COMMENTARY

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PAR Examines Key Components of the Governor's Tax Reform Plan for Louisiana

Louisiana's discussion of tax reform has begun. The proposals on the table will generate the most significant fiscal policy debate in many years in Louisiana. The Governor is proposing a plan that contains several major features: the elimination of three types of taxes, including corporate and individual income taxes; an increase in the state sales tax rate; the addition of a sales tax on services; the elimination of some sales tax exemptions and the allowance of some new exemptions under the expanded base; a new realm of laws and rules resulting from the taxation of services; a consolidation of sales tax collection systems among the parishes; a new annual tax form for individuals to report certain sales tax payments; and the creation of two new cash subsidy programs for low-income and certain retiree households.

With some of these proposals, the Governor and his administration have created a significant opportunity for improvements in the state's tax system by addressing several key changes long needed for a simpler tax code that could create a better business climate. Other parts of the tax overhaul -- particularly the swap of income taxes for higher and more expansive sales taxes -- will tend to shift the tax burden away from middle- and upper-income households toward businesses. The plan would expand the sales tax base into the high-growth sector of services, but that move will have mixed consequences.

This initial review by PAR makes several observations about the current reform package and the primary numerical assumptions underlying the proposal. Whatever decisions are made, they should be based on objective, well-supported and verifiable information.

Needed reforms

The Governor's plan contains a number of needed reforms, which are identified herein. Some other components of the plan might also be beneficial to the state and PAR will provide additional perspectives on those as more information becomes available.

Eliminating the corporate franchise tax. The Governor has proposed the elimination of the corporate franchise tax. The tax is a complicated administrative burden on business and is often difficult to calculate, which leads to time-consuming regulatory problems and litigation. The current tax is a deterrent to capital investments and a disincentive to companies considering a headquarters operation in Louisiana. The franchise tax negatively affects Louisiana's rankings for business tax climate. The tax is expected to generate about $85 million per year in the next few years.

Centralized sales tax collection. Louisiana is one of only a few states in which local sales taxes are administered and collected by local taxing authorities. The Governor is proposing to move away from this inefficient sales tax collection and reporting system by creating a single sales tax administrative agency for both state and local sales taxes. The current system is unnecessarily complicated and time-consuming for businesses that operate in multiple parishes. This initiative could be a first step toward eventual compatibility with proposed federal legislation that would facilitate the equitable collection of sales taxes for online and other remote purchases. Thanks to some creative thinking and negotiation with stakeholders, the administration appears to be making real progress toward implementing this much-needed reform.

Exactly how the proposed system will operate remains to be explained fully. The new system should be designed to eliminate redundant audits and inefficiencies in administration for government and business. Ideally, a new system would ensure that Louisiana is consistent with those other states that have adopted modern, unified tax collection and administration methods for traditional and e-commerce transactions. The improvement should result in the collection of revenues that otherwise would be lost due to poor, inconsistent and inequitable enforcement by an outdated system.

The state Constitution protects the right of local governments to collect local sales taxes, yet the administration does not plan to call for a constitutional amendment to make the state the collector of both state and local sales taxes. Instead, the plan is that a new entity would be created with local governments' advice and counsel. A local government's entry into the new system might have to be made voluntary to comply with the Constitution. A stronger approach would be to pass a constitutional amendment and let the state assume the administration and collection process. But the reform effort is a move in a positive direction.

Adjustment to the movie tax credit program. The movie tax credit program cost the state $224 million to meet its obligation in the last fiscal year and has paid out more than $1 billion since 2006. The investment return in the form of taxes generated by film production has not nearly compensated for this state expense. This transferable tax credit program has succeeded in bringing many film and video productions to Louisiana because it supplies money to movie makers to offset a large portion of their expenditures. The way it currently works, the movie makers do not use the tax break, they secure cash, which is generally about one-third of their qualified in-state costs. The purpose of the 11-year-old program was to build a viable movie-making infrastructure with a talented labor pool in Louisiana. The vision was that the state eventually could become an attractive base for movie-making without heavy reliance on a large, perpetual and growing subsidy. The administration wants to amend the program by tightening some of the rules for eligible tax credit expenditures, which would be good direction for state policy to follow.

