Louisiana Personal Income Taxes: Are There Unintended Consequences And, If So, What Can We Do About Them?

Report Prepared for Greater New Orleans, Inc

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I. Introduction

State governments need tax revenues to provide the basic public services citizens require of their state. A fundamental economic principle of taxation is that the tax system should provide a predictable, reliable, and sustainable stream of tax revenues in line with the expected public services that the state is offering to its citizens and is expected to continue to offer. State tax collections will grow if the economy grows, so it is vital that the tax system does not impede the growth of the economy. Hence, it is important for a state's tax structure to be competitive in terms of attracting individuals and businesses to the state and insuring that individuals and businesses do not leave the state merely for tax reasons. States have a higher burden of concern about competitive tax policy than the national government because labor, knowledge, technology, and capital are mobile resources that can settle in Jacksonville, Florida as easily as Covington, Louisiana or Beaumont, Texas as easily as New Orleans, Louisiana. The new economy is based on businesses and individuals being able to locate in any number of places. Hence, tax policy becomes a more significant dimension of the decision making process.

Louisiana, by choice and circumstances, has selected the personal income tax as one of its major sources of revenue. In 1981 personal income tax collections made up about 5 percent of the state's overall revenue collections. In 2006 personal income tax collections made up almost 25 percent of the state's overall revenue collections. This shift in the sources of state revenue collections is due to decisions made by the citizens of the state and by outside events that the state does not control, but events to which the state must adjust.

Taxes are necessary to fund public services. Taxes can also distort private decision making and, many times in these cases, the state does not collect as much as it anticipated because private individuals and businesses simply re-locate, decline to invest in the state, or choose to make a smaller investment in the state. States have an obligation to monitor its tax laws to minimize the unintended consequences of its tax laws and regulations. For example, states must monitor to ensure that they will not unintentionally lose tax revenues by forcing individuals and businesses to relocate or not to locate in the state or create a business tax environment that may threaten the long-term growth of the state's economy.

The purpose of this report is to examine the Louisiana personal income tax from the perspective of its treatment of investment income and the potential unintended and unwanted

[1] Dr. Richardson is solely responsible for the analysis and findings contained in this report.

consequences of the current method of taxing investment income. The report will include the following sections: (1) a description of the personal income tax in Louisiana and how the personal income tax fits in the overall state tax structure; (2) potential consequences of the personal income tax structure with respect to investment income and possible decisions made by taxpayers to avoid such taxes; (3) comparison of the Louisiana personal income tax to the personal income tax structure in neighboring and nearby states of Alabama, Arkansas, and Mississippi and in high-growth southern states like Georgia, Kentucky, North Carolina, South Carolina, and Virginia; (4) a comparison of financial characteristics of states in the south including Florida, Tennessee, and Texas, states that have no state income tax or a very limited state income tax; (5) investment income earnings in Louisiana and other southern states; and (6) alternative policies, as necessary, to minimize any unintended consequences from the enforcement of current Louisiana income tax policy on various types of investment income.

II. Louisiana Personal Income Tax Structure, 2008

Louisiana's overall tax structure is summarized in Figure 1 from the early 1980s to the present. At the beginning of the 1980s, mineral revenues (severance and royalties, bonuses and rentals) dominated the state budget accounting for almost 40 percent of all state revenues. Presently, mineral revenues make up only about 15 percent of the state tax collections. Sales, personal income, corporate income, fuel, gaming, and other taxes make up the remaining tax collections.

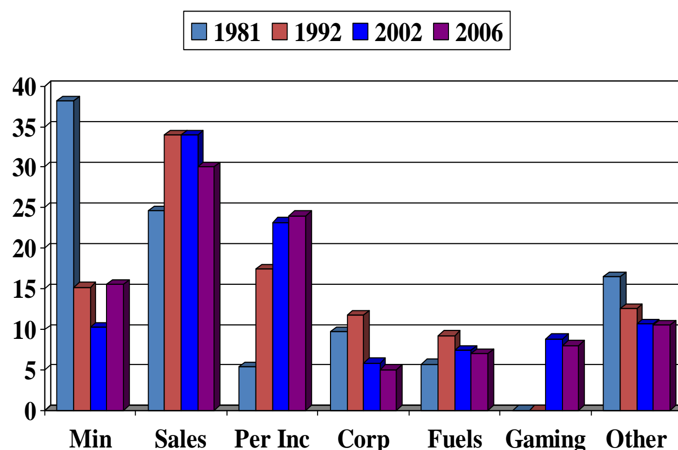
Personal income tax collections in the early 1980s accounted for only about 5 percent of total state tax collections.[2] However, by 1992 personal income tax collections made up about 17 percent of total state collections. There are two reasons for this: first, mineral revenues declined due to the fall in oil prices and the continued decline in oil and gas production, so other revenues necessarily increased in proportion to the total and, second, the 1986 Federal Tax Reform Act made three changes at the federal level that automatically increased state personal income tax collections even if the Louisiana Legislature and Governor did absolutely nothing. Federal tax changes in 1986 included the following features: reducing federal tax liability for most U.S. citizens thereby increasing a person's ultimate burden of state personal income taxation (because Louisiana taxpayers can deduct federal tax liability from adjusted gross income); expanding the definition of federal adjusted gross income thereby expanding the Louisiana personal income tax base (Louisiana uses the same definition as the federal government); and limiting the definition of itemized deductions, thus increasing the tax base of Louisiana personal income. Federal tax policy has a major impact on Louisiana personal income tax collections since, as a matter of simplicity, Louisiana personal income tax laws are closely linked to federal income tax definitions and practices.

By 2006 Louisiana personal income tax collections made up about 25 percent of total state tax collections. This sustained increase in the percent of state collections coming from personal income taxes can be related to continued growth in the economy and continued reduction in

[2] The personal income tax was first authorized in the Louisiana Constitution in 1845. The current rate structure of 2%, 4%, and 6% was first accepted in 1934. Specific income tax rates were put in the state constitution in 1974 and then amended in the constitution in 2002. Information taken from the *Tax Handbook, 1999* prepared by the Public Affairs Research Council of Louisiana.

mineral production in the taxing jurisdiction of Louisiana. The three brackets in the state income tax code mean as you move into higher paying jobs you will also potentially move into a higher tax bracket at the margin and pay more income taxes; and, of course, the constitutionally supported changes in the personal income tax in 2002—the Stelly Plan,[3] which compressed the tax brackets so that the highest tax rate applied for single filers at $25,000 of taxable income (as opposed to $50,000) and $50,000 for joint filers (as opposed to $100,000) and also eliminated the deduction of excess itemized deductions.

