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Louisiana Fiscal Reform: A Framework for the Future

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Executive Summary

Louisiana convened its 2015 legislative session with seemingly insurmountable problems: a $1.6 billion budget shortfall, difficult-to-navigate funding dedications, and a governor who pledged he wouldn't increase taxes. If that combination seems intractable, it was—the session closed with a patchwork of short-term, temporary fixes to plug the budget hole with promises that legislators would be back in the next legislative session to focus on fiscal issues.

Louisiana has reached a fiscal reform crossroads. While the most recent legislative session shows that short-term budget fixes are not tenable, the exercise pushed many to ask the right questions. How can the tax and fiscal system be updated to reflect a changing economy? Why, in the midst of economic expansion, are tax collections failing to meet the state's needs?

Over the course of five months, our team of tax economists met with stakeholders from all walks of Louisiana life, including small business owners, local government officials, trade associations, industry representatives, state officials across the political spectrum, and ordinary taxpayers. We also reviewed the history of the fiscal system, previous tax reform studies, and historical revenue and economic trends.

The result is this book, which is meant to help Louisiana achieve the goal of true fiscal reform—reform that benefits all taxpayers by addressing the many long-term hurdles the state budget has faced, finally bypassing the need for temporary fixes. It's meant to start the conversation about what Louisiana does well, but also what it could do better—by recognizing strengths, diagnosing challenges, and prescribing real, workable solutions.

We undertook this project as an independent national organization familiar with tax developments in many states, with the view that tax systems should adhere to sound economic principles. We formulated these recommendations in the spirit of providing useful information and observations for Louisiana policymakers, journalists, and citizens as they evaluate the state's fiscal system.

The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate the public on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

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During our meetings, several themes arose:

- Louisiana needs a tax structure that mitigates the volatility of the economy and current fiscal system, providing revenues that grow with the economy. The state economy is diversifying, and the tax system needs to reflect this new environment—something that the current tax code does not.

- The Louisiana fiscal system faces a long term structural deficit. Any changes to the tax code need to address this reality so that the state no longer requires short-term, temporary fixes to plug unexpected budget shortfalls each year. Louisiana lawmakers, both state and local, require an increased degree of flexibility in raising revenue and cutting costs. For example, state legislators are limited by the high level of dedications in the state's fiscal system, while local officials are hindered as a result of strict state-imposed limitations on raising revenue. These problems and their implications deserve thoughtful deliberation.

- Louisiana's fiscal system desperately needs administrative improvement. In particular, lawmakers should consider removing multiple duplicative tax regimes by unifying state and local sales tax collections, tax administration, and tax bases under an independent, state-local commission. By doing so, the state would be able to take advantage of increased sales tax revenues collected on remote transactions when federal online sales tax legislation is inevitably passed.

- Most of the state's taxes suffer from narrow bases. Some of this problem stems from the partial repeal of the Stelly Plan, but it has also been exacerbated by the generous use of tax incentive programs, the shifting nature of consumption from brick-and-mortar stores to online venues, and the failure of the sales tax to apply to services, which are a large and growing share of the American economy. While base expansion is a laudable goal, it should be done carefully to ensure economically detrimental changes are not enacted.

- Above all, the tax system should retain elements that ensure Louisiana improves its competitiveness in both the national and global arena.

In the following pages, we provide background on Louisiana's economy (Chapter 1) and on the overall fiscal system (Chapter 2). We then review each major tax, outline concerns, and propose alternatives (Chapters 3, 4, 5, and 6). Chapter 7 proposes some additional reform ideas that fall outside of these four major tax types.

The Committee of 100 commissioned the Tax Foundation to prepare this review of the Louisiana tax system and recommend possible solutions. While they supported our study, neither the Committee nor any of its sponsors directed this analysis or any of the recommendations.

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A Menu of Tax Reform Solutions

Sales Taxes

Louisiana's sales tax is one of the most unique and challenging of any in the country. Business owners note how the cumbersome system is one of the chief tax elements holding the state back. However, it is also important to acknowledge how important the sales tax is to local government operation, and to be mindful of concerns about the impacts of possible changes.

Our **sales tax solutions** eliminate duplicative tax collection and administration and simplify the tax base, making Louisiana eligible for collection of tax on remote transactions when federal legislation (such as the Marketplace Fairness Act or the Remote Transactions Parity Act) is enacted. Moderate base broadening options are also included.

We've provided three different alternatives for lawmakers to consider, some more expansive than others. Unification changes are administrative and thus would be revenue neutral, apart from implementation costs, while sales tax base expansion would increase revenue. If a net increase or decrease in revenue is desired, the tax rates in each option can be dialed up or down, respectively, to achieve a tax cut or tax increase.

Option A would move Louisiana from one of the most challenging tax codes in the country to one that is streamlined and has low compliance costs. It would modestly broaden the tax base as well. Option A would:

- Unify state and local sales tax collections and audits by creating an independent, joint-run state-local sales tax authority composed of representatives from local tax collection bodies and the state department of revenue. This unified collection and audit commission would make Louisiana compliant with pending federal legislation allowing for sales tax collection on internet purchases.

- Unify state and local sales tax bases on all transactions.

- Expand the sales tax base (state and local) to include select services that currently enjoy exemptions. We provide detailed options for small, medium, and large sales tax expansion in Chapter 3.