Enterprise Zones. For several years the Department of Economic Development has taken the lead in scrutinizing this state program that rewards job creation. The department has offered recommendations for improvements that would make the program a more effective business incentive at less cost to the state. The state should consider changes to the program.

Getting the right figures from the start

A critical component of the tax reform debate is the set of numbers used to figure how much state revenue will be lost as a result of the elimination or reduction of taxes and the preservation of economic development programs. The numbers for the amount of revenue to be generated from expanded taxes or new revenue sources is also critical. The administration and the legislative leadership have pledged repeatedly to balance the estimated losses and the gains in a revenue-neutral manner, so that the state will not experience a significant fiscal setback or a windfall as a result of the overall tax reform.

The personal and corporate income tax figures. The administration uses a figure of $2.4 billion as the cost of eliminating the personal income tax. This figure is based on taxes collected in fiscal year 2010-2011, which was two years ago when the state was recovering from a national recession. A more relevant number would reflect a realistic estimation of the tax expected in the next year or two as the tax reform is being implemented. That figure would be approximately $2.7 billion.

Likewise, the administration uses a figure of $262 million to account for the elimination of the corporate income and franchise taxes, based on 2010-2011. The administration's economist expects $340 million in these taxes next fiscal year[i].

Two years ago, the state jobless rate was 7.9 percent. Continued unemployment insurance claims were approximately 60,000 in 2010 and about 45,000 two years ago. Matters have improved since then. Currently, the jobless rate in Louisiana is below 6 percent and continued unemployment insurance claims are down to about 28,000, almost at pre-recession levels.

In sum, the use of income tax figures that were depressed by the economic downturn two years ago, as opposed to the trend of recovery and higher revenues that the state is experiencing currently, can result in the plan not being revenue neutral.

The tax reform estimates should look toward the future, not the past. In fact that is the approach taken by the Ernst & Young analysts hired by the administration when they figured the new revenue that would be generated by expanding the sales tax base under the Governor's plan. They used the state Revenue Estimating Conference's latest forecast for future years' sales tax activity as a base to derive their estimates.

The use of the lower figures of the past to count the costs of the proposal and the higher figures of the future to count the benefits will lead to problems in reconciling the numbers.

A further look is warranted at the other side of the ledger for those figures representing new revenue from expanded taxes or reduced exemptions. These figures need careful attention to gauge whether they are dependable. Inflated expectations of new revenues could create the appearance of a balanced tax plan, but such figuring would not give the state a real revenue-neutral tax reform. Here are a couple of likely examples.

The cigarette tax figure. The administration may be using an optimistic figure for the revenue gain from an increased cigarette tax. The expectation is that a $1.05 per-pack increase in the cigarette excise tax will reap an additional $277 million annually for the state. Of the estimates of a cigarette tax increase calculated by the Legislative Fiscal Office over the years, none has foreseen a revenue gain of that amount. The closest example is a Fiscal Office estimate of a $189 million state revenue gain from a $1 increase in the cigarette tax.

The severance tax figure. The administration wants to reduce exemptions on natural resource extraction taxes in order to create more state revenue to offset the elimination of income taxes. Care should be taken in estimating how much exemption value will be available to the state in the near future, particularly for the horizontal drilling tax break, which is the biggest of the severance tax exemptions. The state offers a severance exemption for deep shale gas mining for up to 24 months or until the cost of the drilling project is covered. This exemption provided a state tax break of about $264 million last year following the 2010-2011 drilling boom at the Haynesville Shale. With natural gas prices dropping to low levels, companies have scaled back their drilling operations. Meanwhile, many of the natural gas wells are surpassing the 24-month window for the tax exemption. So, even if the horizontal drilling exemption were reduced or eliminated, the state in the next couple of years, and perhaps beyond, would not realize an exemption value of $264 million. Recent industry studies project gas prices will remain low for the foreseeable future, which will depress drilling rig deployment and greatly lower the value of the horizontal drilling exemption.

Administration and industry officials are in discussions about how severance tax exemptions might be reduced. Whatever the result of those talks, the administration in its calculations should use a verifiable amount of the state savings from any reduction. The administration's current calculation of $289 million in new revenues from reduced exemptions may be unsustainable.

Based on all these observations, the administration's tax swap plan could be $500 million to $650 million short of being revenue neutral, assuming that all of the other figures in its cost/revenue list are close to being accurate. As this discussion of tax reform begins, lawmakers, government leaders and staff, the media and the public must insist on objective and realistic assumptions about the costs and gains of each proposal on the table.

