Executive Summary
Louisiana Tax Study, 2015*

Presentation for

House Committee on Ways and Means
Chair, Representative Joel C. Robideaux
And
Senate Committee on Revenue and Fiscal Affairs
Chair, Senator Neil Riser

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****The authors are solely responsible for the analysis and findings.**

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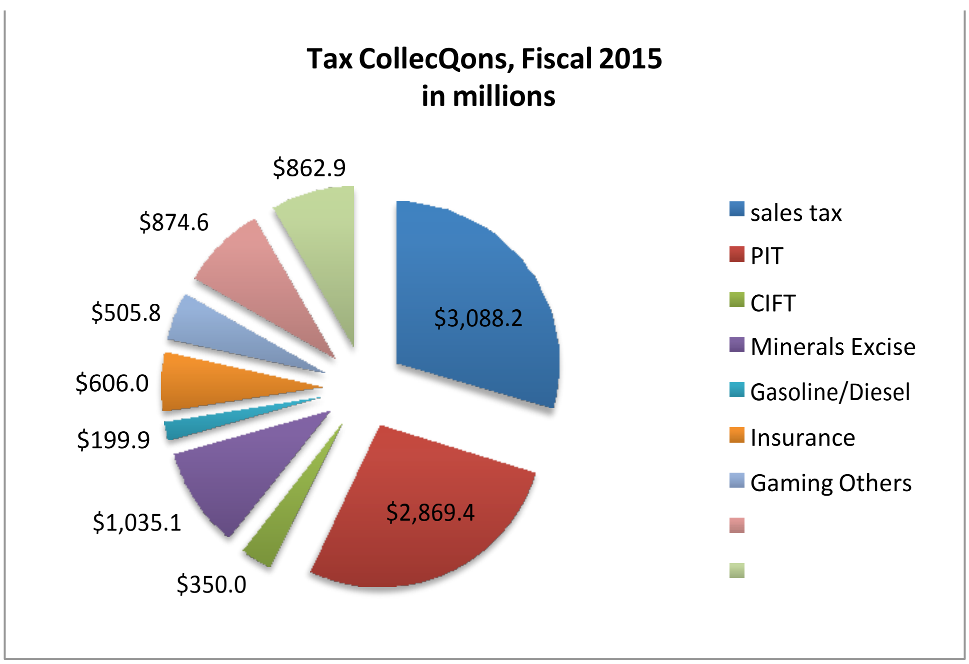
Introduction

Louisiana, like every other state, must **establish the appropriate level of public expenditures** in line with the political preferences of its electorate and **a tax structure capable of funding** these desired state expenditures. At the same time, this tax structure must **not deter economic development** of the state **nor impose a disproportionately large and possibly counter---productive tax burden** on any one segment of the community. The tax structure should also be as **simple and transparent as possible and compatible with the local tax structure**. From an economist's perspective, the guiding principles of constructing a state tax structure include **broad tax bases** (meaning minimizing exemptions, credits, and rebates) allowing for **low tax rates** that typically contribute to simplicity of the tax structure, equity among taxpayers, long---term stability of the tax system, and the adequacy of paying for the public services demanded by the electorate.

