

Itemized Deduction for State and Local Income Taxes Costs Money We Can't Afford to Lose

Louisiana is in the midst of a crisis of historic proportions. Public needs are growing and the resources it takes to meet them have shrunk.

To date, the Governor and Legislature have relied almost exclusively on cutting services to keep the state budget in balance. Three years of this strategy have caused significant, long-term damage to institutions vital to Louisiana's future. Louisiana colleges and universities have eliminated hundreds of programs and dismissed hundreds of faculty. Financially strapped local taxpayers have had to pay more to operate their schools because state support has not kept up with inflation. Maintenance on roads, bridges, and state buildings has been deferred. The state is closing regional Medicaid offices and eliminating hundreds of jobs that service patients. And after all this, Louisiana is still looking at having \$1.6 billion less than it needs to maintain the current level of services in the coming fiscal year.

Although Louisiana has suffered along with other states in the recession and its aftermath, our current fiscal problems are mostly self-inflicted. They result from enacting the largest tax cuts in state history in 2007 and 2008. Louisiana has since then had over \$2 billion less to invest in education, health care, public safety, transportation, and other building blocks of a strong economy. These cuts were a non-partisan mistake that resulted in a fiscal disaster. The first was adopted during the last year of Democratic Gov. Kathleen Blanco's administration and the other passed in the first year of Republican Gov. Bobby Jindal's term. They have created a large gap between the cost of the services the state has promised its residents and the funds available to pay for those services.

To solve this crisis—to get Louisiana's budget out of the ditch—without further damaging institutions and reducing services critical to the state's future growth, will take more than a cuts-only strategy. Instead we need a more balanced approach, one that includes additional sources of revenues. This Research Note is the first in a series of revenue proposals aimed at helping Louisiana solve its problems in a responsible way that promotes job-creation and future prosperity.

Louisiana loses a significant amount of revenue each year due to a loophole on state income tax forms. As most people who pay federal income tax know, those who itemize deductions can reduce their taxable income by the amount of any state and local income taxes they paid in a year. Louisiana is one of only seven states (Arizona, Georgia, Hawaii, Louisiana, Oklahoma, North Dakota, and Vermont) that allow those who claim a deduction for state income taxes on their federal forms to also deduct at least a portion of what they paid in state and local taxes on their *state* forms.

This loophole arises because Louisiana's form for filing state income taxes piggybacks onto the federal form by allowing taxpayers to claim the same deductions claimed on their federal form. That means that those who itemize their deductions on their federal forms, primarily those with higher incomes, receive the bizarre benefit of being able to deduct from their income *for state tax purposes* amounts paid for state taxes. The federal government does not allow a deduction for amounts paid in income taxes to it, and the overwhelming majority of states do not allow a deduction for taxes paid to them.

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To avoid this bizarre result, most states have adopted an adjustment, called an “add-back” provision. Louisiana’s legislators can close this loophole, which is costing the state \$106 million a year in lost revenue, by adopting an “add-back” provision. This “fix” is simple—an extra line would be added on the state tax filing form to subtract these deductions so the state does not inadvertently provide deductions for its own taxes.

In Louisiana, closing this needless loophole would not only provide much-needed revenue, but also would make the state tax code more equitable. An add-back rule would affect only those who itemize their deductions, mostly people with above-average incomes because those with lower income often lack enough deductions to take advantage of itemizing. The Louisianans who don’t itemize already pay a greater share of their income in state and local taxes than do those with bigger incomes. Due in part to a heavy reliance on sales taxes for revenue, the 20 percent of families with the lowest incomes, those making around \$10,000 per year, pay an average of 10.4 percent of their income in state and local taxes, compared with just 5.2 percent (on average) for the highest income households in Louisiana who have average annual incomes of over \$1 million.

If the add-back provision were to become law, according to an analysis by the Institute on Taxation and Economic Policy (see table below), only 18 percent of Louisiana taxpayers would experience a tax hike. In fact, of the 60 percent of Louisianans with incomes less than \$49,000, only 3.3 percent would be affected. The impact on most taxpayers would be small. For example, a taxpayer with an annual income of \$64,000 would pay on average an additional \$30 in state income tax. People making well over a million dollars a year would see their state income taxes increase by \$2,044 on average—less than two tenths of one percent (see table below).

Add-Back Provision for State and Local Income Taxes in Louisiana							
	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
	Less Than \$16,000	\$16,000 - \$31,000	\$31,000 - \$49,000	\$49,000 - \$86,000	\$86,000 - \$170,000	\$170,000 - \$433,000	\$433,000 Or More
Average Income in Group	\$11,000	\$23,000	\$40,000	\$64,000	\$116,000	\$243,000	\$1,150,000
Tax Change as % of Income	-	+0.0%	+0.0%	+0.0%	+0.1%	+0.2%	+0.2%
Average Tax Change	-	\$0	\$6	\$30	\$129	\$457	\$2,044

Louisiana wouldn’t be the first to see the wisdom of an add-back provision. New Mexico created a personal income tax add-back provision in February 2010 that it expects will generate \$90.2 million the first full year that it is in effect. Earlier this year, Hawaii’s governor, describing the state deduction for state taxes as an “absurdity in the tax code,” called for lawmakers to eliminate the loophole.

The reasons for eliminating this bizarre “absurdity” from Louisiana’s tax code are clear:

- The provision makes no sense and costs the state over \$100 million a year.
- The vast majority of states do not allow this deduction.
- Repealing the deduction would make Louisiana’s income tax system more equitable by eliminating a tax benefit for upper income households whose tax share is already lower than that of lower income taxpayers.

In this time of crisis, Louisiana needs to take a more balanced approach to addressing the gap between state needs and state revenues. For policymakers, generating additional revenues by closing this state tax deductibility loophole would be a good start.

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About the Louisiana Budget Project

The Louisiana Budget Project (LBP) provides independent, nonpartisan research and analysis of Louisiana fiscal issues and their impact on Louisiana families and businesses. We seek to bring wider prosperity to Louisiana through a deeper understanding of the state budget, broadening fiscal policy debates, and increasing public participation in decision-making. As part of the State Fiscal Analysis Initiative’s 40 state budget projects that are coordinated by the national Center on Budget and Policy Priorities, we uphold a commitment to issuing work that is Credible, Timely, and Accessible.