Out of Step: Alabama's Unusual State Tax System

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Taxes are the tools that Americans use to pay for education, public health, transportation and other elements of the common good. Just as states differ in the scale of services offered, they also differ on the ways to pay for those services. Some states lean on **property taxes** to fund public services, while others rely more on **sales taxes** or **income taxes**. Some states have only one or two of these basic taxes. Differences in the levels and kinds of taxation help determine how adequate a state's revenues are and how equitably its tax system treats people across the income spectrum.

Partly by accident and partly by design, state taxes affect Alabamians differently than people almost everywhere else. This fact sheet will look at the various ways in which states collect revenue and examine some of the differences that place Alabama's tax system out of line with the way most other states do things.

Keywords

excise tax – a special sales tax on a particular type of product, such as alcohol, tobacco or gasoline.
flat tax – a tax levied at the same rate on all income levels, no matter how much or how little people make.
income tax – a tax on earned income (salaries or wages) and unearned income (dividends, interest, etc.).
income tax threshold – the income level at which people begin to owe income tax.
progressive tax – a tax that requires people who make more money to pay a bigger share of their income than those who make less money.
property tax (also called *ad valorem tax*) – a tax levied by state or local governments 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 those 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.

Different incomes, different effects

Taxes are considered regressive, flat or progressive according to their impacts at various income levels. **Regressive taxes** take a bigger share of income from people who make less than from people who make more. **Flat taxes** require all people to pay the same share of income, no matter how much or how little they make. **Progressive taxes** require high earners to pay a bigger percentage than people who make less.

Sales taxes, especially on necessities like food, are highly regressive because low-income people must spend most of what they make on taxable goods just to maintain a minimal standard of living. (**Excise taxes**, levied on products like alcohol, cigarettes and gasoline, also tend to be regressive.) Property taxes are mildly regressive because they do not respond to changes in incomes and because homes are a much larger share of wealth for low- and middle-income households than for the rich. Income taxes often are progressive by design. Some states (including Alabama) have income taxes that look progressive on paper but are effectively flat in practice because the top rate kicks in at a low income.

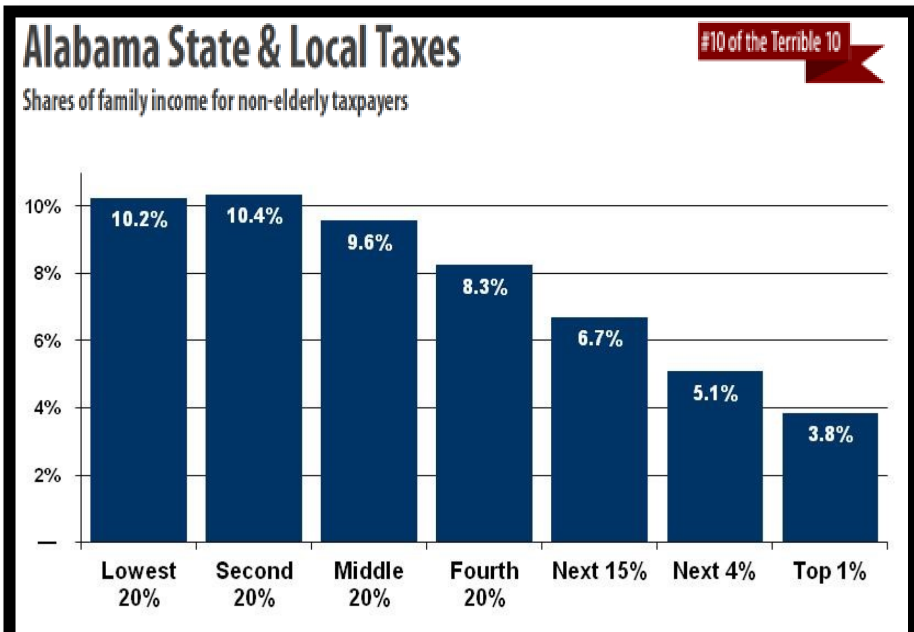
How progressive a state's tax system is depends on how these taxes interact with each other. In most states, income taxes partially offset the regressive effects of sales and property taxes. But state and local taxes are regressive in most states – and in Alabama, taxes are more regressive than the national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