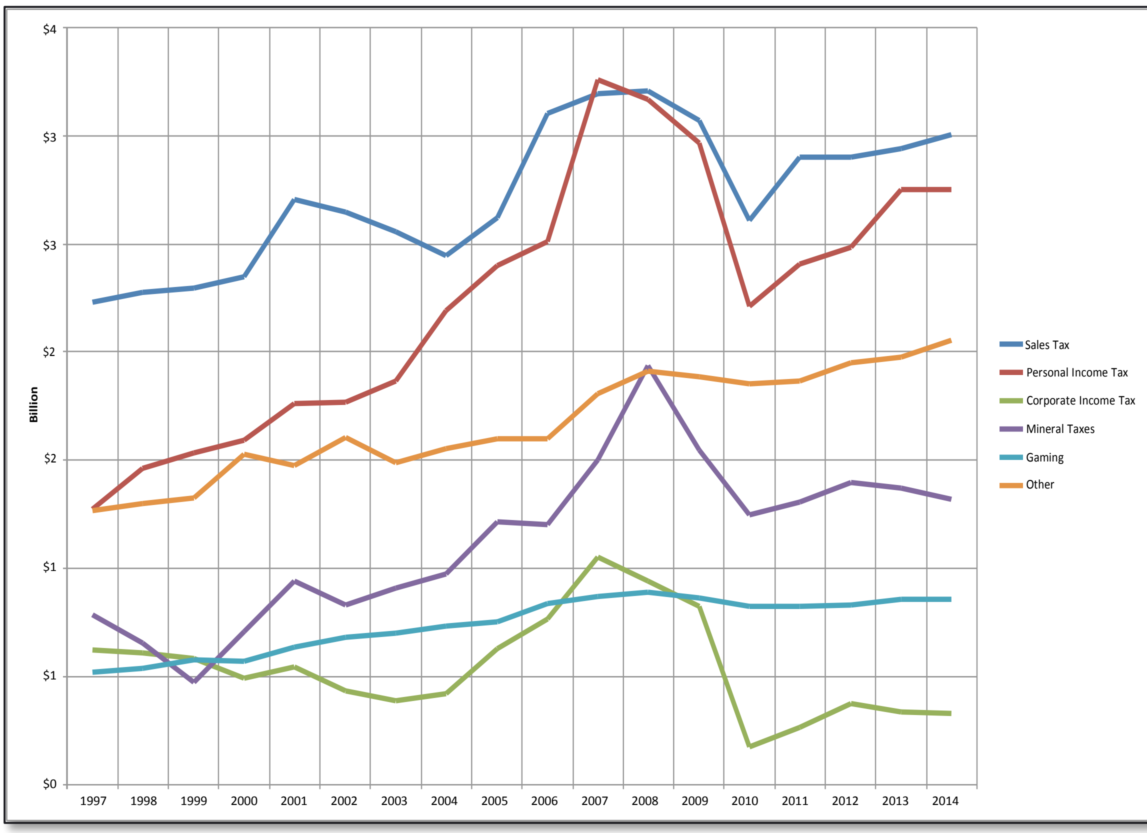
Present Tax Structure

Louisiana's present tax structure includes two major sources of revenues with the sales tax and the personal income tax making up over 57% of total collections. Mineral revenues, including the severance tax, make up just over 10% of revenue collections while gaming and others contribute over 8% of total tax collections. Gasoline and diesel taxes represent almost 6% of revenue collections; corporate income and franchise taxes account for just over 3% of collections; insurance taxes make up almost 5% of all collections: and excise taxes (alcoholic beverages, beer, and tobacco) make up almost 2% of collections.



These tax collections have varied over time responding to changes in economic expansions, national recessions, legislative changes in the tax structure, and energy volatility. From 2008 through 2010, sales taxes, personal income taxes, corporate income and franchise taxes, and mineral revenues (or in total about 70% of the state's revenue sources) declined. Taxes, licenses, and fees declined from just over $12 billion in fiscal 2008 to about $9 billion in fiscal 2010, a decline of 25%. This substantial decline in revenues followed a decline in economic activity related to the national recession and the decline in Katrina---related spending in southeastern Louisiana, a drop in energy prices, and legislatively approved reductions in personal income taxes in 2007 and 2008.

Louisiana Major Tax Sources, 1997 through 2014



Tax collections from the major taxes are also affected by exemptions, credits, and other tax provisions approved either constitutionally or legislatively over a number of years. It is estimated that exemptions, exclusions, credits, and rebates amounted to over $7 billion in fiscal 2010 and increased to approximately $7.7 billion in fiscal 2014, an amount equal to about 70% of the actual collections. Tax exemptions reduce the tax base, thereby reducing the tax collections from a specific tax rate. Tax credits reduce directly the tax liability of a particular taxpayer. Together, exemptions and credits affect the major sources of revenue for the state—sales tax, personal income tax, corporate income and franchise, and the severance tax. Exemptions and credits must be carefully evaluated in any overall examination of a state's tax structure.

The sales tax is also a major source of local revenues along with the property tax. The state sales tax is 4%, and the average local sales tax rate approaches 5%. Together, the combined state and local sales tax rate is approximately 9%, the third highest state and local sales tax rate in the nation according to the Tax Foundation. Tennessee has the highest state and local sales tax rate with 9.45% and Arkansas is second with a state and local rate of 9.19%. Even as we focus on the state tax structure, we must address issues of local taxation as well. We also note that the local property tax base is diminished by several major exemptions—the homestead exemption for homeowners and the industrial tax exemption for manufacturing activities. Local tax capacity is constrained by constitutional mandates and legislative constraints.

Outside Review of Louisiana Tax Structure

In order to get a fresh perspective on the Louisiana tax structure, we retained Professor George Zodrow, Rice University, and Professor William Fox, University of Tennessee, two noted tax experts, to give us their view of the strengths and weaknesses of Louisiana's tax structure. Fox and Zodrow saw the Louisiana tax structure as workable and sustainable but with a number of features that could be corrected. They gave a very **high priority** to the following changes in the Louisiana tax structure: (1) examine the sales tax base from perspective of the many exemptions that have been enacted and from the perspective that services, the fastest growing area of the economy, have been for the most part excluded from the sales tax base; (2) coordinate the administration of the state and local sales tax collections, especially because of the Streamlined Sales and Use Tax Agreement (SSUTA); (3) lower significantly personal income tax rates by removing many exemptions from the tax law; (4) align basic excise taxes (including alcoholic beverages, beer, gasoline and diesel, and tobacco) with rates in other states; and, (5) improve business taxes by lowering the high rates associated with the corporate income tax, re---examining the corporate franchise tax, and reviewing the method of apportioning corporate income for purposes of state taxation. Both Zodrow and Fox noted that local sales taxes were very significant since the other local tax base, the property tax, has been reduced substantially because of major exemptions. Zodrow felt the market would generate appropriate investment in oil and gas activities without the horizontal drilling incentive since horizontal drilling is no longer an infant industry.

Making full use of the Fox/Zodrow reviews and suggestions, along with our own analysis of weaknesses in the Louisiana tax structure, we make the following suggestions for the state and local sales tax, the personal income tax, the corporate income and franchise tax, severance taxes, and excise taxes including alcoholic beverages, beer, tobacco, and gasoline and special fuels. These suggestions focus primarily on the **structure** of taxation in Louisiana. We are not suggesting an increase or decrease in the present **level** of state revenues or spending—this decision is properly the domain of elected officials.

