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Commentary
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The Future is Now

Improved tax policies, a better business climate and an answer to the fiscal cliff are still possible this session

The Louisiana Legislature has yet to articulate a solution to the so-called fiscal cliff that awaits next year. Lawmakers also appear far from a consensus on a new fiscal framework that would provide a more stable revenue outlook for the state and a more predictable tax environment for business. Although the immediate state budget challenge for fiscal year 2018 is more manageable than in recent years, the current session could end with little definition about how the state plans to improve its long-term finances, its credit rating or its economic development position. This situation would not be healthy for the state or the government's capacity for providing needed public services in future years.

While the primary responsibility for next year's state budget is in the hands of the House and Senate committees handling appropriations, the House Ways & Means Committee and its counterpart in the Senate have the primary responsibility for dealing with the upcoming fiscal cliff. With a month left in the session and all relevant bills still under consideration, the House committee is still on the spot to deal with this pending event. Another temporary solution could be the outcome.

Even if no overarching new fiscal structure can be put in place with the short time remaining in this session, legislators and the governor should take steps that show progress in that direction. For example, the Legislature could focus on cleaning up problems with the state sales tax, improve the corporate tax structure and create a more predictable environment for business taxpayers. A more stable and prosperous economic environment would be the most important contributor to the state's fiscal fortunes and its health and education programs.

The situation

In the face of a negative imbalance in the state budget last year, the governor and the Legislature raised the state sales tax from 4% to 5% and forbid a number of regular sales tax exemptions from being applied to the new cent, called a "clean penny." In 2018, this clean penny, along with a number of other temporary tax and credit measures, is scheduled to roll off the books, reducing state revenue by well more than $1 billion.

The state had a plan for dealing with this situation: to come into the 2017 fiscal session and implement a new fiscal structure. The Legislature created the Task Force on Structural Changes in Budget and Tax Policy, with PAR's president as a member, to make recommendations. The Task Force report strongly condemned the current state tax system and outlined options for significant reforms. The guidance was to lower the rate and broaden the base for the state sales tax and to create a more uniform and centralized system for state and local sales tax collections. For the individual income tax system, lower rates could be combined with the elimination of deductions and exemptions. With the new penny, the state has become heavily reliant on sales tax revenue, so a rebalancing between the sales tax and income tax revenue streams was a proposed option.

This basic approach, along with other measures to simplify the tax system and address long-term spending solutions, was a sound plan, and still is. As members of the Legislature indicated that the individual income tax was essentially off limits for changes this session, the governor introduced a form of gross receipts tax on business to replace the state's corporate franchise tax. That initiative failed and left in its place a virtual paralysis on systemic tax reform, a condition brought about by a combination of political reasons, moreso than policy persuasions. The general battle lines are that the governor wants more money for public services he values, conservatives want less spending, and the business community is concerned about being the main target for more revenue generation.

Fuzzy outlook

At this point, the most likely scenario discussed for dealing with next year's fiscal cliff is an extension of the clean penny beyond its current expiration date of June 30, 2018. Some lawmakers seem consigned to the new penny indefinitely. Additionally, the Legislature, which temporarily reduced a number of tax credits, rebates and exemptions in 2015, is poised to extend those reductions. That move would sustain the higher revenue streams that resulted from the reductions in the tax breaks.

Further clouding the picture is the potential for Congress under the new President to change the federal tax code significantly. Unlike the great majority of states, Louisiana's individual and corporate income tax filers can deduct the amount of federal taxes they pay from their state taxable income. Eventually, these federal changes could have an impact on Louisiana state taxpayers and state revenue streams. For example, the White House suggested changes in itemized deductions. A reduction in federal income taxes, either individual or corporate, would tend to increase state income taxes and therefore state revenue streams.

If indeed the Legislature's strategy is to maintain the status quo, a number of unfavorable situations will remain. Even with the help of a tighter rein on the annual budget, the state's underlying credit worthiness still will be viewed with skepticism. The business tax environment and the state's economic development horizon will remain unclear – if not doubtful – for those making investment decisions. And the state's sales tax system, with the highest combined rate in the nation, along with its extraordinary number of exemptions and collection system complexity, will continue to be an inefficient and distorted source of revenue, out of touch with the evolving economy.

Worthy goals for the session

If a comprehensive reform package is not sought this session, and the individual income tax recommendations from the state task force are not pursued, then some steps still could be taken to improve our situation and to move in a positive direction.

Sales taxes: A state sales tax streamlining commission identified reforms to bring greater uniformity in state and local sales tax collections and introduced measures potentially to broaden the base, allowing a lower rate. The Task Force on Structural Changes made complementary recommendations and further described a maximum option for expanding the base and significantly lowering the rate. The goal is not to make the state even more reliant on sales taxes as a source of revenue, but to improve the fairness, stability, efficiency and administration of this tax base.

Uncertain business tax issues: The Legislature should create an environment of greater predictability and stability for several business tax matters that are currently in too much flux:

1. Maintain a 4-cent exclusion of state sales taxes applied to manufacturing machinery and equipment. Do not levy this tax and then offer a state rebate, as has been proposed. While a broad base generally represents good tax policy, sales tax should not apply to some items, such as farm goods for agricultural production, key business inputs and manufacturing investments. Although the state exclusion lacks uniformity with local collections, the higher priority is a competitive position for Louisiana manufacturing and capital investment.

2. Establish a long-term, steady outlook for the business utility tax. The rates changed last year, will change again next year, and are in deep question beyond mid-2018. Although a low utility tax rate is the preferred option, revenue from this tax also could be considered as a partial offset for lower corporate tax rates.

3. Establish a long-term expectation – for business and government – for the amount of the inventory tax credit the state will provide. A reduction in the state's rebate, such as the cut implemented in 2015, is a way of boosting state revenue. Therefore, the credit is a tempting target for state budget cash. As long as the underlying business inventory tax remains, the state will wrestle with how much credit compensation, if any, should be provided to the companies who pay this local tax. Frequent changes and uncertainty in the credit will result in neither a good incentive program nor a good budgeting practice. Here again, a reset of this credit could be considered as an offset for lower corporate tax rates.

4. Provide a stable outlook for the use and scope of the industrial tax exemption program (ITEP) and the use of industrial payments in lieu of taxes. When the governor announced last year that he would revamp the ITEP, manufacturers had little idea where the state would go with this significant local property tax incentive. The governor and the state board overseeing the program have since made progress in defining the new strategy and the role of local governments in its execution. The state is expected to continue to refine this program, and local governments can contribute to the process by preparing plans for implementation.

At this time, the outlook for all these issues is too temporary and too unpredictable for the good of the state's revenue base or the business environment. There is always uncertainty in business and in the economy; the state government should not be a major contributor to the unknown.

Corporate taxes: The Legislature could pursue a phase-out of the corporate franchise tax or a stabilization of the corporate income tax. These could be accomplished in a revenue neutral manner. As a companion to this commentary, a deeper review of corporate tax options is provided in a separate PAR publication, "The State Corporate Tax Structure Revisited", which will be released next.

The Ways & Means Committee and other deeply engaged legislators have an opportunity to make major reforms along the lines the state task force recommended. Short of that, they still could address the challenges of the cliff, the unnecessary uncertainties and the future fiscal climate. Their work and leadership could have a lasting positive impact on the state.

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