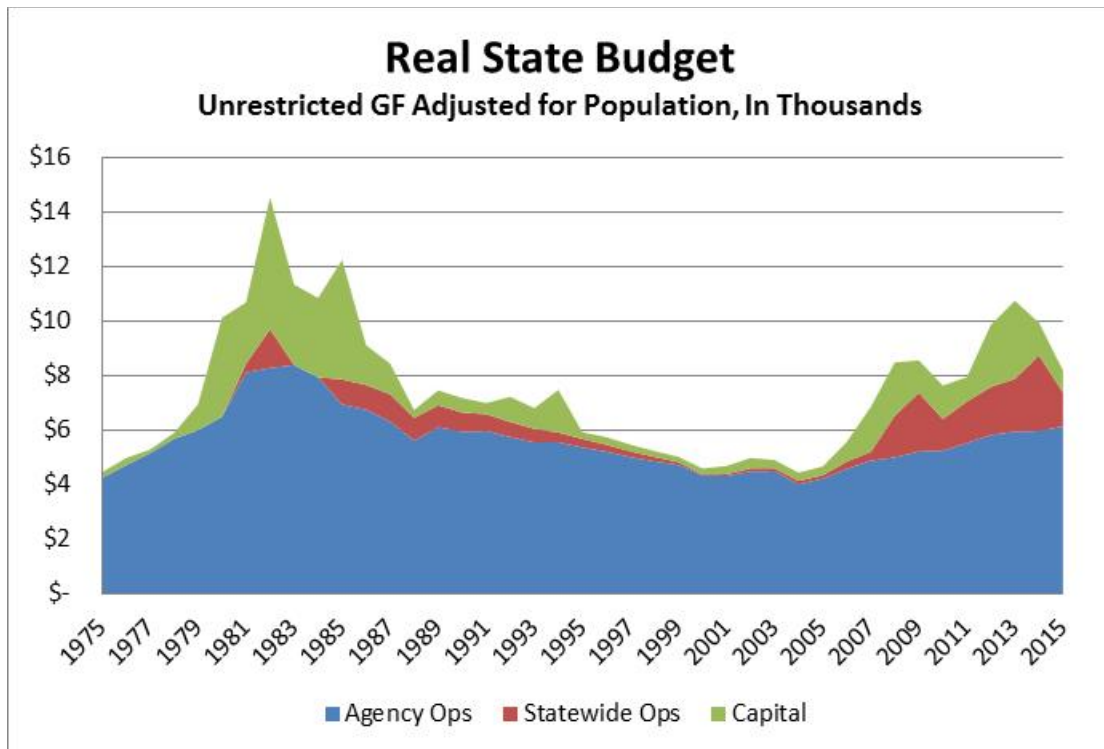
Whatever the issues of boom and bust, the general trend in state budgets has expectedly been upward. However, the perception of bloated government spending is somewhat mitigated when the analysis is adjusted for inflation.



As the chart above graphically demonstrates, when adjusted to real dollars the current operating budget only slightly exceeds 1984 levels after 20 years of steady inflation-adjusted decline. This is important to recognize, as many believe that the post-2005 operating budget growth was in part making up for a generation of highly constrained public spending. In addition it also reflects growth in the cost of certain core services like health care which have become substantially more expensive, even in real terms, over time.

In analyzing historic spending it is also critical to understand that necessary spending on many essential government functions, such as education, transportation, and public safety, are influenced by the size of the community they serve. Alaska’s population has grown steadily over the past 40 years. It is a testimony to Alaska’s success and quality of life that many individuals and families have chosen to become Alaskans and make their lives here. However population growth inevitably increases the cost of providing many public services.

Adjusting for population growth, and presenting the cost of government in terms of inflation adjusted per-capita spending rather than in terms of total nominal spending, the picture changes dramatically.



On March 26, 2015, David Teal of Legislative Finance presented a report on Alaska’s fiscal position and commented that the budget was smaller than it was in the 1980’s. This was surprising to some, but the above graph clearly demonstrates his conclusion. When adjusted for inflation and population, the current unrestricted General Fund budget is indeed lower than during the late 1970’s and early 1980’s when Alaska was in enjoying the post-pipeline revenue boom.

Although the current budget discussions are not reflected on the above graph, the reductions anticipated in the FY16 budget will reduce the state’s per-capita spending, adjusted for inflation, to its lowest level since FY06. Even with spending at near historic lows, the current fiscal outlook requires that continued spending restraint is essential in the years to come. That being said, it is important to recognize in any budget discussion that state budgets are not “bloated” in comparison with historical levels and there is likely very limited potential for further significant cuts if essential services are to be maintained.

#2: Options Involving Alaska’s Financial Assets

Options Involving Non-Permanent Fund Assets

Alaska’s options are unfortunately fewer than they were just a year ago. With the first drawdown of the Constitutional Budget Reserve (CBR) it puts in place a cycle of annual “sweeps” that will, unless reversed by a ¾ vote in both bodies, move all general fund sub-funds into the CBR until the debt is repaid. In addition, in March of 2015 the Treasury Division liquidated the so-called “sub account” of the CBR that had been invested since 2007 in a more aggressive portfolio. Sub account earnings approached \$1 billion in its best years, but fund managers are required under statute to maintain assets in a relatively risk free portfolio in order to preserve value to meet the next five years of expected need. With expected large deficits, it means that the entire CBR, worth roughly \$10 billion, is currently held in cash-based assets. This significantly reduces potential state investment earnings from the CBR.

Options Involving Pension Obligation Bonds, Public Employees’ and Teachers’ Retirement System (PERS / TRS)

Using existing statutory authority the state could issue pension obligation bonds. This involves borrowing money backed by the PERS and TRS trusts as collateral, and investing that money in risk assets such as equities. The theory is that earnings from the investments should be greater than the debt service, which should provide additional revenue to the trust funds. This parallels in many ways the “collateralization” of Permanent Fund assets described below.