Sales and Use Tax

The state's sales and use tax has been levied since the 1930s. The state rate has been 4% since 1984, and the average local rate has increased since 1984 from less than 4% to almost 5% presently. The state and local sales tax rate is now the third highest combined state and local sales tax rate in the nation based on sales tax data collected by the Tax Foundation. Also, it is estimated that current sales tax exemptions are almost $3 billion, an amount that roughly equals the amount of dollars the state sales tax actually generates. We do not believe that Louisiana should increase the state sales tax rate from 4% to any higher rate even if the state decides that it needs additional revenues. Instead, we suggest three major reforms of the sales and use tax: expand the sales tax base by examining existing exemptions, expand the base by adding services; and simplify the administration of the tax.

Sales tax exemptions

Our first major recommendation for the sales and use tax is to reconsider the many exemptions currently present in the sales and use tax. Nearly two---thirds of current sales tax exemptions, or approximately $1.7 billion, is embodied in 7 exemptions of which 4 are constitutionally mandated: food for preparation and consumption at home ($387 million); sales of electrical power, non---residential ($319 million); gasoline sales ($301 million); prescription drugs ($289 million); purchases by state and local governments ($210 million); sale of electrical power for residential use ($176 million); and purchases of machinery and equipment ($60 million). Only seven states tax the purchase of machinery and equipment, and there are a variety of exemptions across states with respect to the sale of electrical power for nonresidential use across states.

Aside from these 7 exemptions, there are over 70 other specific commodities exempted. These products range from medical devices to agricultural purchases of seed and fuel to purchases of breastfeeding items to specialty Mardi Gras items purchased or sold by certain organizations to tax holidays for back to school, hurricane preparedness, and Second Amendment rights. The tax holidays amount to about $4 million in reduced sales tax collections.

Each of these exemptions was passed with a specific purpose in mind. Exemptions, however, diminish the tax base. We suggest several reforms: first, a moratorium on any new sales tax exemptions; second, a removal of the sales tax holidays since there is no evidence of any major gains to the state or to the citizens for this tax advantage; third, a sunset on all other tax exemptions over a five year period; fourth, an analysis of the economic and social value of all exemptions; and, fifth, a requirement that any exemption shall be maintained only after approval by the State Legislature and the Governor.

Services

Our second major recommendation is to expand the sales and use tax to cover personal services. Given the high sales tax rate in Louisiana, expanding the sales tax base offers either strong revenue gains or possibly rate reductions. The taxation of services is likely to increase the progressivity of sales taxation, given the pattern of services consumption across income groups, and it would augment the sensitivity of the sales tax collections relative to overall economic growth since services are becoming much more dominant in the mix of items that people purchase on a regular basis. Of course, expanding the sales tax to services could increase the administrative complexity of the Louisiana sales tax. There will certainly be a learning curve for state administrators who are collecting and monitoring the sales tax collections, but also for taxpayers who must record and remit taxes on services for the first time. The revenue potential ranges from $145 million of state revenues (using the personal services recommended by the 2013 Jindal plan) to $222 million (using services taxed by Texas but not by Louisiana) to almost $500 million (using personal and all other services included in the 2013 Jindal plan).

Administration

Our third major recommendation for the sales tax is to gradually and systematically work our way from the very decentralized system of sales tax administration that exists in Louisiana today to a more uniform system in which the state can apply for membership in the Streamlined Sales

<u>and Use Tax Agreement.</u> We make this recommendation to align Louisiana with almost every other state in the union that has a state and local sales tax and to enhance revenue collections at both the state and local level that might be lost due to internet transactions. The only other states that have a decentralized system of state and local sales tax collections are Colorado, a state that allows home---rule municipalities to collect their own sales taxes, and Arizona, which has just recently passed legislation to create a uniform method of collecting state and local sales taxes.

We propose the following steps in establishing a uniform method of collecting state and local sales taxes.

- As part of the tax reform effort, eliminate optional sales tax exemptions for any future legislative activity.
- Create a Local Sales Tax Commission (with members appointed by the Police Jury Association, the Louisiana Sheriffs Association, the Louisiana School Boards Association, the Louisiana Municipal Association, the Mayors Council, and the Governor, Speaker of the House of Representatives, and President of the Senate) to initiate a process by which **<u>local</u>** taxes can be collected uniformly and appropriate auditing processes can be established.
- Once the Local Sales Tax Commission is working, have the State join the Local Sales Tax Commission to create a uniform process of state and local sales tax administration (collections and auditing).
- Initiate a Study Panel on State and Local Sales Tax Bases to estimate the variation in the tax bases among the state and localities and among the local governments themselves and to map out a reasonable way to gradually eliminate the variation and minimize the cost of such changes. This study should be completed in two years.

Unifying the state and local sales tax base is an important challenge for Louisiana in meeting the criteria for the SSUTA. In making any changes, we must recognize that some local governments have issued bonds based on expected sales tax revenues and that reducing or eliminating those revenue streams could unconstitutionally violate bond covenants. We recommend a series of steps to bring forth the desired uniformity. First, the SSUTA allows local governments to include food for home consumption and prescription drugs in the base even if they are exempt—as they are in Louisiana—at the state level. We would allow this practice to continue. Second, local optional exemptions from the sales tax should be eliminated by state legislation. Finally, legislation should eliminate other state exemptions to insure uniformity in tax bases.

The uniform collection of state and local sales taxes should be completed in a 3 to 5 year window. The establishment of a uniform sales tax collection process is important to both the state and local governmental units. Current revenues are at stake, and even more future revenues are potentially at stake, especially if the sales tax is expanded (as recommended earlier).

