Institute on Taxation and Economic Policy
1616 P Street, N.W. • Washington, D.C. 20036 • Contact: Matt Gardner
(202) 299-1066 x 24

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How Will the 2006 Special Session Affect Louisiana Tax Fairness?

Louisiana lawmakers currently face a pleasant dilemma: how to dispose of a short-term budget surplus exceeding $2 billion. In the opening days of the special legislative session that began last Friday, tax writers in the House of Representatives' Ways and Means Committee approved several bills that would reduce state income tax collections substantially. This analysis looks at the overall fairness of Louisiana's tax system, and assesses the impact of two of these bills on Louisiana tax fairness.

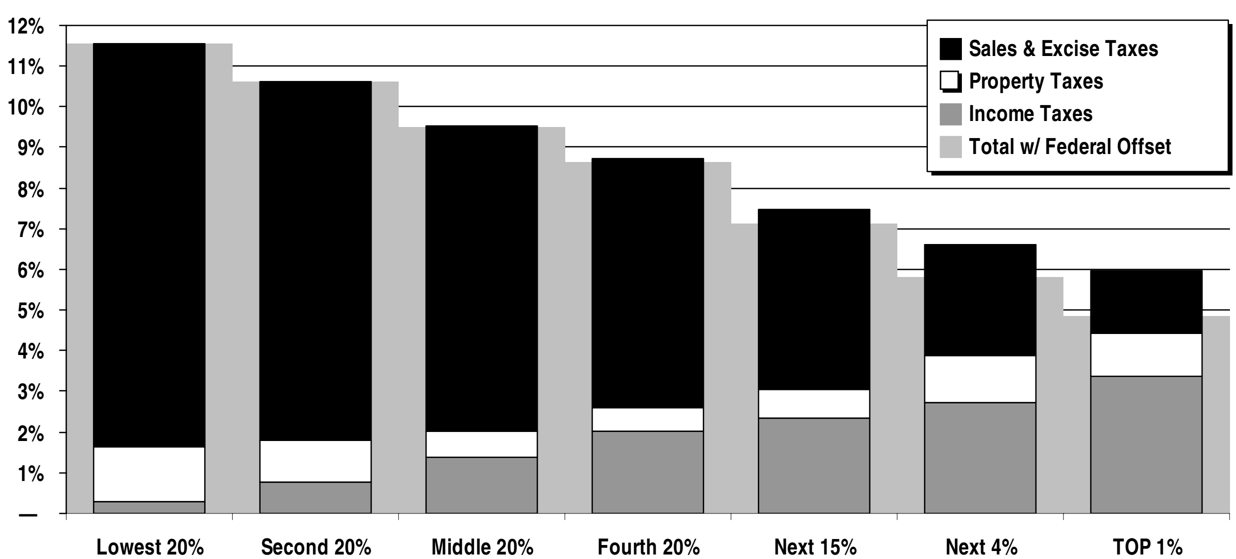
Louisiana's Current Tax System: The Poor Pay More

The current Louisiana tax system is *regressive*—that is, it requires low- and middle-income Louisianans to pay more of their incomes in tax than the wealthiest taxpayers have to pay. In other words, Louisiana's tax laws actually redistribute income away from ordinary families and towards the richest Louisianans. A January 2003 ITEP publication documenting the unfairness of state and local taxes nationwide found that:

- The poorest twenty percent of Louisianans paid, on average, 11.5 percent of their income in Louisiana taxes, while the wealthiest one percent of taxpayers paid only 6.0 percent of their income in state and local taxes.
- After taking account of the deductibility of state income on federal tax forms, the effective tax rate on the wealthiest 1 percent of taxpayers was an average of 4.9 percent— **less than half the effective tax rate on the very poorest Louisianans.**

Louisiana State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



What Makes the Louisiana Tax System Regressive?

Like most states, Louisiana relies primarily on three types of tax revenue: sales and excise taxes, property taxes, and personal income taxes. Of these taxes, only the personal income tax is *progressive*—that is, upper-income families pay a larger share of their income in this tax than do those with lower incomes. Property taxes are moderately regressive, and sales and excise taxes are quite regressive. The overall unfairness of the Louisiana tax system is due primarily to the state's **heavy reliance on regressive sales and excise taxes**, and its **much-lower-than-average reliance on personal income taxes**.

Current Options for Reforming Louisiana Income Taxes

In the opening days of the December 2006 special session, lawmakers have introduced a variety of bills that would cut the state's income tax. One approach, embodied in several bills approved by the House Ways and Means Committee, would allow a tax credit for various expenses that can be deducted on federal tax returns. For example, HB 30 would allow a credit equal to 2 percent of a federal itemizer's mortgage interest deduction, charitable donations, medical expenses, and casualty and theft losses. Another bill, HB 59, would allow families with children a $75 tax credit for children under 19. (This bill would also repeal a currently-suspended $25-per-child education tax credit.)

These bills would have very different impacts on tax fairness in Louisiana.

