

A Plan for Progressive Tax Reform in Alabama

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In 1996, 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 1995, Alabama had a regressive tax structure—that middle- and low-income Alabamians paid a higher share of income in Alabama state and local taxes than did the better-off. In fact, the study ranked Alabama as one of the ten most regressive tax systems in America: the poorest twenty percent of Alabamians paid 11.6% of their income in Alabama taxes, middle-income Alabamians paid 9.1%, while the wealthiest 1 percent of taxpayers paid only 4.8 percent of their income in state and local taxes. One of the principal reasons for this ranking is the lack of progressivity in Alabama's income tax.

The following analysis describes several characteristics of Alabama's income tax which limit its progressivity, and analyzes the effects of a series of possible tax law changes that would reduce the state tax burden on middle- and low-income Alabamians.

Factors Limiting the Progressivity of the Income Tax in Alabama

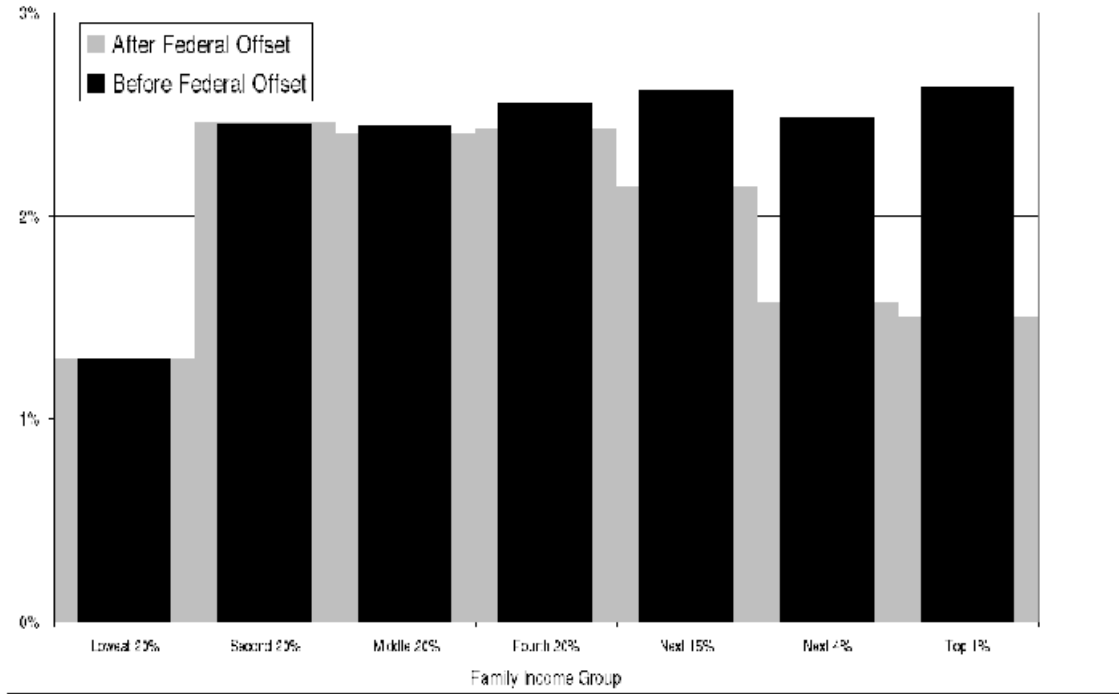
Alabama's income tax is nominally progressive in that it applies higher tax rates at higher levels of income, with marginal tax rates ranging from 2 percent to 5 percent. Yet the effective tax rates—income taxes as a percentage of income—are flat across most income groups, as the table on the next page shows.

The limited progressivity of Alabama's income tax is the product of several uncommon features of the state's tax structure. Most notably:

- # Alabama's standard deduction, personal exemption and dependant exemption are comparatively low.
- # Neither the standard deduction nor the personal exemption is currently indexed for inflation. The personal exemption has not been raised since the state income tax was adopted in 1933 and the standard deduction has not been raised since 1982.
- # While the rate structure is nominally progressive, the top rate of 5 percent applies to all taxable income above \$3,000 for single filers and \$6,000 for married joint filers. We estimate that in 1999 more than three-quarters of all Alabama taxpayers paid income tax at the top marginal rate.