This proposal is submitted with the greatest respect for local governments and with the understanding of the absolute importance of including local governments in every step of the process in establishing a uniform method of state and local sales tax collection. The administration of sales tax collections is not just a state issue; it is a state---local issue.

Personal Income Tax

Louisiana cannot eliminate the personal income tax as a method of paying for public services. This tax is very important to the state budget due to its absolute size, its share of total collections, its growth potential, its contribution to progressivity in the state's tax structure, and its broad reflection of economic activity. The state cannot make further extensive use of the sales tax since local governments in the state are also very reliant on the sales tax and since locals are very constrained by their use of the property tax. The Louisiana personal income tax, as it is now structured, is competitive with other southern states that have an income tax. Louisiana's lowest marginal tax rate applies to the first $25,000 of taxable income of joint filers while most other states have the lowest rate apply to less than $5,000 of taxable income; Louisiana's highest rate is not effective until $100,000 of taxable income while for most other states the highest marginal tax rate becomes effective on average at about $20,000. Three states in the south have higher top marginal tax rates, but no state has the highest rate becoming applicable at $100,000 of taxable income as Louisiana does. Kentucky's highest marginal tax rate becomes applicable at $75,000 and West Virginia's highest marginal tax rate becomes applicable at $60,000. There are ways, however, to reform the Louisiana personal income tax to improve the competitiveness of Louisiana relative to other states with an income tax.

Income Tax Comparisons for States in South with Income Tax
Joint Filers, 2013

States	Lowest Marginal Tax Rate	Applies for first $	number of marginal tax rates	Highest Marginal Tax Rate	When Top Rate Becomes Effective	Federal Tax Liability Deduction
AL	2.0%	$500	3	5.00%	$6,000	yes
AR	1.0%	$4,099	6	7.00%	$34,000	no
GA	1.0%	$750	6	6.00%	$10,000	no
KY	2.0%	$3,000	6	6.00%	$75,000	no
LA	2.0%	$25,000	3	6.00%	$100,000	yes
MS	3.0%	$5,000	3	5.00%	$10,000	no
NC	5.8%	flat rate	1	5.80%	flat rate	no
SC	3.0%	$2,850	5	7.00%	$14,250	no
VA	2.0%	$3,000	4	5.75%	$17,000	no
WV	3.0%	$10,000	5	6.50%	$60,000	no

We suggest the following changes to the personal income tax: (1) eliminate the federal income tax deduction, excess itemized deductions, and the net capital gains exclusion (all together about $1.1 billion of tax exemptions) and reduce the rates to 1%, 3%, and 5%; (2) maintain but decouple the earned income tax credit from the federal EITC; (3) place a moratorium on any new tax credits applying to the personal income tax and sunset all existing tax credits applying to the personal income tax; (4) limit credits for taxes paid to other states to Louisiana tax liability; and, (5)) examine and evaluate other major exemptions in the personal income tax including those exemptions dealing with retirement income and social security income.

The proposal to eliminate the federal income tax deduction reduces the volatility and uncertainty of personal income tax revenues attributable to changes made in Washington D.C. Federal deductibility has allowed the state to reap the benefits if taxes were being cut at the federal level such as in 2001 and 2003, but it has also meant a loss of state income tax collections if the federal government is raising taxes. Changes in itemized deductions by the federal government or changes in the federal earned income tax credit all affect state income tax collections. For this reason we propose restricting the connection of the Louisiana personal income tax structure to the federal system to the definition of adjusted gross income.

Presently, the state generates an estimated $2.9 billion from the personal income tax. The proposed 1%/3%/5% rate structure will generate roughly $3.1 billion. Households making less than $120,000 per year would pay slightly less than they are now paying under the present structure (about 1.6 million households fit in this category); households making more $120,000 annually would pay slightly more with those making over $1 million per year paying on average about $30,000 more per year (the average income for the above $1 million category is $2.8 million).

We also examined a flat tax since it has been discussed nationally and North Carolina just recently passed a flat tax of 5.8%. We found that households in the middle to higher middle---income brackets would pay more in state taxes under virtually any version of a flat tax that did not raise taxes on lower income households. It is very difficult to protect middle---income taxpayers with only a single tax rate. Our recommendation of a 1%/3%/5% rate structure adds desired progressivity to the overall tax structure, progressivity that is simply not possible with a flat rate. Also, it is important in interstate comparisons for the top marginal rate to be attractive, and Louisiana will be in an excellent position relative to other states with the highest marginal tax rate being 5% and becoming effective at $100,000.

Corporate Income and Franchise Taxes

Louisiana last changed its corporate income tax structure in 1977 when the state increased its corporate tax rates from 4% to a graduated rate schedule of 4% on the first $25,000 of net income, 5% on the next $25,000, 6% on the next $50,000, 7% on the next $100,000, and 8% on net income in excess of $200,000. The state increased its corporate franchise tax in 1984 from $1.50 per $1,000 of equity and debt to $3.00 per $1,000. However, borrowed capital has been completely phased out of the tax base for taxable periods beginning on or after January 1, 2011 by the State Legislature, and an adverse legal ruling in 2011 (Utelcom, Inc. and Ucom, Inc. v. Bridges) eliminating the tax for limited partnerships operating in Louisiana. These changes have substantially reduced the revenues from the tax. Additionally, the state has not fundamentally changed the tax law, but even so the state has changed the tax liability of corporations by creating refundable tax credits or special exemptions, such as the inventory tax credit or the net operating loss (NOL) carryback and carry forward. These credits substantially affect corporate tax liability.