Historically this represents something of a lost opportunity. Pension obligation bonds were authorized in 2008 by HB13, but have never been used. At the time, the bill was considered a companion to SB125, which set up the system by which Alaska contributes additional hundreds of millions to the statewide public employee pension system. Analysts believe that had Alaska gone through with the pension bonds it could have achieved an additional several billion dollars in investment earnings thereby reducing the long term shortfalls in the state pension accounts.

Unfortunately implementing the strategy today may expose the funds to significant additional risk at a time when equity markets are near all-time highs and many observers are projecting that future market returns will be below historic norms.

Options Involving the Permanent Fund

During the 2014 legislative budget debates it was understood that Alaska would be facing moderate sized budget deficits for the next several years. Modeling in 2014 showed that the non-Permanent Fund savings could support the expected deficits up to the expected “first gas” in approximately 2024. These savings peaked in 2013 at around \$18 billion. At the same time, the mid-level estimate of the Permanent Fund Corporation projected the fund would be worth \$78 billion in 2024, a substantially greater increase in value than the cumulative budget shortfalls (i.e. reductions in savings) over that same time period. It was only later in 2014 when oil prices dropped dramatically that projected deficits exploded.

These facts, taken in concert, lead to three conclusions. First, non-Permanent Fund savings are expected to rapidly decline in the next several years. Second, the Permanent Fund is expected to continue to grow, possibly at a rate greater than the depletion rate of non-Permanent Fund savings. And third, even

if the AKLNG project proceeds along at the planned schedule, the state will likely need some sort of additional funding source before the gasline is complete.

With oil prices projected to remain low over the next four years, it is essential that revenue discussions include the prudent use of Permanent Fund earnings. Largely due to Permanent Fund performance, Alaska made more in investment earnings in FY2014 and is projected to earn far more in investment revenue in FY2015 than all our other revenues combined. The realized portion of these revenues, while available for appropriation per statute, has historically been considered untouchable.

The Permanent Fund has become in many ways the third rail of Alaska politics, in large part due to the expectation and in many cases dependence of many Alaskans on the annual dividend program. But more fundamentally, any effort to change the way in which the Permanent Fund is used will open a visceral debate over its essential purpose and the original intent of its creators. Most simply put, the two primary schools of thought define the Permanent Fund as:

- 1) A sovereign wealth fund to create a sustainable source of public revenue for a time in the future when the oil is diminished or gone, or
- 2) A fund dedicated to the direct and immediate sharing of Alaska's common resource wealth with its people.

It is highly likely that the sides of this debate are irreconcilable, and it's possible that neither is entirely correct. The one thing that can be definitively taken from the early debates is that the fund was intended to be:

- 3) A mechanism to keep a portion of our current-year revenue out of the hands of the legislature, so that it wasn't spent as fast as it came in. Ultimately this delayed the conversation about the Permanent Fund's roll in the state's long term fiscal planning.

In considering the use of the Permanent Fund in helping to reduce the current fiscal gap, it is important to remember that today's Fund is substantially different, both in its actual size as well as its relative size compared to the rest of the economy, than it was in past fiscal crises. During the post-pipeline crash of 1986, the Fund was worth only about \$6 billion, not nearly enough to generate a sustainable, renewable source of income. In 1999, when the voters were asked to weigh in on the possibility of using it for government operations, it was worth \$26 billion or about half today's value.

There are four key drivers in determining how much revenue the Permanent Fund could contribute to future state spending. First is the fund's actual rate of return. Second is future inflation, which must be "backed out" of any distributed returns in order to protect the value of the Fund through inflation proofing. Third is the calculation of total distributions. Fourth, is the allocation or "split" of that distribution between dividends and funding government.

There are a number of potential options for use of the permanent fund in providing government funding:

Conversion of Permanent Fund to an Endowment Model

The bigger the Permanent Fund becomes, the more unwieldy it becomes to manage the fund using the current "principal / earnings reserve" structure. Many have assumed that Permanent Fund will eventually be converted to and managed as an endowment system similar to a private university. This

model, with annual payments based on overall fund value rather than short term performance, is considered a “best-practice” for management of endowment funds, and has been recommended by the Permanent Fund Board of Trustees. In this model, every year a specified percentage of the total fund value would be diverted for public purposes. The percentage could be directed to dividends, to support government operations, or some combination of the two.

The percent of annual withdrawal would be based on the expected long term average annual earnings, less the amount needed to inflation proof the principal. Managed in this way the Permanent Fund’s principal is protected and continues to grow through the addition of new deposits as well as investment earnings in excess of the withdrawal.

Most recent discussions have assumed an annual payout of about 5%, based on long term earnings estimates of 8% less 3% to inflation proof. The 2015 legislation, HJR2 introduced by Rep. Hawker, uses 4.5%. To further protect the principal, most proposed endowment models have used the average of the value for several prior years as the basis for calculating the allowable withdrawal.

As a simplified example, with a \$50 billion fund and expected 8% returns, it would generate \$4 billion in annual income. But of this, about 3%, or \$1.5 billion, would be needed to inflation proof the principal. Therefore the annual payout could be set at 5%, making \$2.5 billion available. Even if every Alaskan received a \$2,000 dividend, that would only cost about \$1.4 billion making another \$1.1 billion available for government operations. The next year, the fund would have \$51.5 billion to start with, in addition to all new deposits from royalty revenue.

As a general observation, Alaska will do better in the long run the longer it waits to spend funds above the amount presently calculated for the dividend. Currently, the asset base is achieving returns far in excess of the rate of inflation but only a portion of the earnings are actually distributed, for the purposes of dividends and inflation proofing. Therefore, the overall fund is growing at a faster than its “natural” rate of increase. The longer the delay in diverting a larger portion of the Fund’s income to government funding, the larger the Fund becomes resulting in a larger “baseline” for future annual calculations.