¹Who Pays? A Distributional Analysis of the Tax Systems in All 50 States. Ettliger, O'Hare, McIntyre, King, Fray and Miransky (Institute on Taxation and Economic Policy and Citizens for Tax Justice, 1996). The study is available from ITEP and can be found on the Internet at <http://www.ctj.org/html/whopay.htm>.

Alabama Personal Income Taxes as Shares of Income in 1999



A significant reason for the relative lack of progressivity in Alabama’s income tax is the state’s deduction for federal personal income tax payments. This deduction provides little tax relief to most Alabamians and reduces state revenues by over \$450 million. Alabama is one of only three states nationwide to allow a full deduction for federal income tax payments.

Low Exemptions and Deductions

Most states use standard deductions and exemptions as a means of excluding from taxation a basic minimum amount of income. These provisions are particularly important for low-income taxpayers, for whom the amount of income excluded from tax can be a high percentage of their total income.

In Alabama, both the standard deduction and exemption are set at comparatively low levels. In addition, the standard deduction is calculated in a way that lessens its benefit for low-income taxpayers. Alabama’s standard deduction is computed as a capped percentage of adjusted gross income rather than as a flat amount. For tax year 1999, the deduction is calculated as the lesser of twenty percent of

Regional Comparison: Income Tax Thresholds in 1998

	Single-Parent Family of 3	Joint Filers, Family of 4
Alabama	\$4,600	\$4,600
Arkansas	\$13,000	\$15,600
Florida	No personal income tax	
Georgia	\$12,100	\$15,300
Mississippi	\$14,400	\$17,200
South Carolina	\$14,400	\$17,900
Tennessee	No personal income tax	

Source: Center on Budget and Policy Priorities

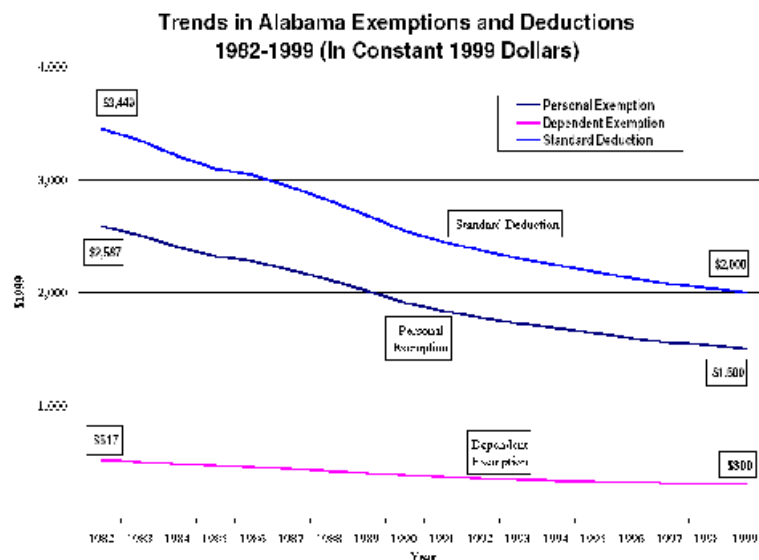
Alabama Adjusted Gross Income or \$2,000—\$4,000 for joint filers. We estimate that more than 15 percent of Alabama taxpayers cannot claim the maximum standard deduction because of the adjusted gross income calculation.

As a result of the low standard deduction, the way it's calculated and low personal and dependant exemptions, more of the income of poor families is subject to income taxation than in other states. A study by the Center on Budget and Policy Priorities found that the “tax threshold” in 1998 for a two-parent family of four—the amount of income that is shielded from taxation through standard deductions, personal exemptions and low-income credits—was lower in Alabama than in every other state.²

Not only are the standard deduction and exemption levels low in Alabama, but they have declined in value over time. For example, in 1982 the current \$2,000 maximum standard deduction for single-filers (in 1999 dollars) was worth \$3,449.