In fiscal 2008 corporate taxes surpassed the $1 billion mark, but revenues fell to less than $200 million in just two years and presently revenues are hovering between $300 and $400 million. The corporate tax structure must be addressed for several reasons. First, corporate taxes are paid by corporations that cross state lines or are global companies. These corporations have a fiduciary obligation to their stockholders to assign their revenues and costs in the most advantageous places for tax minimization. The state has an obligation, not to tax the corporations unfairly, but to tax them consistent with their operations within the state of Louisiana and in line with companies based only in Louisiana. Second, the state wants to be business---friendly, and an 8% top marginal tax rate puts Louisiana as the highest marginal tax rate in the south. The 8% top marginal tax rate is sometimes a company's first impression of Louisiana business climate. Mississippi has a top rate of 5%, Arkansas 6.5%, Tennessee 6.5%, Georgia 6%, North Carolina 6%, South Carolina 5%, Florida 5.5%, and Virginia 6%; Texas does not have a corporate income tax but does have a gross margins tax. Third, the state incurs unnecessary volatility in corporate tax collections due to changes in federal tax policies since Louisiana's corporate collections are tied to federal tax liability.

We recommend a major reduction in the corporate tax rate from the rate structure of 4% to 8% to a single rate of 5% without the deductibility of federal tax liability. These changes would provide approximately the same amount of revenue presently being received. The cost of the federal tax deductibility is estimated to be $175 million.

We also recommend a more fundamental reform of the corporate income tax by making use of "addback statutes" as a means of addressing issues arising from intercompany transactions attributable to passive income. Addbacks are statutes that essentially eliminate certain intercompany transactions as deductions from the corporate tax base within a state. The most intensive addbacks include royalties for trademarks and other such services, intangible---related interest, intercompany interest and management fees. Virtually all states that tax businesses on a separate entity basis have addback statutes; specifically, twelve states have statutes defining these addbacks, including Alabama. The major reason for accepting the addback model is that it will provide stability and certainty for companies since they will now know the rules regarding what royalty income can or cannot be transmitted to another state as an expense. This modification can be easily administered by the Louisiana Department of Revenue.

In the longer run, we also suggest that Louisiana should consider combined reporting. Under combined reporting statutes, corporations are taxed based on their apportioned share of income of their "unitary group". Corporations are combined into a unitary group under a variety of criteria, including common ownership, common management, and operating in the same line of business. The primary advantage of moving toward combined reporting is that it automatically handles the issues addressed in addback statutes without having to anticipate them in specific situations. It is generally acknowledged as the best method for safeguarding a state against corporate tax strategies to shift income to other locations. However, combined reporting does take time to implement, to properly administer, and to train a state's auditing staff. This is why we think it is prudent to start with the addback process and consider adopting combined reporting at a later date.

We also recommend several changes to how Louisiana apportions income for multistate businesses. This is important to make sure that Louisiana taxes its fair share of the income from multistate businesses. We have two major recommendations: *First, we believe that the state should increase the scope of apportioning income from multistate businesses using "single sales factor apportionment".* Louisiana currently utilizes this method for manufacturing and merchandising firms, but we believe it should be expanded without restrictions to most firms except for some specialized industries. *Second, we recommend a new method called "market sourcing of services" for apportioning income from multistate firms that provide services.* This method would apportion income based on where a service is used, not where it is produced.

This would allow Louisiana, for example, to tax the income of large financial firms that operate outside the state but that have customers within the state. These changes are in line with those now being made in other states, and would protect the tax base for Louisiana.

The net operating loss carryback and carry forward deduction allows the averaging of income for businesses that have fluctuations in their earnings. *We recommend that the carryback be eliminated or, at least, be reduced to 2 years, consistent with the practice in most other states, while the carryforward be maintained at 15 years.* Eliminating the carryback and allowing for a 15 year carry forward would be very representative of practices in other states.

Finally, we recommend phasing out the franchise tax. As we discussed, as a result of legislative changes and adverse court decisions, the tax applies only to equity in corporate entities and the base of the tax is narrowing over time. It is also not an economically sound tax. *We recommend phasing out the franchise tax. An alternative to its total elimination that could be considered would be to cap the tax at a relatively low level, but to restructure the tax to have it apply to all business entities, not just corporations.*

Property Tax

In most of the country, local governments rely primarily on property tax revenues to finance their activities, along with some use of local sales and use taxes. In Louisiana, there is a much stronger reliance on local sales taxes. Local governments have little choice but to rely on the sales tax, as their property tax base is limited by two very large state---controlled exemptions: the homestead (or homeowners) exemption and the industrial property tax exemption.

Since 1982, homeowners have been able to exempt the first $7,500 from the assessed value of their property before any property tax in incurred. Since this type of property is assessed at 10% of fair market value, this is equivalent to exempting the first $75,000 of market value. By national standards, this is an extremely generous exemption, and it allows Louisiana to have one of the lowest average effective tax rates on homeowner property in the country and one that is lower than other southern states. Since the homestead exemption has not been changed since 1982, its effects on the tax base have eroded over time as property values increased. In 1990, the homestead exemption reduced the taxable base by approximately 28%; in 2013, the taxable base was reduced by only 16%.