Dividend Cap

The fund has shown strong growth from FY2009-2015. In 2014, the impacts of the market crash of late 2008 fell off the five-year average used in calculating dividends, resulting in the dividend payment jumping from \$900 to \$1,884. Looking ahead, and using the Alaska Permanent Fund Corporation’s midpoint projections, one could easily anticipate several more years of increasing dividends, growing to \$2,000, \$2,500, and beyond. If current trends continue, people may very well begin to normalize their expectation of receiving these larger dividend payments. Thus it may be advisable to pursue a dividend cap sooner rather than later before these expectations materialize.

A “cap” could be placed on the amount of the dividend, perhaps at \$1,200 which is about the average of the last three years (2012’s \$878 + 2013’s \$900 + 2014’s \$1,884 / 3 = \$1,221), and is slightly higher than the historic average dividend of \$1,122. Assuming the current \$1.4 billion appropriation for the October 2015 dividend, every Alaskan would receive about \$2,100. If instead of paying the entire amount in dividends, the dividend was capped at \$1,200, it would make available about \$600 million for government funding. In considering a cap it is important to recognize that the first year or two of “splitting the pot” will set its own expectation precedents. The \$1,200 figure would represent about a 60/40 split in favor of the dividend payment.

Diversion of Earnings Reserve

The entirety of the Permanent Fund's Earnings Reserve, currently about \$9 billion, is available to be appropriated for government spending by the legislature by simple majority vote.

The existence of the earnings reserve is largely what triggers the need for a ¾ vote to access the Constitutional Budget Reserve using Article IX, Section 17(c). This is because the courts have determined the earnings reserve to be part of the "amount available for appropriation," thus eliminating the ability to access the CBR by simple majority using Sec. 17(b). In the budget negotiations at the end of the 2015 regular session, there were rumors the legislature might appropriate a significant portion of Earnings Reserve, in a contingency tied to a failed CBR vote, to balance the FY16 budget. Another option introduced during the 2nd Special Session would move funds from the Earnings Reserve to the Corpus (or Principal) of the Fund, in order to enable a 17(b) majority vote to access the CBR. While this has not yet materialized, it remains a legally simple but politically very difficult legislative option and creates a dynamic whereby, even if oil prices recover in the next couple of years, Alaska may lack sufficient savings to commit to the AKLNG project.

Diversion of Surplus Royalties

Per the constitution, 25% of mineral royalties are deposited into the Permanent Fund. However, by statute this increases to 50% of royalties from leases signed after December 1, 1979. A bill, HB11 by former Rep. Norm Rokeberg, passed in 2003 and temporarily reduced the royalty deposit for these newer leases to the constitutional 25% level. The provision sunset automatically once the impact on each person's dividend reached \$20; this occurred in 2008. Over the four years this bill was in effect nearly \$550 million was diverted to the General Fund. Based on current price and production, reinstating this change would add about \$80 million per year to the General Fund.

Endowment with Changes to Payout Mechanism

A modified annual endowment payout option was introduced as SB114 by Sen. Lesil McGuire, at the end of the 2015 session. Instead of splitting the allowable withdrawal between the dividend and the general fund, it would divert the entire amount to the general fund. Simultaneously, the dividend itself would be funded by the 74.5% of royalty and other lease income that is not already constitutionally diverted to the permanent fund principal and the school fund. Currently, most of that portion of royalty income goes to the general fund.

This approach would tie the dividend more closely to Alaska's current production as well as to the price of oil. Based on current projections, the change in royalty treatment would divert about \$1.1 billion from the general fund to the dividend. By simultaneously appropriating the Permanent Fund endowment payout into the general fund, the legislature would replace the royalty diversion with about \$2.5 billion of general fund revenue making an additional \$1.4 billion per year available for the budget.

Additionally, Sen. McGuire's bill caps the annual payout to the amount that actually exists in the Earnings Reserve. This language enables the fund to maintain its current split Principal / Earnings Reserve structure, and thus could be implemented without a constitutional amendment.

Collateralization and Securitization

This falls into a broader category that includes more aggressive leveraged investment strategies for state assets, attempting to better capitalize on potentials of modern securities markets.

At the most basic level, collateralization, or leverage, would involve borrowing new money using existing assets as security on long term, low interest loans. The newly borrowed money would be invested alongside the existing diversified portfolios. As an example, if \$10 billion could be borrowed at 4% long term interest, and then invested at an average annual 7% rate of return, the difference of 3% would generate \$300 million per year in new income for the state.

Once this cash flow was established, an additional step of securitization could be taken. This would entail separating the income and the borrowed money into two pots- one of which would earn the revenue to pay the annual interest on the borrowed money, and the other which would be turned into a tradable security. Using the above example, the state could package the expected 30 year cash flow of \$300 million per year, and sell the cash flow itself for a lump sum of \$6 billion or more. This one-time windfall could then be reinvested, or used for ongoing operations.

The risks of any leveraged investment strategy may be amplified at present, given the lofty levels of equity markets. Prominent money managers have bemoaned the lack of worthwhile investments, central bankers have warned of tightening monetary policies, and some analysts project negative real returns over the next seven years. Although there is little disagreement that in the long term this strategy would increase the value of the state financial assets, in the short term there is a risk that a market correction could leave the state liable for debt payments, without offsetting investment gains, which would only make the current fiscal imbalance worse.

These strategies carry definite risks and uncertainty, but potentially extraordinary rewards. Any collateralization and leveraged investment strategy should be subject to careful review and analysis by independent experts. It must also earn the trust and support of Alaska's citizens, who may be rightly suspicious of what will no doubt be characterized as, "mortgaging the Permanent Fund."

