Fair and Sustainable Tax Reform: Options for Louisiana

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Fair and Sustainable Tax Reform: Options for Louisiana

Louisiana lawmakers are in what appears to be an enviable position. At a time when legislators in many other states face daunting budget shortfalls, Louisiana enjoys a projected short-term budget surplus for the upcoming fiscal year.

But Louisiana's tax system remains troubled in one important sense. It is profoundly unfair, imposing much higher effective tax rates on low- and middle-income families and individuals than on the very best-off Louisianans.

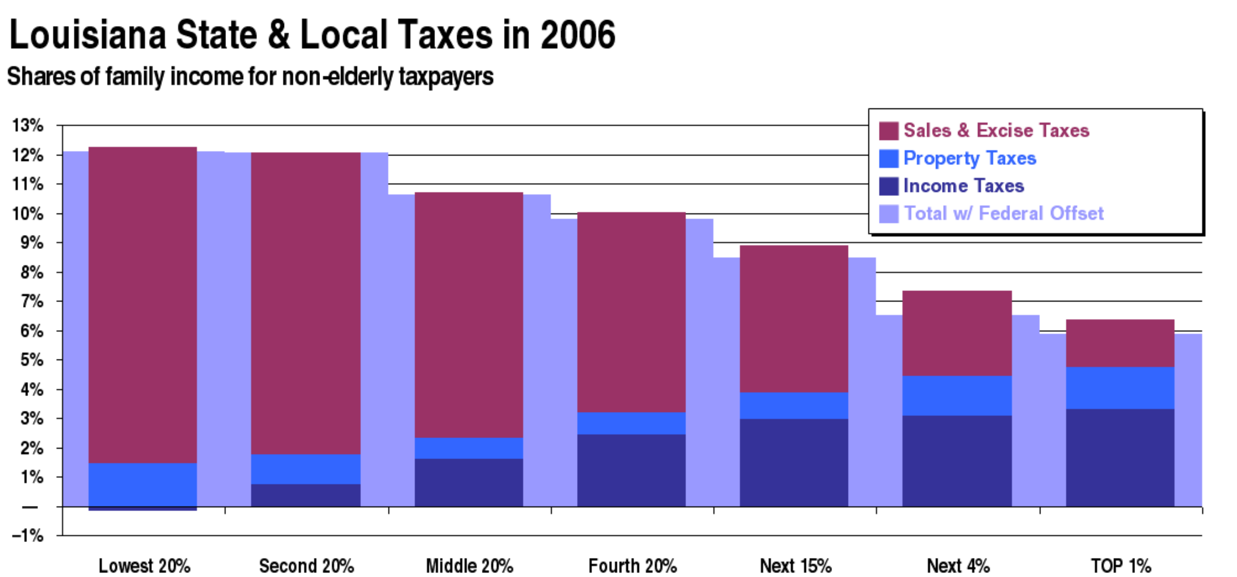
The projected surplus gives lawmakers a golden opportunity to reduce the unfairness of the Louisiana tax system. But, as this analysis shows, the tax-cutting measure recently approved by the House Ways and Means committee, Senate Bill 87, would cut state income taxes in a way that would actually make the state's tax system even more unfair.

This analysis assesses the impact of SB 87 on Louisiana tax fairness, and looks at a variety of other tax reform options, each of which could provide more meaningful tax cuts to middle- and low-income working families than would Senate Bill 87.

The Current Louisiana Tax System: Unfair to Working Louisianans

A useful starting point for assessing options for cutting taxes in Louisiana is to consider who pays Louisiana taxes under current law. ITEP's Microsimulation Tax Model is able to analyze the overall impact of state and local taxes—including income, sales, excise and property taxes—on Louisiana families at different income levels. The following chart shows the results of this analysis for non-elderly Louisiana families in 2006:

- The poorest twenty percent of non-elderly Louisianans, with incomes averaging $8,000 in 2006, paid 12.1 percent of their income in Louisiana taxes.
- Middle-income Louisianans paid 10.7 percent of their income, on average, in Louisiana state and local taxes.
- The very best-off one percent of non-elderly Louisianans paid only 6.4 percent of their income in state and local taxes.