The industrial tax exemption is a program operated by the Louisiana Economic Development and the State Board of Commerce and Industry. The exemption offers full property tax abatement on new manufacturing investment for up to ten years (an initial five years with a five year renewal). It includes taxable equipment but excludes land and inventories. While other states have similar exemptions, most states are not as generous, limiting their exemption period to five years. In addition, in other states, local governments must first request the exemption, while in Louisiana the exemptions are determined at the state level and the local parishes have no say in the process. Our estimates suggest that the reduction of the property tax base from the industrial tax exemption program is approximately the same size as the homestead exemption in terms of reducing the tax base, although the differences vary sharply across parishes.

Unlike the homestead exemption (which is naturally reduced by increases in property values over time as long as the exemption is not increased), there are no mechanisms to decrease the industrial property tax exemption. *Our proposal is to limit the amount of the exemption to 80% and to limit it to one seven year period.* This is a still a generous incentive for manufacturing, but would put a partial brake on the expansion of this exemption. Local parishes would then regularly assess and tax the other 20%. *An important additional change would be to require approval by the local parish before approving any exemptions.*

Exemptions and Tax Credits

Louisiana has, over a long period of time, added numerous exemptions and tax credits to the tax law. An exemption reduces the tax base; a tax credit reduces directly the tax liability. As noted earlier, it is estimated that all exemptions and credits amount to $7.7 billion, an amount that has grown by about 10% since 2010. Even aside from the already discussed exemptions and tax credits for the sales, personal income, and corporate income taxes, we believe that the various economic development incentives must be reconsidered. For all development incentive programs, *we recommend that each incentive program must be specifically justified, designed with a sunset provision, limited in its magnitude, and evaluated regularly with rigorous and impartial analysis to determine whether its stated benefits exceed its costs.* We also believe that certain tax credits need clarification and improvement. These tax credits are the inventory tax credit, the motion picture film credit, and the enterprise zone exemption, in addition to the homestead exemption and industrial tax exemption as previously discussed.

Inventory Tax Credit

The inventory tax credit is a product of the 1990s, and it was an attempt to eliminate the Louisiana inventory ad valorem tax, a property tax that was not levied in most states. Presently, nine states tax inventories with an ad valorem tax. The tax credit was phased in over 7 years. It has grown rather quickly in the last decade, and it is now the third largest tax credit/exemption, just behind the Subchapter S Corporation tax exemption and the federal tax liability deduction (both individual and corporate).

Taxing inventories is not a productive economic development policy. However, some changes are needed in the current method of providing this tax credit. The assessor values a company's inventories; the company pays the tax bill; and the company then submits its tax bill to the state government to lower the company's tax liability or to receive a refund since this credit is refundable. The company has no incentive to question the assessment of its inventories since the state is fully obligated to the payment. *We recommend that the inventory tax credit be changed to 75% of the value of the assessment thereby giving the company some "skin in the game".* Over time we believe that the inventory ad valorem tax should be eliminated and replaced with other local revenues. However, this long run change cannot be done quickly since local governments currently rely on property tax revenues.

Motion Picture Investor Tax Credit

Louisiana's motion picture investor tax credit (film credit) provides a 30% transferable tax credit on total in---state expenditures, including resident and non---resident labor, with no cap, subject to a $300,000 minimum expenditure. The credits can offset personal or corporate tax liability, can be sold or transferred to third parties, or can be sold back to the state for 85% of face value. For productions using in---state labor, there is an additional 5% payroll tax credit. In the last year, Louisiana awarded approximately $250 million in credits. There have been a number of formal and informal analyses of the motion picture investment credit, including those commissioned by the Louisiana Economic Development Agency. A fair reading of this literature suggests the following four points:

1) The credit has been successful in attracting production of films to Louisiana and generating local economic activity.
2) The credit has cost the state considerable revenue, even after allowing for offsets due to the generation of new economic activity. The most recent study from the Louisiana Economic Development agency pegged the budgetary cost for 2012 at approximately $170 million, while allowing for roughly a 33% offset from increased activity.
3) There is no natural ending point to the subsidization of the film industry. While there has been some infrastructure development, most observers believe that the level of film production we have witnessed in Louisiana is contingent upon the program continuing.
4) Although the program is structured as providing tax credits, it really has nothing to do with taxes and is effectively a subsidy program to the industry.

These four points can be summarized simply: the film tax credit should be viewed as an ongoing spending program that provides some benefits to the state.

As such, <u>*we recommend that the firm tax credit should be treated by the Legislature on par with other spending programs. We also recommend that caps should be placed on the expenditures for the program, so that it is not an open---ended entitlement.*</u> We believe that current practice is an irresponsible budgeting practice for the state. In setting a cap, the Legislature can determine how much activity it wants to subsidize and, if resources become limited, what types of activity it wishes to subsidize. Reconfiguring the film tax credit as an explicit expenditure program will require careful thought to structure a program that the state can afford and that meets the broader needs of its residents. This is an appropriate role for the Legislature.

<u>Enterprise Zone Program</u>

Louisiana's Enterprise Zone (EZ) program is a jobs incentive program that provides income and franchise tax credits to a new or existing business located in Louisiana creating permanent net new full---time jobs and hiring at least 50% of those net new jobs from targeted groups. The benefits include a one---time $2500 job tax credit for each net new job created; the benefits also provide either a 4% rebate of sales and use taxes paid on qualifying materials, machinery, furniture, and/or equipment purchased, or a 1.5% refundable investment tax credit on the total capital investment, excluding tax exempted items. The intent of the EZ program is to encourage economic development in areas with high unemployment and/or low income, especially in areas with high concentrations of individuals on public assistance. The Louisiana Department of Revenue estimates that the EZ program led to a loss of $50.9 million in 2013, of which $8.0 million is due to the sales tax rebate, $11.6 million is due to the jobs credit, and $31.3 million is due to the investment tax credit. The estimated annual revenue loss has averaged $61.0 million over the last 3 years.

