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Commentary

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Out of Chaos Comes Change

The special session left hard choices but made significant changes and set up Louisiana's opportunity to move forward with reform

With the special session over, state leaders now will take a deep breath and turn their attention to the regular session and a projected \$800 million budget imbalance for next fiscal year. The special session bought time but not long-term solutions. Looming on the 2018 horizon is an immense revenue cliff that could pressure leaders finally to establish a foundation of financial prudence and stability.

The state's fiscal outlook was recast in the special session by significant changes. Most of these new impacts were overshadowed by the attention placed on the Legislature's chaotic finale and the failure to fully balance the current-year budget. The session created the nation's highest consumer sales tax, a large-scale reduction of sales tax exemptions, a statewide ballot that would trigger a flat tax rate for corporate income, an expansion of the franchise tax to a new business category and the resurrection of a handicap on industry capital investments. Also important, a majority in the House of Representatives expressed reluctance to raise individual income taxes as part of the revenue solution.

This commentary reviews the highlights of the current situation and offers some guidance.

The regular session

Unlike in the recent special session and last year's fiscal session, the Legislature is not supposed to raise tax revenue in the regular general session starting this week. The special session tax increases, still being calculated, are expected to raise about \$1.2 billion that can be attributed to the budget for the 2017 fiscal year beginning July 1. Even so, a projected \$800 million shortage remains. The governor and lawmakers will have to focus on state expenditures, including possibly unlocking some state dedications and keeping long-term cost drivers under control. The governor already has pledged not to cut state funding for local schools next year. As always, the use of one-time resources will be tempting. The governor has not counted out the idea of another special session to raise more revenue.

During the regular session, the Legislature can plan next year's budget and adjust the current-year budget, which despite the recent tax increases is still out of balance by an estimated \$50 million or more. Although this is a large figure with potentially great impact, it is less than the \$107 million shortfall anticipated under the governor's plan. Although higher education and health care are the usual suspects for taking cuts, the gap also could be addressed with a small percentage decrease in state payments to local school districts for the remaining months of the fiscal year. Indeed, difficult times create unprecedented options; to the

astonishment of Capitol observers, cuts were made to the legislative and judicial budgets for the current year, a PAR recommendation.

The next fiscal cliff

Many of the revenue-raising measures passed last year and in the recent special session are scheduled to last until June 30, 2018. A precise number is not known, but this fiscal cliff represents probably more than \$1.5 billion in annual state revenue. The deadline applies to the new penny sales tax, the temporary elimination of many sales tax exemptions and last year's reduction of various tax credits and exemptions. Surely the credit rating bureaus are taking note of the temporary nature of Louisiana's financial solutions. This deadline might be one of the more important outcomes of the special session. It will provide a strong incentive – and time -- for state leaders to agree on a new fiscal plan for Louisiana's future.

We're No. 1

The state portion of the sales tax will increase from 4 cents to 5 cents on the dollar starting next month. Louisiana's combined state and local sales tax will rise to a level of 10% on purchases on average across all parishes. That figure will lift Louisiana from 3rd to 1st place in the Tax Foundation's national sales tax rankings of the states. Louisiana will overtake Arkansas and current leader Tennessee, which does indeed have a high combined sales tax but also has no personal income tax except on investment earnings. A major argument for the sales tax increase was that it could raise a large sum of money in the very near term, something that income taxes could not do as well. Local governments depend upon sales taxes and are among the stakeholders with the greatest concerns about the impact of the tax hike.

Sales taxes have been a weakening source of revenue for the state. Several reasons may account for this trend. Louisiana exempts many basic items from the state portion of the tax. The economy offers consumers a growing wealth of services that are not taxed, or have a tax base separate from the sales tax. Some goods – such as music, videos and software – are acquired increasingly through digital transfers rather than through a retail store purchase of a taxable tangible item. Internet sales growth also undermines state sales tax collections. The Legislature passed a bill to boost certain Internet sales tax collections, but eventually U.S. Congressional action may be needed for a real national solution. The state's sales tax structure and collection system are ripe for reform, and next year's fiscal session is the time to streamline it.

