BRIEF

TAX SWAP IS NOT REFORM

Louisiana Budget Project

SUMMARY

Louisiana's tax structure fails its citizens in two fundamental ways: First, it does not raise enough revenue to support people and communities by adequately funding good schools, reliable infrastructure and a strong safety net. Second, it is regressive - meaning low-income households pay taxes at higher rates than those at the very top. This is because Louisiana has very high sales taxes (which eat up a disproportionate share of household income for low-income people, who must spend more of their take home pay on immediate needs than their wealthier neighbors) and comparatively low income taxes (where the top rate applies to higher incomes, and therefore charge high-income households the most).

A proposed constitutional amendment on the Nov. 13 statewide ballot represents the most significant tax policy change in almost two decades. Unfortunately, Amendment 2 would do almost nothing to make our tax system more fair - and would make it harder to raise the revenue we need to ensure our teachers are paid adequately, all citizens have access to quality health care and families have the support they need to thrive.

Amendment 2 would eliminate an expensive tax break which mostly benefits corporations and wealthy people, that is part of our state constitution and that is nearly unique to Louisiana. In exchange for ending this costly deduction, however, the amendment would cut income-tax rates for people and corporations and would also reduce a franchise tax paid by corporations. The amendment also would cap the state individual income tax rate at 4.75%, which means it could not be changed without amending the state's constitution with another vote of the people.

In effect, Amendment 2 trades a tax loophole that helps the rich for tax cuts that help the rich, while making it harder for Louisiana to pay for the schools, roads, health care, and safety net programs that benefit all of us.

Should the amendment become law, it could also lead to across-the-board tax cuts in future years if Louisiana's economy reaches certain growth targets. This means tax cuts would take priority over other potential needs in the state budget.

With failing infrastructure, poor educational outcomes, and 1 in 4 of our state's children living in poverty, Louisiana has many pressing needs. Amendment 2 would make it harder for the state to address them.

BACKGROUND

Louisiana is one of only two states that allow people and corporations to deduct all the federal income taxes they pay from their state taxable income—a policy that has been part of the state constitution since 1974. (Alabama is the other). In 2019-20, the deduction cost the state an estimated [$796 million in lost revenue] that otherwise would have been paid in taxes. Most of this tax break benefited the wealthiest households and corporations in the state, making Louisiana's tax system more regressive.

In addition to costing the state a lot of money, the federal income tax (FIT) deduction leaves Louisiana's tax system vulnerable to changes in federal tax policy. That's because the value of the deduction rises and falls based on how much people owe in federal taxes. When the federal government raises the income tax, Louisianans get a bigger tax break and pay less money into the state treasury. When federal taxes are cut, the value of the deduction goes down and the state government in Baton Rouge collects more revenue.

For these reasons - cost and volatility - economists across the ideological spectrum have advocated doing away with the federal income tax deduction. Eliminating the deduction is at the heart of the tax-swap amendment.

But there is a lot more to this proposal that isn't clear from the language on the ballot.

WHAT'S IN THE TAX SWAP?

The ballot language for Amendment 2 is fairly simple. It reads:

> ***"Do you support an amendment to lower the maximum allowable rate of individual income tax and to authorize the legislature to provide by law for a deduction for federal income taxes paid?"***

But the amendment actually authorizes a package of four bills approved in the spring 2021 legislative session, all of which would only take effect if voters approve the amendment. The ballot language tells us very little about what the four bills actually do:

Act 134 (Senate Bill 159) - Constitutional amendment - income tax

- Caps the top income-tax rate for individuals at 4.75% (down from 6% in current law);
- Changes the constitution to allow for a federal income tax deduction in state law, instead of requiring the deduction

Act 395 (House Bill 278) - Personal income tax

- Eliminates the federal income tax deduction
- Allows for deductions of some medical expenses, but eliminates the ability to deduct "excess" federal itemized deductions on state taxes
- Cuts personal income tax rates across the board, with the biggest cuts coming on the top rate
- Includes a "trigger" for automatic additional tax cuts if certain economic conditions and revenue thresholds are met
- **Annual revenue impact: (Negligible)**

INDIVIDUAL INCOME TAX RATE CUTS IN HOUSE BILL 278		
Income bracket*	Current tax rate	Proposed tax rate
$0-$25,000	2%	1.85%
$25,000-$100,000	4%	3.5%
<$100,000	6%	4.25%

*Married couples filing joint returns

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Act 396 (House Bill 292) - Corporate income tax

- Eliminates the federal income tax deduction for corporations
- Reduces the number of corporate income tax brackets and lowers the rates:

