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ELIMINATING LOUISIANA'S INCOME TAX WILL HARM THE STATE'S BUDGET OUTLOOK, COMPETITIVENESS

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On April 29, the Louisiana Senate voted to phase out the state's income tax over 10 years without proposing any replacement revenues. The House Ways and Means Committee is expected to consider this proposal, along with others that would significantly cut the income tax but not eliminate it, on Monday May 12.

The desire to cut taxes seems to be precipitated by a particularly rosy fiscal outlook in the state, as unprecedented high energy prices and post-Katrina construction have allowed Louisiana to largely escape the fiscal woes most other states currently are experiencing. Few experts, however, expect oil and gas prices to remain as high as they are now; the post-storm construction eventually will come to an end and already shows signs of tapering. Great care should be taken to consider the impact of a permanent elimination of the income tax on public services and the quality of life in the state. In addition, research suggests that the long-term competitiveness of a state requires strong infrastructure, schools, and amenities that the elimination of the income tax would put at risk.

Before embarking on major, permanent tax cuts, Louisiana should conduct a careful review of future revenue and expenditure projections, taking into account upcoming economic and demographic changes, possible future fluctuations in the price of oil, and the fiscal implications of various types of tax changes.

- **Eliminating the income tax would leave a huge gap in Louisiana's budget.** In fiscal year 2006-2007, the income tax brought in $3.1 billion, or 36 percent of total state tax revenue. This is more than the state spent on veterans' affairs, corrections, public safety and law enforcement, transportation, economic development, environmental quality, recreation and tourism, wildlife and fisheries, forestry, and youth services *combined*. It exceeds the state's combined general fund spending on higher education and health care.[1]

- **Eliminating the income tax would cause increases in other taxes.** The revenue to pay for needed state services has to come from somewhere. Not surprisingly, the nine states without income taxes tend to impose much higher taxes on sales and property. In 2002, Oklahoma considered the "Texas Plan," which would have abolished the state's income tax

[1] http://doa.louisiana.gov/OPB/pub/FY09/SupportingDocument/StatewideSummary.pdf

and created a tax system more like the one in Texas. The plan was rejected after a report by leading Oklahoma economist found that replacing the revenue would require either tripling property taxes, substantially expanding the base and increasing the rate of the sales tax, or creating a gross receipts tax.[2] In Florida, the heavy reliance on property taxes has led to tremendous discontent and repeated efforts to limit and cut property taxes. Overall, in the nine states without income taxes, property taxes average $1,245 per person in 2005, compared to $539 in Louisiana.[3]

- **Revoking the income tax would make Louisiana's tax system the fifth most regressive in the nation.** Low-income workers in Louisiana already pay higher taxes as a share of their income than upper-income people. In 2006, the highest-income 20 percent of Louisiana residents (those with income above $90,000) paid 7.9 percent of their income in state and local taxes, while the bottom 20 percent paid 12.1 percent — an effective tax rate one and a half times as large. Without the personal income tax, these disparities would be even greater. The bottom 20 percent of families in Louisiana would pay two and a half times as much as the top 20 percent as a share of income. By one estimate, Louisiana's tax system would be the fifth most regressive in the nation.[4]

- **Eliminating the income tax will increase the volatility of Louisiana's revenues.** Currently the taxes that Louisiana relies most heavily on to fund education, health care and other services are the income tax, the sales tax, and the severance tax. If the income tax were repealed, the state would become much more reliant on the sales tax and the severance tax. The increased importance of the severance tax in particular would reduce the stability of the state's revenue system over time. In the past, states that depend heavily on severance taxes have seen large swings in revenues from year to year — or even within budget years — as energy prices rise and fall. Currently, oil prices are rising sharply but their future trend is uncertain. As Louisiana State University Professor James Richardson has noted, "…states that use severance taxes to fund key programs need to be aware of the 'boom and bust' cycle associated with such revenues."

- **This year's experience around the country highlights the risk of over-reliance on sales taxes.** A broad and varied tax base is essential to stability in state tax systems. The more narrow a state's tax base, the more susceptible it is to wide swings when specific segments of the economy have problems. The experience of states with no income tax this year demonstrates this problem.

  States without income taxes have been hit as hard or harder than other states by the economic downturn. In particular, the sales taxes on which states with no income taxes rely heavily have been declining as consumption weakens throughout the economy. According to preliminary data reported by the Rockefeller Institute, nearly every state of the 41 they surveyed is collecting less sales tax revenue this year compared to last year after adjusting for

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[2] Robert Dauffenbach, Alexander Holmes, Kent Olson, David Penn and Larkin Werner, "Final Report: Revenue Neutral Tax Reform for Oklahoma: Issues and Options, a Study for Governor Frank Keating, Senate President Pro Tempore Stratton Taylor and House Speaker Larry Adair," June 2001.
[3] CBPP calculations from U.S. Census Bureau, Government Finances data.
[4] Institute on Taxation and Economic Policy calculations.

inflation.[5] Sales tax revenues in Louisiana are buoyed by post-Katrina construction, but even there revenue has slowed. After increasing by 50 percent between the fourth quarter of 2004 and the second quarter of 2006, sales tax revenue fell seven percent by the fourth quarter of 2007, and was flat over the last three quarters of 2007.[6]

Of the nine states without broad-based income taxes, two-thirds — Florida, Nevada, New Hampshire, Tennessee, Washington and Texas — are experiencing or anticipate budget problems this year or next.