#3: Oil and Gas Taxes

In looking at options for increasing oil and gas tax revenue it is necessary to analyze revenue options on a go forward basis and not get caught up in revisiting issues of the past. SB21 is the law of the land and was upheld by the voters in August of 2014. The basic concepts underlying the structure of SB21 are: reduced progressivity that is not punitive at high prices, credits that reward production instead of spending, and specific benefits for “new oil.” Any discussion around changes to the production tax should remain within this framework. However, that does not mean that there isn’t room for a discussion on the improvement of the oil production tax structure, or the necessity of tweaking certain provisions going forward. As a historical note, ACES, the former tax regime, was passed in November 2007 and there were oil bills proposed as early as the 2008 session with substantial “tweaks” that ultimately passed in 2010.

The following are several approaches that have been proposed that would increase state revenue. Some would be more relevant at lower prices and some at high. These include:

Minimum Tax Changes

As a point of reference, the minimum tax floor could be increased to reflect the gross tax that was received in the last years of ELF, about 7% or 8% of gross value. Another point of reference is the Governor Palin proposed 10% in her original ACES bill. However, at very low prices, such as Alaska is currently experiencing, there is limited incremental revenue that can be extracted from the oil industry. Based on modeling done in the Tax Division, an increase to a 10% minimum tax would generate about an additional \$500 million in revenue.

Modify Per-Barrel Credits

During the last weeks of the 2013 session the per-taxable barrel credit in SB21 was changed from a flat \$5/barrel to a sliding scale that went from \$0/barrel at well head value oil prices above \$150 to \$8/barrel at prices \$80 and below (seen as a low price range at the time but now likely the upper limit of near term pricing). During the 2014 session, Sen. Bert Stedman introduced SB192 that would have cut the per-barrel credits in half, to \$4/barrel at the lowest prices. An alternative approach that has been suggested is to merge the SB21 proposals and cut off the credits at the \$5 level, removing the \$6-\$7-\$8 credits for wellhead values below \$110.

Modifying per barrel credits either by itself or in combination with a strengthening of the minimum tax, would add revenue protection for Alaska at low oil prices, especially in a high cost environment, with the greatest fiscal impact likely seen in the price range of \$80-\$110 per barrel.

Modify New Oil Provisions

The Gross Value Reduction or “GVR” provisions, which provide benefits for “new oil,” are calculated against the gross value but create an offset against taxable net profits. A 20% “gross value reduction” can in this way reduce a taxpayer’s liability by 40% or more. A mechanism to minimize the long term impacts of GVR provisions while still allowing for the recapture of the costs associated with new field development would be to sunset the GVR after a specified number of years. This would allow sufficient time to recapture the costs of building a new field, and would prevent the gradual trend towards

increasing shares of production receiving the benefit. Other GVR amendments that have been proposed include reducing the rate from 20% to 10%, or excluding certain fields from being counted as “new oil”.

The SB21 fiscal note from 2013 estimated the cost of the GVR provisions to gradually increase from about \$25 million/year initially to \$75 million in FY19. This assumed the higher oil prices of the time and did not include any projects or developments that did not meet the threshold for inclusion in the Department of Revenue production forecast, such as any development from Repsol, Great Bear, etc.

Interest Rate Changes

One of the lesser discussed changes in SB21 reduced the tax rate for delinquent or audit-assessed taxes from 11% to a floating number that is currently about 4%. In addition, a late technical amendment changed the formula, many believe inadvertently, so that the 4% is only collected on the initial value and does not compound.

According to the SB21 fiscal note from 2013, the change to the interest rate cost the state an estimated \$25 million/year. If the rates themselves were revisited and restored to the former levels it would add back that revenue. Another option to consider, which would further increase that \$25 million/year figure, is having a lower statutory interest rate for refunds than for assessments. Many states have differential interest rates in this manner.

Reform North Slope Credits

Refundable oil and gas credits will remain at approximately \$400 million for FY16. These will reduce slightly starting in FY17 but they may remain a significant general fund cost as the North Slope continues to develop additional fields. The system is set up to reimburse a portion of the “losses” (in the years before a field has production and thus taxable income) with cash rebates. The Department of Revenue’s estimates of the revenue impacts only include known and sanctioned projects; if substantial new oil is developed it could dramatically increase the state’s expected repurchases.

Alaska’s credit regime was initially set up to be used against tax liability or transferred to taxpayers in an open market. Only later did state repurchase become the norm. A cap on annual repurchase could help the state’s cash flow in low revenue years. However, a cap would have to be carefully constructed to minimize the impact on explorers, some of whom would have to wait to monetize credits or sell them at a discount to producers who would apply them against their own production taxes. In this scenario, the state’s net fiscal impact would be unchanged, but a portion of the benefit of the credit would shift from the explorers to the major taxpaying producers.

As an alternative, there is already some movement towards using AIDEA as a development bank for drill rigs, processing and other support facilities. In addition, there has been some initial discussion of transforming parts of Alaska’s credit system into a direct investment model, where the state’s contribution would be used more like venture capital in exchange for an equity share of projects. This could be done to provide up-front financing, potentially saving start-up companies the very high interest rates many of them are currently paying.

Reform Cook Inlet Taxes and Credits

When PPT passed in 2006, changing Alaska’s oil and gas production tax to a net profits-based system, Cook Inlet was held harmless. Through 2022, Cook Inlet oil and gas production is taxed at a rate tied to

the old ELF rates that were in place in 2006. Because of that, production tax on oil is locked into a rate of zero, and gas is taxed at a rate that varies from field to field but averages about 17 cents/mcf. This limited tax liability is then generally wiped out by the Small Producer Credit and other credits. A recent analysis by the Department of Revenue showed that Cook Inlet producers saved an estimated \$500-\$800 million over the years 2007-2013 due to the tax cap.