- After taking into account the ability to write off state taxes on federal tax forms, the effective tax rate (that is, the share of income paid in state and local taxes) on the wealthiest 1 percent of Louisianans was 5.9 percent.
- In other words, **the best-off Louisianans currently pay less than half as much of their income in Louisiana taxes as middle- and low-income Louisiana families must pay**.

How Louisiana Stacks Up: Low Income Taxes, High Sales Taxes

The main reason for the unfairness of Louisiana taxes is that the state relies very heavily on the sales and excise taxes that hit low-income families hardest, and relies relatively little on income taxes. The following table compares Louisiana taxes to nearby states, and to the national average, for fiscal year 2006.[1] The chart shows that **while some Louisiana taxes are above the national average, the personal income tax is not among them**:

- Louisiana's personal income taxes were 2.0 percent of statewide personal income in 2006, 20 percent below the national average and 35th highest in the nation (out of 42 states that levy broad-based income taxes).
- By contrast, Louisiana's sales and excise taxes were the highest in the nation, taking 7.1 percent of Louisianans' income. Overall, state and local sales and excise taxes in Louisiana were 83 percent above the national average.
- Louisiana property taxes were 41 percent below the national average, ranking 44th highest in fiscal year 2006.
- "Other" taxes – that is, taxes besides income, property, and sales taxes – were 10 percent higher in Louisiana than the nationwide average. This is because oil and gas production is a key component of the Louisiana economy; consequently, Louisiana collects more in taxes levied on natural resource extraction than most other states.

Louisiana Taxes as a % of Personal Income in 2006

	Personal Income Tax	Rank	Sales & Gross Receipts Taxes	Rank	Property Taxes	Rank	Other Taxes	Rank
Alabama	2.1%	34	4.4%	15	1.4%	50	1.3%	24
Arkansas	2.6%	25	6.0%	5	1.7%	46	1.0%	43
Louisiana	2.0%	35	7.1%	1	2.0%	44	1.6%	16
Mississippi	1.6%	40	5.2%	8	2.7%	34	1.1%	33
Oklahoma	2.5%	31	3.8%	26	1.6%	49	2.2%	8
Texas	—	44	4.3%	16	4.1%	11	1.2%	31
All States	2.5%		3.9%		3.4%		1.5%	
Addendum: Louisiana Compared to National Average								
	–20%		**+83%**		**–41%**		**+10%**	

Source: Bureau of Economic Analysis; Bureau of the Census

[1]Fiscal year 2006 is the most recent year for which complete state/local data is available.

Options for Tax Cuts in Louisiana

As the previous sections have shown, Louisiana's taxes currently fall much more heavily on low- and middle-income families than on the very best-off Louisianans. This section describes several tax-cutting options available to Louisiana lawmakers, including Senate Bill 87, a measure recently approved by the House Ways and Means Committee and likely to be considered by the full House of Representatives in the coming weeks.

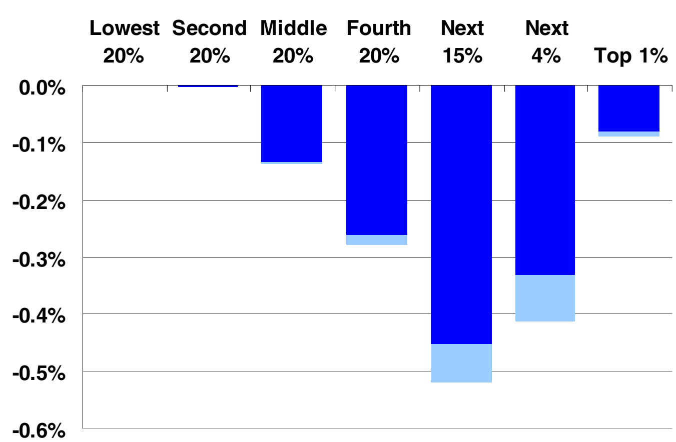
For each option described below, the accompanying bar charts show the impact of the option, expressed as a share of family income, on various Louisiana income groups. The dark portion of each bar represents the net tax change (after taking federal tax changes into account) for each income group. The lighter portion of each bar shows the full impact of the option *before* consideration of federal tax changes. The data are presented in this fashion because Louisianans who itemize deductions on their federal income tax returns tend to experience changes in their federal tax liabilities whenever state income taxes change. (Appendix I provides more detailed information on the impact of each option.)