Winners and losers under the tax swap

The heart of the administration's plan is to eliminate personal and corporate income taxes and the franchise tax while raising the state sales tax from 4 to 5.88 percent and expanding the sales tax to certain service industries. Many items would remain exempt from the state sales tax, including household foods, prescription drugs and utility bills. The administration's plan calls for the newly taxed services to be subject to the state 5.88 percent tax but not subject to a local sales tax[ii].

Personal income taxpayers. So far the promotion of the plan has focused mainly on the winners in the tax swap deal. Thanks to the proposed elimination of the personal income tax, middle- and upper-income individuals and families generally would get a tax break overall, even with higher sales taxes. The more people earn, the bigger the probable net tax benefit of the new plan. The administration released examples of the probable net impact of the tax plan on individuals and families at various income levels. Further illustrations, particularly for those with very high incomes, would benefit the discussion.

Although the administration has not placed much emphasis on the magnitude of this tax break for the very wealthy, the net advantage for them would be substantial. This is certainly one of the underlying reasons for the tax plan; economic analyses that favor an income tax repeal say this impact would be a prime benefit of such a plan because it would encourage wealthy investors to reside and do business in the state and help keep budding entrepreneurs from leaving. Currently in Louisiana, about 29,000 tax filers earn more than $250,000, including about 3,000 filers who earn more than $1 million, many of them small business owners.

Low-income residents. As part of the elimination of the personal income tax, the administration would create the Family Assistance Rebate Program (FARP) targeted at taxpayers with incomes of $20,000 or less. It also would create the Retirees Benefit Program targeted at certain populations, such as government and military retirees, who currently enjoy a state income tax exemption for all or much of their income. The programs would provide direct payments to those who qualify for the benefit. The reasoning is that these groups would receive little or no benefit from an income-tax repeal but would be hit by higher sales taxes. The administration cites figures showing that the state payments would exceed the impact of the likely sales tax increase on these people. If the subsidy program operates as intended and it receives the necessary appropriations, then qualified low-income households could experience no large net loss or gain as a result of the tax plan.

The impact is less clear for those with incomes on the lower end of the scale who do not qualify for the subsidy. Administration figures indicate that taxpayers with earnings just above the $20,000 level would receive a lighter tax burden overall, even though they would not qualify for the state payments. Policymakers should take a close look to measure the impact on this group and to verify the probable impact.

What remains to be explained is how the subsidy programs would identify and make payments to the people negatively affected by the tax swap and whether some low-income people would fall through the gaps of this new government safety net. A key component will be whether the subsidies will operate as a program with annual appropriations by the Legislature or whether the financing will be required automatically by the state. The administration so far has chosen the latter concept, in which the state will owe and send the payment to everyone who qualifies.

The new subsidy system will have to cope with the possibility and probability of fraud by those who do not deserve the benefits, which is a common problem for the government's administration of various taxes and current entitlement programs. Residency requirements and enforcement mechanisms will be necessary, along with government expense to maintain and police such a program. In all, the creation of a major new government entitlement program, along with its social and economic impacts and fiscal costs, must be evaluated carefully.

Businesses. With so many people receiving a net tax break under the governor's plan, someone has to pick up the tab for the revenue offsets. The losers in the tax swap deal need to be identified and the impact on them needs to be explained more fully. Overall, there will be a shift of the tax burden from individuals to businesses, but that burden will not be evenly shared by all businesses.

The Governor's plan would expand the new state sales tax of 5.88 percent to many services that currently are not taxed. The administration has released a list of industry sectors that would be required to collect a state sales tax for their purchased services. The service sales tax would not be a tax on the service industries themselves, although certainly their pricing and therefore their profits could be affected. The tax would be on the service transactions, not the businesses per se. The purchaser would pay the tax, although the seller might absorb or share the cost with reduced pricing.

Businesses are significant users of business services. They consume services such as those provided by architects, engineers, data managers, software developers, employment and management consultants, scientific and technical consultants, security systems and waste management firms. The more a business uses taxable services, the more likely it will be a loser in the tax swap proposal and in the end will be carrying the shifted burden.