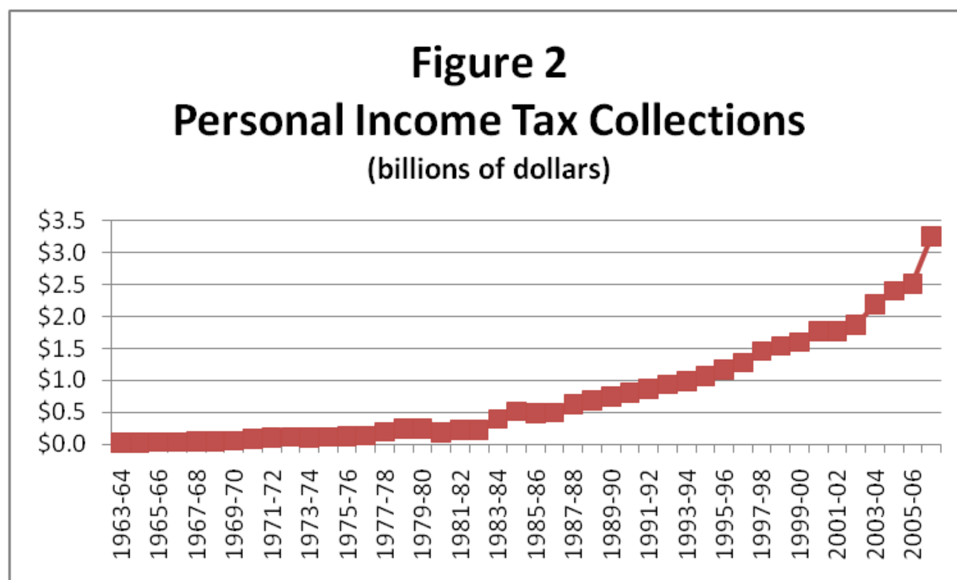
Figure 1. Louisiana's Revenues for selected years
(Percent of total State Collections)



The Louisiana personal income tax has increased proportionately as a major contributor to overall state revenues. The absolute size of the personal income tax is illustrated in Figure 2 where actual personal income tax collections from the early 1960s to 2006-07 are illustrated. Louisiana did not collect $0.5 billion from personal income tax collections until 1984-85; the state did not collect more than $1.0 billion until 1994-95; Louisiana did not collect more than $2.0 billion until 2003-04; and, the state surpassed the $3 billion mark in 2006-07. The conclusions are twofold: first, the personal income tax is a major source of state revenue so any change in the personal income tax has to be weighed against other budget priorities, including both spending proposals and other proposed tax cuts; second, the amount of personal income tax collections may suggest some disincentives have been creeping into the personal income tax

[3] The change in the constitution was referred to as the Stelly Plan since Representative Vic Stelly was the member of the House of Representatives that led the charge to pass the proposed constitutional amendment through the legislative process and then traveled the state to persuade voters to pass the amendment.

structure, not by design, but by lack of attention since the issue seems to lack significant political relevance.



Description of Louisiana Personal Income Tax

The Louisiana personal income tax is described in Table 1 starting with the definition of Louisiana taxable income. Also noted are special definitions of certain types of income that may be treated differently from the federal definition of taxable income, such as the exemptions, deductions, and excess itemized deductions available to taxpayers along with the tax brackets and tax rates for various categories of taxpayers. The final note in the table is to identify the various tax credits that are now available to Louisiana taxpayers. These tax credits are listed in Table 2. It is important to note that the way that the State Legislature has dealt with income tax changes is to propose tax credits—a means of targeting income tax relief without seriously and substantially affecting the overall personal tax collections.

Another important point to appreciate is how investment income is treated. Interest and dividends are treated for Louisiana tax purposes exactly the same way that these incomes are treated at the federal level, except that U.S. government bond interest is not taxed in Louisiana. Business/rent/farm income is treated for Louisiana tax purposes in exactly the same way that it is treated at the federal level. Finally, capital gains (or losses) are treated for tax purposes in Louisiana in exactly the same way that they are treated nationally.

Table 1
Louisiana Personal Income Tax

Definition of Louisiana Taxable Income	Step 1: Federal Adjusted Gross Income Step 2: Deduct Federal Tax Liability Step 3: Deduct Standard Deduction and Personal Exemption Step 4: Deduct Excess Itemized Deductions for those taxpayers who itemize on federal returns Equals: Louisiana Taxable Income
Treatment of Various Income **(affecting federal adjusted gross income and/or Louisiana taxable income)**	Interest/Dividend: Same as Federal, except U.S. Government bond income is exempt Business/Rent/Farm: Same as Federal Capital Gains/Losses: Same as Federal Pension/Retirement Income: Private: $6,000 exclusion for those over 65 Public: Certain benefits from Louisiana retirement exempt; for others, same as private U.S. Civil Service: exempt Military: exempt Active Military Duty: same as federal Social Security Benefits: exempt State/Municipal Bond Interest: taxable except for Louisiana obligations
Tax Rates and Tax Brackets	Single Filer 2% $0 to $12,500 taxable income 4% $12,501 to $25,000 taxable income 6% over $25,001 taxable income Joint Filer 2% $0 to $25,000 taxable income 4% $25,001 to $50,000 taxable income 6% over $50,001 taxable income
Tax Credits	Listed in Table 2.
Louisiana Tax Liability	Adjusted Gross Income less (deductions, exemptions, federal tax liability, and other deductions based on treatment of various forms of income) times the appropriate tax rates less any tax credits that may apply.

Source: Louisiana Department of Revenue, www.rev.louisiana.gov/sections/individual/

Table 2
Louisiana Tax Credits

Tax Category	Tax Credits Enumerated
Tax Credits Based on (1) Creating Competitive tax environment, (2) enhancing employment opportunities in certain locations, (3) targeted investments, (4) equity issues, and (5) other reasons	Atchafalaya Trace Heritage Area Basic Skills Training Biomedical research and development park Bone marrow donor expenses Broadway South—live productions/infrastructure Brownfields investors Bulletproof vest purchase for law enforcement Child care Contributions to educational institutions Conversion of vehicles to alternative fuels Debt issuance costs Dedicated research investment fund Digital interactive media Disabilities Donations to Qualified Playgrounds Earned Income Tax Credit (3.5% of federal credit) Employment of first-time drug offenders Employment of first-time nonviolent offenders Employment related expenses for households with disabled dependents Enterprise zone Family responsibility program Federal Credits—lesser of $25 or 10% of federal elderly, foreign tax, investment tax, and jobs credits Fuels tax paid by commercial fishing boats Hiring unemployed Income taxes paid to other states Insurance premium tax Inventory tax Investment in capital companies, economically distressed areas, and musical recording productions and infrastructure Law enforcement undergraduate degrees LA Community Development Financial Institution investment Manufacturing establishments Motion picture investment and employment New Markets Organ donation Prison industry enhancement program Property taxes paid by telephone companies, natural gas companies, and certain vessels Quality jobs program Recycling Rehabilitation of historic structures Research and Development Small town doctors and dentists Tax Equalization Technology Commercialization

Source: Louisiana Department of Revenue, www.rev.louisiana.gov/sections/individual/

A tax code by itself for one state does not provide relative information with respect to other states. One has to compare the tax code in Louisiana to tax codes in other states in order to gain insight into how the tax system may assist or impede business development and growth on a relative basis. This comparison is completed in the next section.

III. Louisiana Personal Income Tax Compared to Selected States

The Louisiana personal income tax structure is compared to neighboring and nearby states of Alabama, Arkansas, and Mississippi, growth states in the southeast such as Georgia, Kentucky, North Carolina, South Carolina, and Virginia, and states in the south that do not have a broad base personal income tax or any income tax at all - Florida, Tennessee, and Texas. The comparison is based on definition of taxable income, treatment of investment income, the tax rates and tax brackets, and the use of tax credits.