Meanwhile, producers in Cook Inlet are still eligible for many reimbursable credits that result in below-zero taxation. The Cook Inlet Recovery Act of 2010, while primarily written to provide a tax credit for a gas storage facility to provide for seasonal demand fluctuations, also included substantial credit changes and increases targeted at Cook Inlet. As a result, reimbursable oil and gas tax credits have increased from \$33 million in FY11 to an estimated \$281 million in FY15. Many of these credits are received by companies that produce oil and gas and are presumed to be profitable but because of the tax cap have little or no tax liability against which to apply them. Therefore these are reimbursed through cash payments by the state.

The underlying tax regime in Cook Inlet was not modified by SB21 and is still effectively an ACES structure. The result is that Cook Inlet retains the “expenditure-based” credits of the ACES era while the North Slope tax structure has been replaced with the “production-based” credits of SB21.

If Cook Inlet were converted to a SB21 tax structure (regardless of whether the tax cap was removed), the reimbursable credits would be limited to the 35% Carried-Forward Annual Loss credit. By eliminating the 20% capital credit and the 40% well lease expenditure credits, it would reduce the state’s reimbursable credit liability by \$165 million in FY16.

Restore Progressivity at Higher Prices

SB21 is for the most part structured as a flat tax. One or more “tax brackets” could be added to restore a degree of progressivity at higher prices. One such proposal was introduced as an amendment during the House floor debate on SB21 bill. This would have added a single “bracket” where only those profits (production tax value) of greater than \$60 / bbl would be subject to an additional 10% on top of the 35% base tax. This change would have zero impact at prices below about \$110 / bbl, but would create an enhanced profits tax above that point. This would raise roughly \$1 billion in additional revenue if oil reached \$150 per barrel.

Separate Accounting

For several years in the late 1970s, Alaska’s corporate income tax for oil and gas companies used a “separate accounting” method, meaning that Alaska-specific revenues and profits were used as the basis for the tax. This was in contrast to the worldwide apportionment formula used in the tax for other corporations, which instead used proportional calculations. This was subject to a major lawsuit, and in advance of a decision the Hammond administration decided to drop separate accounting and settle the suit. At the time, the state feared having to refund about \$1.8 billion which was the estimated additional taxes that had been collected in the four years between 1978 and 1981 under separate accounting. In the end, the former tax regime was upheld at the Supreme Court, but the system was never re-implemented. In the immediate aftermath of the change, Alaska’s corporate income tax collections dropped dramatically.

There have been several attempts in the intervening years to reintroduce separate accounting. Analysis done by Department of Revenue in the mid 2000's indicated that the effective tax "difference" between the systems was somewhat less than it was 25 years earlier, due to the changes in the asset base in Alaska as well as declining production. In 2012 Rep. Paul Seaton introduced HB328. This bill received five hearings in the House Resources Committee before it eventually stalled. Rep. Seaton introduced a new version, HB191, in 2015. Although the Department of Revenue's fiscal note showed an indeterminate revenue impact from this bill, had separate accounting been in effect for the prior seven years (i.e. 2007 – 2013), the largest oil and gas corporations would have paid approximately \$220 million more per year in corporate income taxes.

Gas Reserves Tax

A natural gas reserves tax was first proposed in a 2006 ballot initiative, which would have raised \$1 billion per year via a 3 cents/mcf tax on large proven reserves. In the initiative, the tax would have been refundable over time from gas production taxes once commercial operations began. Another reserves tax initiative with improved language was also proposed in 2009 but did not obtain the requisite signatures to be put on the ballot.

A reserves tax has important precedent in Alaskan history. The legislature in 1975 passed an oil reserves tax which served as an essential "bridge" revenue source in the years before TAPS was completed. The taxes were credited back to industry in the early years of North Slope oil production. When considering a gas reserves tax it is important to also consider the significant dampening effect the liability of a reserves tax could have on new exploration for both gas and oil.

#4: Non-Oil and Gas Taxes

Alaska has a Corporate Income Tax for non-oil and gas companies, as well as a substantial group of smaller, primarily excise taxes that have not historically been considered a major component of the overall revenue picture. In aggregate these generate much of Alaska's roughly \$500 million in annual "non-oil and gas" revenue. This \$500 million, while equaling 10% or less of unrestricted general funds over most recent years, is closer to 25% of available revenues in FY15 and FY16. Also, all of these taxes and fees are considered material by the industries they impact, and many also include a substantial revenue sharing component with municipal governments. They are also less volatile than oil and gas revenue.

Excise taxes must therefore be part of any comprehensive revenue discussion. The last time Alaska looked seriously at new revenues, in the early 2000's, it was in this area that actual changes were made. This included a doubling of alcoholic beverage taxes in 2002, with an associated diversion of half of revenues to programs benefiting individuals with alcohol problems. Also during this time period large increases were made to the cigarette tax plus new taxes were implemented on vehicle rentals and certain tires.

Although there have been several tax changes made by voter initiative (cruise ship head tax and gambling tax; marijuana excise tax), there were no legislative-passed tax increases other than changes to the oil and gas production tax system between 2005 and 2014. In the recently concluded 2015 regular session, the legislature passed a surcharge of less than 1 cent per gallon on certain refined fuels to fund the Spill Prevention and Response Division at the Department of Environmental Conservation. This \$7.5 million revenue item was the first new or increased tax passed by the legislature in 10 years.

A thumbnail discussion of various options follows. References to specific revenue numbers comes from the Tax Division's 2014 Annual Report:

Increases to Existing Taxes

Alcohol Taxes

The alcohol tax is collected from wholesale distributors and is a per-gallon tax with four levels based on different products: distilled spirits, wine, beer, and beer brewed in-state from small breweries. In general (with the exception of the in-state breweries), the tax rates are set to be roughly equate to 10 cents per drink and are the highest rates in the US. This excludes the 17 states where government directly controls the sales of distilled spirits, effectively building their taxes into the price.

