A N A L Y S I S

No. 305
September 2002

The "Stelly Plan"

A Proposed Income/Sales Tax Swap

The "Stelly Plan" is one of a dozen proposed constitutional amendments voters will find on the November 5th ballot this year. However, this is one of the more significant and contentious issues to be considered. The running battle in the media between supporters and opponents has raised numerous arguments, pro and con, creating a great deal of confusion over the potential impact of the proposed tax changes.

The purpose of this report is to examine basic questions concerning the plan and provide an independent analysis of the impacts of the proposed tax changes.

What Is the "Stelly Plan?"

The "Stelly Plan," named for its primary author Representative Vic Stelly, is the author's second effort to address what is commonly viewed as a basic imbalance in the state's tax structure. The proposal would swap an increase in personal income taxes for a decrease in state sales taxes. The temporary state sales tax on food and residential utilities would be permanently eliminated and the lost revenue replaced by increasing the income tax on higher incomes.

The proposed amendment and companion legislation would make the following specific changes:

- **The state would be constitutionally prohibited from taxing the purchase of food for use in the home; residential natural gas, electricity and water; and prescription drugs.**

While food and utilities are currently taxed, prescription drugs are not. The prohibition would not apply to utilities purchased by businesses, which would remain subject to temporary taxes.

- **The temporary sales tax on food and utilities would drop from 3.9% to 2% for the first six months of calendar 2003 and then be eliminated beginning July 1, 2003.**

The first full fiscal year under the proposal would run from July 1, 2003 to June 30, 2004; however, the proposed income tax increase would apply to the calendar 2003 tax year. The six-month reduction in the sales tax would offset the additional income taxes that would be collected during that period.

- **The individual income tax brackets would be constitutionally revised as follows:**

Income Tax Rates	2% of Taxable Income	4% of Taxable Income	6% of Taxable Income
Single Filer:			
FROM:	Up to $10,000	$10,000 to $50,000	Over $50,000
TO:	Up to $12,500	$12,500 to $25,000	Over $25,000
Joint Filer:			
FROM:	Up to $20,000	$20,000 to $100,000	Over $100,000
TO:	Up to $25,000	$25,000 to $50,000	Over $50,000

By compressing the existing tax brackets, the proposal would lower the taxes paid on lower incomes and raise the taxes paid at higher income levels.

- **The statutory income tax deduction for excess federal itemized deductions would be statutorily eliminated.**

This would remove a tax benefit currently provided the 21% of taxpayers who itemize deductions for federal income tax purposes. The existing constitutional deduction for federal taxes paid would not be affected.

How Stelly 2002 Differs from Stelly 2000

At the 2000 election, the voters defeated a proposed package of two constitutional amendments, also referred to as the "Stelly Plan." However, the current proposal, sometimes called "Stelly II," differs substantially from the earlier version. The major difference is that the current plan was designed to be essentially revenue neutral, at least initially.

The earlier defeated proposal had been amended to raise more than $200 million in additional taxes to fund teacher raises. As a result, the current proposed swap is much smaller–$240 million compared to $440 million.

The differences in the two plans are outlined in the following chart:

	Stelly Plan 2000	Stelly Plan 2002
Impact on total state tax collections:	Increase tax collections by $200 million to fund teacher pay raises.	Revenue neutral. Would offset lower sales taxes by raising income taxes.
Sales tax removed from:	All purchases of food used at home and natural gas, electricity and water paid by individuals and businesses alike. ($440 million)	Food used at home and electricity, natural gas and water for residential use only. ($240 million)
Change in income tax deductions:	Eliminate deductions for federal income taxes paid and excess federal itemized deductions.	Eliminate only the deduction for excess federal itemized deductions.
Change income tax brackets and rates for married, filing jointly **From:** 2% on first $20,000, 4% on next $80,000, and 6% on over $100,000 of taxable income. (Brackets for single filers are half of the above.)	**To:** 2% on first $5,000 3% on next $5,000 4% on next $40,000 5% on over $50,000. (Brackets for single filers are half of the above.)	**To:** 2% on first $25,000 4% on next $25,000 6% on over $50,000. (Brackets for single filers are half of the above.)

The "Stelly Plan" and Tax Reform

Beginning in the mid-1980s, a series of studies and reform efforts developed a fairly consistent set of recommendations for fiscal reform. While most of the proposed changes in budgeting and financial management were adopted, little has been done regarding the tax portion of the reform package. Major efforts to achieve comprehensive tax reform failed in 1989 and 1992 leaving some to believe that only a piecemeal approach might be successful.

PAR and others have continued to recommend that the state and local tax structures be simultaneously redesigned on a revenue neutral basis to enhance equity, balance, economic development and revenue growth. The suggested comprehensive reform package included an upward revision in the personal and corporate income tax, reduction in the state sales tax and corporate franchise tax, phasing out or reduction of the homestead and industrial tax exemptions and exemption of manufacturing machinery and equipment from the sales tax.

The "Stelly Plan" obviously is not a comprehensive tax reform package nor is it being promoted as such. It is being touted as a "first step" toward tax reform in that it would act on two of the major elements of tax reform–reducing the state sales tax and increasing reliance on the individual income tax. However, the plan differs from traditional proposals for those two elements of the tax reform package.

The previous reform proposals called for cutting the state sales tax in half but maintaining a broad tax base (including food and utilities). They also proposed greater reliance on the income tax to offset part of the sales tax loss by expanding the base (eliminating deductions for federal taxes paid and for excess federal itemized deductions), phasing out the standard deduction/personal exemption as income rises and applying a flat income tax rate.

The "Stelly Plan" would attempt to help lower income taxpayers by permanently exempting food and utilities purchased for home use from the 4% state sales tax. Since 1986, the state has levied a portion or all of the 4% tax on food and utilities on a "temporary" basis–with biennial renewals. The new plan aims to achieve one objective of tax reform–reducing the overused sales tax.