CORPORATE INCOME TAX RATE CUTS IN HOUSE BILL 292			
Current brackets	**Current rates**	**Proposed brackets**	**Proposed rates**
$0-$25,000	2%	$0-$50,000	3.5%
$25,000-$50,000	4%		
$50,000-$100,000	6%	$50,000-$150,000	5.5%
$100,000-$200,000	7%		
<$200,000	8%	<$150,000	7.5%

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The bill also cuts tax rates for "Subchapter S" corporations (small businesses) that choose to file as corporations, making their rates the same as those for personal income taxes. **(Annual revenue impact: $29 million per year in new revenue)**

Act 389 (Senate Bill 161) - Corporate franchise tax

Louisiana currently levies a franchise tax on corporations, which is charged as a percentage of a company's net worth. Unlike corporate income taxes, which are a tax on corporate profits, companies pay the franchise tax as a fee for doing business in a state. Louisiana companies owe $1.50 per $1,000 on the first $300,000 of taxable capital, and $3 per $1,000 of taxable capital above $300,000. The bottom tier of the tax is currently suspended through 2022.

Act 389 would permanently eliminate the franchise tax on the first $300,000 of taxable capital, and reduce the franchise tax on capital above that threshold to $2.75 per $1,000. The law also includes a trigger for additional tax cuts if certain revenue thresholds are met. **(Annual revenue impact: $56 million per year in lost revenue)**

The Legislative Fiscal Office estimates that the overall tax package will result in a $27 million per year revenue loss for the state once it's fully implemented. The effect of the plan will vary for individual taxpayers, but most people will not see a significant change in the overall taxes they pay. The fiscal office estimates that most people who don't itemize deductions on their state tax returns will see a modest tax cut, with the exception of people with very high incomes (more than $900,000 per year) who will see a small increase. The vast majority of households that itemize deductions - which make up a relatively small percentage of all taxpayers - will see an overall tax increase.

It's a similar story for corporations. The Fiscal Office estimates that 85% of Louisiana corporations that report a profit will see a small tax increase, while a small number of very large, profitable companies would pay more income taxes. By contrast, virtually all Louisiana companies would pay less in corporate franchise taxes.

PROBLEMS WITH THE TAX SWAP

The tax swap on the ballot offers voters the prospect of technical improvements in the state tax system at the cost of Louisiana's ability to invest in critical priorities in the future.

Erasing the requirement for a federal income tax deduction from the state constitution will make

Louisiana's tax system more predictable and less prone to large fluctuations in state income-tax revenue. Although revenue estimates will always be just that - a prediction, based on the best available economic data - future governors and legislators will have an easier time forecasting how much income-tax revenue the state will collect from year to year, and will no longer be vulnerable to fluctuations due to changes in federal tax policy. This change would reduce the possibility of mid-year budget cuts (which happen when revenue forecasts are too optimistic) and large budget surpluses (which occur when forecasts are too low).

But the price of this stability is high, as it comes with short- and long-term implications for Louisiana's ability to provide services that citizens need and expect.

It cuts revenue: The tax swap package was designed to be "revenue-neutral," meaning it is supposed to raise the same amount of tax revenue as Louisiana does under the current system. But this bill is not revenue neutral. The Legislative Fiscal Office estimates that the package will result in a $27 million per year net revenue loss. While that may not seem like much in the context of a $10 billion state general fund, it is more than the state spends each year on the Department of Veterans Affairs ($12 million) the governor's executive office ($8 million) and the Governor's Office of Homeland Security and Emergency Preparedness ($3.2 million) - combined.

Unlike the federal government, which can borrow money to finance government services, Louisiana is required to maintain a balanced budget every year. Every dollar the state cuts in taxes is a dollar that isn't available to invest in education, or health care, or public safety or any of the other services people expect from their state government. Instead of cutting taxes, the state should be looking for ways to increase revenues — and to do so fairly — so that we can make new investments in people to drive our economy forward.

It mostly maintains the status quo: The status quo was failing Louisiana families long before anyone had even heard of Covid-19. Before the pandemic, 51% of Louisiana households were struggling to make ends meet. Louisiana trails only Mississippi in the percentage of people living below the poverty line and the percentage of kids in poverty. The situation is worse for communities of color: More than 4 in 10 Black children in Louisiana live below the federal poverty line. The pandemic exacerbated these numbers as hundreds of thousands of Louisianans abruptly lost their jobs through no fault of their own, forcing many families into unpredictable financial situations.

Compared to other states, Louisiana's state government is small when measured as a share of the overall state economy. And because it relies heavily on sales taxes and comparatively little on personal income taxes, Louisiana's tax structure is regressive, meaning people with low- and moderate incomes pay a higher percentage of their income in state and local taxes than people with higher incomes.