Total FY14 revenue was about \$40 million. The most recent change was in 2002, when rates were roughly doubled. At that time, 50% of revenue was diverted to programs that support individuals with alcohol or drug abuse problems. Currently, about \$20 million of Alaska's alcohol tax revenue supports programs in the Mental Health budget.

Fisheries Taxes

The state collected \$64.2 million between the Fisheries Business Tax and the Fishery Resource Landing Tax in FY 2014. However, \$32 million of these were shared with municipalities, leaving \$32.2 million for

the state. Tax rates for fisheries range from 1% to 5% of gross value, with 3% being the most common rate.

Mining Taxes

Current rates are 0-7% of net income depending the level of net income. The first 3.5 years of income after production begins for a new mine are exempt from the tax. The first \$40,000 of net income is also exempt. In 2012, new legislation removed sand and gravel from the definition of “mining,” effectively exempting these operations from the tax. FY 2014 net collections were \$23.5 million, and FY 2015 collections are expected to rise to \$33.2 million. DOR estimates that if mining license tax rates were raised one percentage point across the board (thus ranging from 1-8%), the tax would generate \$39.4 million total, an increase of \$6.2 million. Another option would be to switch from a “net” to a “gross” value calculation, or to simply reduce the minimum tax threshold.

Motor Fuel Taxes

Alaska’s four motor fuel taxes (highway, marine, jet, and general aviation) together raise about \$40 million per year. At 8 cents per gallon, our highway tax is the lowest in the country. The taxes on the other three fuel types are even lower. Together, about 650 million gallons of fuel are taxed in Alaska per year. A larger amount, nearly 1 billion gallons, is untaxed due to federal constitutional issues as well as various exceptions in state law. Each one cent increase to the tax would generate \$6.5 million/year.

Tobacco Taxes

At \$2/pack, Alaska’s cigarette tax is the 10th highest in the US. The “other tobacco product” tax is 75% of the wholesale price. Together these raised \$51.9 million in FY 2014. A 50% cigarette tax increase to \$3/pack would raise an additional \$24 million/year. A 33% other tobacco tax product increase to 100% would raise another \$3 million.

There is also a major loophole in the current tobacco tax, as so-called “electronic cigarettes” are currently not subject to the tax. Since e-cigarettes are not a “roll” as defined in current statute, and since the nicotine in many types is not derived from tobacco, it would require specific legislation to extend the current tobacco tax to this growing industry. Many states have recently updated their tobacco statutes to incorporate e-cigarettes.

New or Revived Taxes

Health Care Provider Tax

Alaska is currently the only state in the US that does not levy a health care provider tax. This tax is levied on hospitals, doctors and other health care providers and the revenue is used to pay for the state’s share of Medicaid. It allows states to claim a larger share of federal Medicaid funds which can be used to increase provider reimbursement rates, making it easier for Medicaid recipients to find a provider. In Alaska, the federal government pays \$1.42 for every dollar the state spends on Medicaid. This means that a new health provider tax would generate \$2.42 in total Medicaid spending for every dollar it raises. Hospitals tend to support these taxes if carefully crafted, because the increased reimbursement rate more than pays for the tax.

A Vermont study estimated that a 1% tax on providers could raise about \$8.3 million per year. Adjusting this to Alaska’s population, we estimate that a similar tax could raise about \$9.5 million in Alaska. Most

states with provider taxes have rates between 3-6% (there is a 6% safe harbor threshold for the federal government that holds states harmless for taxes up to this rate, so a provider tax should not exceed this). A 6% tax would raise about \$57 million, which in turn would generate about \$80.9 million in federal matching funds. Thus, a 6% provider tax in Alaska could potentially lead to a \$137.9 million increase in Medicaid funding in the state.

Another alternative would be to use the provider tax to finance the state's participation in the federal Medicaid expansion. The state's share of the Medicaid expansion in 2017, the first year of a reduced federal contribution, could be paid for by a 1.5% provider tax that would be among the lowest in the nation.

Business License Tax/Gross Receipts

The Business License Tax (AS 43.70), was originally passed in 1949. It consisted of a \$25 license fee plus 0.5% of gross receipts over \$20,000 plus 0.25% of gross receipts over \$50,000. After it was repealed in 1979, the licensing authority was transferred to the Department of Commerce and Economic Development. Currently the business license is an annual flat fee of \$50. A revived business license tax could be an alternative mechanism to reach the revenues of so-called "pass through entities" like S-corporations and partnerships, which do not pay the state's corporate income tax. The other primary way to reach these companies is via the personal income tax.

In other states, this sort of tax is called a "Gross Receipts Tax" or sometimes a "Commercial Activity Tax." Preliminary modeling indicates that restoring this tax at the historic levels would raise about \$60 million per year.

Coin Operated Devices Tax

This historic tax (AS 43.35), originally passed in 1941, for many years collected 12.5% of the gross receipts on coin-operated machines. It was repealed in 1999.

#5: New Statewide Taxes

Alaska earned statehood on the idea that it would be self-sustaining on revenues it could earn from resource development. To date Alaska has used the revenues from a single resource, the largest oil fields on the North Slope, to support nearly the entirety of state government as well as to keep taxes low on all other industries and to subsidize and attract others. As the state seeks to further grow and diversify its economy, broad based statewide taxes necessarily become the link between economic growth and the revenues necessary for government services to support that growth.

Income Tax- Traditional

Approximately 43 states currently collect a tax on individual and family income. Alaska had an income tax for many years, although it was repealed in 1981 at the height of the Prudhoe Bay oil boom. Income taxes are broad based, touching nearly everyone in the state. They could also have the advantage of taxing income earned in Alaska by non-residents.