The impact will have to be measured on an industry by industry basis. For example, most bank profits are exempt from state corporate income taxes but banks pay local governments a special banking tax, which is assessed by the Louisiana Tax Commission. The elimination of the corporate income tax will have little effect on their tax burden because their special banking tax will remain. However, they will face a sales and use tax on the newly taxable business services they purchase. Banks are large consumers of data, accounting and security services, among other potential new expenses. Another example might be insurance companies, which collect premium taxes and can offset some of those amounts against their corporate income taxes. They, too, might use a lot of newly taxable business services.

With such a large amount of tax dollars being shifted among various payers, an important focus of the tax reform debate should be placed on who will be responsible for offsetting the expected tax cuts. The administration should provide whatever information it has researched and should share whatever information it has learned from its many meetings with industry groups. The administration's knowledge of these specific impacts could be limited. The industry groups themselves should be brought into the public discussion so that the consequences of the tax reform can be better understood.

Arguments for and against the taxation of services

Across the country, the expansion of sales and use taxes to include services has its proponents and opponents. We should recognize that the taxation of services will result in both advantages and disadvantages for the state. The PAR Tax Advisory Group[iii] in January recommended that, if needed as part of a strategy to lower Louisiana sales or income tax rates, the state should consider broadening and expanding sales taxes to include additional services similar to the services taxed in competing states. Texas places a sales tax on a modest variety of services. The Governor's proposal would make

Louisiana one of the nation's most expansive tax collectors of service industry transactions. In the interest of outlining some of the major discussion points on this issue, the pro and con perspectives of service sales taxes are presented below.

Pros. Among the arguments in favor of such an expansion are that service industries make up a growing portion of modern economies. Capturing these services in the sales tax base is a fairer allocation of the tax burden on a broader set of economic transactions. The services sector is likely to provide stronger annual growth in sales tax revenue than the goods sector. Taxes on services might also be seen as progressive, because wealthier people tend to use more services. For many services, people have a choice of whether to purchase them. In this regard, the administration's approach to exemptions has been to exclude those services from taxation, such as funeral services, in which a person may have little choice about making such a purchase. A widely spread sales tax that includes both goods and services can offer a state the opportunity to lower the overall sales tax rate and still sustain historic revenue levels. Many states have taxes on at least some services, and several states currently are considering expanding in this area. The Republican governor of Ohio is proposing an expansion of the sales tax to services in a move that would *lower* the state sales tax rate *and lower* state income taxes.

Cons. Among the arguments against expanding sales taxes to services is that such taxes tend to restrain growth in these sectors. Maybe one of the reasons the service sector has been growing is because it has not been subject to a sales tax. The Governor's proposal includes many services and excludes many others, putting the government in the position of choosing winners and losers in the economic marketplace, rather than attempting to cover all or nearly all types of services. The new tax plan would create many new exemptions from the new state tax on services, even though the Governor planned to reduce exemptions through reform. One of the great challenges of implementing a tax on services is establishing and enforcing rules on which types of service transactions are taxable, what apportionment of collectable taxes belong on transactions conducted by multi-state companies, and what definitions will play a critical role in determining how transactions are classified under the new law. The compliance regime for this tax expansion, for both the government and for businesses, will be significant and potentially costly to all parties. Over time, companies and individuals will find opportunities to acquire their services in ways that may avoid the payment of the sales and use tax, and this trend will slow the revenue growth of the new tax base. An argument against the planned expansion of sales taxes to services is that the new system will not be simpler, fairer or neutral. It will play favorites and run the risk of uncertainty about future state revenue, particularly in the early years of implementation. By contrast, the personal income tax is one of the least costly taxes to administer, it is applied to all people, and a person without taxable income does not have to pay it.

Although these arguments capture some of the debate, more information will likely emerge on the service tax reform proposal that will allow businesses and the public to appreciate its consequences more fully.

Summary

This initial PAR review of the administration's tax plan covers a few key points as the debate gets under way. Other aspects of the tax plan and alternative tax proposals will be reviewed in subsequent reports.

The plan contains several strikingly useful reforms, and the Governor and his staff are to be congratulated for their political will and creativity in attempting to reform some of the state's tax policies and practices. As lawmakers and the public evaluate the overall proposal, they should be provided accurate assumptions and clear identification of the parties who would be affected in the tax swap, as best as one can estimate.