Option B includes some elements of Option A, but is less comprehensive. It would unify collections and audits while broadening the tax base (state and local base unification would not occur under this option). Option B would:

- Unify state and local sales tax collections and audits by creating an independent, joint-run state-local sales tax authority composed of representatives from local tax collection bodies and the state department of revenue. This unified collection and audit commission would make Louisiana compliant with pending federal legislation allowing for sales tax collection on internet purchases.

- Expand the sales tax base (state and local) to include select services that currently enjoy exemptions. We provide detailed options for small, medium, and large sales tax expansion in Chapter 3.

Option C is more limited, but would still unify the state and local sales tax base with some exceptions. In addition, it would broaden the sales tax base.

- Unify state and local sales tax bases on all transactions except for food for consumption and prescription drugs.

- Expand the sales tax base (state and local) to include select services that currently enjoy exemptions. We provide detailed options for small, medium, and large sales tax expansion in Chapter 3.

Individual Income Tax

Our **individual income tax solutions** improve the tax code by broadening the tax base and reducing tax rates, making the state more competitive with its neighbors and the system more neutral and fair. We've provided three different alternatives for lawmakers to consider.

Each of the following options are designed to be revenue neutral within themselves. If a net increase or decrease in revenue is desired, the tax rates in each option can be dialed up or down, respectively, to achieve a tax cut or tax increase.

Option A would retain the current three bracket structure, but reduce tax rates. It also includes base broadening components and resembles the income tax structure recommended by Dr. Jim Richardson of Louisiana State University and Dr. Steven M. Sheffrin and Dr. James Alm of Tulane University. Option A would:

- Retain the existing three bracket structure, with rates reduced to 1 percent, 3 percent, and 4.5 percent.

- Eliminate the deduction for federal taxes paid.

- Retain the current Earned Income Tax Credit of 3.5 percent of the federal credit.

- Eliminate excess itemized deductions.

- Retain the existing personal exemption but adjust the tax brackets and personal exemption for inflation.

Option B converts the progressive income tax into a single, flat rate on all income levels, while providing additional relief to low-income taxpayers. Option B would:

- Move from three brackets to a single, flat-rate tax of 4 percent on all income levels.
- Eliminate the deduction for federal taxes paid.
- Increase the personal exemption to $10,000 per filer and index it to inflation (maximum of $20,000 per family).
- Increase the Earned Income Tax Credit from 3.5 percent of the federal credit to 10 percent of the federal credit, nearly tripling benefits for low-income households.
- Retain current itemized deductions.

Option C is the most broad-based option of the three, retaining the single rate structure of Option B, but eliminating more preferences to bring the overall rate lower. Option C would:

- Move from three brackets to a single, flat-rate tax of 3.5 percent on all income levels.
- Eliminate the deduction for federal taxes paid.
- Increase the personal exemption to $10,000 per filer and index it to inflation (maximum of $20,000 per family).
- Increase the Earned Income Tax Credit from 3.5 percent of the federal credit to 10 percent of the federal credit, nearly tripling benefits for low-income households.
- Eliminate excess itemized deductions.

Corporate Income Tax

Our **corporate income tax solutions** would make Louisiana more competitive with neighboring states by bringing its rate from the highest in the region to the lowest among neighboring states that levy a corporate tax. It also includes base-broadening elements and helps mitigate tax uncertainty for businesses.

This option is designed to be revenue neutral. If a net increase or decrease in revenue is desired, the tax rate can be dialed up or down, respectively, to achieve a tax cut or tax increase.

This option would:

- Flatten tax brackets into a single rate of 3.5 percent or 4 percent.
- Eliminate the deduction for federal taxes paid.
- Increase net operating loss carrybacks from zero to three years.

Property and Related Taxes

Property taxes are a local levy, and localities depend on their revenue to fund government functions. While the state has authority over changing the parameters of these taxes, care must be taken to ensure that any property tax reform be considered with impacts on local government finance in mind.

Our **property tax solutions** broaden the local property tax base and eliminate distortionary and economically damaging taxes. These alternatives would:

- Repeal the inventory tax and inventory tax credit.
- Permanently limit the total annual value of the industrial tax exemption program to 80 percent.
- Allow localities to approve or reject any extensions of the industrial tax exemption program (that is, the second five-year exemption period).

Additional Important Improvements

Below, we provide recommendations that do not fit into the four major tax categories above, but warrant their own separate discussion. We provide solutions that would address lackluster transportation infrastructure and prevent budgetary distress brought on by revenue volatility.

Addressing Lackluster Transportation Infrastructure

- Increase the excise tax on gasoline and diesel fuel.
- Index the gasoline and diesel excise tax to inflation to keep up with transportation demands.
- Consider further tolling of vital roads and bridges to help pay for repairs and enhancements.

Preventing Budgetary Distress Brought on by Revenue Volatility

- Devote 2 percent of revenues to a rainy day fund each year to make for a healthy nest egg to protect against calls for tax increases during economic downturns.

Our Objective

We hope these solutions continue the tax conversation in Louisiana by providing a framework upon which legislators and citizens can make further decisions. The menu of choices we present all ensure that the state builds a tax system for a diversified economy and positions itself as a destination for investment, entrepreneurs, and talented individuals in the years ahead.