

Revenue Raising Plans for Louisiana: Who Pays?

Prepared By:

**The Institute on Taxation and Economic Policy
Washington, DC 20005
www.itepnet.org**

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Baton Rouge Catholic Worker

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The state of Louisiana is currently facing a substantial budget shortfall. Recent estimates suggest that legislators crafting the state's fiscal year 2001 state budget must make up almost \$540¹ million in revenues through budget cuts or tax increases. Among the more prominent revenue-raising solutions recently under discussion have been an extension of the state's "temporary" 3 cent tax on the retail sale of food and utilities and an increase in the state general sales tax rate from 4 percent to 5 percent.

Louisiana is also facing a longer-term fiscal crisis. The state's current heavy reliance on sales and excise taxes as a source of revenue makes it likely that the revenue yield from the existing tax structure will be insufficient to support the provision of essential government services in the future.

The following analysis assesses Louisiana's current tax system from an equity perspective and evaluates several proposed options for resolving the state's revenue crises, focusing on the fiscal and distributional impact of various proposals for revenue raising. Among the principal findings of the analysis are that:

- # Louisiana relies more heavily than most states on sales and excise taxes as a source of revenue.
- # Sales tax increases would place a greater burden on low-income and middle-income Louisianans than would income tax increases.
- # Revenue-raising measures enacted through the income tax would result in a decrease in federal income taxes paid by Louisiana residents.

The Current Louisiana Tax System

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*.² One of the findings of the study was that in 1995, Louisiana had a regressive tax structure—that middle- and low-income Louisianans paid a higher share of income in Louisiana state and local taxes than did the better-off. In fact, the study ranked Louisiana as one of the ten most regressive tax systems in America: the poorest twenty percent of Louisianans paid 13.4% of their income in Louisiana taxes, middle-income Louisianans paid 10.4%, while the wealthiest 1 percent of taxpayers paid only 6.0 percent of their

¹House Fiscal Division Briefing, February 17, 2000. Downloaded from <http://www.legis.state.la.us/housefiscal/2000fiscalbriefing/index.htm> on 3/28/00. This estimate factors in the recent renewal of the state "temporary" 3 cent sales tax on food and utilities, which will increase state tax revenues by an estimated \$327 million in FY 2001. Without the renewal of this tax, the FY2001 deficit is projected to be \$867 million.

²*Who 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>.

income in state and local taxes. ITEP's analysis identified two principal reasons for this ranking: the lack of progressivity in Louisiana's income tax and the state's heavy reliance on regressive sales and excise taxes.

Louisiana Revenue Sources: A Comparative Perspective

Louisiana's tax system is notable primarily for its above-average reliance on regressive sales and excise taxes as a source of revenue. In fiscal 1996³, Louisiana relied on sales and excise taxes for almost 55 percent of its revenue—greater than all but 3 states. Conversely, Louisiana relies less on personal income taxes as a source of revenue than all but 1 of the 42 states (including DC) currently levying broad-based income taxes.

The Composition of Louisiana Tax Revenue, 1996 Percent of Total Revenue from:

	Individual Income Tax		Sales and Excise Taxes		Property Taxes	
	1996	Rank	1996	Rank	1996	Rank
Alabama	21.5%	29	51.2%	9	13.1%	50
Louisiana	13.7%	41	54.9%	4	16.0%	45
Florida	—	48	52.4%	6	35.2%	14
Mississippi	14.4%	40	51.7%	8	23.5%	38
Georgia	24.5%	20	39.4%	19	27.7%	32
Tennessee	1.1%	44	60.8%	2	22.7%	39
Arkansas	24.0%	23	47.8%	12	15.5%	47
ALL STATES	21.3%		36.1%		30.4%	

SOURCE: Bureau of Economic Analysis, Bureau of the Census

Tax changes enacted over the past fifteen years have resulted in an increase in the state's revenue imbalance. The extension of the sales tax to food and utilities has resulted in a further increase in the state's reliance on regressive sales and excise taxes as a source of income, as the following table shows—and has increased the tax burden on low- and middle-income Louisianans.