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[i] **Tax credits impact**. Keeping a tax reform plan revenue neutral can be complicated. If personal and corporate income and franchise taxes are eliminated entirely, the state would have to convert tax credit programs into a different form of subsidy payment if it wants to keep these programs as economic development incentives. This is already taking place to some extent with the movie tax credits. With some productions, the state purchases the tax credits at a discount directly from the movie investors who have earned them. But the sometimes overlooked impact of eliminating the income taxes is that the state will bear the cost to keep some of these incentive programs running in order for the same type of benefits to paid. In some cases the credits could be shifted to other types of taxes.

The inventory tax credit is a significant example. In Louisiana, companies pay an inventory ad valorem tax to local governments. Those companies that qualify can get a state tax credit against their income or franchise taxes to offset the inventory taxes they pay to the local government. Last year the state awarded companies about $370 million in inventory tax credits that were offset from state corporate tax revenues. (Some credits were counted against individual income tax revenue.) It is an awkward arrangement that was created because the state wanted to offer relief from the tax as a business development tool but did not want to take away the revenue stream from the local governments.

The inventory tax would be kept in place under the Governor's current plan. So if the inventory tax credit is to continue, it would have to take a new form – such as a cash rebate from the state -- if the corporate income and franchise taxes were eliminated. The cost to eliminate the corporate and franchise taxes must add on the cost of the tax credit program. At the least it would cost $340 million in lost revenue from the tax elimination and an additional $370 million to replace the inventory tax credit. That is a total of more than $700 million that the state must offset to keep the proposed tax plan revenue neutral.

Thus far the administration appears to have taken these tax credit costs into account. The costs of maintaining the incentive programs have been included in the list of costs of lost revenues for the state under the tax reform plan.

Companies and individuals can spread certain tax credits over several years, adding additional complication to the task of figuring the true transitional cost to the state of maintaining the tax credit programs.

[ii] **Sales tax.** The local sales tax varies from place to place in Louisiana and on average is 4.86 percent, the highest local rate in the nation, according to the Tax Foundation. Local governments vary in the exemptions they offer and they do not offer the same exemptions as the state. So the total combined state and local sales tax depends on the type of item and the location where it is purchased. The combined state and average local sales tax rate in Louisiana currently is at 8.86 percent, just behind Tennessee's 9.43 percent, which is the nation's highest combined rate.

The proposed 1.88 percent increase would result in a 10.88 percent total sales tax for many typical purchases in Louisiana. No other state has a combined sales tax that high for product purchases, although it should be noted that households pay a lower overall sales tax rate when the state's sales tax exemptions for food, drugs and other expenses are taken into consideration. As for Louisiana's neighboring states, the combined sales tax rate is 7 percent in Mississippi, 8.25 percent in Texas and 8.65 percent in Arkansas.

[iii] **PAR Tax Advisory Group.** The Public Affairs Research Council of Louisiana is the author of this report. Its research was assisted by the PAR Tax Advisory Group, which produced its own tax policy guidance in January 2013. PAR established the Tax Advisory Group in November 2012 to provide information to PAR and to consider tax policy reforms for Louisiana. The Group has discussed many of the key issues and has heard from stakeholders, content experts and policy leaders. Administration officials have engaged in an open and constructive dialog with the Tax Advisory Group. The PAR Tax Advisory Group is comprised of the following members: Co-Chair: Jim Richardson, Louisiana State University economist and past PAR Chairman; Co-Chair: Robert Travis Scott, PAR President; Facilitator: Angele Davis, management consultant and former commissioner of administration; J.H. Campbell, Jr., Associated Grocers Inc. and PAR board member; John Dean, Heard, McElroy & Vestal LLC; Chris Dicharry, Kean Miller LLP; Mark Drennen, Cornerstone Government Affairs Group, former commissioner of administration and former PAR President; Nicole Gould, Breazeale, Sachse & Wilson LLP and former Department of Revenue attorney; Jerry Luke LeBlanc, University of Louisiana Lafayette, former commissioner of administration and former House Appropriations Chairman; John Pierre, Southern University Law Center; William Potter, Postlethwaite & Netterville; Kimberly Robinson, Jones Walker LLP and former attorney at the Department of Revenue and governor's office; Tim Ryan, University of New Orleans economist; William Scheffy, former banker and CFO and PAR board member; Steven Sheffrin, Tulane University economist.