The remaining three states have relied on budget reserves to balance their budgets. Alaska and Wyoming depend heavily on energy-related severance taxes which have grown as oil prices soar and have built up large budget reserves. South Dakota also balanced its budget by drawing down reserve funds.

- **A "surplus" does not indicate an ongoing increase in tax revenues that can be used to support a permanent tax cut; a surplus often reflects one-time revenue caused by special circumstances.** Reports of a state budget surplus may make the income tax repeal seem affordable. A surplus is temporary, however, while a reduction or elimination of the income tax is permanent. Surpluses occur when revenues come in stronger than the state estimated when the budget was enacted. Louisiana's recent surpluses result in large part from the increase in severance tax revenues following the huge recent rise in oil prices and from the post-storm increase in sales tax collections. Sales tax collection growth has already slowed and the future trend in energy prices is uncertain.

  It is particularly problematic to fund the first year or two of a phased-in tax cut with one-time money. Once the temporary funds are gone, the state must either cut spending or raise other taxes to both replace those revenues and continue to replace the revenues lost by the remaining steps of the tax cut.

  The use of funds should match their nature. One-time funds can be best used to build the state's rainy day fund or invest in infrastructure.

- **Eliminating the income tax would hurt the state's long-term competitiveness.** Most researchers find that reduced taxes can modestly spur economic growth. But the effect is quite small, and depends on holding expenditures on public services constant— which rarely is possible in the real world. And researchers also find that state expenditures on education, infrastructure, highways, and public health matter as much or more than taxes in determining economic growth rates. Reduced taxes that are accompanied by reductions in spending on services that benefit the economy and businesses can have a negative effect on economic growth.[7]

[5] Donald J. Boyd and Lucy Dadayan, "State Revenue Flash Report: Sales Tax Declines in Most States," May 2008, with CBPP adjustment for general inflation (CPI-U).
[6] Louisiana Legislative Fiscal Office, Revenue Estimating Conference Report, February 10, 2008.
[7] A recent interpretive survey of the literature by Northwestern University Economist Therese McGuire finds that the results of research on interregional differences in taxes is mixed; depending on the decade studied and the measures used, one can find significant effects of taxes on economic growth or not. Timothy Bartik, Senior Economist at the W.E. Upjohn Institute for Employment Research, finds that "Equally competent research projects may get widely divergent estimates of the economic development effects of fiscal variable." Literature that shows expenditures matter

> Business group also recognize the importance of state spending. According to Adam Knapp, president and chief executive officer of the Baton Rouge Area Chamber (BRAC) has said, "Funding LSU to become a top-tier research university is just as fundamental to our regional strength as having competitive funds for our business recruitment strategy."[8]

Before embarking on a repeal of the income tax (or even a major reduction of the tax), policymakers should understand fully the future ramifications. At a minimum, it would be prudent to have a 10-year projection of revenues and expenditures. Such a projection could be developed by the Louisiana Legislative Fiscal Office, perhaps under the direction of a legislative study commission.

The projection should take into account the fact that sales taxes grow more slowly than income taxes, and consider various scenarios of potential world prices for oil and gas. In addition, the projection should consider different scenarios of potential health care cost growth over the period, since health care expenses make up a major part of the state's budget, as well as attempt to accurately project the growth rates of other public services the budget supports. Finally, it should consider different scenarios of population growth as the state fully recovers from Katrina's devastation. The projection also should consider the impacts of various types of changes to the income tax (and potentially other taxes). Armed with such information, policymakers could make an informed decision about whether or not it would be a good idea to eliminate or substantially reduce the state's income tax.

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includes a well-regarded early study by Jay Helms, and a later review by Ronald Fisher. Economist Robert Lynch reviews the literature and finds that increases in taxes, when used to expand the quantity and quality of public services, may promote economic development and economic growth. Therese J. McGuire, "Do Taxes Matter? Yes, no, maybe so," *State Tax Notes*, Vol. 28 No. 10, June 9, 2003; Timothy Bartik, *New England Economic Review*, March/April 1997; Jay L. Helms, "The Effect of State and Local Taxes on Economic Growth: A Time Series-Cross Section Approach, *The Review of Economics and Statistics*, Vol. 67, No. 4, November 1985; Ronald C. Fisher, "The Effects of State and Local Public Services on Economic Development, *New England Economic Review*, March/April 1997; Robert Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development,* Economic Policy Institute, 2004.

[8] http://www.2theadvocate.com/news/politics/18791129.html