The most straightforward way to implement an income tax would be to piggyback on the federal tax return. The tax could be based on either a percentage of adjusted gross income, or as a percentage of federal tax liability. The difference is one of emphasis and progressivity: since the federal system is relatively progressive, a tax based on a straight percentage of federal liability would provide the identical level of progressivity to the federal system. In contrast, basing a system on adjusted gross income could provide a more “flat” tax that would impact all income levels at a similar level. Some states use adjusted gross income but provide some form of state progressivity via tax brackets for different income levels.

Based upon the Department of Revenue’s income tax model, for each 1% of federal tax liability, about \$35 million would have been raised in 2016 with gradual increases thereafter based on growth and inflation in the underlying economy. A tax based on adjusted gross income would raise about \$240 million per 1% of adjusted gross income. Taxing the Alaskan income of out of state workers would increase either of these by up to 10%.

Income Tax- Capital Gains Surtax

Some states have implemented separate capital gains taxes, based again on the federal tax return. Currently, federal capital gains are taxed at only 15% whereas the top marginal tax rate is nearly 40%. A capital gains surtax adds another element of progressivity and helps reach income that many feel is currently under taxed. Based on the Department of Revenue’s income tax model, a 10% capital gains surtax would raise about \$84 million in 2016.

Rep. Paul Seaton’s HB182 was introduced in 2015. It includes a tax of 15% of federal liability, paired with a 10% capital gains surtax and language that specifically targets out of state residents. The bill would indirectly tax the earnings of S-corporations. According to the Department of Revenue’s fiscal note, it would generate an estimated \$655 million in its first full year.

Income Tax- Out of State Partnership Income

There is ongoing concern with Alaska's State Corporate Income Tax (SCIT) which is limited to taxing the income of traditional corporations. Many have discussed the need to develop a mechanism to tax so-called "S-corps," who are not subject to the SCIT.

Receiving revenue from S-corps isn't just a simple legislative change. By the nature of S Corps, they don't actually retain their earnings which would then be subject to taxation. Instead, all of their earnings are treated as income by their owners, using the same distribution method (federal schedule K-1) as some partnerships and LLCs.

Therefore, Alaska would need to tax the income of S-corps operating in Alaska directly. Alternatively, a state personal income tax could be written to tax the income from partnership, S-corp, LLC, and sole proprietor distributions. The most recent Department of Revenue study, in 2001, estimated that taxing S-corps could generate \$29 million in annual revenue.

Payroll Tax / Former School Tax

For many years, Alaska had a small, flat rate payroll tax for schools until it was repealed in 1980. Sen. Click Bishop has suggested restoring a form of this, as a payroll tax on a worker's first two paychecks, which would maximize proportional revenue from Outside workers. Late in the 2015 session he introduced this concept as SB97. The tax would be scaled to income level and, as written, be a maximum of \$500 per person. Although the Department of Revenue has not modeled it in detail, our preliminary estimates is that it would likely raise about \$100 million per year.

Pay-as-You-Go Tax

Many countries have a simple form of income tax which is withheld and paid by the employer. The tax is similar to the payroll tax discussed above but is withheld from every paycheck. It is similar to the State's current unemployment insurance tax in that it is a multi-tiered rate based on wages. At the end of the year the individual receives a letter from the taxing authority stating how much they paid in tax, but there is no return to file. A pay-as-you-go tax would require far fewer resources to administer than a traditional income tax. Because of the narrower tax base made up of employers, it would also likely increase compliance. However, the down sides are that the tax is not progressive, it is difficult to tax the self-employed, and it does not tax unearned income.

Sales Tax

Of Alaska's 164 incorporated municipalities, 107 currently collect a sales tax, ranging from 1% to 7%. Some of these municipalities have expressed concern over the impacts of adding a state sales tax on top of their existing tax. Conversely, some smaller jurisdictions lacking the resources to implement an independent sales tax have expressed interest in piggybacking a local sales tax onto a statewide sales tax.

A statewide sales tax of 3% would raise \$418 million. If food were exempted, which is done in 39 states, it would reduce the revenue to \$358 million. In a state with widely varying cost of living such as Alaska, one major concern with a statewide sales tax would be that it would be quite regressive, placing a disproportionate share of the burden of revenue on rural Alaska and other high-cost communities.

State Property Tax

The total value of property assessed in Alaska is \$108.6 billion, including oil and gas property. A statewide 10 mil (1% tax) would therefore generate a little over \$1 billion. However, a state property tax already exists for oil and gas property; a 10 mil tax on only non-oil and gas property would generate closer to \$800 million per year.

One option that has been proposed would be to set a state tax at 2.65 mils to replace the Required Local Contribution education funding, depending on the ultimate outcome of the Ketchikan lawsuit. That would raise about \$280 million per year.

Implementing a statewide property tax would be relatively simple in the incorporated areas of the state that currently assess real and personal property. However a large portion of the state remains unincorporated and the data on property ownership and value would have to be developed before the tax could be collected.

Hybrid / Permanent Fund Linked Tax

A “hybrid” system could be derived that combines a payroll tax with a dividend cap. For example, the non-resident would directly pay the tax of, say, \$500 while the Alaskan would pay it indirectly via a reduction from the “official calculated” dividend amount down to a specified “capped” amount.

An even simpler mechanism, which was proposed by former Governor Hammond in the later years of his life, was to implement an income tax and simply cap the tax at the amount of the permanent fund dividend, so that the amount of the tax would never be more than the dividends earned in the same year by the adults in the household.

#6: Non Tax Measures & Miscellaneous

Various other proposals have been suggested as a way of reducing the fiscal shortfall. Several are listed here.