Impact of Personal Income Tax Changes Considered By Louisiana Legislature, December 2006

All Louisiana Families, 2006

2006 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $14,000	$14,000 – $24,000	$24,000 – $40,000	$40,000 – $69,000	$69,000 – $129,000	$129,000 – $308,000	$308,000 – Or More
Average Income in Group	$8,000	$18,000	$31,000	$53,000	$91,000	$180,000	$742,000
HB 30 (Allow 2% credit for various itemized deductions)							
Tax Change as a % of Income	–0.0%	–0.0%	–0.1%	–0.1%	–0.2%	–0.1%	–0.1%
$ Average Tax Change	$ –0	$ –1	$ –20	$ –55	$ –137	$ –254	$ –566
Share of Tax Change	**0%**	**1%**	**8%**	**21%**	**40%**	**20%**	**11%**
HB 59 ($75 per child refundable credit, repeal $25 education credit)							
Tax Change as a % of Income	–0.4%	–0.2%	–0.1%	–0.1%	–0.1%	–0.0%	–0.0%
$ Average Tax Change	$ –34	$ –32	$ –32	$ –41	$ –49	$ –54	$ –46
Share of Tax Change	**18%**	**17%**	**17%**	**21%**	**19%**	**6%**	**1%**

Source: Institute on Taxation and Economic Policy, December 2006

- **HB 30**'s tax credit for federal itemized deductions **would offer little or nothing to most low-income families**. The 40 percent of Louisiana families earning less than $24,000 would receive less than 1 percent of the state tax cuts from HB 30's tax credit. The 20 percent of upper-income Louisianans earning more than $69,000 a year would receive more than two-thirds of the state tax cuts.
- **HB 59**'s $75 per child tax credit **would target tax cuts much more effectively** to the low- and middle-income families who are hit hardest by the current tax system. All families with eligible children would receive tax cuts, but these cuts would be much more valuable, as a share of income, to fixed-income families.

The dramatic difference between the impact of these two proposals is primarily due to two features of the bills. First, HB 59's tax credit is refundable, which means that the credit is available to low-income families who pay much of their income in regressive sales, excise and property taxes, but owe little or no income tax. HB 30's tax credit is non-refundable, which means that many low-income families would be ineligible for this credit. A second important feature distinguishing these credits is that HB 30's tax breaks would only be available to the 20 percent of (mostly upper-income) Louisiana families who itemize their federal income tax returns. The remaining 80 percent of Louisianans would receive nothing from HB 30. By contrast, HB 59's tax breaks would be available to families at all income levels. As a result, HB 30 would make the state's tax system even more regressive, while HB 59 would make the tax system somewhat less regressive.

Interaction With Federal Tax System Would Reduce Benefits of HB 30

Louisiana families who itemize their federal income taxes can write off their Louisiana state income taxes as an itemized deduction. As result, when Louisiana state income taxes go up, federal income taxes paid by itemizing Louisianans go down (because they have more state income tax to write off). One often-ignored consequence of this interaction is that state income tax cuts for upper-income families will generally result in federal tax hikes for the same families. HB 30's tax changes would reduce Louisiana income tax collections by over $100 million in 2006—but would increase federal income taxes on Louisianans by about $17 million. In other words, **17 percent of the tax cuts from HB 30 would never see the inside of Louisianans' wallets at all**, but would go immediately to the federal government.

What's In Your Wallet?

% of Tax Cuts Lost to Federal Gov't

- ☞ HB 30: **17%**
- ☞ HB 59: **4%**
- ☞ EITC: **0%**

Because HB 59's tax breaks are geared more toward low- and middle-income families who are less likely to itemize their federal taxes, a much smaller share of HB 59's tax cuts (about 4 percent) would be offset by federal tax hikes.

If lawmakers want to ensure that the benefits of future state income tax cuts will go entirely to Louisianans rather than to the federal government, an even better approach would be to target income tax cuts to low- and middle-income working families exclusively. For example, lawmakers could follow the lead of 20 other states by enacting a state Earned Income Tax Credit. This approach would ensure that all the tax cuts enacted by Louisiana lawmakers would ultimately be received by Louisiana residents.

Strategies for a Fair Louisiana Tax System

Louisiana relies much more heavily on low-income families to fund public services than do most other states. The state's moderately progressive income tax is an important counterbalance to the regressive sales taxes that dominate Louisiana's revenue mix. Cutting state income taxes for upper-income families would make Louisiana's already-regressive tax system even more unfair—and could unwittingly send millions of dollars in Louisiana tax revenues to the federal government rather than to Louisiana families. As lawmakers consider tax reform issues in 2007, they should be mindful of these potential pitfalls of state income tax cuts.

About ITEP: ITEP is one of the leading research and education organizations in the country working on government taxation and spending policy. Since its founding in 1980, ITEP's work has played a key role in educating the public and informing federal and state tax policy. ITEP's website is http://www.itepnet.org .

The analysis presented here was conducted using the ITEP microsimulation tax model. Since 1996 ITEP has used this model to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data that is extrapolated to the year being analyzed. This is the type of tax model used by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, the Congressional Budget Office, and many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. Included in the sample are federal tax returns, with statistically valid samples from every state and the District of Columbia. A sampling of records from the U.S. Decennial Census five percent sample (which contains a random sample of five percent of all census forms received by the Census Bureau) are also included, and statistically matched with the tax return records. Other data sets are used to impute detailed expenditures for each record and other information. The data on the records is extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and government and other widely respected macro data sources. (A complete description and methodology for the ITEP model is available on request.)