Change in Louisiana Tax Revenue Sources, 1985 to 1996

Year	Individual Income Tax		Sales and Excise Taxes		Property Taxes		Corporate Income Tax	
	%	Rank	%	Rank	%	Rank	%	Rank
1985	9.1%	39	52.9%	6	13.6%	48	5.0%	22
1996	13.7%	41	54.9%	4	16.0%	45	3.9%	28

SOURCE: Bureau of Economic Analysis, Bureau of the Census

³Fiscal 1996 is the most recent year for which the U.S. Bureau of the Census has published data for combined state and local taxes for all states. This data is available on the Census Bureau website at <http://www.census.gov/ftp/pub/govs/www/index.html>.

Louisiana's Fiscal Future

An important goal in the design of a tax system should be responsiveness to economic growth. Since the cost of government services tends to grow with the economy, tax revenues should exhibit (at least) the same rate of growth. Taxes whose revenue yield grows with (or faster than) the economy are said to be elastic, while taxes that grow more slowly than the economy are labeled inelastic. The overall elasticity of a given state's tax system depends largely on the mix of taxes it levies, and the linkage between tax types and tax elasticity is fairly predictable. In particular, economists agree that personal income taxes are relatively elastic, while sales and excise tax revenues are relatively inelastic. This means that states relying primarily on income taxes as a source of revenue will likely enjoy adequate revenue growth as the economy expands, while states relying primarily on sales and excise taxes will likely be forced to enact tax increases to keep overall revenue growth on a pace with the economy.

Louisiana's unusually high reliance on sales and excise taxes suggests that the state's tax system is relatively inelastic. As the state's economy continues to grow, it is likely that the yield of the existing tax system will shrink as a share of the state's economy—and that future tax hikes will be necessary to provide the same level of services provided today.

Revenue Raising Options

Louisiana policy makers are currently considering several options for resolving the state's fiscal shortfall. These include sales tax-based and income-tax solutions. This section focuses more closely on several options, including:

- # Extending the state's "temporary" 3 cent tax on sales of food and utilities;
- # Increasing the overall state sales tax rate by 1 cent;
- # Eliminating the state's income tax deduction for federal income taxes paid;
- # Increasing income tax rates across the board.

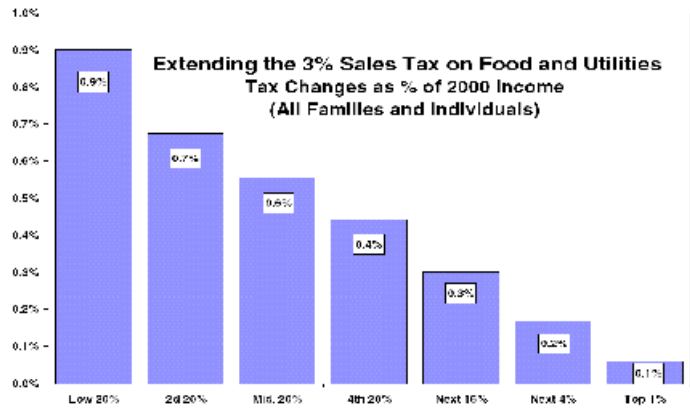
For each option described below, the accompanying charts show tax changes as a percent of income by income group.

Extending the Temporary Tax on Food and Utilities

One of the most frequently discussed proposals for resolving Louisiana's immediate fiscal shortfall is an extension of the "temporary" sales tax on food and utilities.