One way to increase the value of Alabama's standard deduction and personal exemption is linking the value of these exclusions to the amounts allowed under the federal income tax. As shown in the box at right, a number of states now link their standard deductions and exemptions to the federal amounts.

Adopting the federal standard deduction and personal exemption would allow Alabama taxpayers to enjoy the benefits of higher exclusions without requiring taxpayers to make additional calculations for tax purposes. And because the federal deductions and exemptions are indexed for inflation, the real value of these exclusions would not decline over time. Taken by itself, such a tax change would significantly reduce taxes for most Alabama residents.



State Conformity to Federal Tax Structures, 1999		
	Standard Deduction	Personal Exemption
Colorado	Y	Y
Idaho	Y	Y
Maine	Y	Y
Minnesota	Y	Y
Missouri	Y	N
Nebraska	Y	N
New Mexico	Y	Y
North Dakota	Y	Y
Rhode Island	Y	Y
South Carolina	Y	Y
Utah	Y	Y
Vermont	Y	Y

Note: Utah's personal exemption is calculated as 75% of the federal exemption.

²State Income Tax Burdens on Low-Income Families in 1998: Assessing the Burden and Opportunities for Relief. Nicholas Johnson, Christina Smith FitzPatrick, Elizabeth McNichol (1999)

Earned Income Tax Credit

An increasingly popular means of achieving tax relief for the working poor is an Earned Income Tax Credit (EITC). Calculated as a percentage of earned income, the federal EITC is designed to provide targeted tax relief to low-income working taxpayers. Eleven states now allow an EITC modeled on the federal credit. The federal credit is refundable. This means that low-income taxpayers are paid any EITC in excess of their pre-credit tax liability. Thus, the EITC not only reduces the personal income tax liability for low-income taxpayers, but serves to offset other taxes which often impose a much greater burden than income taxes. It allows low-income taxpayers with little or no income tax liability to claim the full EITC to mitigate the effect of regressive sales and excise taxes.

Because the benefits of the EITC phase out above a specified income level, the credit is targeted to the working families who need it most, and the cost of the credit is kept to a minimum. The tax plan described below adopts a refundable EITC set at 10 percent of the federal credit.

Federal Income Tax Burden Alabama Residents in 1999

Income Group	Tax as % of income
Lowest 20%	-6.7%
Second 20%	-4.4%
Middle 20%	3.3%
Fourth 20%	8.0%
Next 15%	11.4%
Next 4%	16.6%
Top 1%	24.1%

The Deduction for Federal Personal Income Taxes Paid

One of the most costly exclusions from Alabama taxable income is the state deduction for federal personal income taxes paid. All Alabama income tax filers are allowed to deduct from taxable income the full amount of federal income taxes paid during a given tax year. The following table shows the distributional effects of the deduction as it is currently structured.

- # The very wealthiest one percent of Alabama taxpayers receive 32 percent of the benefits from this tax break, for an average 1999 tax break of over \$7,200.
- # The very poorest Alabamians—the twenty percent of taxpayers with income less than \$12,000 in 1999—receive an average tax break of \$3 from the deduction for federal income taxes.
- # The poorest eighty percent of Alabama taxpayers receive less than 22 percent of the tax benefit from this exclusion in 1999, with

Effect of Alabama's Deduction for Federal Income Taxes Paid

Alabama Residents by Income Group, 1999

Income Group	Tax Benefit as % of Income	Average Tax Benefit	Percent of Total Tax Benefit
Lowest 20%	0.0%	\$3	0.2%
Second 20%	0.1%	\$21	1.9%
Middle 20%	0.2%	\$62	5.5%
Fourth 20%	0.4%	\$158	14.0%
Next 15%	0.6%	\$395	26.1%
Next 4%	0.8%	\$1,143	20.3%
Top 1%	1.2%	\$7,244	32.0%
ALL:	0.6%	\$225	100.0%
ADDENDUM:			
Lowest 99%	0.5%	\$156	68.0%

the remaining 78 percent accruing to the wealthiest twenty percent of Alabamians.