Table 3 illustrates the comparison with nearby states. The Louisiana personal income tax starts with federal adjusted gross income, as do the other neighboring and nearby states; Louisiana does not, however, deviate from the treatment of investment income from the federal guidelines, whereas Arkansas excludes up to 30 percent of net long-term capital gains in calculating the personal income tax payable in the state. Alabama places full capital gain or loss as taxable income in the same year it is gained or incurred.

Louisiana has a more generous standard deduction and personal exemption than do other states, with the exception of Mississippi. Even after the tax changes were passed in 2002 and the brackets were narrowed considerably, Louisiana also has a more generous bracket width; the top marginal tax rate for joint filers does not become effective until a family has earned over $50,000 of taxable income, which means the family's adjusted gross income is estimated to be about $75,000. In Alabama the top marginal tax rate for joint filers becomes effective after earning $6,000 of taxable income; in Arkansas $29,200; and in Mississippi $10,000.

This same comparison of Louisiana personal income tax is made in Tables 4 and 5 with growth states that have an income tax in the southeastern United States. Louisiana is bordered by Texas, which has no personal income tax. Georgia borders Florida, but the state to its north, South Carolina, has a high marginal income tax rate of 7 percent. North Carolina and Virginia, of course, border each other. Virginia is bordered to its west by Tennessee and so is North Carolina.

North Carolina and South Carolina start with federal taxable income as their tax base as opposed to adjusted gross income. This calculation includes the subtraction of the federal standard deduction or itemized deductions along with any federal exemptions from adjusted gross income; thus, these federal tax policies are embedded in the state tax structures of North Carolina and South Carolina. All other states start with adjusted gross income.

Tennessee has a tax on certain investment income, but there are numerous exceptions. All capital gains in Tennessee are exempt from the state's 6 percent tax rate except for capital gains from the sale of mutual funds. Interest and dividends are exempt on certificates of deposit,

Table 3
Louisiana Personal Income Tax Compared to Alabama, Arkansas, and Mississippi

Tax Comparisons	Neighboring and Nearby States			
	Louisiana	Alabama	Arkansas	Mississippi
Definition of Taxable Income Starts with	Federal Adjusted Gross Income	Federal Adjusted Gross Income	Federal Adjusted Gross Income	Federal Adjusted Gross Income
Treatment of Investment Income	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: Same as Federal Capital Gains/Losses: Same as Federal	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: State Schedule for Rental Income Capital Gains/Losses: Same as Federal, except all gains are taxable and all losses deductible in year incurred	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: Same as Federal Capital Gains/Losses: Excludes up to 30% of net long-term capital gains	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: Same as Federal Capital Gains/Losses: Same as Federal
Standard Deduction and Personal Exemption	\$4,500 single filer \$9,000 joint filer	20% of AGI With Maximum \$3,500 single filer \$7,000 joint filer	\$2,000 single filer* \$4,000 joint filer*	\$8,300 single filer \$16,600 joint filer
Are Itemized Deductions Allowable?	Excess Itemized Deductions—above federal standard—are allowable in addition to Louisiana standard deduction	State Itemized Deductions are allowable with variations from federal itemized deductions; as alternative to standard deduction	State Itemized Deductions are allowable with variations from federal itemized deductions; as alternative to standard deduction	State Itemized Deductions are allowable with variations from federal itemized deductions; as alternative to standard deduction
Is Federal Tax Liability Deductible?	Yes	Yes	No	No

Table 3 Continued

	Louisiana	Alabama	Arkansas	Mississippi
Calculation of Taxable Income	Federal AGI, modified by definition of investment income, less standard deduction/ Exemption, less excess itemized deductions less federal tax liability	Federal AGI, modified by definition of investment income, less standard deduction/ exemption or itemized deductions less federal tax liability	Federal AGI, modified by definition of investment income, less standard deduction/exemption or itemized deductions	Federal AGI, modified by definition of investment income, less standard deduction/exemption or itemized deductions
Rates and Brackets Applicable to Taxable Income, Single Filer	2%, first $12,500 4%, next $12,500 6%, over $25,000	2%, first $500 4%, next $2,500 5%, over $3,000	1%, first $3,499 2.5%, next $3,500 3.5%, next $3,500 4.5%, next $7,000 6.0%, next $11,700 7.0%, over $29,200	3%, first $5,000 4%, next $5,000 5%, over $10,000
Rates and Brackets Applicable to Taxable Income, Joint Filer	2%, first $25,000 4%, next $25,000 6%, over $50,000	2%, first $1,000 4%, next $5,000 5%, over $6,000		
Computed Tax Liability Before Credits	Appropriate Rates multiplied times Taxable Income	Appropriate Rates multiplied times Taxable Income	Appropriate Rates multiplied times Taxable Income	Appropriate Rates multiplied times Taxable Income
Tax Credits	Multiple credits	Multiple credits	Multiple credits	Multiple credits
Tax Liability	Computed Tax Liability less tax credits	Computed Tax Liability less tax credits	Computed Tax Liability less tax credits	Computed Tax Liability less tax credits

*exemptions are granted as a tax credit, $21 for a single filer and $42 for a joint filer.

Table 4
Louisiana Personal Income Tax Compared to Georgia, Kentucky, and North Carolina

Tax Comparisons	Growth States in Southeastern United States			
	Louisiana	Georgia	Kentucky	North Carolina
Definition of Taxable Income Starts with	Federal Adjusted Gross Income	Federal Adjusted Gross Income	Federal Adjusted Gross Income	Federal Taxable Income
Treatment of Investment Income	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: Same as Federal Capital Gains/Losses: Same as Federal	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: State Schedule for Rental Income Capital Gains/Losses: Same as Federal,	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: allows federal farm averaging using Kentucky income Capital Gains/Losses: gains on Kentucky Turnpike bonds and property taken b y eminent domain are exempt	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: Same as Federal Capital Gains/Losses: Same as Federal plus exemptions from certain NC obligations issued before July 1, 1995
Standard Deduction and Personal Exemption	$4,500 single filer $9,000 joint filer	$5,000 single filer $8,400 joint filer	$1,910 single filer* $1,910 joint filer*	$5,000/$5,500 single filer $8,000/$9,000 joint filer (higher exemption applies based on income)
Are Itemized Deductions Allowable?	Excess Itemized Deductions—above federal standard—are allowable in addition to Louisiana standard deduction	State Itemized Deductions are allowable with variations from federal itemized deductions; as alternative to standard deduction	State Itemized Deductions are allowable with variations from federal itemized deductions; as alternative to standard deduction	State Itemized Deductions are allowable with variations from federal itemized deductions; as alternative to standard deduction
Is Federal Tax Liability Deductible?	Yes	No	No	No