Medicaid Expansion

Accepting Medicaid Expansion, with the federal funds that come with it, has been shown to bring up to \$146 million/year into Alaska's economy. The direct budgetary estimates are about \$8 million in reduced expenditures and additional tax revenue.

Municipal Revenue Sharing

The default appropriation to replenish the Municipal Revenue Sharing fund is \$60 million. In FY 15 the legislature appropriated \$52 million. The program is structured to distribute 1/3 of the fund balance each year, thus providing some cushion to municipalities in times of shortfall. If zero dollars are appropriated for FY 16, it would mean FY 16 revenue sharing of \$57 million (based on a current balance of \$172 million) and FY 17 payments of about \$38 million (based on a remaining value of \$115 million).

Capital Re-appropriation

There are substantial prior years' capital appropriations, many of which are for only a fraction of a project's eventual cost. Many of these funds are not yet encumbered, and may not be fully funded for several years in the current climate. There has been some discussion of targeted re-appropriation (cancellation) of this funding. This goes against legislative tradition, which has held that money appropriated in a district stays in that district. Because of this concern, it is important to share the impact throughout the state. This could be accomplished by a targeted list of projects where the administration says it will suspend any spending or encumbering of funds, paired with a bill that would delete the prior appropriations.

Section 41(d) of this year's capital budget, SB26, begins this process, which could be an important component of the "government" leg of the stool.

Indirect Expenditures

The reports mandated in 2014 by HB 306 (Rep. Steve Thompson) documented a large number of tax exemptions, credits, and other tax avoidance mechanisms imbedded in the current statutes. These range in annual cost from just a few hundred dollars to hundreds of thousands and more. Follow-up legislation introduced in 2015 attempts to reduce some of the most obvious "low hanging fruit" of these indirect expenditures. A more comprehensive program to eliminate these items could, in the aggregate, save the state several million dollars per year.

Lottery

Lotteries have a long history of being used as a tool of government finance in our country. Jamestown, the first British colony in the New World, was funded in part by lottery proceeds. Lotteries helped fund the Colonial Army, provided start-up money for hundreds of institutions including Harvard, Princeton, and Yale universities, and offered a method for businesses and governments to raise capital before the U.S. developed a sophisticated banking system. However, during the 1800's lottery corruption grew and

the criminal elements began to outweigh the benefit of lotteries. In 1905 the last public lottery, sponsored by the State of Louisiana, was shut down, ending an important chapter in American history

After nearly 60 years, a new era of government-sponsored lotteries began in 1963 when New Hampshire authorized a state lottery. As of 2013, Alaska was one of only 6 states that do not have state lotteries. Of the other states, two have significant casino gaming (Mississippi and Nevada) and three have a strong history of religious or moral opposition to any form of gambling (Utah, Hawaii and Alabama). While it was once the norm, Alaska is now clearly in the minority of states by not having a state lottery.

Generally, a state-sponsored entity oversees the lottery (in 2004, 65% of lotteries were administered by a lottery commission or board, 15% were administered by a lottery corporation, and 20% were administered directly by a state agency), but lottery sales are made at private retail locations such as grocery stores, convenience stores and newsstands. Major expenses for the lottery agency include prize payouts, retailer commissions, marketing, and other administrative and operational expenses. Even with these expenses, every lottery in the U.S. was profitable in the 2013 fiscal year. Lottery income in FY 2013 varied from \$8.3 million in North Dakota to \$3.1 billion in New York. On a per capita basis, income ranged from \$11.5 per capita in Montana to \$360.4 per person in Rhode Island.

Given the geographical distribution of Alaska's population, and the relatively small population base, it could be argued that income would come in on the low end of the range in other states. However, this may be offset by the lack of access to other gaming opportunities, such as casinos and card rooms.

The most recent proposal for a state lottery in Alaska came in 2003, when Senator Robin Taylor, a Wrangell Republican, introduced SB178. Sen. Taylor proposed to create a corporation within the Department of Revenue that would oversee a state lottery, with a board of directors that set policies and regulations. Revenue would have been directed to a special account to support education in the state. This legislation could provide a starting point for future lottery proposals.

An Alaska lottery would probably offer games that fit into one or more of three categories:

- *Instant ticket lotteries:* Players would purchase preprinted scratch-off or pull-tab tickets, similar to those currently used in Alaska's charitable gaming activities. Raffle-type drawing would also be classified under this category.
- *Numbers lotteries:* This is the type of game most commonly associated with state lotteries. Players pick from a set of numbers, and win if they match enough numbers to those picked in a subsequent official drawing. "Pick 3", "Lotto", "MegaMillions" and "PowerBall" are all examples. Often, these are pooled among multiple states, creating potentially much larger jackpots.
- *Video lotteries:* This type of lottery uses a "video lottery terminal" (VLT), similar to a slot machine, to play electronic games with instant payout.

To estimate how much revenue an Alaska lottery could bring in, the Department of Revenue looked at statistics from the 10 lowest population states. We looked closely at Wyoming, the most recent entrant into the lottery market which expects to earn \$13 to \$17 million in its first year of operation. It opened August 2014 with Powerball and Mega Millions and is adding two Wyoming-specific games this year. Wyoming's model may be a good model to emulate. Alaska could start off with Powerball and Mega Millions and then create its own unique Alaska lottery game.

Although the per capita income of the 10 least populated states ranged from \$11.45 to over \$360, using the lowest per capita income of North Dakota of \$11.45 (which is only able to offer multistate draw games), Alaska could generate annual proceeds of around \$8 million. The addition of video lottery terminals could have a significant impact on the amount of income that could be generated for the State.

On the other hand, an expansion of gaming through any sort of lottery, while beneficial to state revenue, would almost certainly have some negative impact on current gaming activities such as pull tabs and raffles. These current activities support numerous nonprofits in the state; any changes would likely be opposed by the entities that benefit from the current system.