The tax swap package would mostly preserve that status quo. That means Louisiana will keep struggling to pay its public school teachers, whose average salaries are $3,000 below the Southern Regional average, public colleges and universities will remain underfunded, and funding for early childhood education will continue to be scarce.

It makes future reforms more difficult: Raising revenues to support public investments is always difficult under the best of circumstances. Louisiana already makes it harder to raise revenues than in most states by imposing a supermajority requirement (two-thirds majorities in the House and Senate) to raise taxes or fees. Putting a constitutional cap on the state income tax means that future legislators would have to get a supermajority of both houses of the Legislature - plus a favorable vote of the people - if they wanted to use the personal income tax to raise more revenues.

While it takes a supermajority to raise revenue, it only takes a majority vote of the Legislature to cut the budget. In other words, it's much easier to raise the cost of a college education by reducing the amount of state support for public colleges and universities than it is to keep college affordable for everyone by raising the revenue our state schools need to operate.

State constitutions are [supposed to serve as a guiding charter] that lay out the rights granted to citizens and the powers and responsibilities of the different branches of government. But Louisiana's constitution has been amended more than 200 times since it was first adopted in 1974, and has become cumbersome and unwieldy.

While it's a good idea to take the federal income tax deduction out of the state constitution, it's a bad idea to put a 4.75% cap into the same document.

It prioritizes future tax cuts over needed investments: The personal income tax bill (HB 278) and franchise tax bill (SB 161) both include tax reduction "trigger" language that would require automatic additional tax cuts if certain economic and budget conditions are met. Similar triggers have been enacted in other Southern states, including North Carolina, Missouri and Oklahoma, many of which have confronted budget shortfalls as a result. While these tax cut triggers are often framed as fiscally responsible legislation, there is nothing responsible about forcing a future tax cut.

Legislators are not fortune tellers, and have no way of knowing when future recessions, natural disasters or pandemics will take place. Nor do they know whether future legislators will want to prioritize tax cuts over investments in public schools, teachers, infrastructure, public health or other priorities. A tax cut trigger essentially means that tax cuts take priority over everything else under certain conditions.

Tax cut triggers not only prevent legislators from making new investments during good years, but can also deepen a state's fiscal turmoil during lean years. Since many tax reduction triggers - including the one proposed for Louisiana - are based on metrics from previous fiscal years, they can create a false sense of financial stability when a state's economic situation begins to worsen. In worst case scenarios, they could trigger revenue and spending cuts in the midst of a recession - or in Louisiana's case, a major natural disaster - due to economic growth from previous years, drastically reducing the state's ability to respond to emerging needs.

The Legislature laid out a three-part test that must be met before income-tax rates can be cut:

1. The balance of the Budget Stabilization Fund ("rainy day fund") must be at least 2.5% of total state spending.

2. Personal income tax collections from the previous year have to exceed the state's "growth factor," which is the average growth in personal income of the previous three years; and

3. Total collections of taxes, licenses and fees have to exceed the state's growth factor.

In an effort to gauge how the trigger might affect Louisiana in the future, LBP analyzed what would have happened if the trigger language had been in place for the past 15 years (2006 to 2020). Louisiana would have come uncomfortably close to hitting the trigger several times, but would not have met all three benchmarks in a single year.

- The "rainy day fund" benchmark would have been hit five times over that period (in fiscal years 2006, 2009, 2010, 2011 and 2012);

- The other two triggers (tax collections that exceed the state "growth factor") would have been hit twice - in fiscal years 2007 and 2008.

MOVING FORWARD

Any reform of Louisiana's tax structure should start with two simple questions:

1. Does the current system raise enough revenue to fund the type of schools we want, the infrastructure we deserve, and the public safety net that families need when they fall on hard times?

2. Is our tax system fair to everyone, by ensuring that those with the greatest means pay higher rates than families that struggle?

Right now in Louisiana, the answer to both of these questions is no. And the Legislature's latest attempt at "reform" won't change that.

Real tax reform means getting rid of tax breaks, deductions and other breaks that favor the rich, and using part of that revenue to bring down the state sales tax. It means being willing to raise enough revenue to ensure that our teachers are no longer lagging behind their Southern peers, that our colleges are well-resourced and affordable, and that every Louisianan, regardless of race or income, has access to quality health care in their community.

Louisiana can - and must - do better.

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The Louisiana Budget Project (LBP) monitors and reports on public policy and how it affects Louisiana's low- to moderate-income families. We believe that the live of Louisianans can be improved through profound change in public policy, brought about by: creating a deeper understanding of the state budget and budget-related issues, looking at the big picture of how the budget impacts citizens, encouraging citizens to be vocal about budget issues that are important to them and providing insight and leadership to drive the policy debate.

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