<table>
<tr><th colspan="5">Table 4 Continued</th></tr>
<tr><th></th><th>Louisiana</th><th>Georgia</th><th>Kentucky</th><th>North Carolina</th></tr>
<tr><td>Calculation of Taxable Income</td><td>Federal AGI, modified by definition of investment income, less standard deduction/ Exemption, less excess itemized deductions less federal tax liability</td><td>Federal AGI, modified by definition of investment income, less standard deduction/exemption or itemized deductions</td><td>Federal AGI, modified by definition of investment income, less standard deduction/exemption or itemized deductions</td><td>Federal AGI, modified by definition of investment income, less standard deduction/exemption or itemized deductions</td></tr>
<tr><td>Rates and Brackets Applicable to Taxable Income, Single Filer</td><td>2%, first $12,500
4%, next $12,500
6%, over $25,000</td><td>1%, first $750
2%, next $1,500
3%, next $1,500
4%, next $1,500
5%, next $1,750
6%, over $7,000</td><td rowspan="2">2%, first $3,000
3%, next $1,000
4%, next $1,000
5%, next $3,000
5.8%, next $67,000
6%, over $75,000</td><td>6% first $12,750
7% next $47,500
7.75%, next $60,000
8.25%, over $120,000</td></tr>
<tr><td>Rates and Brackets Applicable to Taxable Income, Joint Filer</td><td>2%, first $25,000
4%, next $25,000
6%, over $50,000</td><td>1%, first $1,000
2%, next $2,000
3%, next $2,000
4%, next $2,000
5%, next $3,000
6%, over $10,000</td><td>6% first $21,250
7% next $78,750
7.75%, next $100,000
8.25%, over $200,000</td></tr>
<tr><td>Computed Tax Liability Before Credits</td><td>Appropriate Rates multiplied times Taxable Income</td><td>Appropriate Rates multiplied times Taxable Income</td><td>Appropriate Rates multiplied times Taxable Income</td><td>Appropriate Rates multiplied times Taxable Income</td></tr>
<tr><td>Tax Credits</td><td>Multiple credits</td><td>Multiple credits</td><td>Multiple credits</td><td>Multiple credits</td></tr>
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*exemptions are granted as a tax credit, $20 for a single filer and $40 for a joint filer.

Table 5
Louisiana Personal Income Tax Compared to South Carolina and Virginia

Tax Comparisons	Growth States in Southeastern United States		
	Louisiana	South Carolina	Virginia
Definition of Taxable Income Starts with	Federal Adjusted Gross Income	Federal Taxable Income	Federal Adjusted Gross Income
Treatment of Investment Income	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: Same as Federal Capital Gains/Losses: Same as Federal	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: Out of state losses/gains are not deductible/taxable Capital Gains/Losses: 44% exclusion for long-term (more than 1 year) gains	Interest/Dividend: Same as Federal, except exempts U.S. bonds Business/Rent/Farm: Same as Federal Capital Gains/Losses: Excludes gains on land sales for open space use.
Standard Deduction and Personal Exemption	$4,500 single filer $9,000 joint filer	Same as federal but additional exemption of $3,200 for each child under 6	$3,900 single filer $7,800 joint filer
Are Itemized Deductions Allowable?	Excess Itemized Deductions—above federal standard—are allowable in addition to Louisiana standard deduction	State Itemized Deductions are allowable with variations from federal itemized deductions; as alternative to standard deduction	State Itemized Deductions are allowable with variations from federal itemized deductions; as alternative to standard deduction
Is Federal Tax Liability Deductible?	Yes	No	No
Calculation of Taxable Income	Federal AGI, modified by definition of investment income, less standard deduction/ Exemption, less excess itemized deductions less federal tax liability	Federal AGI, modified by definition of investment income, less standard deduction/ exemption or itemized deductions less federal tax liability	Federal AGI, modified by definition of investment income, less standard deduction/exemption or itemized deductions

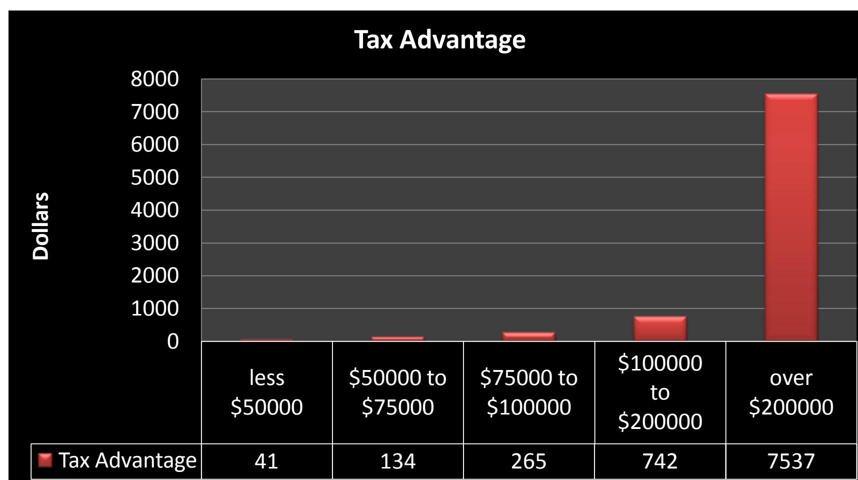
Table 5 continued			
	Louisiana	South Carolina	Virginia
Rates and Brackets Applicable to Taxable Income, Single Filer	2%, first $12,500 4%, next $12,500 6%, over $25,000	2.5%, first $2,530 3%, next $2,530 4%, next $2,530 5%, next $2,530 6%, next $2,530 7%, over 12,650	2%, first $3,000 3%, next $2,000 5%, next $12,000 5.75%, over $17,000
Rates and Brackets Applicable to Taxable Income, Joint Filer	2%, first $25,000 4%, next $25,000 6%, over $50,000		
Computed Tax Liability Before Credits	Appropriate Rates multiplied times Taxable Income	Appropriate Rates multiplied times Taxable Income	Appropriate Rates multiplied times Taxable Income
Tax Credits	Multiple credits	Multiple credits	Multiple credits
Tax Liability	Computed Tax Liability less tax credits	Computed Tax Liability less tax credits	Computed Tax Liability less tax credits

saving accounts, checking accounts, money market funds, short-term commercial paper, insurance policies, and repurchase agreements. Dividends in Tennessee from state banks, national banks, savings and loan institutions located in Tennessee, insurance companies, loan companies, and cemeteries in Tennessee are exempt. All credit union income is exempt.

Several states have imposed specific limitations on capital gain taxation. The state of Arkansas excludes up to 30 percent of long-term capital gains. The state of South Carolina excludes up to 44 percent of long-term capital gains. Other states such as Kentucky, North Carolina, and Virginia have a narrow limitation of capital gains taxation with very specific circumstances in which there is relief from the taxation of capital gains.

The Louisiana Personal Income Tax system does not stand out in terms of the definition of taxable income from the other southern states that have an income tax. However, its allowance for a deduction for federal tax liability does set it apart from most other states in the south with the exception of Alabama. This is a major tax deduction, with an estimated reduction in revenue to the state of over $400 million per year. This tax deduction is more favorable to higher income taxpayers as illustrated in Figure 3. To a taxpayer making $200,000, the federal deductibility means an estimated $7,537 tax reduction, while a taxpayer making less than $50,000 receives a state tax reduction of about $41 due to the federal tax deductibility. Families earning between $50,000 and $75,000 receive a reduction in state tax payments of $134 per taxpayer due to federal deductibility; families earning $75,000 to $100,000 receive a state tax reduction of $265 per taxpayer due to federal tax deductibility; and, families earning between $100,000 and $200,000 receive a state tax reduction of $742 per taxpayer due to federal tax deductibility.