The income tax portion of the plan would also give lower income taxpayers a small break by raising the amount of income that is subject to the lowest rate (2%). The plan would expand the tax base by eliminating the deduction for excess federal itemized deductions and lowering the income threshold for applying the highest tax rate (6%). These changes would increase the tax burden on the higher income levels. The traditional tax reform proposal would have spread the increase more evenly across all income levels.

In short, the "Stelly Plan" would take a first step toward achieving some of the aims of tax reform through its targeted but limited sales tax reduction and its offsetting increased reliance on the income tax. If adopted, some suggest that, by leaving the even more-contentious tax changes for another day, the "Stelly Plan" could also become the last step the state makes towards tax reform. However, considering the public's rejection of comprehensive tax reform efforts in the past, this targeted, incremental approach may be the only practical way to achieve change.

The Impact on State Revenues

On July 17, 2002, after passage of the proposed constitutional amendment and companion legislation, the Legislative Fiscal Office (LFO) prepared a revised fiscal note. The combined impact of the two bills was estimated to produce a $9 million loss during the last six months of FY 2002-03 and only a $4 million increase in the first full fiscal year–FY 2003-04. The individual income tax increase is projected to slightly exceed the estimated $240 million loss in sales tax revenues for that year.

The "Stelly Plan" is projected to be revenue neutral for the change-over year. In future years, the net revenue gains are projected to increase due to the substitution of the faster growing income tax (7.5% annual growth) for the slower growing sales tax (1.8% annual growth). Assuming the growth trends continue, the LFO estimates net revenue increases of $18 million in FY 2004-05, $33 million in FY 2005-06, and $50 million in FY 2006-07.

The Impact on Local Government

Whereas local governments would feel no direct effect from passage of the "Stelly Plan," some critics have suggested that, by relieving taxpayers of $240 million in state sales taxes, local governments might be emboldened to take up the slack. This might be a more credible possibility if the state were to lower its tax on all sales–for example from 4% to 3%. Local taxing bodies might see that as an invitation to seek an additional penny local tax. However, the "Stelly" proposal would simply remove a temporary suspension of a traditional exemption for limited types of purchases– food used at home and residential utilities.

There is no easy way for local governments to assume the tax base that the state would give up. Most local sales taxes already apply to food used at home and to prescription drugs. Residential utilities are exempt from local sales taxes, but it is quite unlikely that the Legislature would turn around and remove the exemption for local governments after voters had passed a constitutional amendment to restore it for state taxes. A new local tax would have to be one on all types of purchases.

To take advantage of the state sales tax reduction to increase a local tax, local taxing bodies would face several hurdles. In many cases, the taxing body has already used its authorized tax rate or the combined local tax rate in the jurisdiction is already at or above the 5% limit. In either case, the taxing body would require special legislative approval for an additional tax to exceed the limits. Getting this approval has not been difficult in the past. More than a hundred such approvals are currently on the books. However, with so many additional taxes already approved, many taxing bodies may be reticent to ask for more. The primary hurdle would be the required local election to approve any sales tax increase.

It should be noted that the large bulk of the reduction in food and utility sales tax collections would occur in the most populous parishes, which also currently have total sales tax rates that are among the highest in the state and the nation.

The Impact on the State's Budget Process

Temporary taxes have regrettably become an ongoing and growing feature of the state's budgeting process. Every two years, temporary taxes come up for renewal resulting in what the current governor has referred to as the "dance of death."

This year, $593 million in temporary taxes were scheduled to expire on July 1, 2002. The Revenue Estimating Conference cannot include the temporary taxes in its revenue estimate until they have been renewed. Thus, every other year, the state budget must be prepared based on the permanent revenues only. The governor is forced to make cuts in existing programs, which are shown in a supplemental section ("below the line"), and made hostage to renewal of the temporary taxes.

Recipients of the cut programs then have to come begging at the Capitol to have their funds restored. The governor must make concessions (allegedly $30 million to $40 million in local projects) to legislators to get the two-thirds vote needed for the tax renewals. Thus the continued use of temporary taxes results in budget instability, unnecessary drama and confusion, costly political deals and poor long-range planning. The process tends to undermine the confidence of the general public and generate mistrust in government.

The use of temporary taxes is an important factor negatively affecting Louisiana's bond rating–currently the lowest in the nation. Low bond ratings result in higher costs for state borrowing. While bond raters would certainly view the "Stelly Plan" positively, it is not known whether it alone would result in a rating upgrade.

The "Stelly Plan" would significantly reduce the state's reliance on temporary taxes but would not entirely eliminate them. The plan would remove more than $300 million in temporary taxes ($240 million in sales taxes and $62.8 million in income taxes). However, even if the plan is approved, nearly $194 million in temporary taxes would

remain on the books. This would include $157.2 million in sales taxes (2.8% on business utilities and other items) plus $36.4 million in taxes not set to expire until 2006 or 2012.

In 2004, the governor will again have to prepare a budget based on revenues with temporary taxes excluded. The revenue shortfall due to expiring taxes will be $396.9 million without adoption of the "Stelly Plan." If the plan is approved, the shortfall would still be about $157 million. However, this would be a great improvement over the $593 million problem in 2002.

Table 1 lists the $433.3 million in temporary taxes remaining in effect if the "Stelly Plan" is, or is not, approved by the voters.

TABLE 1
Temporary Taxes Remaining in Effect (In Millions)

Temporary Tax	Expiration Date	If Stelly Plan Is Not Approved	If Stelly Plan Is Approved
2.8% sales tax on food, utilities, etc. (1% becomes permanent–$119.3 million)	July 1, 2004	$334.1	$157.2
65% limit on deduction for excess federal itemized deductions	2004 tax year	62.8	0.0
Expiring in 2004		**$396.9**	**$157.2**
$25 per child tax credit	2006 tax year	18.0	18.0
Four cent tobacco tax	July 1, 2012	13.9	13.9
Short-term auto rental tax	July 1, 2012	4.5	4.5
Expiring after 2004		**$36.4**	**$36.4**
TOTAL		**$433.3**	**$193.6**

The Impact on Taxpayers

The impact of the "Stelly Plan" tax changes on individual taxpayers naturally depends on the type of filer; their level of income; whether they itemize their federal deductions; the size of their deductions; the number of dependents and exemptions; their propensity to eat at home; and their use of natural gas, electricity and water. PAR has calculated the first-year tax impact for a wide range of specific scenarios. These include three filer types: single; married, filing jointly (no dependents or two dependents); and head of household with two dependents. Two small groups of filers were excluded–those married, filing separately and qualified widows.

