

Two Steps Back: Alabama's Structural Deficit

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A built-in shortfall

Alabama's latest budget crisis points to a deeper problem that can't be fixed with short-term measures: *The state doesn't take in enough money from year to year to support state services at an adequate level.* Economists call this built-in shortfall a *structural deficit*.

When a structural deficit exists, the Legislature must decide each year how to meet rising costs with a balanced budget. It can draw on reserve funds and one-time funding sources, cut services, raise taxes, or choose a combination of these options. Periodic recessions only make the structural deficit more obvious. The problem reflects the fact that our state fiscal system has remained largely unchanged for decades.

Our historical reliance on *earmarking* compounds the revenue lag. The fastest-growing major revenue sources – income and sales taxes – were set aside for education more than 50 years ago. Other state services got the leftovers – an assortment of low-yield revenues that have kept vital programs like Medicaid and corrections permanently short-changed.

The income tax lag

Alabama's personal income tax was well-designed – for 1935! In that year, when our state began to tax incomes of \$3,600 or more, the average teacher salary was around \$500, and only about 7,000 Alabamians

earned enough to be taxed. After adding a standard deduction, Alabama now begins taxing a family of four at an income of \$4,600, about one-quarter of “poverty line” wages.

- **Our income tax is nearly flat.** Alabama's top tax rate of 5 percent starts at only \$6,000 of taxable income for a couple.
- **A flat income tax makes the whole tax system regressive.** Without a *progressive* income tax to offset the regressive sales tax, low-income people pay a larger share of their income in taxes than higher-income people pay.
- **Other tax rules benefit wealthy Alabamians.** For example, a state deduction for federal income tax payments gives individuals with the highest incomes the biggest breaks. During the stock market boom of the 1990s, the nearly flat income tax on *capital gains* favored those who profited the most.
- **Tax breaks for older Alabamians will grow in cost as baby boomers retire.** Our income tax exempts income from “defined benefit plans,” which include military and civil service pensions. There is an unlimited exemption for Social Security income.

The sales tax lag

Alabama's sales tax was modernized – in 1959! The Legislature introduced the sales tax in 1939 at 2 percent on retail sales of tangible personal property. Twenty years later, the tax was increased to 3 percent and expanded to include amusements and entertainments. The most recent change came in 1963, when it was raised to 4 percent.

- **Our sales tax continues to rely solely on consumption of goods and entertainment,** although spending patterns have shifted toward greater consumption of services.
- **Growth of “remote sales” has also eroded the sales tax base.** Federal law prohibits states from taxing Internet and mail-order purchases from vendors with no physical presence in the state.

Researchers at the University of Tennessee – Knoxville's Center for Business and Economic Research (<http://cber.bus.utk.edu>) estimate that in 2001 Alabama lost \$221 million in state sales taxes to a combination of e-commerce (Internet sales) and the shift from goods to services. In 2006, they estimate, the state will lose \$600 million to these factors.

Keywords

structural deficit – the inability of a government's annual revenue to keep up with the normal increases in program costs caused by inflation and population growth.

earmarking – the practice of setting aside – through constitutional provision or statutory law – revenues from particular sources for particular budget items.

regressive tax – a tax that requires people who make less money to pay a bigger share of their income than people who make more money.

progressive tax (also called *graduated tax*) – a tax that requires people who make more money to pay a bigger share of their income than those who make less.

capital gains – net income from the sale of certain kinds of property, such as buildings or stock shares.

tax base – the total value of income, goods, properties or services subject to a particular tax.

decouple (also called *de-link*) – break the connection between a state's tax code and certain provisions of the federal tax code.

transparent budget – a spending plan that lets taxpayers see how every tax dollar will be spent.

The property tax lag

For decades, Alabamians have been proud to have the lowest property taxes in the nation. The price for this distinction is the millions of dollars the state denies our schools each year by undervaluing agricultural and timber property. Owners of giant corporate farms and timberland benefit from discounts put in place decades ago under the guise of protecting small farmers. Alabama's 22 million acres of timber make up more than 70 percent of the state's land area but bring in less than 2 percent of state property tax revenues.

The corporate tax lag

Over the long term, corporate tax revenues in Alabama are declining. According to the U.S. Census Bureau, the share of total Alabama taxes contributed by the corporate income tax fell from 5.8 percent to 3.8 percent between 1979 and 2000. In addition, we lose substantial revenues from corporations through our low property tax and special sales tax breaks for business construction.

Beginning in 2003, President Bush's tax cuts have further lowered Alabama's corporate taxes. Unless states elect by law to *decouple* from a federal tax provision that is changing, they must follow the federal lead. Most states have decoupled from the new corporate tax provisions, but Alabama has not. These bonus depreciation rules allow businesses to "write off" the cost of new equipment more quickly. The cuts are scheduled to phase out in '05, but supporters want to make them permanent.

Regardless of the tax rates, corporate tax revenue varies more from year to year than any other major state revenue. This instability reflects the ups and downs of profits, along with some corporations' use of loopholes to avoid paying their fair share.

The estate tax lag

By 2002, the estate tax was a growing source of revenue for Alabama. Even though the tax affected fewer than 2 percent of those who died, its growth indicated that more and more Alabamians were accumulating substantial wealth over their lifetimes. Since Congress began phasing out the estate tax in 2002, some states have chosen to *decouple* from the federal provision, but Alabama has not. The Center on Budget and Policy Priorities estimates that the four-year phase-out of Alabama's estate tax cost the General Fund \$20.4 million in 2003 and will cost \$33.8 million in FY '04 and \$43.9 million in FY '05.

What can we do?

Eliminating Alabama's structural deficit is a massive undertaking. The following are examples of policy changes that would help get the process started:

- **Make the personal income tax more progressive** by creating a new top rate of 6 percent to capture revenue from higher-income individuals; increasing the income threshold of \$4,600, at which a family of four now starts paying, to \$18,850, the federal poverty line; and removing the deduction for federal income tax payments.
- **Adjust the corporate income tax** by removing the deduction for federal income tax payments and lowering the rate from 6.5 percent to 6 percent. (The deduction reduces the effective rate of the current tax to only 4.2 percent.)
- **Reexamine tax breaks for retirees.** For example, Alabama could tax pension benefits and Social Security for couples earning high incomes. (Social Security is currently deductible both "going in" as payments and "coming out" as benefits.)
- **Revamp the state property tax** to capture fairer revenue, especially from under-taxed timberland and large farms. Our property tax could be doubled and still be the lowest in the nation.
- **Modernize the state sales tax** by taxing more of what people are consuming today – services, both personal and professional.
- **Decouple from federal tax cuts.** Alabama can preserve some of the business taxes currently being phased out. Restoring the estate tax would require multi-millionaires' estates to pay something for the privilege of accumulating wealth in a stable, financially regulated society.
- **Save for the future.** Build up a Rainy Day account equal to 10 percent of the General Fund by putting money away during good years. Increase the Education Trust Fund Rainy Day account from the current 6 percent to 10 percent.
- **Reduce earmarking.** Give our leaders the flexibility to create a budget that reflects current needs and priorities, not those of decades past.
- **Exercise spending discipline.** A simpler and more *transparent budget* would reduce opportunities for favoritism and focus attention on the greater public good.

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