Figure 3. Value of Federal Tax Deductibility in Louisiana to Taxpayers by Income Categories



	less $50000	$50000 to $75000	$75000 to $100000	$100000 to $200000	over $200000
Tax Advantage	41	134	265	742	7537

After the 2007 Legislative session, Louisiana reinstated the excess itemized deductions based on federal itemization. Louisiana taxpayers can take the standard deduction as provided by Louisiana law and then, if they itemize at the federal level, take the difference between the amount itemized and the federal standard deduction—this is called excess itemized deductions. These excess itemized deductions can be deducted from adjusted gross income in order to derive Louisiana taxable income.[4] According to the federal tax tables, 26 percent of all taxpayers in Louisiana itemize deductions on their federal tax returns broken down as follows: 14 percent of all taxpayers making less than $50,000 in adjusted gross income; 45 percent of all taxpayers making between $50,000 and $75,000; 60 percent of all taxpayers making between $75,000 and $100,000; 78 percent of all taxpayers making between $100,000 and $200,000; and 89 percent of all taxpayers in the above $200,000 income category.

Louisiana's tax rates are not out of the ordinary when compared to other states that have income taxes. North Carolina has a rate structure that starts with a 6 percent marginal tax rate and rises to 8.75 percent as the top marginal tax rate. Louisiana's highest marginal tax rate is North Carolina's lowest marginal tax rate. The highest marginal tax rate among the southeastern states, notwithstanding North Carolina, averages around 5 to 6 percent. Louisiana is squarely in the middle of this pack.

Louisiana's personal income tax structure is not out of kilter with respect to other southern states that have personal income tax as a method for supporting public services.

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[4] This tax reduction is being phased in with taxpayers getting to take 57.5 percent of excess itemized deductions in tax year 2007. The overall value of this tax reduction is estimated by the Legislative Fiscal Office to be about $125 million.

Louisiana's tax structure has a high standard deduction and personal exemption thereby providing assistance to taxpayers in the lower income brackets. Louisiana also has several exemptions, namely the federal tax deductibility and the exemption of excess itemized deductions that provide proportionately more tax relief for the higher income brackets than the lower income brackets.

This does not automatically mean that there are not unintended consequences related to the personal income tax in Louisiana. For whatever reason, Arkansas and South Carolina made a decision to exempt a fraction of long-term capital gains earned in the state. Investment income is a mobile income source. Taxpayers earn the income from a variety of sources, many of which are not Louisiana based. Taxpayers can easily relocate in order to avoid a burdensome income tax assessment. Similarly, certain persons may choose not to settle in Louisiana due to the prospective income tax on major investment income. There is anecdotal evidence to substantiate such concerns. We cannot quantify precisely the number of such persons who have determined that it is better to make certain transactions as a resident of Florida or Texas than as a resident of Louisiana because of the personal income tax; it is reasonable, however, to accept the fact that the incentive to relocate is present. The question is how to deal with such a disincentive without creating a financial hole for the state.

IV. Financial Characteristics of Louisiana and Selected States

The distribution of taxpayers in Louisiana, states that are neighboring or nearby states, and growth-oriented states in the south is illustrated in Table 6. This information is derived from U.S. federal tax returns for 2005, the latest year that is listed on the Internal Revenue Service information sheet. The information in Table 6 notes that in the United States just over 68 percent of all taxpayers fall into the range where their adjusted gross income is less than $50,000, while 2.7 percent fall in the income category of over $200,000 per year. In the southern states, every state with the exception of Virginia has an even greater proportion of taxpayers in the less than $50,000 category. Louisiana has almost 74 percent of its taxpayers in this category. Similarly, every southern state with the exception of Florida and Virginia have fewer taxpayers proportionately in the over $200,000 income category than the United States as a whole.

Table 6
Income Distribution of Taxpayers in United States and Selected States, 2005

States	Percent of Tax Returns In Each Income Category				
	Less $50,000	$50,000 to $75,000	$75,000 to $100,000	$100,000 to $200,000	Greater than $200,000
United States	68.1%	13.5%	7.8%	8.0%	2.7%
Alabama	73.1%	12.3%	6.9%	6.1%	1.8%
Arkansas	75.1%	12.4%	6.1%	5.0%	1.5%
Florida	71.5%	12.1%	6.6%	6.9%	2.9%
Georgia	70.2%	12.5%	7.2%	7.6%	2.5%
Kentucky	71.9%	13.7%	7.1%	5.7%	1.6%
Louisiana	73.7%	12.0%	6.7%	5.9%	1.8%
Mississippi	77.2%	11.2%	5.8%	4.6%	1.3%
North Carolina	71.0%	12.8%	7.2%	6.9%	2.1%
South Carolina	73.2%	12.3%	6.8%	6.6%	1.8%
Tennessee	72.5%	13.0%	6.7%	5.8%	1.9%
Texas	71.2%	11.8%	7.0%	7.5%	2.5%
Virginia	62.6%	14.3%	8.8%	10.8%	3.4%

Source: IRS Tables for State Tax Information

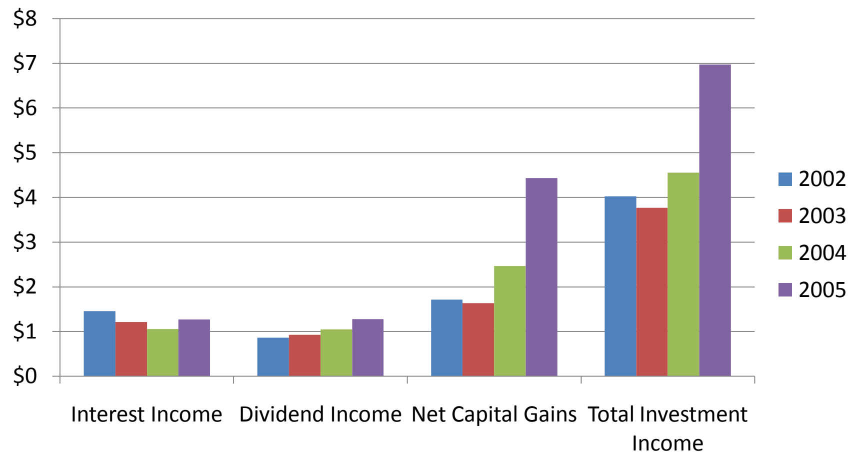
Income by different categories, including wages and salaries, interest income, dividends, and net capital gains, are included in the analysis. Just over 70 percent of all income is earned in wages and salaries, while interest income and dividends make up around 2.0 percent of total income. Capital gains for all taxpayers make up 8.5 percent nationally, over 7 percent in Georgia, Texas, and Virginia. For taxpayers making more than $200,000, capital gains income makes up almost 25 percent of all income earned in this category for all U.S. taxpayers. In Louisiana capital gains income makes up 5.7 percent of all income for all taxpayers and 20.9 percent of all income earned by those earning more than $200,000. The one state that stands out for capital gains income is Florida with over 15 percent of all income earned being from capital gains and almost 35 percent of all income earned for taxpayers in the $200,000 and above category coming from net capital gains.