The skewed distribution of the tax break for federal income tax payments is due to the fact that better-off people pay more in federal personal income taxes than middle- and low-income taxpayers.

Consequences of the “Arise” Reform Proposal in 1999

The analysis so far has identified several ways in which the progressivity of the income tax could be increased. The following table shows, at 1999 levels, the consequences of a revenue-neutral tax plan combining the three elements discussed so far:

- # Conforming Alabama’s personal and dependent exemptions to the federal levels,
- # Conforming Alabama’s standard deduction for married couples to the federal standard deduction (\$7,200 in 1999), and setting the standard deduction for single filers and heads of households to half the married amount.
- # Adopting a refundable Earned Income Tax Credit set at 10 percent of the federal credit.
- # Repealing the deductibility of federal personal income taxes against Alabama taxable income.³

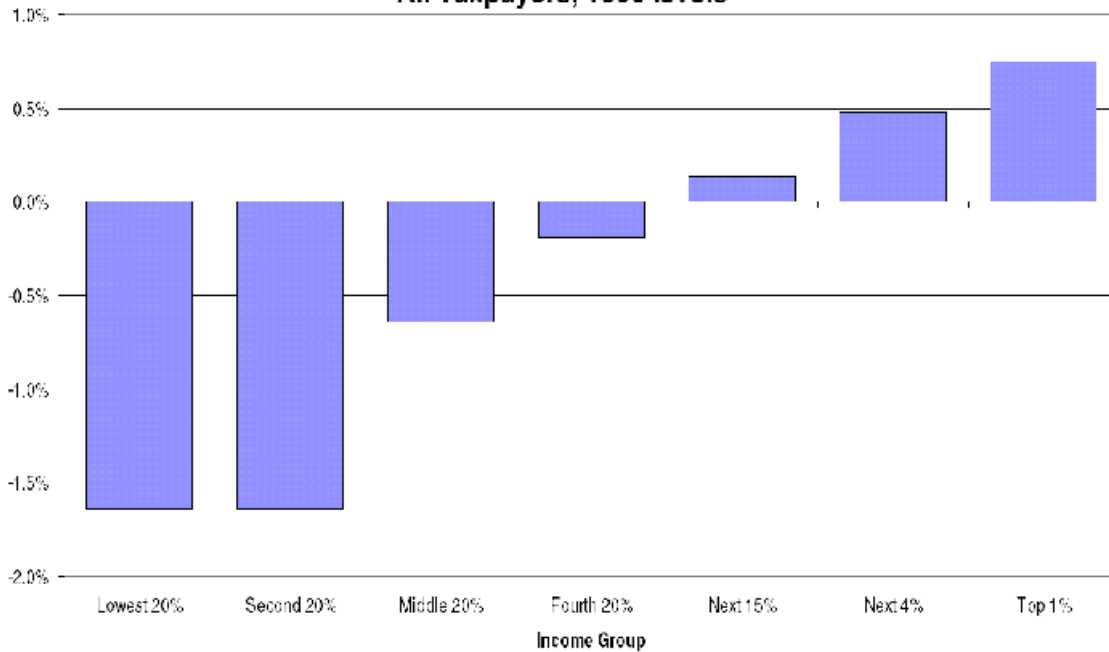
Effect of Arise Tax Reform Plan Alabama Residents by Income Group, 1999

