

Off Balance: Alabama's Regressive Tax System

An Arise Citizens' Policy Project Fact Sheet made possible by the Ford Foundation

June 11, 2008

Like snowflakes, no two tax systems are alike.

Across the country, states have different taxes applied at different rates to different taxpayers and taxable "things." Some states lean on *property taxes* to pay for their public services, while others rely more on *sales taxes* or *income taxes* to pay the bills. Some states have only one or two of these basic taxes. Those variations help determine how fair a state's tax system is to people across the income scale.

Alabama has a more imbalanced tax system than the average state, according to a recent study by the *Institute on Taxation and Economic Policy (ITEP)*. The organization's *Who Pays?* report, updated every five years or so, takes a state-by-state look at the shares of income that people in each income range pay annually in state and local taxes. ITEP's latest data, released in April 2008, show that Alabama's tax system is skewed against its low-income residents and is out of line with the way other states do things.

Why state tax systems differ

Taxes can be classified in one of three ways: *regressive*, *flat* or *progressive*. Regressive taxes take a bigger percentage of income from people who make less than from people who make more. Flat taxes take the same percentage of income from everyone, no matter how much or how little they make. Progressive taxes require high earners to pay a bigger share of their income than people who make less.

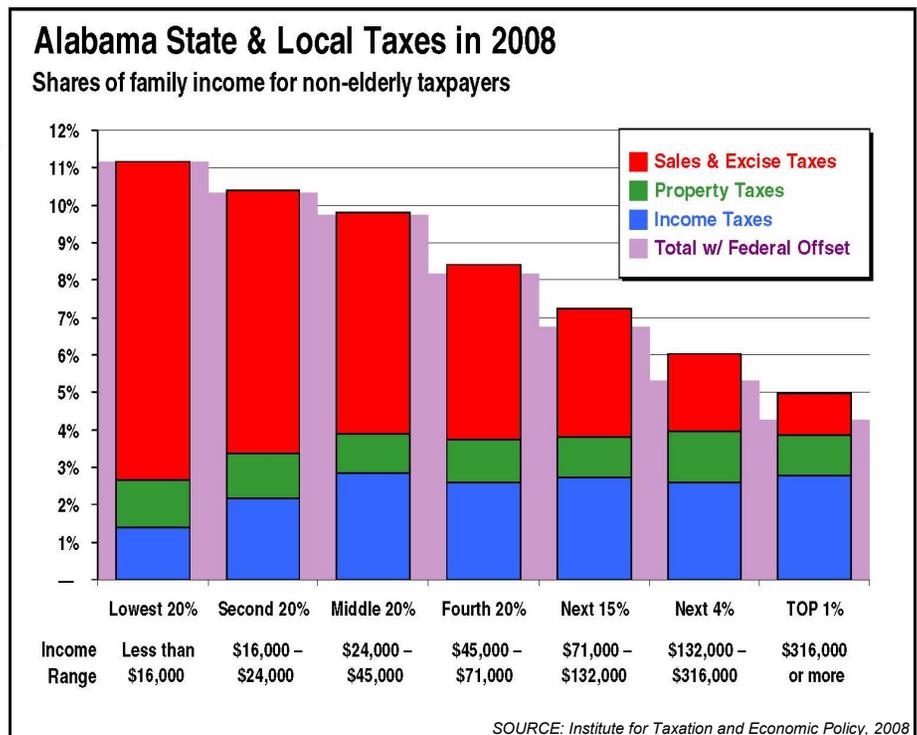
Sales taxes, especially on necessities like food, are highly regressive because low-income people spend most of what they make on taxable goods. The same is true for *excise taxes*, which are collected on special products like alcohol, cigarettes and gasoline. *Property taxes* are mildly regressive because the growth in people's incomes at the top of the income scale tends to outpace the growth in their home values. *Income taxes* are usually progressive, but some states have income taxes that seem progressive on paper but are flat or even slightly regressive in action.

How progressive a state's tax system is depends on how these taxes interact with each other. In the most progressive systems, income taxes offset the regressive effects of sales and property taxes. But combined state and local taxes are regressive in most of the United States – and in Alabama, the taxes are even more regressive than the national average.

Making less and paying more

The lowest-income Alabamians pay a far bigger piece of their income in state and local taxes than the state's highest-income residents do, the ITEP study says. The bottom fifth of the state's earners pay 11.2 percent of their income in state and local taxes, while the top 1 percent pay 5 percent. The effective rate at the top falls to 4.3 percent after the federal offset for state income taxes is considered.

High sales taxes play a big role in the imbalance. Alabama's sales taxes are 34 percent higher than the national average as a share of income, ITEP says.



Further, the state's sales taxes are more regressive than in most other states because Alabama is one of only two states that still fully tax groceries with no discount or rebate. (Mississippi is the other.)