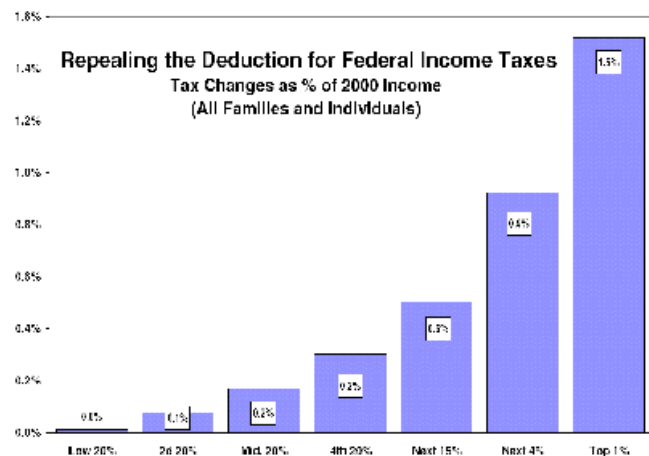
Louisiana has levied a general sales tax since 1938, and has taxed at the current 4 percent rate since 1984. As originally enacted, the tax was not applied to sales of goods deemed "necessities," including sales of food and certain utilities. However, since 1986 the state legislature has enacted (and extended) a series of "temporary" suspensions of these exemptions, with the result that since 1986 sales of food and

utilities have generally been taxed at a rate of 3 percent.⁴ This approach has been estimated to increase Louisiana tax revenues by \$372 million in fiscal 2001.⁵ This approach to revenue raising is inherently regressive because lower-income families spend a greater share of their income on “necessities” such as food and utilities. Moreover, the revenue yield of this “extension” approach is likely to decrease in future years, as sales tax revenues continue to grow more slowly than the economy. Only 18 states include sales of groceries in the sales tax base, and several states have enacted food exemptions in recent years.⁶



Repealing The Deduction for Federal Personal Income Taxes Paid

One of the most costly exclusions from Louisiana taxable income is the state deduction for federal personal income taxes paid. All Louisiana income tax filers are allowed to deduct from taxable income the full amount of federal income taxes paid during a given tax year. This deduction provides little tax relief to most Louisianans and reduces state revenues by over \$450 million. Louisiana is one of only three states nationwide to allow a full deduction for federal income tax payments. The table on the following page shows the distributional effects of the deduction as it is currently structured.



The very wealthiest one percent of Louisiana taxpayers receive more than 41 percent of the benefits from this tax break, for an average 1999 tax break of

⁴From July 1, 1993 until September 30, 1996, food and utilities were taxed at a 4 percent rate.

⁵Louisiana House of Representatives Fiscal Briefing, February 18, 2000.

⁶Georgia phased out its food tax between 1996 and 1998; North Carolina phased out its tax between 1997 and 1999; Missouri lowered its food tax from 4.225% to 1.225% in 1997; and Virginia recently began a series of rate reductions, beginning in January of 2000, that will lower the state sales tax on food from 3.5% to 1.5% by 2003.

over \$10,700.

The very poorest Louisianans—the twenty percent of taxpayers with income less than \$12,000 in 1999—receive an average tax break of \$1 from the deduction for federal income taxes.

The poorest eighty percent of Louisiana taxpayers receive less than 15 percent of the tax benefit from this exclusion in 1999, with the remaining 85 percent accruing to the wealthiest twenty percent of Louisianans.

**Effect of Louisiana's Deduction for Federal Income Taxes Paid
Louisiana Residents by Income Group, 1999**

Income Group	Tax Benefit as % of Income	Average Tax Benefit	Percent of Total Tax Benefit
Lowest 20%	0.0%	\$1	0.1%
Second 20%	0.1%	\$12	0.9%
Middle 20%	0.2%	\$43	3.3%
Fourth 20%	0.3%	\$128	9.9%
Next 15%	0.5%	\$378	21.9%
Next 4%	0.9%	\$1,445	22.3%
Top 1%	1.5%	\$10,774	41.7%
ALL:	0.6%	\$256	100.0%

ADDENDUM:

Lowest 60%	0.1%	\$19	4.3%
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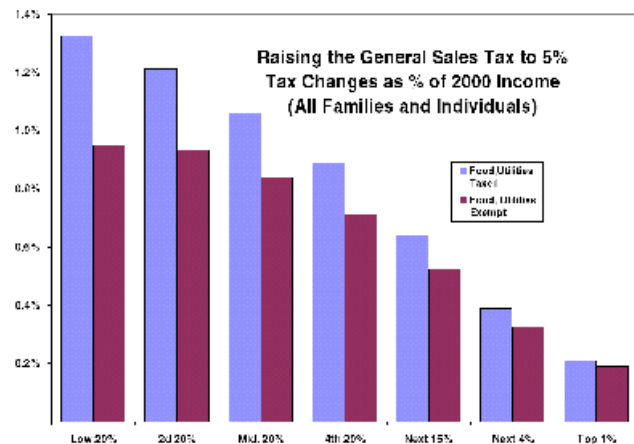
Source: ITEP Microsimulation Tax Model, April 2000

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.