Income Group	Income Range	Average Income	Alabama Tax Change as % of Income	Federal Tax Change as % of Income	Net Tax Change as % of Income	Net Average Tax Change (\$)
Lowest 20%	Below \$12,000	\$7,300	-1.6%	—	-1.6%	\$ -120
Second 20%	\$12,000-19,000	\$15,300	-1.6%	0.0%	-1.6%	\$ -251
Middle 20%	\$19,000-31,000	\$25,100	-0.6%	-0.0%	-0.6%	\$ -161
Fourth 20%	\$31,000-54,000	\$41,800	-0.2%	-0.0%	-0.2%	\$ -80
Next 15%	\$54,000-103,000	\$71,500	0.2%	-0.0%	0.1%	\$ +95
Next 4%	\$103,000-228,000	\$139,600	0.6%	-0.2%	0.5%	\$ +667
Top 1%	Above \$238,000	\$602,400	1.2%	-0.5%	0.7%	\$ +4,506
Addendum: Bottom 60%		\$15,900				\$ -178

The plan provides progressive tax relief to a large majority of Alabama taxpayers. In particular:

³The Alabama state constitution requires that the federal income tax be deductible. For this reason, passage of the reforms described here would require a constitutional amendment.

**Tax Change as a % of Income from Arise Conformity Plan
After Federal Offset
All Taxpayers, 1999 levels**



- # The poorest twenty percent of Alabama taxpayers would receive an average Alabama tax cut of \$120.
- # The lowest-income eighty percent of Alabama taxpayers would, on average, receive a net tax reduction of \$153 from this reform.
- # The wealthiest twenty percent of Alabama taxpayers would receive a net tax increase from the plan.

Interaction with the Federal Income Tax

While the wealthiest twenty percent of Alabamians would experience a substantial net increase in Alabama taxes as a result of this tax plan, the overall tax increase on wealthy Alabamians would be significantly smaller than it first appears. Because state income taxes can be deducted by taxpayers itemizing deductions on their federal tax returns, any increase in Alabama income taxes paid results in a decrease in federal income taxes paid by Alabama residents. The overall effect on the very wealthiest Alabamians in 1999 would be to increase their state personal income tax burden by an average of \$7,324, while

The Interaction Between Alabama Income Tax Hikes and Federal Income Tax Cuts: Arise Plan at 1999 levels			
Income Group	Top 20%		
	First 15%	Next 4%	Top 1%
Avg. State Tax Increase	\$ 124	\$ 905	\$ 7,324
Avg. Federal Tax Cut	\$ (30)	\$ (239)	\$ (2,817)
Net Tax Hike	\$ 95	\$ 667	\$ 4,506
% of State Tax Hike Paid for By Federal Government	24%	26%	38%

simultaneously decreasing their federal income tax burden by an average of \$2,817. In other words, more than 38 percent of the increased state income tax burden on the wealthiest Alabamians would essentially be paid from the coffers of the federal government in the form of reduced federal income taxes.

Because the lower-income taxpayers who receive net tax cuts under this plan are unlikely to itemize deductions on their federal tax returns, they, as a group, see only a very small increase in their federal taxes because of lost deductions for state taxes paid.

The net effect of the federal-state interaction would be that while the aggregate Alabama income tax burden would remain approximately unchanged, the federal income tax burden on Alabama residents would decline by almost \$85 million. Thus, total taxes paid by Alabama residents would decline by \$85 million as well.

Summary

ITEP's Who Pays study found that Alabama's tax system ranked among the ten most regressive tax systems in the nation. This ranking is due to the state's relatively high reliance on regressive sales and excise taxes—and the lack of progressivity of its personal income tax. The tax plan described above would not eliminate the fundamental regressivity of Alabama's tax system: if enacted, the resulting tax structure would still tax middle- and low-income Alabamians more heavily than wealthy Alabamians as a percent of income. The proposal outlined above would, however, reduce the regressivity of the tax system as a whole, by lowering income tax burdens for the poorest 80 percent of Alabamians. The proposal would also simplify the tax system by linking it more closely to the federal system. Finally, the proposal would achieve this while leaving the aggregate Alabama income tax burden unchanged—and while lowering the aggregate federal income tax burden on Alabama residents.

ITEP METHODOLOGY

The Institute on Taxation & Economic Policy 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.