These changes can often be quite significant. For instance, suppose an itemizing Louisiana taxpayer in the 28 percent federal income tax bracket receives a $1,000 state income tax cut. Her federal itemized deductions will fall by $1,000. Consequently, $1,000 *more* of her income will be subject to federal taxation after the Louisiana tax cut. Since this last increment of income was originally taxed at 28 percent, her federal taxes increase by $280, meaning that her *overall* tax cut is actually $720, not $1000. Thus, an analysis that examined only the *state* impact of the proposal would overstate the tax cut for some Louisianans.

1. Senate Bill 87: Reduce the Top Income Tax Bracket

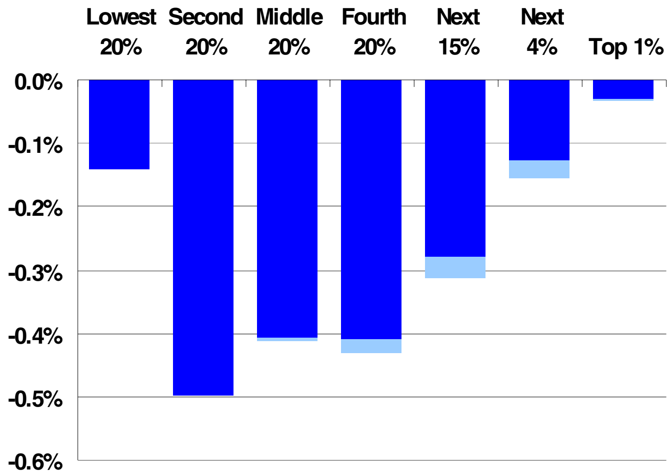
SB 87, as approved by the House Ways and Means Committee on May 14, would repeal part of the 2002 "Stelly Plan," raising the income levels at which Louisianans begin to pay the state's 6 percent top tax rate from $50,000 to $100,000 for married couples (and from $25,000 to $50,000 for singles). As a result, it would reduce the amount of income subject to the top tax rate. This proposal suffers from several flaws:

- Less than 40 percent of Louisianans would receive a tax cut under this proposal.
- More than a quarter of the benefits from this proposal would accrue to the best-off 5 percent of Louisianans, a group of taxpayers with incomes exceeding $138,000 in 2008.
- Although the proposal would reduce Louisiana income taxes by close to $300 million, the *federal* taxes on Louisianans would actually increase by $38 million if SB 87 were enacted, as federal itemizers living in Louisiana would have less state income tax to deduct from their federally taxable incomes. In other words, a substantial share of the state's revenue loss would never see the inside of a Louisianan's wallet.



2. Create a New "Zero Percent" Bottom Income Tax Bracket

A fairer and more far-reaching alternative to SB 87 would be to provide a tax cut to all Louisianans currently paying income taxes. There are several ways in which this could be accomplished, two of which are detailed here. First, creating a new "zero percent" income tax bracket would, for each and every Louisianan currently paying the income tax, effectively exempt a portion of their income from tax. In particular, taxing the first $14,000 of married couples' taxable incomes and the first $7,000 of single people's incomes at a zero percent rate would reduce state taxes by an amount comparable to SB 87—by just under $300 million per year —but would cut the taxes paid by working families in a much more meaningful way:



- The poorest fifth of Louisianans would see their taxes fall by 0.2 percent of income, on average. Individuals in the second quintile of the income distribution–with incomes between $14,700 and $26,100–would see an average tax cut equal to 0.6 percent of their incomes. SB 87, in contrast, would mean virtually no change at all in the taxes owed by the members of these income groups.
- Middle-class families would also do far better under this option than under SB 87. They would receive an average tax cut of $149 , more than three times the average tax cut they would experience if SB 87 were made law.