The types of filers include itemizers and non-itemizers for all but the head of household (only about 8% of this group itemizes). Tax return data from the Louisiana Department of Revenue was used to determine appropriate amounts of itemized deductions by filer type and income level. For each type of filer, taxes were calculated on 11 levels of federal adjusted gross income ranging from $10,000 to $200,000. It is assumed that no tax credits are claimed.

The federal income tax calculations use 2002 tax rates and standard and personal exemptions. The state income tax calculations are for 2003 and assume itemizers can deduct 65% of their excess federal itemized deductions.

Taxpayer Income

The different concepts of income used in this tax analysis can be confusing:

Adjusted Gross Income (AGI) is the basis for the income categories in PAR's tax analysis. AGI, which is found on line 33 of the federal tax return, is total income adjusted to remove such things as business losses, capital losses and alimony payments. The federal standard deduction or itemized deductions and a deduction for personal exemptions are subtracted from AGI to determine the federal taxable income.

Louisiana Tax Table Income is the figure taxpayers use to look up their tax liability in the tax tables provided with their returns. Tax table income is the federal AGI minus federal taxes paid and a deduction for excess federal itemized deductions. The tax table income for all filers is roughly 80% of AGI after these deductions.

Louisiana Taxable Income is the figure used to define the tax brackets to which the 2%, 4% and 6% tax rates are applied. The tax tables automatically take into account the combined personal exemption/standard deduction ($9,000 for a married, joint filer; $4,500 for a single filer) and the $1,000 per person exemption. In the case of a married couple filing jointly, their Louisiana taxable income would be $11,000 ($9,000 + 2 X $1,000) less than their Louisiana tax table income.

Putting it all together, a married couple filing jointly and having an AGI of $100,000 could have Louisiana tax table income of $80,000 and Louisiana taxable income of $69,000. Looking at it another way, the couple would have to have a total income of $130,000-$140,000 to reach Louisiana's $100,000 income tax bracket.

It should also be noted that Louisiana taxable income is reduced by numerous exemptions and credits. These include a full exemption for social security benefits, federal retirement benefits, Louisiana public employee retirement benefits and U.S. government interest; and a $6,000 exemption for retirement or disability income

Louisiana Income Tax Payers

For the 2000 tax year, over 1.7 million income tax returns were filed, of which more than 99% were by residents. (See Table 2.) Out of a total state population of 4,468,976, the resident returns account for a total of 3,773,811 filers and dependents. This leaves 695,165 residents (15% of the population) unaccounted for and presumably without reportable income. Among others, these would include the institutionalized, those living on non-taxable transfer payments, the unemployed and those operating in the underground economy.

Itemizers and Non-Itemizers. The "Stelly Plan" would eliminate the deduction for excess federal itemized deductions for the 2003 income tax year. This would remove the tax break which itemizers currently receive in figuring their Louisiana income tax.

Only about one-fifth of all Louisiana income tax payers itemize their personal deductions (e.g. medical costs, mortgage interest, state and local taxes, charitable contributions, etc.) on their federal income tax returns. The remainder take the standard deduction. In calculating his Louisiana income tax, the itemizer is allowed to deduct from his taxable income the amount by which his federal itemized deductions exceed the federal standard deduction. However, for 2000 and 2001, this deduction was temporarily reduced to 50% of the excess itemized deductions, thus raising the Louisiana tax paid by itemizers by $90 million. The 2002 legislative session partially restored the deduction for 2002 and 2003 by raising the percentage that could be deducted to 57 1/2% and 65% respectively. Left alone, the deduction would return to 100% in 2004.

The most likely to itemize are the married, filing jointly taxpayers. Yet, even in this group, only one-third itemize and those typically have incomes of $65,000 or more. The amount of excess deductions rises with income and typically becomes an increasing share of the taxpayer's AGI as his income rises–rising from less than 1% at

TABLE 2
Louisiana Resident Income Tax Returns, 2000 Tax Year

Type of Filer	Number of Filers	Average Adjusted Gross Income	Percent Itemizing	Average Number of Dependents	Number of People
All Types	1,625,385	$37,642	20.7%	0.93	3,773,811
Single	600,634	20,252	12.1%	0.19	719,202
Married, Joint	630,302	64,672	36.3%	1.30	2,082,673
Married, Separate	17,430	44,134	26.6%	0.43	24,920
Head of Household	375,714	19,816	8.0%	1.51	944,651
Widows	1,405	31,809	20.6%	0.68	2,365

NOTE: Non-resident returns (120,768) bring the grand total to 1,746,153 returns.

$65,000 AGI to 16% at $200,000 and over 20% above $1,000,000. On average, based on Louisiana Department of Revenue return data, $500 in excess itemized deductions would be associated with an AGI of $65,000; over $30,000 in excess deductions with a $200,000 AGI and $265,000 with a $1.3 million AGI.

In calculating the "Stelly Plan" impacts, PAR only included itemized deductions for the single and married, joint filers and only for incomes over $40,000 and $60,000 respectively. In showing the change due to the plan, PAR has chosen to compare the plan result to the tax with a 65% deduction for excess deductions, which would be the situation in 2003 when the plan would take effect. If the plan is not approved, the 100% deduction would be operative the following year (2004), but the lesser deduction could be renewed if another temporary tax fix was needed that year. Thus it does not seem fair to make the "Stelly Plan" responsible for the whole increase.

The higher income itemizer would see a far greater state tax increase due to the "Stelly Plan" than would a non-itemizer with the same income. However, this does not mean the itemizer would pay more than the non-itemizer, he would simply be losing the advantage he previously enjoyed over the non-itemizer.