Raise the General Sales Tax Rate to 5 Percent

The state sales tax rate on most retail sales in Louisiana is 4 percent. One proposal for increasing the state’s sales tax revenue would increase the total state rate to 5 percent. The revenue yield from this approach would depend on whether the “suspended” exemptions for food and utilities would apply to the fifth cent of the tax. It has been estimated that the 1-cent tax hike would raise \$430 million if the food and utilities exemptions were applied to the extra cent, and \$540 million if these exemptions did not apply to the extra cent.

While the inclusion of food and utilities in the base of the “fifth-cent” tax hike increases the regressivity of this approach, an increase in the general sales tax rate would have regressive consequences in either scenario, as the chart at right shows.



Raise Income Tax Rates Across the Board

One alternative for modifying the structure of the existing income tax involves changing the marginal tax rates applied to taxable income. The chart at right shows the distributional impact of moving to a personal income tax rate structure that

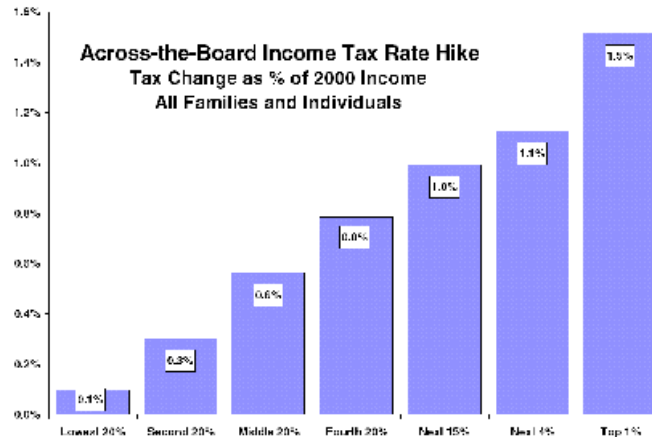
increases rates across the board by 50%. The new rate structure, which would range from 3 percent to 9 percent, would result in almost \$800 million in extra revenue in fiscal year 2001. The impact of this tax option is clearly progressive.

Comparing the Options

Because these options result in significantly different revenue gains, it is difficult to provide a straightforward comparison of the average tax change that would result from each proposal. The simplest way to directly compare the impact of these tax proposals on taxpayers at each income level is to measure the percentage of additional tax burden that would be shouldered by taxpayers at a given income level. The table in Appendix 1 provides this information in detail for each proposal described above.

Among the most notable results of this comparison are that:

- # The two income-tax-based solutions focus their tax increases primarily on wealthier Louisianans. The poorest twenty percent of Louisiana



taxpayers would pay less than 1 percent of the tax increase under either of these proposals, and would pay less than a tenth of one percent of the tax hike from eliminating the state’s deduction for federal income taxes paid.

- # The sales tax-based solutions are significantly more regressive in their impact. The poorest twenty percent of Louisiana taxpayers would pay more than 5 percent of the cost of each sales tax hike described above.
- # The extension of the “temporary” 3 percent tax on food and utilities is noticeably more regressive than either of the other sales tax alternatives. The poorest twenty percent of Louisianans would pay 8 percent of the tax hike from extending the sales tax on food and utilities.
- # The poorest eighty percent of Louisiana taxpayers would pay a greater percentage of the tax increases under each of the sales tax reforms than under either of the income tax reforms.