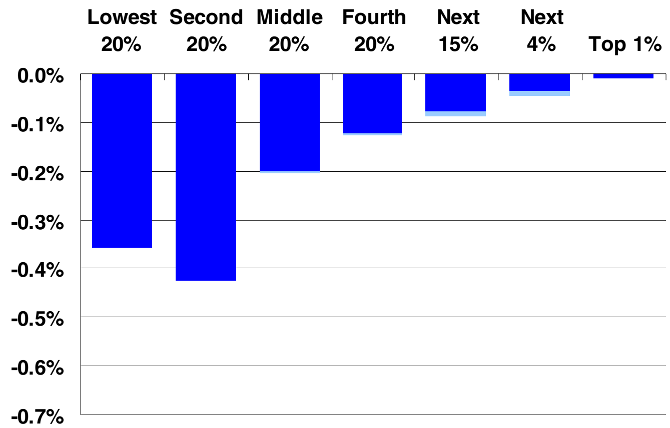
3. Cut the Tax Rate for the Bottom Income Tax Bracket in Half

Another way in which Louisiana policymakers could provide an across-the-board income tax cut would be to reduce the lowest income tax rate – which currently stands at 2 percent on the first $25,000 of taxable income for married couples and the first $12,500 for singles. Since, by definition, everyone now paying the Louisiana income tax pays some tax at the 2 percent rate, cutting that rate in half would ensure that their taxes would fall to some degree. The benefits of this plan could be extended even further by expanding the bottom tax bracket – for instance, by having it cover the first $32,000 of taxable income for married couples and the first $16,000 for singles.[2] The combination of these changes would reduce state revenue by an amount equal to the revenue loss incurred by SB 87, but would benefit nearly twice as many taxpayers. In addition:

- Like the "zero percent" bracket option described above, cutting the lowest income tax rate in half would ensure that the benefits of tax reduction would be more fairly

[2]This analysis assumes that this option would also change the way in which Louisiana's combined deduction/ exemption is applied to taxable income. However, such a change may not be possible at this stage in the legislative session due to state rules. In the absence of such a change, the cost of this option would grow, and its impact would likely shift in favor of upper-income taxpayers.

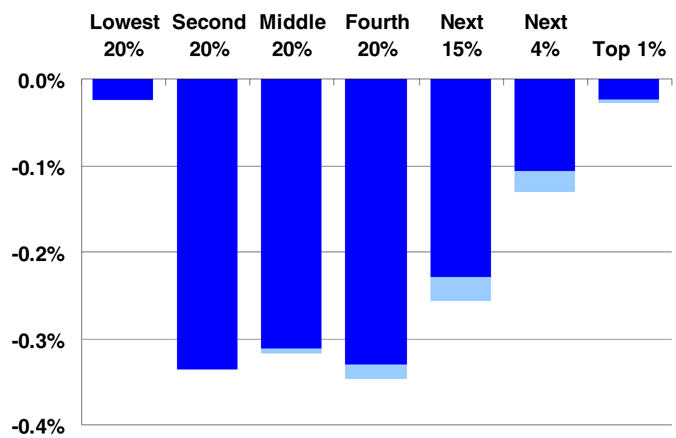
distributed than under SB 87. While SB 87 would mean almost no change at all in the taxes owed by the poorest 40 percent of Louisianans, this option would cut the taxes owed by the very poorest quintile by 0.1 percent of income and by the next poorest quintile by 0.5 percent of income.