Federal Income Tax Savings. One reason for swapping income tax for sales tax is that sales taxes are not deductible for federal income tax purposes. Taxpayers who itemize can deduct the additional income tax and reduce their federal tax liability. The federal government would, in effect, be picking up a portion of the extra state tax. The amount would depend on the taxpayer's marginal federal tax rate, which would typically range from 27% to 38.5%.

Those taxpayers who itemize would be more likely to be among those who would pay an increased state income tax under the "Stelly Plan." As much as one-third of the cost of eliminating the sales tax on food and utilities ($80 million) might, in effect, be passed on to the federal government under the plan. Non-itemizers would not benefit from the offsetting federal tax savings; however, most non-itemizers would not have a net tax increase.

Sales Tax on Food and Utilities

The U.S. Bureau of Labor Statistics periodically conducts a Consumer Expenditure Survey (CES) that attempts to determine how much households of different sizes and incomes spend. PAR used this data to estimate purchases of food and utilities for households with specific incomes through $100,000 and to project purchases for $150,000 and $200,000 incomes. The national average data was not adjusted for regional differences or other variations. The data is too inexact to justify such adjustments. These are, however, averages and food and utility purchases for similar households can vary greatly.

Table 3 presents estimates of annual food (at home) and utility expenditures for different types of income tax filers at selected AGI levels. The data clearly points out the regressive effect of the sales tax. For the family of four at $10,000 AGI, food and utility expenditures take 46% of income, while at $200,000, they take only 4.2%.

TABLE 3
Estimated Monthly Expenditures for Food Used and Home and Residential Utilities

Type of Filer	Adjusted Gross Income (As Reported on Federal Tax Return)				
	$10,000	$25,000	$50,000	$100,000	$200,000
Single, No Dependents	$189	$221	$259	$271	$300
Married, No Dependents	285	359	409	437	479
Head of Household, Two Dependents	338	407	447	543	654
Married, Two Dependents	386	429	525	597	683

Low Income Impact Problems. Two factors make it difficult to assess the impact of the sales tax reduction on low income taxpayers. First, households with very low reported incomes tend to spend considerably more than the incomes would indicate. For example, the CES data shows that a three-person household with before-tax-income of $5,000 or less has average annual expenditures of $25,756. On average, household spending exceeds before-tax-income until income reaches about $40,000 ($20,000 for a single person).

A second factor is the use of food stamps. One of the main arguments for exempting food and utilities from the sales tax is that low income families spend more of their income on these necessities than do upper income persons thus placing a heavier effective tax on the poor. However, because food stamp purchases are already exempt from the sales tax, the "Stelly Plan" food exemption would obviously have less of an impact on households eligible for food stamps.

Over 200,000 Louisiana households, representing over 500,000 persons, are currently eligible for food stamps. How these households are distributed among the filer types and income levels is not known. Many of them may be among the nearly 700,000 persons not accounted for in Louisiana tax returns. However, certainly many of them may be found among the lower income tax filers who would have a net savings under the "Stelly Plan." At incomes below $15,000, roughly two-thirds of the projected tax savings would be due to exempting food and the remaining tax savings would typically be less than $100 at most.

It would, however, be wrong to use the food stamp argument to write off the tax impact on the poor. Judging from the income tax returns, over 2 million Louisianians lived in households with incomes below $15,000 in 2000. Only about one-fourth of those were receiving food stamps.

Current Sales Tax Reduction. In the 2002 session, a minor reduction was made in the temporary tax on food and utilities so that it would fall to 3.9% July 1, 2002 and 3.8% during the first year the "Stelly Plan" would be in effect. The rate could also return to the full 4% in the next year. The difference between 3.8% and 4% means only about $5 a year to the single filer at $15,000 in income and about $15 a year for a family of four at $200,000. PAR has used the 4% rate to calculate savings because the spending estimates are simply not exact enough to warrant minor adjustments.

How Would the Bracket Change Work?

By raising the lower income tax bracket for the married, joint filer from $20,000 to $25,000, the "Stelly Plan" would tax $5,000 at 2% rather than 4% thus saving the tax payer up to $100 (2% X $5,000) when Louisiana taxable income reached $25,000. By lowering the top bracket from $100,000 to $50,000, the plan would tax income from $50,000 to $100,000 at 6% instead of 4% providing a tax increase beginning at taxable income of $50,000 and topping out at $1,000 (2% X $50,000) when income reached $100,000. For a taxable income of $55,000, the increase from the top bracket would only be $100, which would offset the $100 decrease from the bottom bracket.

With Louisiana taxable income of $100,000, the $1,000 maximum top bracket increase, minus the $100 decrease, results in a net increase of $900 for the non-itemizing married, joint filer. The same $900 increase applies to any taxable income above $100,000 for non-itemizers. (The single filer with taxable income of $50,000 would experience a $500 maximum top bracket increase and a $50 bottom bracket decrease for a maximum net increase of $450.)

"Stelly Plan" Impact Calculations

Table 4 shows the PAR calculation of the "Stelly Plan" impact on one of the seven taxpayer situations used in this study. In this scenario, a married couple with two dependents is filing jointly and excess itemized deductions are included at appropriate levels for incomes of $60,000 and above. The following are some of the more significant impacts of applying the "Stelly Plan" changes:

- State income tax liability remains the same or drops by $100 or so until beginning to rise at about the $60,000 income level. The tax increase then rises consistently to nearly $2,200 at the $200,000 income level.

- Nearly one-third of the state income tax increase is, in this case, offset by savings in the taxpayer's federal income tax payments due to itemized deduction of the added state tax.

