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TESTIMONY

RECOMMENDATIONS FOR TAX REFORM IN ALASKA

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Chairman Costello, Vice Chairman Hughes, and distinguished members of the Senate Labor and Commerce Committee:

Thank you for accepting my testimony on creating an alternative source of revenue in Alaska and on the features of economically sound tax policy. My name is Adam Millsap, and I am a research fellow at the Mercatus Center at George Mason University, where I study state and local public policy. As Alaska's legislature considers alternative revenue sources, my message today is that tax policy that is economically efficient and promotes economic growth has two important features: 1) low rates and 2) a broad tax base with few exemptions or deductions.[1]

TAX REFORM IN ALASKA

The most common sources of revenue for state governments are the income tax and the sales tax. Alaska has neither of these, instead relying on taxes, rents, and royalties tied to the extraction of oil and gas for much of its revenue. The price and production of these commodities fluctuates for a variety of supply and demand reasons, and Alaska's reliance on them as a source of revenue results in some of that volatility being transferred to the state's revenue stream.

In recent years Alaska has experienced significant budget deficits, which has generated a search for more stable alternative sources of revenue. An income tax, a sales tax, or a combination of the two is capable of providing that revenue. However, the efficacy and efficiency of any tax depends on the way it is structured. For a tax to generate revenue efficiently, it should consist of low rates and a broad base.

In combination, these features reduce the number of tax-related distortions to the economy and maximize the amount of resources left in the hands of taxpayers, while still raising adequate revenue for government functions. They also reduce compliance costs, which are the costs associated with obeying the law. Reducing the number of deductions and exemptions saves time and effort required to ensure compliance.

[1] Adam Millsap and Olivia Gonzalez, "State and Local Tax Policy," Economic Perspectives, Mercatus Center at George Mason University, January 2016.

A simple tax code also means less effort needs to be expended monitoring year-to-year changes in brackets and allowable deductions and exemptions. Finally, a broad tax base is generally less variable over time, which makes it easier for policymakers to forecast revenue during the budgeting process.[2]

STRUCTURE INCOME TAX TO AVOID DISTORTIONS

As mentioned previously, two common state taxes are the income tax and the sales tax. Income taxes distort people's choices of how much to work by reducing the benefits of work. Low marginal income tax rates reduce this distortion. Limiting deductions and exemptions also allows rates to be lower by broadening the tax base.

Numerous income tax brackets increase the complexity of the tax code and deter additional work near each bracket threshold, since any additional income is subject to a higher tax rate than previous income. The more brackets there are, the more often workers confront changes in the incentive to work. Reducing the number of brackets encourages more work across the income distribution. Some progressivity in the tax code may be desirable, but it should be achieved with as few brackets as possible.

States have implemented income taxes at different times, and there is evidence that states experience slower per capita income growth following the adoption of an income tax.[3] This is consistent with other studies that find that states with higher income tax rates experience slower per capita income growth.[4] There is also evidence that people migrate in order to reduce their tax liability.[5] Thus the creation of an income tax may harm Alaska's economy by reducing the incentive to work and by inducing people to emigrate from the state.

However, the potential costs to economic growth from the implementation of an income tax must be weighed against the costs of chronic budget deficits and spending cuts. For example, some studies find that government spending on education, public health, and infrastructure can counteract the disincentive effects of greater taxation and actually improve economic growth.[6] And since people and businesses are forward looking, large and frequent budget deficits will cause them to expect future tax increases and will create uncertainty about the state's economic and fiscal future.

The net effect on Alaska's economy will ultimately depend on the structure of the income tax, the state's spending decisions, and whether an income tax can assure residents, investors, and firms that the state's finances are sound.

Many states have reformed their income tax codes recently, and these reforms provide some guidance for Alaska.[7] Reforms in Utah and North Carolina broadened their income tax bases by eliminating

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[2] Richard F. Dye and Therese J. McGuire, "Growth and Variability of State Individual Income and General Sales Taxes," *National Tax Journal* (1991): 55–66.
[3] Thomas R. Dye and Richard C. Feiock, "State Income Tax Adoption and Economic Growth," *Social Science Quarterly* (1995): 648–54.
[4] Barry W. Poulson and Jules Gordon Kaplan, "State Income Taxes and Economic Growth," *Cato Journal* 28, no. 1 (2008): 53. Randall G. Holcombe and Donald J. Lacombe, "The Effect of State Income Taxation on Per Capita Income Growth," *Public Finance Review* 32, no. 3 (2004): 292–312.
[5] Ira S. Saltz, "State Income Tax Policy and Geographic Labour Force Mobility in the United States," *Applied Economics Letters* 5, no. 10 (1998): 599–601. Martin Feldstein and Marian Vaillant Wrobel, "Can State Taxes Redistribute Income?," *Journal of Public Economics* 68, no. 3 (1998): 369–96. Richard J. Cebula and Gigi M. Alexander, "Determinants of Net Interstate Migration, 2000–2004," *Journal of Regional Analysis and Policy* 36, no. 2 (2006): 116–23.
[6] L. Jay Helms, "The Effect of State and Local Taxes on Economic Growth: A Time Series—Cross Section Approach," Review of Economics and Statistics 67, no. 4 (1985): 574-82. Alaeddin Mofidi and Joe A. Stone, "Do State and Local Taxes Affect Economic Growth?," *Review of Economics and Statistics* (1990): 686–91.
[7] George R. Crowley, "Case Studies in the Political Economy of Tax Reform" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2016).

various credits, exemptions, and deductions and replaced their systems of tax brackets with one flat rate. These changes eliminated distortions in the tax code and improved the efficiency of each state's income tax. Alaska can eliminate the need for future reform by implementing an income tax with similar features from the start.