- If the bottom income tax rate in Louisiana were cut to 1 percent and the bottom bracket were expanded, 60 percent of the benefits from those changes would go to taxpayers in the middle 60 percent of the income distribution, while the wealthiest 20 percent of taxpayers would realize about 39 percent of the benefits. Under SB 87, the best-off 20 percent of taxpayers would see 75 percent of the benefits.

4. Expand the Bottom Income Tax Bracket

Louisiana legislators could take yet another approach to reducing income taxes: rather than cutting the bottom tax rate, they could choose to expand the bottom bracket still further, so that it ended at $40,000 for married couples and at $20,000 for singles. The main effect of this change would be to reduce the amount of income (as well as the number of taxpayers) subject to the state's 4 percent middle income tax rate. In this respect, this option would resemble SB 87, which would reduce the amount of income (and the number of taxpayers) subject to Louisiana's 6 percent top rate. But this option would cut taxes for many more Louisianans than SB 87, and would also yield larger tax cuts for middle-income Louisianans than SB87, yet would do so at a lower cost to the state treasury. This option would reduce state tax revenue by roughly $250 million.



5. Expand the Bottom Income Tax Bracket and Increase the EITC

One final option for reducing the personal income tax in Louisiana would be to expand the bottom income tax bracket but, at the same time, to bolster the state's earned income tax credit (EITC). Raising the income level at which Louisianans begin to pay the 4 percent income tax rate – to $30,000 for married couples and to $15,000 for singles – while doubling the value of the EITC from its present level of 3.5 percent of the federal EITC to 7 percent of that credit – would cost half as much as SB87 but would reach many more

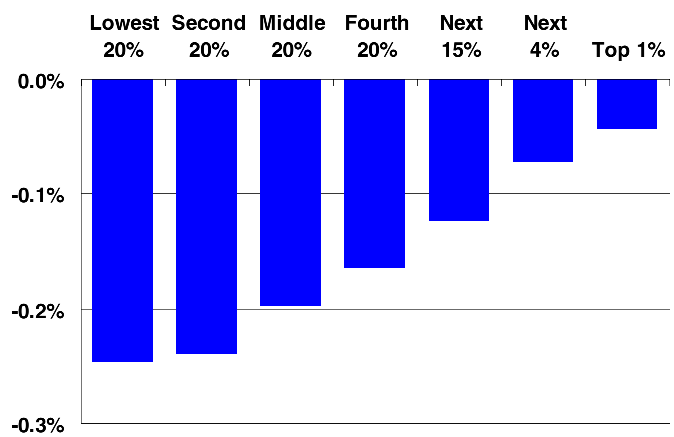
Louisianans. State finance rules barring the consideration of changes in state tax credits at this stage in the legislative session might pose a barrier to this option, but it would nevertheless provide the most help to working Louisianans struggling with higher fuel, food, and other prices. Of note:

- This option would provide a tax cut to more than three-quarters of all Louisiana taxpayers.
- Over half of the benefits from this option would flow to the bottom 60 percent of Louisianans – those with incomes below $43,300 in 2008. The wealthiest 5 percent of Louisianans would realize only 6 percent of the benefits from this option.
- Due to its comparatively small cost, and since many of its recipients would be non-itemizers who would not experience a change in federal taxes owed, this option would lead to a federal tax increase of just $6 million for Louisiana residents.

6. Reduce the State Sales Tax Rate

As noted earlier, state and local sales and excise taxes are higher in Louisiana than in any other state in the nation. This has profound consequences for tax fairness in Louisiana, since sales and excise taxes hit low-income families hardest. Low-income individuals and families often must spend every dollar they earn just to get by, thus subjecting a much larger fraction of their incomes to sales taxes than is the case for upper-income taxpayers. Thus, one common sense option for reducing taxes and for enhancing tax equity would be to drop the state sales tax rate from 4.0 to 3.75 percent.

- While every income group would see a tax cut from this option, low- and moderate-income families would see the most meaningful tax cuts.
- This option would also help restore balance to the Louisiana tax system, which currently relies heavily on sales taxes.