TABLE 4
Sample Calculations of the Impact of the "Stelly Plan"
(Married, Filing Jointly, Two Dependents, With Itemized Deductions)

	Adjusted Gross Income (As Reported on Federal Tax Returns)								
	$10,000	**$25,000**	**$50,000**	**$75,000**	**$100,000**	**$150,000**	**$200,000**	**$500,000**	**$1,000,000**
Excess Itemized Deductions	0	0	0	4,000	11,000	22,000	33,000	74,000	174,000
2003 Louisiana Income Tax									
Current (From Tax Table)	0	355	1,225	1,995	2,595	4,135	6,013	16,835	30,717
Stelly Plan	0	270	1,123	2,356	3,532	5,900	8,207	20,628	38,410
Increase or (Decrease)	$0	-$85	-$102	$361	$937	$1,765	$2,194	$3,793	$7,693
Sales Tax Savings	-185	-206	-252	-267	-287	-314	-328	-328	-328
Federal Income Tax Savings	0	0	0	-97	-253	-530	-658	-1464	-2,969
Net Tax Change	**-$185**	**-$291**	**-$354**	**-$3**	**$397**	**$921**	**$1,208**	**$2,001**	**$4,396**
	Assumed Monthly Expenditures for Food and Utilities								
Food at Home	$268	$292	$375	$389	$414	$442	$458	$458	$458
Utilities	118	136	150	168	183	213	225	225	225
Total Food and Utilities	$386	$428	$525	$557	$597	$655	$683	$683	$683

- Sales tax savings increase throughout the range of incomes–from $185 at the $10,000 income level to $328 at $200,000. The regressive nature of the tax is again demonstrated by the fact that the tax is 2% of the lower income and less than 0.2% of the higher income as food and utilities become an increasingly smaller portion of the household income.

- The sales tax savings, together with the federal tax savings, combine to offset the state income tax increases that occur between the $60,000 and $75,000 income levels. The break-even point–where tax decreases equal tax increase–occurs at about $75,000. Roughly 76% of all married, filing jointly returns have incomes of $75,000 or less.

- The net tax increases rise from zero at $75,000 to $397 at $100,000, $921 at $150,000 and $1,208 at $200,000. These increases appear to be proportional to income from $100,000 on, but that is due primarily to the assumption of increasing itemized deductions. Without excess deductions, the dollar amount of the tax increase would remain about the same from $150,000 on.

Seven Scenarios Compared

Table 5 shows the net tax changes under the "Stelly Plan" for the seven selected taxpayer situations at different income levels. The net savings appear to peak at about the $25,000 income level for single filers and heads of households and at $50,000 for married, filing jointly taxpayers. The amount of the net savings, for the most part, does not exceed 1% of income. The savings range from $93 for the single filer with $10,000 AGI to $362 for a married joint filer with two dependents at $50,000 AGI.

At the other end of the spectrum, the net tax increase for the itemizing, single filer would top out at about 1.5% of AGI at $100,000. At the $150,000 and $200,000 income levels the net tax increases for married taxpayers with large itemized deductions would top out at 0.6% or 0.7% of AGI. The non-itemizers would have much smaller tax increases.

TABLE 5
Net Tax Change - Seven Scenarios

Taxpayer	Adjusted Gross Income (As Reported On Federal Tax Returns)											Approximate Break-even Point	Percent Paying Same or Less Taxes
	$10,000	$15,000	$25,000	$30,000	$40,000	$50,000	$60,000	$75,000	$100,000	$150,000	$200,000		
Single Filer													
No dependents, no itemization	-$93	-$148	-$153	-$112	$35	$194	$311	$330	$ 327	$ 321	$ 313	$37,500	88%
No dependents, itemization	-93	-148	-153	-112	59	249	446	776	1,496	1,276	1,504	36,500	87
Head of Household													
Two dependents, no itemization	-162	-196	-227	-156	4	163	254	243	216	179	163	40,000	92
Married, Filing Jointly													
No dependents, no itemization	-140	-154	-249	-273	283	-294	-217	-2	352	687	677	75,000	76
No dependents, itemization	-140	-154	-249	-273	283	-294	-189	36	447	957	1,306	72,500	74
Two dependents, no itemization	-185	-188	-291	-304	336	-362	-266	-44	302	592	579	78,000	78
Two dependents, itemization	-185	-188	-291	-304	336	-362	-240	-3	397	921	1,208	75,000	76

NOTES:
Net tax change includes sales tax savings, change in state income tax and, where applicable, federal income tax savings.
Itemizing begins at $40,000 income for single filers and $60,000 for married, filing jointly.

The Break-even Point

There has been a great deal of interest in determining the break-even point of the "Stelly Plan." At what income level does the tax decrease stop and the tax increase begin? The answer depends on the type of taxpayer being considered. The earlier estimates produced a single cut-off point for tax savings based on combined data for all taxpayers. PAR has calculated the approximate break-even points for seven different taxpayer scenarios. (See Table 5.)

These calculations indicate that the "Stelly Plan" would leave unchanged or lower the taxes of 87% of the single filers, 92% of heads of households and 74% or more of those married, filing jointly. The reciprocal percentages would experience tax increases. These percentages refer to the number of returns and not the number of people represented. It does not include the Louisianians not reflected in the income tax returns who might also benefit to some degree from the sales tax exemption.

A rough estimate of the number of people who would either have no change or a net tax benefit under the "Stelly Plan" is obtained by applying the break-even percentage to the number of people in each filing group. These total nearly 3.1 million, which combined with the 695,165 who are not reflected in the income tax returns, comprise 84% of the state's population. About 16% of the state's population would be in households that could expect some net tax increase under the plan.

Itemizers and Non-itemizers

Because it eliminates the deduction for excess federal itemized deductions, the "Stelly Plan" has a more pronounced effect on itemizers than on non-itemizers. For example, Table 6 compares the impact on a married, filing jointly taxpayer with two dependents, income of $100,000 and $11,000 in excess itemized deductions and the same filer with no itemized deductions.

The itemizer, who currently pays less tax than the non-itemizer, would have a state income tax increase greater than the non-itemizer's. However, the itemizer would have a federal tax savings large enough to reduce his tax burden slightly below that of the non-itemizer. The same process holds at the $200,000 income level. In either case, the "Stelly Plan" eliminates the advantage the itemizer previously held and leaves the itemizer and non-itemizer with basically the same tax burden.