Enterprise zone programs have been extensively studied. The general conclusion from these many studies is that enterprise zone programs have been largely ineffective in encouraging targeted economic development, despite their considerable revenue cost.

Accordingly, <u>*we recommend that the Enterprise Zone incentives be eliminated.*</u> However, if lawmakers wish to preserve the credits, the credits should be restricted to firms that actually operate in designated low income areas, to firms that actually create new jobs, and to non---retail firms. Incentives should also be limited, either by designing the incentive program as an explicit expenditure program or by capping the magnitude of the tax credit or exemption and limiting its transferability. The program should be evaluated regularly with rigorous and impartial analysis to determine whether it has achieved its stated justification, and at what cost.

Quality Jobs Program

Louisiana's Quality Jobs (QJ) program provides a cash rebate to companies in order to encourage the creation of well---paid jobs and promote economic development. The incentives include up to a 6% cash rebate of annual gross payroll for new, direct jobs for up to 10 years; the incentives also provide either a 4% sales and use tax rebate on capital expenditures or a 1.5% investment tax credit for qualified expenses. The intent of the QJ program is to give an incentive to firms to locate or to expand their operations in the state.

Job creation programs like the QJ program have been extensively studies. The general conclusions from these studies are that: (1) job incentive programs have been at best only modestly successful in encouraging net new job creation; (2) seldom is there solid evidence that the job incentive programs encourages economic development that would not have occurred anyway, in the absence of the programs; (3) the main beneficiaries of the job incentive programs have not been "mobile" workers but instead "immobile" factors of production, especially owners of land and commercial real estate; and, (4) the job incentive programs have cost the government considerable tax revenue, even after allowing for offsets due to the possible generation of new economic activity.

The Louisiana Department of Revenue estimates that the QJ program has led to a loss of $51 million in revenues in 2013. The estimated annual revenue loss has averaged $44 million over the last 3 years, an average that is somewhat lower than in previous years. To make up these outlays, the economic development projects would have to create over $600 million of net new personal income that would not have otherwise been created in the Louisiana economy, or over 15,000 net new jobs.

We believe that the long run goal should be to gradually eliminate the QJ program. However, a more immediate set of recommendations recognizes that complete elimination may not be feasible or even desirable in the short run. Our main short run recommendations for the quality jobs program are therefore the following:

1. *Limit the magnitude of the quality jobs program tax incentives, either by designing the program as an explicit expenditure program or by capping the magnitude of the rebate/tax credit.*
2. *Evaluate the quality jobs program regularly with rigorous and impartial analysis to determine whether it has achieved its stated justification, and at what cost.*

Mineral Taxes

Louisiana has a long history of taxing oil and gas. In the 1970s the state changed its taxation of oil from a tax rate of 26 cents per barrel to 12.5% of value with lower rates for incapable wells and stripper wells. The state also raised the tax rate on natural gas from 3.3 cents per mcf to 7 cents per mcf. The reason for not taxing natural gas on value related to market conditions. Namely, in the 1970s natural gas was subject to interstate price controls so natural gas produced in Louisiana but shipped across state lines was subject to price controls, while natural gas produced in Louisiana and used in Louisiana as either heating fuel or a feedstock was not subject to price controls. The state decided to tax natural gas on a volume basis. The timing of this legislative action was significant since oil prices quadrupled and then doubled from 1973 to 1981 and Louisiana enjoyed the additional revenues associated with oil and gas.

Taxes from oil and natural gas provided well over 40% of the state's revenues through 1982 and then fell dramatically during the 1980s as oil prices plunged. Mineral revenues now make up about 12 to 15 percent of the state's revenues depending on the price of oil. A major tax provision was introduced in 1994 providing a special tax advantage for horizontal drilling, a technique that in the 1990s could be classified as an "infant industry". This tax provision was then used in 2008 in conjunction with the Haynesville Shale and is applicable in the Tuscaloosa Marine Shale and the Brown Dense. The horizontal drilling tax break amounted to almost $240 million in fiscal 2014.

We have two major recommendations regarding the taxation of oil and gas. *Our first recommendation is to eliminate or scale back substantially the horizontal drilling exemption.* This exemption was created in an entirely different market and technology environment than the present. The market provides the most effective incentive for oil and gas operators and producers to initiate investments. Oil and gas prices along with cost considerations will then drive investments, not tax policy.

Our second recommendation is to initiate a major study of the appropriate taxation of oil and gas. Our tax structure was created in the 1970s, a time in which the market environment was very different from the present. Most states tax oil and gas at about the same rate. Texas taxes natural gas more prominently than oil. Louisiana taxes oil more substantially than natural gas. This would be a good time to work through the overall tax structure regarding oil and gas taxation. We recommend an updated analysis of overall oil and gas taxation to be completed by March 2017 or sooner.