Another key contributor to the imbalance of Alabama's tax system is its effectively flat income tax. State lawmakers increased the *income tax threshold* for a family of four from \$4,600 to \$12,600 in 2006, but they didn't change the income tax rates. That means the state's top rate of 5 percent kicks in on all *taxable income* of \$6,000 or more for married couples. As a result, almost 80 percent of Alabama families pay at the state's top rate, ITEP says.

Alabama's income taxes are low for people at the very top of the income scale but high for people at the bottom. For the top 1 percent of earners, the state's income taxes are the third lowest among the 42 states that have a broad-based income tax, ITEP says. But for Alabama's bottom fifth, the state's income taxes are the nation's third highest.

How can Alabama rebalance its tax scales?

Arise Citizens' Policy Project has endorsed the Tax Fairness Amendment as a way to make Alabama's tax system fairer to low-income residents. The measure would allow state voters to decide on a constitutional amendment that would do three things: (1) eliminate the 4 percent state sales tax on groceries, (2) increase the income tax threshold for a family of four from \$12,600 to \$20,000, and (3) end the state's full deduction for federal income taxes, which mainly benefits the top fifth of taxpayers. The plan would be revenue-neutral and wouldn't take any money from the state's

Keywords

excise tax – a special sales tax levied on the purchase of a particular type of product, such as alcohol, tobacco or gasoline.

flat tax – a tax levied at the same rate on all levels of income.

income tax – a tax on earned income (salary, wages, etc.) and unearned income (dividends, interest, etc.).

income tax threshold – the lowest income level at which people must pay income tax.

Institute on Taxation and Economic Policy (ITEP) – a nonprofit, nonpartisan group based in Washington, D.C., that researches federal and state tax policies.

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

property tax (also called *ad valorem tax*) – a tax levied by state or local government on the assessed value of real estate and certain other property.

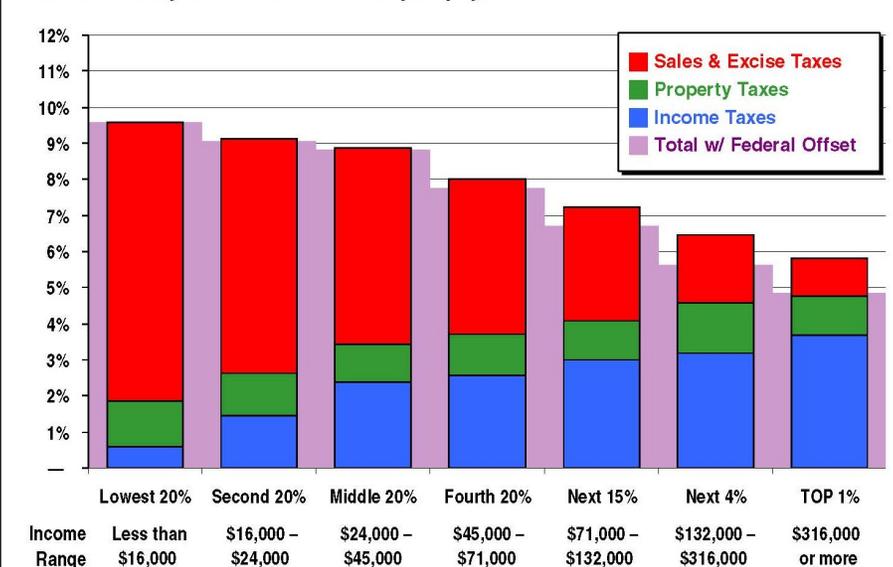
regressive tax – a tax that requires people who make less money to pay a bigger share of their income than people who make more money.

sales tax – a tax levied by a state or locality on the retail price of an item, collected by the retailer.

taxable income – the amount of income subject to income tax (after subtraction of all deductions and exemptions).

education budget. If voters approved the amendment in November 2008, its changes would take effect on Jan. 1, 2009.

Alabama Taxes in 2008 If Tax Fairness Amendment Passes
Shares of family income for non-elderly taxpayers



SOURCE: Institute for Taxation and Economic Policy, 2008

The Tax Fairness Amendment

would make Alabama's tax system more progressive. After the federal offset for state taxes, the plan would cut the combined state and local tax rate for the bottom fifth from 11.2 percent to 9.6 percent, according to ITEP calculations. Meanwhile, the rate for the middle fifth would drop from 9.7 percent to 8.8 percent, and the rate for the top 1 percent would tick up from 4.3 percent to 5.1 percent. The changes would be slight, but they would be a big step toward a more balanced tax system for Alabama.

This fact sheet was prepared by policy analyst Chris Sanders. It may be reproduced with acknowledgment of Arise Citizens' Policy Project, P.O. Box 1188, Montgomery, AL 36101; (800) 832-9060; arisecitizens.org.