TABLE 6
The "Stelly Plan" Income Tax Impact: Itemizer and Non-itemizer Compared

	Itemizer	Non-itemizer	Difference
Adjusted Gross Income	$100,000	$100,000	
Excess Itemized Deductions	11,000	0	
State Income Tax Before "Stelly Plan"	2,595	2,765	-$170
State Income Tax After "Stelly Plan"	3,532	3,354	+178
Increase	937	589	
Federal Tax Saving	-253	-0-	
Effective State Income Tax After "Stelly Plan"	3,279	3,354	- 75

The Very High Income Taxpayer

As explained above, for non-itemizers, the income tax increase due to the "Stelly Plan" levels off at about $900 for married, joint filers and $450 for single filers when Louisiana taxable income rises above $100,000 and $50,000 respectively ($120,000 and $58,000 in AGI.)

For itemizers, however, the "Stelly Plan" income tax would likely continue to increase as incomes rise. Typically, as income rises, itemized deductions grow as a percentage of income. Thus higher income filers get a larger benefit from the current deduction and would likewise see a larger tax increase as that deduction is removed. (See Table 5.)

PAR has calculated the tax changes for a married, joint filer with two dependents and itemized deductions with AGI of $500,000 and $1,000,000. Excess itemized deduction were assumed to be $74,000 and $174,000 after the federal phase-down of the itemized deductions–a relatively small adjustment even at these income levels (e.g. $1,000,000 minus $137,330 = $862,670; $862,670 X 0.03 = $25,880; $200,000 minus $25,880 = $174,000).

The "Stelly Plan" would have an increasing dollar impact on the higher income itemizers, but the impact, as a percentage of AGI, would be less than one-half of one percent even with large itemized deductions.

How Do Louisiana's Family Tax Burdens Compare Nationally?

An important argument of supporters of the "Stelly Plan" is that it would create a better balance among the major taxes and bring Louisiana closer to national norms. Just how different Louisiana is can be demonstrated by a national family tax burden comparison prepared annually by the government of the District of Columbia. The comparison calculates major taxes for a family of four at different income levels for the largest city in each state and Washington, D.C. (See Table 7.)

The D.C. tax comparison employs a controversial method of assigning home values to the families in different states, which probably tends to overstate the Louisiana family's property tax. Even so, the comparison shows the Louisiana family combined tax burden for the major taxes ranging from 71% of the U.S. average at the $25,000 income level to 85% at $150,000.

The comparison demonstrates Louisiana's overuse of the sales tax, compared to the U.S. average, and the state's

TABLE 7
Estimated Burden of Major Taxes for a Family of Four, 2000 Louisiana and U.S., Incomes of $25,000 to $150,000

Income Level	Income Taxes	Property Taxes	Sales Taxes	Auto Taxes	Total Taxes	Percent of Income	Rank
$25,000							
Louisiana	385	0	892	156	1,434	5.7	43
U.S. Average	404	825	691	211	2,007	8.0	
$50,000							
Louisiana	1,225	740	1,008	163	3,136	6.3	41
U.S. Average	1,641	1,652	773	254	4,019	8.0	
$75,000							
Louisiana	1,985	1,748	1,512	360	5,605	7.5	40
U.S. Average	2,958	2,549	1,155	440	6,584	8.8	
$100,000							
Louisiana	2,675	2,554	2,016	413	7,658	7.7	39
U.S. Average	4,360	3,273	1,541	559	8,982	9.0	
$150,000							
Louisiana	4,319	4,167	2,675	514	11,675	7.8	39
U.S. Average	7,216	4,723	2,288	705	13,718	9.1	

Louisiana as a Percent of the U.S.

Income Level	Income Taxes	Property Taxes	Sales Taxes	Auto Taxes	Total
$ 25,000	95%	0%	129%	74%	71%
$ 50,000	75%	45%	130%	64%	78%
$ 75,000	67%	69%	131%	82%	85%
$100,000	61%	78%	131%	74%	85%
$150,000	60%	88%	117%	73%	85%

Income Tax as a Percent of Income

	$25,000	$50,000	$75,000	$100,000	$150,000
Louisiana	1.5%	2.5%	2.6%	2.7%	2.9%
U.S. Average	1.6%	3.3%	3.9%	4.4%	4.8%

NOTE: U.S. average is based on number of states where tax is levied.

relative underuse of the income tax. The tax imbalance is as obvious at the individual taxpayer level as it is when looking at the make up of total state/local tax collections. The "Stelly Plan" would, to some extent, address this imbalance.

Some critics of the plan's greater reliance on the income tax point to Texas and Florida as examples of southern states which have managed to operate successfully without employing an income tax. Both Florida and Texas, like Louisiana, are very high sales tax states. Both states have higher state/local taxes than Louisiana, on a per capita basis, in spite of their lack of an income tax. (See Table 8.) Both states have per capita property taxes above the national average and 150% higher than Louisiana's.

A comparison of state income tax rates is nearly meaningless considering the wide variation in income bases used, brackets, deductions, exemptions and credits. What is striking, however, is the fact that Louisiana's income tax, either on a per capita basis or related to personal income, ranked 40th among the 43 states levying the tax in 1999.

TABLE 8
Per Capita Sales, Property and Individual Income Taxes State/Local Combined, 1999

	Sales Tax	Property Tax	Income Tax	Total
U.S. Average	$736	$881	$694	$2,310
Louisiana	934	371	351	1,656
Florida	957	920	0	1,887
Texas	803	938	0	1,741

Pros and Cons of the "Stelly Plan"

This report has analyzed the more significant questions raised by the proposed "Stelly Plan." In doing so, the report has validated or challenged various arguments advanced by the proponents and opponents of the plan. While many of the arguments are amenable to factual analysis, some are more a matter of personal opinion or political philosophy.

The following is a list of pro and con arguments that have arisen during the debates over the "Stelly Plan." These are not PAR's arguments but those raised by the active proponents and opponents. In each case, PAR has provided a comment based on its own research and analysis.