Table 7
Wage and Salary Income and Investment Income
by Income Categories in United States and Selected States, 2005
(investment income includes interest earnings, dividends, and net capital gains)

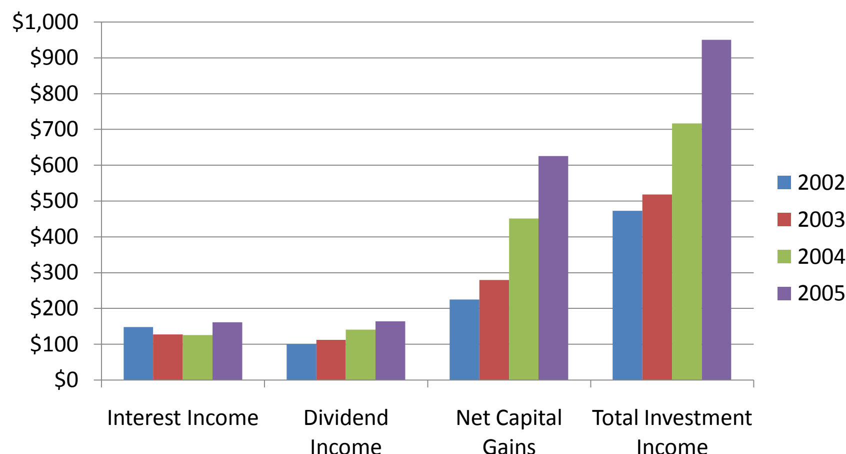
States	Percent of Income Earned in Each Category Within State				
	Wage and Salaries, All Taxpayers	Interest Income, All Taxpayers	Dividend Income, All Taxpayers	Net Capital Gains	
				All Taxpayers	Over $200,000
United States	70.1%	2.2%	2.2%	8.5%	24.4%
Alabama	71.1%	1.8%	1.7%	6.1%	25.5%
Arkansas	71.0%	2.1%	3.2%	5.6%	21.1%
Florida	58.6%	3.0%	3.0%	15.1%	34.9%
Georgia	73.3%	1.6%	1.9%	7.4%	22.7%
Kentucky	73.5%	1.7%	1.8%	5.2%	19.6%
LOUISIANA	71.9%	1.6%	1.6%	5.7%	20.9%
Mississippi	74.1%	1.6%	1.4%	4.7%	20.1%
North Carolina	72.3%	2.1%	2.1%	6.2%	20.5%
South Carolina	71.0%	1.6%	1.7%	6.7%	24.4%
Tennessee	73.5%	1.8%	1.7%	6.8%	23.3%
Texas	72.0%	2.0%	1.9%	7.8%	23.1%
Virginia	72.0%	1.7%	2.0%	7.3%	21.6%

Source: IRS Tables for State Tax Information

Louisiana investment income from 2002 through 2005 is illustrated in Figure 4 for interest income, dividend income, and net capital gains. Investment income, especially net capital gains, rose substantially in 2004 and even more substantially in 2005. Net capital gains jumped from an average of $1.65 billion in 2002 and 2003 to $2.4 billion in 2004 and $4.4 billion in 2005. In Louisiana net capital gains increased from 2002 to 2005 by about 166 percent. Dividends increased from $0.86 billion in 2002 to $1.28 billion in 2005. Interest income actually fell from 2002 to 2005 by about $200 million.



As a comparison investment income for the United States is illustrated in Figure 5. Interest income fell from 2002 to 2003 and 2004, but rose in 2005. Interest income in 2002 was just modestly ahead of interest income in 2005. Dividend income rose substantially from 2002 to 2005 from just over $100 billion to almost $165 billion. Net capital gains increased from $225 billion in 2002 to over $625 billion in 2005, an increase of over 178 percent. Movement in investment income in Louisiana was not unique to Louisiana, but rather in common with the rest of the country.



Investment income in Louisiana compared to that of the United States illustrates as noted in Figure 6 the relative decline in investment income in Louisiana compared to the rest of the country from 2002 to 2005. The large decline came in 2003 and 2004, although it increased in 2005; however, the relative investment income in Louisiana in 2005 compared to the United States is still lower than the relative investment in Louisiana in 2002. Louisiana trends are in line with trends in the country; however, the magnitude of the positive changes in the rest of the country is larger than the magnitude of the positive changes in Louisiana.

Finally, in Table 8 the relative investment income in southern states is compared to Louisiana's investment income and to the state's population and gross state product, a measure of the production occurring within the state. These measurements serve as a barometer to gauge the relative amount of investment income in each of the selected states. The only state that has proportionately more investment income than the population and gross state product would suggest is Florida—this indicates the large number of affluent retirees in the state. The only two other states that come close to having their investment income match proportionately their population and gross state product are Texas and Virginia. All other states in the south have less investment income proportionately than their population or gross state product would suggest.

Louisiana is no exception. Louisiana's population is just over 1.5 percent of the nation's total population (pre-Katrina); post-Katrina the state's population is about 1.4 percent of the nation's population. Louisiana's gross state product is just over 1.2 percent of the nation's gross domestic product, so production in the state does not match population. Investment income in the state was also proportionately lower in 2005, varying from 0.8 percent for interest and dividend income to 0.75 percent for net capital gains.

Figure 6. Louisiana Investment Income Compared to U.S. Investment Income, 2002 through 2005 (percent)

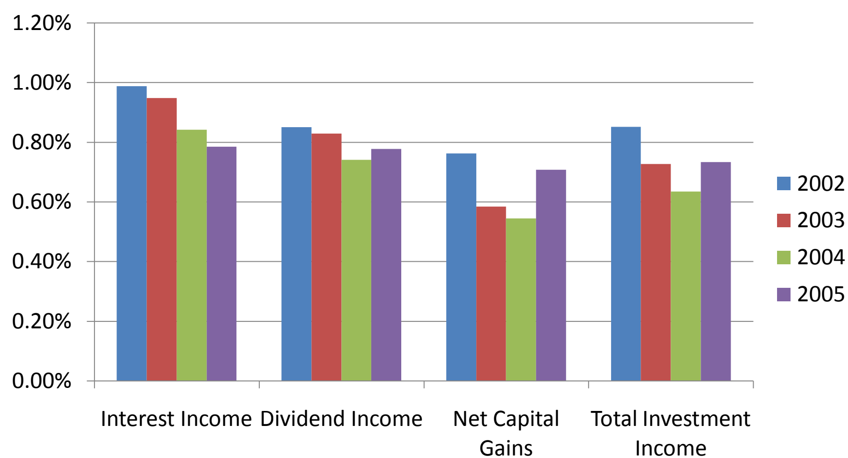


Table 8
Investment Income by Selected States Compared to U.S. Investment Income
With Comparisons to Relative Population and Gross State Product

States	Percent of U.S. Total				
	Population	Gross State Product	Interest Income	Dividend Income	Net Capital Gains
United States	100.0%	100.0%	100.0%	100.0%	100.0%
Alabama	1.54%	1.2%	1.0%	0.9%	0.9%
Arkansas	0.94%	0.7%	0.6%	0.9%	0.4%
Florida	6.00%	5.4%	9.0%	8.7%	11.7%
Georgia	3.86%	2.97%	2.0%	2.3%	2.4%
Kentucky	1.41%	1.1%	0.8%	0.8%	0.6%
LOUISIANA	1.53%	1.2%	0.8%	0.8%	0.7%
Mississippi	0.99%	0.6%	0.4%	0.4%	0.3%
North Carolina	2.93%	2.8%	2.4%	2.4%	1.8%
South Carolina	1.44%	1.1%	0.8%	1.0%	0.9%
Tennessee	2.07%	1.8%	1.4%	1.3%	1.3%
Texas	7.71%	7.7%	6.4%	5.8%	6.4%
Virginia	2.55%	2.9%	2.2%	2.6%	2.5%

Source: IRS Tables for State Tax Information

V. Louisiana and its Comparison to Other States

Louisiana's economic landscape can be described in the following perspectives. First, Louisiana is similar to other southern states in terms of having a gross state product that is proportionately lower when defined by population. The only state in the south whose gross state product fraction exceeds its population fraction is Virginia. Texas is almost even. Otherwise, all of the southern states, including Georgia, North Carolina, South Carolina, and Tennessee, have a relatively larger population than gross state product.