Summary

Louisiana legislators face what appears to be an enviable choice: how best to cut taxes in the face of a budget surplus. But at the same time, they must confront an important challenge: how best to improve the fairness of the state's tax system. As the analysis above indicates, Louisiana's tax system is extremely regressive, imposing an effective tax rate on poor Louisianans that is twice the rate levied on the rich. Louisiana's House of Representatives is poised to consider a bill, Senate Bill 87, that would actually make this challenge even more daunting, as it would drive most of its $300 million in benefits to the very best-off Louisianans. But, as this paper has shown, other options – such as expanding the state's lowest income tax bracket or reducing its sales tax rate – would more directly respond to this challenge and provide working Louisianans substantially larger tax cuts.

Appendix I: Comparing the Impact of Tax-Cutting Options

Impact of Louisiana Tax Reform Options *All Louisianans, 2008 income levels*							
2008 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $14,700	$14,700 – $26,100	$26,100 – $43,300	$43,300 – $72,600	$72,600 – $138,200	$138,200 – $351,200	$351,200 – Or More
Average Income in Group	$ 8,800	$ 19,200	$ 33,400	$ 55,100	$ 97,400	$ 206,200	$ 975,100
OPTION 1 (SB 87): Increase the starting point for the top (6%) income tax bracket to $100,000 for married couples and to $50,000 for singles/heads of households							
Tax Change as % of Income	—	–0.0%	–0.1%	–0.3%	–0.5%	–0.4%	–0.1%
Average Tax Change	—	–0	–46	–153	–507	–851	–877
Share of Total Tax Change	—	0%	6%	19%	48%	22%	5%
OPTION 2: Create a new bottom income tax bracket with a 0% rate for income up to $14,000 for married couples and $7,000 for singles/heads of households							
Tax Change as % of Income	–0.2%	–0.6%	–0.4%	–0.4%	–0.3%	–0.1%	–0.0%
Average Tax Change	–19	–116	–149	–209	–246	–260	–251
Share of Total Tax Change	3%	15%	21%	28%	25%	7%	2%
OPTION 3: Reduce the lowest income tax rate rate from 2% to 1%; increase the end point for the bottom bracket to $32,000 for married couples and to $16,000 for singles; ensure that the combined standard deduction/personal exemption contiues to apply to the bottom bracket							
Tax Change as % of Income	–0.1%	–0.5%	–0.4%	–0.4%	–0.3%	–0.2%	–0.0%
Average Tax Change	–12	–95	–138	–237	–304	–321	–318
Share of Total Tax Change	2%	12%	18%	30%	29%	8%	2%
OPTION 4: Increase the end point for the bottom (2%) income tax bracket to $40,000 for married couples and to $20,000 for singles/heads of households							
Tax Change as % of Income	–0.0%	–0.3%	–0.3%	–0.3%	–0.3%	–0.1%	–0.0%
Average Tax Change	–2	–65	–106	–190	–251	–270	–264
Share of Total Tax Change	0%	10%	17%	31%	30%	9%	2%
OPTION 5: Increase the end point for the bottom (2%) bracket to $30,000 for married couples and to $15,000 for singles/heads of households; raise the EITC from 3.5% to 7% of the federal credit							
Tax Change as % of Income	–0.4%	–0.4%	–0.2%	–0.1%	–0.1%	–0.0%	–0.0%
Average Tax Change	–32	–82	–68	–70	–85	–91	–88
Share of Total Tax Change	9%	24%	21%	21%	19%	5%	1%
OPTION 6: Reduce the state sales tax rate from 4.0% to 3.75%							
Tax Change as % of Income	–0.2%	–0.2%	–0.2%	–0.2%	–0.1%	–0.1%	–0.0%
Average Tax Change	–22	–46	–66	–90	–119	–149	–425
Share of Total Tax Change	6%	12%	19%	25%	25%	8%	6%

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.