Interaction with the Federal Income Tax

The preceding section has compared the impact of various tax reform options on Louisiana’s state tax burden. Yet it is equally important to consider the very different impacts these proposals have on federal taxes paid by Louisiana residents. In particular, the proposed sales tax hikes discussed here have no effect on federal income taxes, while the income tax proposals result in a net decrease in federal income tax liability. This is because federal income taxpayers who itemize their

returns are allowed to deduct state income tax payment from federal taxable income—but are not allowed to deduct sales taxes paid. Thus, any increase in Louisiana income taxes paid results in a decrease in federal income taxes paid by Louisianans. The table on the preceding page demonstrates the importance of this “interaction effect” by examining the proposal to eliminate the federal income tax deduction. The effect of this proposal on the very wealthiest Louisianans in 1999 would be to increase their state personal income tax burden by an average of \$10,774, while simultaneously decreasing their federal income tax burden by an average of \$3,990. In other words, 37 percent of the increased state income tax burden on the wealthiest Louisianans would essentially be paid from the coffers of the federal government in the form of reduced federal income taxes.

The Interaction Between Louisiana Income Tax Hikes and Federal Income Tax Cuts: 1999 levels			
Income Group	Top 20%		
	First 15%	Next 4%	Top 1%
Avg. State Tax Increase	\$ 378	\$ 1,445	\$ 10,774
Avg. Federal Tax Cut	\$ (57)	\$ (416)	\$ (3,990)
Net Tax Hike	\$ 95	\$ 667	\$ 4,506
% of State Tax Hike Paid for By Federal Government	15%	29%	37%

The net effect of the federal-state interaction in 1999 would be that while the Louisiana income tax burden would increase by more than \$450 million, the federal income tax burden on Louisiana residents would decline by more than \$120 million.

Summary

Louisiana faces two distinct fiscal crises—a short-term revenue shortfall and a longer-term structural deficit. State policymakers must decide how best to modify the state’s tax structure to make up the state’s current \$540 million revenue shortfall, while ensuring the long-term adequacy of the tax structure.

Louisiana also faces a tax equity crisis: ITEP’s Who Pays study found that Louisiana’s tax system ranked among the ten most regressive tax systems in the nation. This ranking is due to the state’s high reliance on regressive sales and excise taxes—and the lack of progressivity of its personal income tax.

This analysis has reviewed several options for resolving these crises. While any of the tax reform options outlined above will help the state solve its short-term revenue shortfall, the various approaches described here have very different implications for the state’s long-term ability to provide adequate tax revenue—and for the fairness of the overall state and local tax burden.

Louisiana’s current over-reliance on sales and excise taxes as a source of revenues, combined with its under-reliance on personal income taxes, are features that reduce the long-term sustainability of Louisiana’s tax revenue stream, while placing the greatest tax burden on those who are least able to afford it. Revenue-raising solutions that rely on sales or excise taxes will exacerbate both of these problems, while tax hikes achieved through the income tax are more likely to alleviate them.

APPENDIX I: COMPARING THE IMPACT OF REVENUE RAISING OPTIONS

Targeting Tax Hikes: Who Bears the Burden Under Selected Tax Reform Options								
Effect by Louisiana Income Group in 1999								
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%			ALL
					Next 15%	Next 4%	Top 1%	
Average Income in Group	\$7,400	\$16,800	\$28,900	\$48,500	\$85,700	\$189,100	\$1,278,500	
Income Range	Less than \$12,000	\$12,000 – \$22,000	\$22,000 – \$37,000	\$37,000 – \$63,000	\$63,000 – \$130,000	\$130,000 – \$494,000	\$494,000 – or more	
% of Tax Hikes Paid Under:								
Extension of "temporary" sales tax	8%	14%	20%	26%	23%	7%	3%	100%
1% Sales (food, utilities exempt)	5%	12%	18%	26%	25%	8%	5%	100%
Tax Hike (food, utilities taxed)	6%	12%	19%	26%	24%	8%	5%	100%
Eliminate federal income tax deduction	0%	1%	3%	10%	22%	22%	42%	100%
Income tax rate increase	0%	2%	7%	17%	28%	18%	27%	100%

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, March 30, 2000.

APPENDIX II: 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.