Making less but paying a larger share

Alabama is widely known as a "low-tax state," but taxes are not low for everyone. Low- and middle-income Alabamians pay more than twice as much of their income in overall state and local taxes as do those with the highest incomes, according to a 2013 study by the Institute on Taxation and Economic Policy (ITEP; *see chart on next page*) that ranked Alabama 10th among the "Terrible 10" states with the most regressive tax systems. The bottom fifth of Alabama's earners pay 10.2 percent of their income in state and local taxes, ITEP found, while the middle fifth pay 9.6 percent. By contrast, the top 1 percent of earners – those who made $371,000 or more in 2010 – pay an effective 3.8 percent share after deducting state taxes from their federal income taxes.

Low property taxes and high sales taxes are two key reasons that Alabama's tax system hits low- and middle-income residents harder. Property taxes in Alabama are by far the nation's lowest – then-Gov. Bob Riley said in early 2011 that the state's property taxes could double and still be lower than in any other state – and the state constitution makes it hard for the state or counties to raise property taxes. As a result, leaders seeking new revenue for public services often increase sales taxes, further squeezing low-income families. Alabama's statewide sales tax is 4 percent, but local sales taxes have driven the total rate to 10 percent in Birmingham, Montgomery and other cities.

Alabama's effectively flat income tax does little to offset the regressive effects of its high sales taxes. 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. The state's top rate



Source: Institute on Taxation & Economic Policy, 2013

of 5 percent applies to all taxable income of $6,000 or more for couples. As a result, nearly two-thirds of Alabama's families pay at the top rate, ITEP found.

An unusual tax and an unusual tax break

Unlike most Americans, people in Alabama pay the same sales taxes on groceries that they pay on clothes, furniture and other taxable items. Of the 45 states that have a general sales tax, about two-thirds completely exempt most food for home consumption from state sales tax. Most of the rest either tax food at a lower rate or provide tax credits or partial refunds to help offset food taxes for lower-income people. Only Alabama, Kansas, Mississippi and South Dakota still fully tax groceries with no discount or rebate *(source: Federation of State Tax Administrators, January 2014)*. The grocery tax is highly regressive because many low-income families must spend a large part of what they earn on mere sustenance. Groceries bought with food stamps are not taxed, but food stamps cover only a portion of food costs for most recipients. Many eligible families do not apply for any food assistance.

Another unusual feature of Alabama's tax system is one that low-income people likely never encounter: the state income tax deduction for federal income taxes. Alabama allows individual taxpayers to deduct the entire amount they pay in federal income taxes (FIT) from their state taxable income. Only five other states allow taxpayers to deduct any portion of their federal income taxes paid, and only two others – Iowa and Louisiana – allow a full FIT deduction as in Alabama.

Upper-income households receive most of the deduction's benefits. The top fifth of Alabama income earners receive 82 percent of the deduction's total value, compared to 4 percent for the middle fifth, ITEP found in 2014. Taxpayers in the middle fifth get an average benefit of $58 from the deduction, according to ITEP, compared to an average benefit of $9,663 for the top 1 percent of the state's earners. Overall, Alabama lost $581 million, or a fifth of the revenue generated by its income tax, to the deduction in 2013, ITEP estimates.

Some state lawmakers in recent years have proposed measures to reform Alabama's tax system. Rep. John Knight, D-Montgomery, has introduced numerous proposals to remove the state sales tax on groceries and replace the lost revenue by limiting or ending the FIT deduction. Rep. Rod Scott, D-Fairfield, introduced legislation in 2014 that could expand the reach of the corporate income tax. These or other reforms could bring Alabama more in line with other states and ensure the state's tax system no longer demands so much from those who can least afford to pay.

For a broader look at state and local tax policy, check out* The ITEP Guide to Fair State and Local Taxes *at www.itep.org/state_reports/guide2011.php. For more on how state and local taxes affect people by income level in each state, check out ITEP's* Who Pays? *report at www.itep.org/whopays.

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