ARGUMENTS *FOR* THE PLAN

1. A tax cut for the overwhelming majority of taxpayers.

While there has been some confusion over the numbers, all of the estimates agree that the great majority of taxpayers would experience net tax savings from the "Stelly Plan." PAR's analysis indicates that about 84% of the population live in households that would benefit from the plan. Only about 16%, in higher income households, would experience a net tax increase.

2. A first step toward "tax reform."

The plan is not a comprehensive restructuring of the state/local tax structure nor is it identical to some of the more deeply entrenched reform proposals of the state's public finance experts and study groups. Still, it does take a first step toward achieving several of the general goals of tax reform–improving the balance of revenue sources, increasing equity and providing growth over time.

Failure of this proposal could be the death knell for future tax reform. Tax reform opponents would likely point to a negative vote and say that the people have spoken on the issue.

3. Eliminates most, but not all, of the temporary taxes.

In 2002, $593 million in temporary taxes came up for renewal. Currently, about $397 million in temporary taxes is scheduled to expire in 2004. The "Stelly Plan" would bring this number down to about $157 million.

Fewer temporary taxes would greatly improve the budget process, possibly reduce the "horse trading" of projects for tax renewal votes, save program recipients from having to come begging to have their cuts restored and make a positive impression on bond raters, who might be more inclined to upgrade the state's terrible bond rating.

4. The plan is essentially revenue neutral.

Unlike the earlier Stelly proposal, this plan is as close to revenue neutral in the first year as one might hope to achieve. Over time, a very modest revenue growth is expected–about $15 million to $18 million in additional money annually for the next few years.

5. Reduces the regressivity of the sales tax to benefit lower income families.

As a whole, the sales tax is regressive because lower income persons spend more of their income on taxable items. The poor clearly spend more of their income for food for home use and residential utilities than do the wealthy. The savings–roughly $200 or less for a lower income family of four–while substantive, would be parceled out over a year's purchases and could go unnoticed by many recipients.

6. A modest shift from the slow growing sales tax to the more growth-oriented income tax.

Louisiana's tax structure is far too dependent on sales taxes, while income and property taxes have been relatively underused. The state sales tax on food and utilities is only growing at an annual rate of 1.8%. A greater reliance on the income tax, with its 7.5% growth rate, would help overall revenue growth better keep pace with the economy.

A more growth-oriented tax structure would help avoid the pressure for new taxes, give businesses more stable expectations and perhaps reduce the need for special sessions of the Legislature. However, the "Stelly Plan" effect would be relatively small. It would shift less than $250 million from a $2.7 billion revenue source to a $2 billion revenue source. This would not greatly reduce the predominant role of the sales tax in the state's tax structure. It would have a slight, but positive, impact on the revenue growth rate.

7. The increase in taxes for the wealthier taxpayers would be relatively small.

At most, a non-itemizing single filer might pay net additional taxes of $330 or 0.4% of a $75,000 adjusted gross income. The single filer itemizer might pay about $1,500 more, or 1.5% on $100,000 AGI. In either case, only a very small percentage of single filers would be affected by these top effective rates.

For non-itemizing married, joint filers with two dependents, the added tax burden would top out at less than $600 (0.4%) at $150,000 AGI and the amount would remain about the same for higher incomes. The same taxpayer with typical itemized deductions would pay an added $920 (0.6%) at $150,000 AGI. The added tax would continue to rise with the itemizer's income but would decline as a percent of AGI (e.g. $4,400 or 0.44% at $1,000,000 AGI).

8. The federal government would pick up a sizeable share of the income tax increase.

State income taxes are deductible for federal income taxes while sales taxes are not. Thus an increase in one's state income tax would be partly offset by a decrease in his federal tax. This would be true only for taxpayers who itemize their deductions; however, those affected most by the "Stelly Plan" would also be those most likely to itemize. Roughly one-third of the itemizer's state income tax increase and perhaps as much as one-third ($80 million) of total income tax increase would be passed on to the federal government under the "Stelly Plan."

ARGUMENTS *AGAINST* THE PLAN

1. It is not comprehensive tax reform and would have a relatively small impact.

The plan ignores business tax issues and fails to address the property tax and local funding problems. It would take a relatively small step towards tax reform and there is no indication of how or when subsequent steps might be taken. While it would be the first reform in a tax structure that has resisted change for decades, it is possible that adopting the more palatable parts of tax reform might postpone action on the remaining elements indefinitely.

2. The problem of temporary taxes would remain.

The plan would not affect $193.6 million in temporary taxes (on business utilities, auto rentals, tobacco and the suspended education tax credit) now on the books. Of this amount, $157.2 million is set to expire in 2004 creating a budgeting shortfall that year.

The proposal would not prevent the addition of other temporary taxes in the future, although it protects the traditional "go to" sources of food and residential utilities. There is no guarantee that the state's bond rating would be upgraded, although passage would certainly be viewed favorably by the rating agencies.

While the pressure to trade projects for tax votes might be reduced, it is unlikely that the custom of "horse trading" for votes will ever disappear.

3. Increasing the growth of state revenues would help further expand a dysfunctional state government that is already growing too fast.

The added growth potential from the "Stelly" swap is estimated at $15 million to $18 million a year–less than 3/10ths of one percent of the general fund taxes, licenses and fees and about 1/10th of one percent of total state spending. While this would hardly be the impetus for expanded spending, some would object that it does nothing

to force state government to economize and modernize its service delivery systems.

Others who see major deficiencies in teacher pay, support for higher education, highways, coastal restoration and a host of other programs would find the expected revenue growth severely insufficient to address the state's unmet needs.

4. The sales tax is preferable to an increased income tax.

Polls have long shown a public preference for the sales tax over other forms of taxation. The tax is easy to collect and administer; it is relatively painless (being collected a little at a time); and, most importantly to many supporters, everyone pays it.

"Everyone" means the poor, who, some argue, benefit disproportionately from public services and assistance and yet do not pay an income tax.