Getting tough on sales tax exemptions

After years of threatening to do something about the long list of state sales tax exemptions, legislators eliminated or reduced a large number of them that are not farm-related or protected by the state Constitution. Among the smaller revenue exemptions, the targets included state sales tax holidays, Mardi Gras beads and retail purchases by certain charities. On the larger side, the Legislature targeted the exemption on business utilities, which will be a significant new cost for the private sector. Many purchases will remain exempt from the state sales tax, including most grocery store food, prescription drugs and residential utilities.

The new changes in exemptions may be hard to follow and complicated to implement. The Legislature removed exemptions from both the existing state sales tax as well as the new penny increase but did not do so in an entirely uniform manner. Also, the Legislature removed exemptions on the existing 4 pennies for the rest of this fiscal year and then for 2 pennies for the next two years.

While the motivation of the Legislature was raising revenue, this focus on exemptions could actually lead to long-term positive change. PAR has recommended a decrease in these exemptions while at the same time recognizing that some might justifiably be kept due to legal limits, court decisions, double taxation or competitive reasons. No doubt the constituents of the newly reduced exemptions will come to the Legislature in search of relief. State leaders are in a stronger position now to scrutinize and take action accordingly, and this opportunity should be pursued along with the overall sales tax reform effort.

Corporate income tax reforms

The Legislature passed an ambitious corporate income tax streamlining package in the special session. Voters will decide on a statewide ballot in November whether to pull the switch to put the new system in place. Currently, the state Constitution allows corporations to deduct the amount of their federal taxes from their income in figuring their state tax liability. If voters remove that deduction from the Constitution, corporations in exchange will get a flat state tax rate of 6.5%. The current rates are bracketed by income levels and range from 4% to 8%, with the top rate being higher than in other states in the Southeast.

From the state government's perspective, this package of changes would bring in about the same level of corporate income tax revenue or maybe a little more, based on a Legislative Fiscal Office analysis. The state's corporate income receipts would be less affected by up or down changes in federal tax law and regulation. The state also would have a lower and more competitive upper rate to attract business and would receive better corporate tax rankings from the Tax Foundation.

From the business perspective, the impact depends on who you are. Some big companies have relatively large federal income tax liabilities and may end up paying more state income tax even at the lower 6.5% rate. Some companies that typically post smaller earnings might see a modest increase in their tax bills. And some companies will pay about the same or less.

Another corporate income tax change

The Legislature made progress in achieving another structural corporate income tax reform. There were several proposals aimed at making corporations pay their "fair share." One concern was with companies that operate in multiple states, particularly when one of those states does not have a corporate income tax. In those cases companies can book their profits in the tax-free state and transport costs to their affiliate in Louisiana. Legislators adopted some "add-back" provisions for corporate income tax to make companies "add-back" income to their tax statement to account for this strategy. While there is no immediate fiscal impact that could be estimated, supporters of this measure say the new law closes loopholes in the state's corporate tax code. *[This paragraph was updated from the original version of the commentary.]*

Expansion of the franchise tax

In addition to the corporate income tax, which taxes earnings, Louisiana levies a corporate franchise tax, which taxes capital assets and net worth. This franchise tax on wealth and investments is widely recognized as an ancient and complicated type of taxation that discourages investment, inhibits economic development, provides a disincentive to corporate headquarters operations and causes costly compliance and auditing problems.

Eighteen states currently have a franchise or capital stock tax, and three of those states are phasing theirs out. Three other states have recently eliminated theirs. Only Connecticut has a higher franchise tax than Louisiana, and in that state a company can choose to pay either the franchise or income tax liability, whichever is greater. Also, Louisiana is one of only 10 states with an unlimited franchise tax. Basically, a large and growing number of states have figured out that the franchise tax is a bad tax and have found a way to get rid of it. The tax is fortunately on the decline in America, except in Louisiana.

The Louisiana franchise tax is structured in a way that exempts certain business partnerships. The administration argued that these limited liability companies should be taxable as a matter of fairness. So in the special session the Legislature passed a bill to expand the franchise tax to this category of business. Although some legislators may have voted for the bill in the name of fairness, its basic purpose was to raise more revenue for the state. In fact, the bill limits the franchise tax to firms with at least 100 shareholders, so the legislation did not achieve the equity its supporters claim.