Second, Louisiana's investment income is proportionately smaller than its overall population and gross state product compared to the country's population and gross domestic product. This dimension is similar to all of the states in the south with the exception of Florida, a state that has a large number of affluent retirees.

Third, Louisiana's income tax structure compares favorably with those states that use a personal income tax to pay for public services. The standard deduction is generous compared to most of the other states meaning that there is a higher income that people must obtain before having a family's income taxed at the state level. The tax rates are comparable to tax rates levied in other states. The highest rate is levied at a relatively high income compared to most other states. Louisiana also provides certain exemptions that reduce the tax liability of Louisiana taxpayers including the ability to deduct excess itemized deductions as computed at the federal level from your adjusted gross income and the ability to deduct federal tax liability from your adjusted gross income.[5]

Fourth, Louisiana's treatment of investment income is consistent with the federal treatment of investment income in terms of defining it and making it part of the tax base. States in the south that have a personal income tax treat interest earnings and dividend income precisely as the national government does with the exception of exempting earnings on U.S. government securities. With respect to capital gains, states in the south that have a personal income tax will start with the federal definition of net capital gains but may modify it to reduce it to a fraction of the federal investment income tax base. For example, Arkansas reduces the net capital gains by a 30 percent margin. South Carolina reduces long-term capital gains by a 44 percent margin. Kentucky and North Carolina have very specific exceptions to the taxation of capital gains, but not broad exceptions to the taxation of capital gains.

Finally, as a practical manner one must recognize that Louisiana has, by choice and circumstances, made the personal income tax a major revenue source—the personal income tax now provides about 25 percent of the revenues to support the state spending priorities. It is also recognized that taxes cause unintended consequences, and these unintended consequences can stymie the growth of the tax base over time because the incentive to avoid the tax is real.

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[5] Excess itemized deductions will be deducted starting in the 2007 tax year at a rate of 57.5 percent of excess itemized deductions and will gradually get to 100 percent of excess itemized deductions by 2010.

VI. Viewing Alternatives to Minimize Unintended Consequences of the Louisiana Personal Income Tax

An unintended consequence of a tax system is a tax law that may encourage a taxpayer to make a decision that he or she would not have made if it were not for the tax law. The personal income tax laws are meant to raise revenues to support public services; they are not written to encourage taxpayers to relocate to other states. Yet, one of the effects of the income tax structure might be to encourage or, at least, to make taxpayers think about alternative places to live.

It is also important to appreciate that tax structures play a role in creating a fertile economic environment; this fertile economic environment, however, also depends on other factors such as a highly educated and technologically trained work force or a well-developed transportation system. If two states had all other things the same, the tax structure would be the dominant factor.[6] But if one state had a splendid set of public services compared to the other state, the state with the excellent set of public services may be able to maintain a slightly less competitive tax structure.

Louisiana has the complicating problem of a relatively poor set of public services; hence, it cannot portray its tax structure as being non-competitive in order to pay for the excellent public services. Louisiana has to find a tax system that does not create any relocation or reduces any in-migration. The tax system cannot discourage mobile resources from locating within the state or staying within the state. Yet, the state also has to find a way to pay for public services.

The personal income tax structure is the focus in one sense, but in this study, the focus has been on the taxation of investment income within the personal income tax structure. Activities associated with investment income, defined in this case as interest earnings, dividends, and capital gains, tend to be highly mobile with the exception of certain businesses constrained by industrial location. Yet, even a person owing a Louisiana business can sell it and perhaps benefit as a resident in another state when the sale is completed. In this simple example, the person has a reason to consider relocating to another state because of the tax structure. In this example the business does not move; just the person or family who formerly owned the business. The state loses productive citizens.[7]

The next question is what would the state have gained by keeping the person from moving in terms of future tax receipts or future investments in the community. That is, would the gain in future tax revenues be equal to or greater than the loss of income tax revenues that would have been incurred if the tax code had permitted a tax reduction for this taxpayer. Ultimately, tax advantages have to be justified on the basis that this tax change will create the same amount of revenues or even more tax revenues because of increased business activity.

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[6] Katherine Barrett and Richard Greene, "Growth and Taxes," *Governing* (January 2008).

[7] This issue of persons relocating in order to avoid personal income taxes is not unique to Louisiana. The states of New York and Pennsylvania actually tried to collect taxes from citizens who had lived in those states for many years and then, just before selling property or businesses within these states, relocated to another state without a personal income tax. Ultimately, the taxpayers prevailed in the judicial proceedings.

In Table 9 a series of different types of investment income are identified along with potential changes in the tax code, the estimated cost to the state treasury if the tax reduction is approved, and the likelihood that these revenues would be recovered by additional economic activity. The bottom line is that broad tax proposals such as those suggested in HB 836 in the 2007 Regular Legislative Session will have a substantial fiscal note if all investment income is included in the legislation. It is also impossible to establish a series of economic activities that will allow the state to recoup these tax dollars because of accelerated economic activity, especially in the next four years. The fiscal note becomes smaller as the investment income is divided into separate parts such as only interest income, only dividend income, or only net capital gains. It is still difficult to establish a series of economic events that would allow the state to recoup its lost tax revenues because of elevated economic activity due to this tax reduction, especially, within the next four years.

Arkansas and South Carolina provided examples of reducing the capital gains tax base by 30 percent and 44 percent respectively. This reduces the fiscal note and also allows tax relief to individuals who may be seriously considering relocating because of the state income tax rate. The other alternative is to define investment income in a way that focuses on the issue of taxpayers having the incentive to relocate in order to avoid Louisiana personal income taxes. This definition needs to identify the economic behavior most likely to be affected by the personal income tax and to define precisely the purpose of the tax proposal—the types of business decisions that hopefully will be affected by the change in the treatment of investment income in the Louisiana personal income tax structure.

Alternatively, one could re-examine the entire personal income tax structure and focus on such changes as eliminating investment income from the Louisiana personal income tax base but eliminating the federal tax deductibility, either in total or in part depending on the revenue implications. For example, some states that allow federal tax deductibility, such as Missouri, allow up to $5,000 for a single filer and $10,000 for a joint filer. This obviously maintains the federal tax deductibility for the income categories below $100,000, but reduces this tax advantage for income categories above $100,000. However, eliminating the taxation of investment income would also affect most positively those taxpayers in the higher income brackets.