The "Stelly Plan," it is argued, is styled on the "Robin Hood" approach which takes from the rich to give to the poor. Of course this argument assumes that the current distribution of tax burdens is fair and appropriate.

What is "fair" is often a matter of political philosophy. However, two criteria are commonly used to measure equity–the "benefit" principle and the "ability to pay" principle. The income tax relates well to the ability to pay principle, but the sales tax is neither related to benefits received nor ability to pay.

It has been further suggested that the plan would not help the poor much because food stamps are already exempt from the sales tax. This ignores the fact that, while a half-million Louisianians receive food stamps, about two million Louisianians live in households with incomes under $15,000.

Finally, if "Stelly" passes, the sales tax would still remain, by far, the state's largest revenue source and lower income households would still be paying a disproportionately large share of their incomes in sales taxes.

5. The middle class would be clobbered by the income tax increase. Businesses, young affluent families and retirees would be driven from the state.

While most people consider themselves "middle-class," the term has little meaning. In Louisiana, an income of $75,000 (AGI) places one among the wealthiest 10% of all tax filers. The fact is that even a family with a $75,000-a-year income would be basically unaffected by the "Stelly Plan." The question then is whether a family with a $100,000-a-year income would pick up stakes to avoid a $300-$450 tax increase. Likewise, would a person making $500,000 a year move his business to another state to avoid an added tax of $2,000? While young, educated people are leaving the state to seek jobs elsewhere, it is illogical to believe that they are leaving high paying jobs to do so.

As for retirees, Louisiana is presently considered to have one of the most retiree-friendly tax systems in the country. The "Stelly Plan" would make Louisiana a bit more costly for very wealthy retirees; however, the great majority of retirees would likely benefit from the proposed tax changes.

6. The numbers used to support the plan cannot be trusted.

Some opponents of the plan have made a major point of the fact that the impact estimates used to explain the plan as it passed the Legislature have been updated and revised. The earlier estimates were simplistic and slightly overstated the percentage of taxpayers that would be positively affected. Subsequent revisions and refinements, including those by PAR, have changed the numbers very modestly. All of the data tends to agree that the vast majority of taxpayers would experience a net tax savings under the plan.

7. Reduces the state's budget flexibility in times of fiscal crisis.

Much of the Legislature's taxing authority has already been limited by the constitution. Some question whether it would be fiscally healthy to create further constraints.

The state has continually managed to find a funding crisis requiring a "temporary" use of the revenue for the past 18 years. Taking $240 million in potential revenue off the table could force the state to either cut spending or consider permanent increases in other taxes to meet spending needs. However, the plan would not prevent the creative use of other "temporary" taxes.

8. Local governments would take advantage of the state tax reduction to increase their own taxes.

Some have suggested that local governments would reinstate the taxes eliminated by the "Stelly Plan." Others have suggested they might simply raise sales taxes to make up the difference. Neither argument is very realistic.

Local taxing bodies could not simply levy a local tax on food and utilities. They already tax food and the Legislature would have to repeal the local utility exemption statewide–an unlikely event after the people had voted a state exemption for the same purchases in the "Stelly Plan."

Of course, a local taxing body can always seek an increase in its general sales tax at any time and might argue the tax is a replacement for the state's sales tax reduction. However, local taxes have reached the legal limit in most urban areas of the state and special legislative approval is required for a taxing body to exceed it. While this approval has been easily obtained in the past, any increase requires local voter approval, which remains a serious hurdle.

Public Affairs Research Council of La., Inc.
4664 Jamestown Avenue, Suite 300
P.O. Box 14776
Baton Rouge, LA 70898-4776
Phone: (225) 926-8414 ● Fax: (225) 926-8417
E-mail: staff@la-par.org or jimbrandt@la-par.org

Non-Profit Org.
U.S. Postage
PAID
Baton Rouge, LA
Permit No. 330

9. Tax provisions should not be imbedded in the constitution and the "Stelly Plan" would add to the problem.

While changing the income tax brackets, the "Stelly Plan" would retain the new brackets in the constitution, by reference. This continues to greatly limit the flexibility of the Legislature in revising the income tax.

The proposal would also place in the constitution sales tax exemptions that, in the past, have always been enacted by statute. This places new limits on the Legislature's power to tax. This also could possibly open the door to further amendment. Other special interests might begin to seek constitutional protection for their exemptions. For example, residential propane, apparently intended for inclusion in the proposal, was not specifically named. While propane could be excluded from the tax later by statute, some might want another amendment to rectify the oversight.

The voter must answer for himself whether the "Stelly Plan" changes in the tax structure are important enough to merit inclusion in the constitution where they might remain for the next 30 years.

UNSUPPORTABLE ARGUMENTS

The pro and con arguments discussed above have at least some basis in fact or philosophy. However, several arguments cited in the media were so poorly conceived that they are simply unsupportable on any grounds. These include the following:

- **Because federal itemized deductions are phased out as income rises above $150,000, middle income taxpayers who itemize will be hit harder.**

The federal phase-down of itemized deductions is so slow that it has no significant impact until one's income exceeds $1 million a year. The phase out would not noticeably affect the middle income taxpayer's relative tax burden.

- **The state would lose taxes it might otherwise be able to collect from visitors or tourists.**

Perhaps some revenue would be lost from campers or persons renting hotel suites or summer homes. However, the vast majority of tourists purchase little food for home use and few utilities.

- **A young family starting out with a $35,000 income and buying a house would get pounded.**

Typically, a bank would limit the mortgage payments to one-fourth of annual salary–in this case $8,750. With no other deductions, this would result in a $900 excess deduction or a $36 savings in state income tax ($23 at 65% of excess deduction–as of 2003). Under the "Stelly Plan," the couple would lose that $23-$36 but save $73 due to the bracket change and another $175-200 in sales tax savings. Even with twice as much excess itemized deductions the couple would still break even.

CONCLUSION

This report has attempted to place the various arguments regarding the "Stelly Plan" in proper perspective and to apply relevant data where possible. There are valid arguments on both sides of the issue and it is the voter's job to decide which of those arguments are most important and most persuasive.