The bill raises no revenue for the state immediately but could raise about \$10 million next year and about \$90 million annually thereafter, according to the Legislative Fiscal Office. Expanding this tax has made the state more dependent on it and therefore all the harder to get rid of it eventually. If the state wants a strong tax base that best serves higher education and health care, it should strive to reduce or eliminate pernicious, anti-competitive tax policies, not expand them.

Manufacturing investment handicap

In 2003 Kathleen Blanco, along with every other major candidate for governor, ran on a platform that included elimination of the state sales tax on manufacturing machinery and equipment. The tax put Louisiana at a competitive disadvantage to other states and served as a disincentive to capital investment and business expansion. Manufacturers expect a return on investment when they expand or modernize machinery, and even a few percentage points of extra cost can make a difference in a company's decision. The state was taxing companies' investments and not just the sale of their end products. Acting upon a broad public mandate and consensus, Blanco passed a law to phase out this particular form of sales tax. Legislators in the special session partially restored the tax.

Such a hard-won and carefully planned policy change should not be reversed lightly. Also, many companies have announced manufacturing expansions in Louisiana but have not completed their plant work, so the sudden reintroduction of the machinery sales tax is a blindside hit by the state. Although the new penny sales tax will not apply to manufacturing machinery, the bill to sweep away sales tax exemptions went too far when it included the partial reinstatement of this tax.

A grab bag of higher taxes

The Governor and Legislature also passed a variety of other revenue raising measures, though with comparatively smaller impact than the sales tax increases. They raised taxes on tobacco and alcohol. They reduced compensation to vendors for collecting state sales and excise taxes. They renewed a telecommunications tax that was slated to sunset. They made sure online hotel bookings collect their share of state tax. An older tax on car rentals that had lapsed during Gov. Jindal's term will be renewed.

Some tax types untouched

All forms of gambling taxes were untouched as a potential source of new revenue for the state. The Governor's call did not allow gambling taxes to be considered in the special session. The motor fuel excise tax – taxed at the gas pump – was not considered, although this revenue source is likely to be discussed seriously in the near future as a means to support state highway and infrastructure programs. A state property tax has not been on anyone's radar, although it remains an option as part of an overall tax restructuring plan.

Health care funding

Under the current budget strains, one of the immediate risks the state faces is the possibility that some of the private operators of the formerly state-run charity hospital services will opt to cancel their contracts due to lack of health care funding. These contractual issues will be a concern during the regular session. Also, to raise revenue for Medicaid programs, the Legislature passed a bill during the special session that would increase the premium tax on HMOs in the state's Bayou Health program from 2.25% to 6%, the maximum allowed by federal law. The idea is to leverage federal health care dollars. But the plan must be approved by federal regulators, who will have to decide whether the tax is broadly based enough to meet federal rules.

Managing volatile revenue

Louisiana finds itself in a fiscal crunch partly because of declining oil and gas revenue. Changes over time have made the state more resistant to mineral revenue drops. The creation of the Budget Stabilization Fund, known as the Rainy Day Fund, was one such mechanism. It controls the flow of mineral revenue into the general fund and provides a savings account. Some policymakers say the current function of the Budget Stabilization Fund is inadequate and needs to be revamped not only to anticipate fluctuations in mineral revenue but also to cope with volatile corporate revenues. Good proposals along these lines were presented and discussed during the special session and similar bills have been filed for the regular session. Managing these volatile funds should be on the legislative agenda as part of an effort to create long term solutions.

Conclusions

PAR has made a number of specific budget recommendations in previous reports. (See, for example, "A Plan to Control State Spending," January 2016) As policy makers turn to the expenditure side of the budget during the regular session, long-term cost drivers such as pensions, state employee Group Health plans and Medicaid programs should be controlled and contained. While the process of eliminating unnecessary tax exemptions got a jump start in the special session, dedicated funds still need a serious review.

A lot happened during the special session that should not be overlooked. A majority-Republican Legislature raised taxes by \$1.2 billion and in doing so reduced many tax exemptions, even if only temporarily. Serious changes were made to corporate taxation and voters will have a choice about a corporate flat tax. The next challenge is to fix the state tax and spending structure before Louisiana falls off the cliff in 2018 when a host of revenue sources come to a halt. Despite the poor reviews of the special session, the opportunity is great for a revamp of Louisiana's financial system and the establishment of a more stable long-term fiscal outlook.

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