This proposal will change the distribution of who pays the personal income tax, but not overwhelmingly. Figure 7 illustrates the federal tax liability versus investment income by income category. A straight elimination of the federal tax liability as a deduction and making all investment income tax exempt will increase the burden of the income tax on income categories of less than $200,000 and lower the tax burden on those making more than $200,000. However, providing some federal tax liability exemption up to a fixed amount such as $10,000 for a joint filer and $5,000 for a single filer will eliminate any major shift in the tax burden to the less than $200,000 income categories. This becomes a legitimate tax choice—does eliminating investment income from the tax base have a greater impact on economic behavior than keeping the federal income tax deductibility? The economic implications can be discussed objectively. Federal tax deductibility will have no unintended economic consequences because no one will intentionally increase their federal tax liability in order to get a state tax advantage. Persons can

relocate or alter their behavior in order to move investment income out of the reach of state tax collectors.

The political ramifications may be another story. Political opinion probably favors keeping the deductibility of federal tax liability. However, the public has never been provided such a choice. Persons may not get any immediate tax benefit; however, the purpose of the tax change is to prevent unintended consequences of tax policy, and this proposal will eliminate any and all unintended consequences associated with the taxation of investment income.

Table 9
Analysis of Alternative Changes in Taxation of Investment Income

	Possible Change	Projected Fiscal Note Regarding Tax Change (Loss of Tax Collections to State)	Projected Increased in Business Activity and impact on state income tax collections
Possible Change in Taxation of Investment Income	Eliminate all Investment Income from Tax Base for Louisiana PIT	$159.6 million	1. Reduction in state taxes increases federal taxes and reduces state taxes again 2.increase net economic activity 3. net increase in taxes of $5 million
	Eliminate Only Interest Income	$41.3 million	same as above except net increase in taxes of $1.5 million
	Eliminate Only Dividend Income	$33.8 million	same as above except net increase in taxes of $1.0 million
	Eliminate Only Capital Gains	$84.5 million, assuming no one decides to relocate prior to the state taxes being eliminated	same as above except net increase in taxes of $2.5 million
	Eliminate 50% of Capital Gains	$42.25 million, assuming no one decides to relocate prior to the state taxes being eliminated	same as above except net increase in taxes of $1.25 million
	Eliminate Capital Gains Tax if Reinvested in Louisiana	To Be Determined	To Be Determined
	Limited Definition of Investment Income Related to Relocation and/or Unwillingness to Move to Louisiana	Focus on Economic Activities Most Susceptible to Tax Laws and Most Likely to Relocate	Creates incentive to react to tax system
	Eliminate Taxation of Investment Income	Eliminate partially or completely Federal Tax Deductibility to offset immediate cost of eliminating taxation of investment income	Could make revenue neutral at beginning and investment activities should generate additional revenues in future

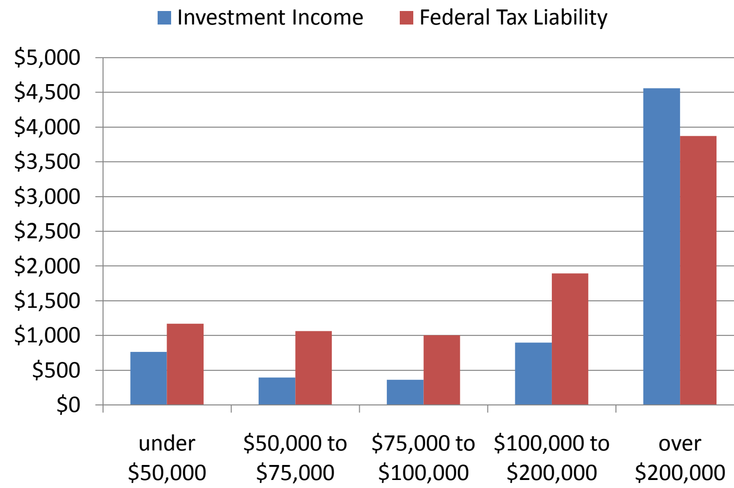
Figure 7. Comparison of Federal Tax Liability and Investment Income (in millions of dollars)
Investment Income
Federal Tax Liability
$5,000
$4,500
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
under $50,000
$50,000 to $75,000
$75,000 to $100,000
$100,000 to $200,000
over $200,000

VII. Summary and Conclusions

State governments need tax revenues to provide the basic public services citizens require of their state. A fundamental economic principle of taxation is that the tax system should provide a predictable, reliable, and sustainable stream of tax revenues in line with the expected public services that the state is offering to its citizens and is expected to continue to offer. State tax collections will grow if the economy grows, so it is vital that the tax system does not impede the growth of the economy. It is important for a state's tax structure to be competitive in terms of attracting individuals and businesses to the state and insuring that individuals and businesses do not leave the state merely for tax reasons. States have a higher burden of concern about competitive tax policy than the national government because labor, knowledge, technology, and capital are mobile resources.

Louisiana, by choice and circumstance, has selected the personal income tax as one of its major sources of revenue. In 1981 personal income tax collections made up about 5 percent of the state's overall revenue collections. In 2006 personal income tax collections made up almost 25 percent of the state's overall revenue collections. This shift in the sources of state revenue collections is due to decisions made by the citizens of the state and by outside events that the state does not control, but events to which the state must adjust. Louisiana, by choice, has also followed the federal government in the definition of the tax base which includes investment income. Other states such as Texas, Florida, and, for all practical purposes, Tennessee have chosen not to tax personal income in their states.

Louisiana's personal income tax structure is comparable and competitive to other states in the south that have a personal income tax, such as Alabama, Arkansas, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, and Virginia in terms of the definition of income, rates, brackets, standard deduction, personal exemptions, and the treatment of investment income. Louisiana is different from the southern states, with the exception of Alabama, by allowing taxpayers to deduct federal tax liability from adjusted gross income in order to reach Louisiana taxable income. Louisiana's treatment of investment income is comparable to most southern states, though Arkansas and South Carolina reduce investment income by 30 percent and 44 percent respectively. Most states treat investment income as the federal government does.

All taxes will have unintended economic consequences—that is, the tax laws may generate responses that did not enter into the debate on the merits and demerits of a given tax. Such unintended consequences are certainly possible with regard to investment income because investment income by its nature is highly mobile. All taxes also provide funding for public programs, which also contribute to the overall well-being of the community. Merely cutting a tax may not produce additional revenues for the state because the forthcoming economic activity just will not generate the state tax revenues forgone due to the tax reduction. The question is how do you eliminate or minimize the unintended consequences of a tax while maintaining the fiscal soundness of the state government.

With respect to investment income the following options are available: (1) eliminate investment income or a portion of investment income as taxable—this proposal eliminates any and all unintended consequences associated with taxing investment income, but the proposal does not take into account the fiscal stability of the state at least in the short-run; (2) eliminate the tax on an amount of investment income as defined by law with consideration of those economic activities most likely to be motivated by a tax on investment income—this proposal can limit the fiscal consequences for the state and can affect the unintended consequences associated with the tax if the investment income that is tax exempt is defined appropriately; or (3) a more comprehensive change can be made by eliminating the personal income tax on investment income and offset the revenue loss to the state by eliminating the deductibility of federal tax liability on the Louisiana personal income tax—this eliminates the unintended consequences associated with the taxation of investment income, does not require a very specific definition of investment income that is tax exempt, and does not reduce the projected tax revenues for state government.

Tax policy is always a matter of choice. Business leaders and state officials have to decide what is in the best interest of the state. The issue of the taxation of investment income requires a choice to be made.