STRUCTURE SALES TAX TO LIMIT DISTORTIONS AND REGRESSIVENESS

In addition to the income tax, a sales tax is a common way for government to raise revenue. A sales tax is a tax on consumption, so it discourages consumption and encourages saving. More saving means more investment and ultimately more economic growth. Conversely, the income tax's main flaw is that it discourages work and saving. This is why many economists prefer a comprehensive consumption tax over an income tax as a means of generating revenue.

However, a sales tax also has drawbacks, the primary one being that in its most common and basic form it is regressive. Since lower-income people spend a larger portion of their income than higher-income people, a sales tax imposes a relatively larger burden on those with lower incomes. This undesirable feature can be mitigated by applying the sales tax to a broad base that includes both goods and services. Taxing services is also important since unlike in the past, most consumer spending today is on services rather than goods.

Applying a sales tax to all final goods and services allows the rate to be lower to achieve a given revenue target, which reduces the burden on all consumers.[8] A broad base can also reduce the tax's regressiveness, since higher-income people spend a larger share of their income on services than lower-income people.[9] If only goods are taxed, a sizeable amount of consumer spending, especially by higher-income people, will be unfairly exempt from taxation.

Product-specific sales taxes, commonly referred to as "sin taxes," are especially egregious since they are routinely applied to goods disproportionately consumed by lower-income people. The limited scope of sin taxes creates large welfare losses as consumers expend time and effort seeking out tax-free alternatives.[10] They also invite lobbying from various interests, both for and against the taxes, which wastes resources in a process called rent-seeking.[11] Product-specific or industry-specific sales taxes should be avoided for these reasons.

MAKE THE TAX CODE MORE EQUITABLE

Equity is another important feature of tax policy that could be improved in Alaska. Horizontal equity is achieved when taxpayers who earn the same income face the same tax burden. In Alaska, revenue is primarily raised through the oil and gas industry. In fiscal year 2016, oil and gas revenue accounted for 72 percent of the state's general fund unrestricted revenue.[12]

Since all taxes are ultimately paid by people, taxes on the oil and gas industry are paid by some combination of its workers, owners, and customers. This means that workers and investors in this industry bear more of the tax burden in the form of lower wages and dividends than similar people in other industries, which violates the principle of horizontal equity.

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[8] Thomas Stratmann, "More Sales Tax Exemptions, Higher Sales Tax Rates," Mercatus Center at George Mason University, September 17, 2014.
[9] John J. Siegfried and Paul A. Smith, "The Distributional Effects of a Sales Tax on Services," *National Tax Journal* 44, no. 1 (1991): 41–53.
[10] Adam J. Hoffer, William F. Shughart, and Michael D. Thomas, "Sin Taxes and Sindustry: Revenue, Paternalism, and Political Interest," *Independent Review* 19, no. 1 (2014): 47–64.
[11] Richard Williams and Katelyn Christ, "Taxing Sin" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, July 2009).
[12] Alaska Department of Revenue, Tax Division, "Revenue Sources Book: Fall 2016," accessed April 26, 2017.

Moreover, the benefit principle of taxation states that those receiving the benefits of government goods and services should contribute to their provision. While Alaska does levy some user fees, product-specific sales taxes, and a corporate income tax, these taxes generate significantly less revenue than the taxes on the oil and gas industry. To the extent that Alaska's state government is providing goods and services that benefit each resident, each resident should contribute to their cost. A broad-based income or sales tax would be more equitable, and it would better satisfy the benefit principle of taxation than the current system, since it would more evenly distribute the cost of government.

CONCLUSION

Efficient and effective tax policy should consist of low rates that are applied to broad bases. Together, low rates and a broad base reduce distortions, decrease compliance costs and ensure that the tax burden is shared equitably by all taxpayers.

Finally, it is important to note that the creation of an income tax, sales tax, or both should not be viewed as a panacea. Such taxes can provide a relatively stable source of additional revenue, but it is also important for state governments and their citizenry to live within their means. Government spending in Alaska as a percentage of total state personal income was 31 percent in 2015, nearly two and a half times the national average of 13 percent.[13] Maintaining such a high level of spending relative to income would likely require more than a modest tax increase, and higher tax rates increase the likelihood that an income or sales tax will have a negative net effect on Alaska's economy. For this reason, efforts to balance Alaska's budget should consider both revenue increases and spending cuts.

Thank you for inviting me to speak with you today about tax policy in Alaska. I look forward to answering any questions you may have concerning my testimony.

[13] Eileen Norcross and Olivia Gonzalez, "Ranking the States by Fiscal Condition: 2017 Edition" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, forthcoming).