Use of Mineral Revenues

Mineral revenues are being generated by the depletion of finite resources. It may be prudent for the state to discuss the appropriate use of mineral revenues in the operating budget of the state. In 1973 when Louisiana made significant and economically appropriate changes in the taxation of oil and gas, the state also made decisions to use the revenues from oil and gas to offset reductions in the sales tax (by eliminating food and drugs from the sales tax base) and in the personal income tax (by adopting federal tax liability as a deduction from adjusted gross income in calculating Louisiana taxable income). In other words, oil and gas revenues were paying for operating expenses of the state even though oil and gas are finite resources.

We have a new opportunity to reevaluate our use of oil and gas revenues. The Tuscaloosa Marine Shale (TMS) has been projected to have as many as 9 billion barrels of oil with about 7% of this oil being recoverable with current technology. Although production is in the early stages and there is still uncertainty about what prices will be needed to support sustained production in this play the dollars associated with TMS production have not been absorbed into the operating budget of the state. *We believe that this provides a unique opportunity for the state to create a "permanent trust fund".* Even with only 7% being recoverable and assuming an average price of $80 per barrel, the permanent trust fund could accumulate as much as $6.3 billion, a fund that could be used for major projects deemed important by the state such as infrastructure improvements or other long---run state commitments. By designating severance tax revenues associated with TMS towards principal in a permanent trust fund, the state would create a financial asset for future generations of Louisianans. Not only would this be beneficial to the state in the long run, it has the opportunity to mitigate intergenerational equity concerns associated with extraction of a finite resource. Alaska has a permanent dividend fund established in 1976, and Texas has a permanent fund that was initiated in 1876.

Excise Taxes

Louisiana, like most other states, collects a number of taxes based on volume of consumption, including alcoholic beverages ($25 million), beer ($33 million), tobacco ($142 million), and gasoline and special fuels ($625 million). The gasoline and special fuels tax is dedicated to the Transportation Trust Fund. Together these taxes contribute $825 million to the state's budget or almost 8% of the state's budget. At present, Louisiana excise taxes are lower, and in some cases significantly lower than regional or national average excise taxes. *<u>We recommend that in all cases the Louisiana excise taxes be aligned to national or regional averages.</u>*

<u>Beer and Alcoholic Beverages</u>

Louisiana taxes alcoholic beverages on a volume---metric base at the wholesale level. The tax is organized into a low alcohol content beverage tax (beer and malts) and a high alcohol content beverage tax (liquor and wine). In the 2013 fiscal year, receipts form alcoholic beverages totaled approximately $57 million, a slight increase from the previous year. Beer and malts are taxed at a rate of $10.00 per 31 gallon barrel, or $.32/gallon. This rate is relatively low compared to states in the south region; nevertheless, it is slightly higher than the national average of $.28/gallon. The average beer tax in Alabama, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, and Tennessee averaged 83 cents per gallon or over 2.5 times the Louisiana rate. Texas has a beer tax of 20 cents per gallon. If we compare Louisiana to its neighboring states, the average beer tax is 32.3 cents per gallon or just about the Louisiana rate. At $34.9 million, beer receipts in Louisiana account for a majority of total alcoholic beverage revenue despite its leveling growth patterns.

Growth in alcohol revenue can be attributed to liquor and wine sales. Liquor and wine are taxed at a rate of $.66/liter ($2.50/gallon) and $.03/liter ($.11/gallon), respectively. Louisiana's liquor excise rate falls well below the national average, while the wine excise is the lowest in the United States. In addition, the state imposes a graduated tax on wine of higher alcohol content. Just as a comparison, the average liquor tax is $8.78 per gallon for Alabama, Georgia, Kentucky, North Carolina, South Carolina, and Tennessee, an average rate that is 3.6 times the Louisiana tax rate. Using comparable rates in Texas, Arkansas, and Mississippi, the average liquor rate is $5.46 per gallon. Regardless of what average we use, the liquor rate in Louisiana is extremely low compared to other states.

Based on regional comparisons, these taxes can be raised in an overall attempt to update the tax structure and produce a certain amount of revenues for the state general fund. We may also want to index the taxes so that the tax rates will grow with inflation. The tax will still be a volume tax but the rate will change from year to year.

<u>Tobacco</u>

The tobacco tax in Louisiana is 36 cents per pack. The average tobacco tax in Texas, Arkansas and Mississippi is $1.08 per pack, while the average for Alabama, Georgia, Kentucky, North Carolina, South Carolina, and Tennessee is 53 cents per pack. According to the Tax Foundation

Louisiana is the 48th state in the country in terms of the tobacco tax. Tobacco taxes can be increased with a minimal impact on revenue collections unless the rates are increased in order to deter smoking. Very high tax rates can create activity on the part of citizens to avoid the tax entirely by purchasing tobacco in other venues, so any increase in tobacco taxes must recognize that there are limits on any tax increase by the state. However, the evidence suggests that Louisiana could implement a substantial increase in the tobacco tax without encouraging persons to find alternative venues for purchasing tobacco.

Gasoline

The gasoline tax is a tax that is used to pay for the Department of Transportation and Development, highway maintenance, and other highway improvements in Louisiana. The gasoline tax is a tax related to the volume of gasoline purchased. The amount of gasoline required to drive on the state highways and roads depends on the gas mileage relating to the fleet of cars and trucks that are on the road. The method of paying for roads and highway maintenance has not changed over many years, but the relationship between driving, gasoline mileage, and miles driven has changed over time. In comparing Louisiana to other states, Louisiana imposes a relatively similar tax burden. The average gasoline tax for Alabama, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, and Tennessee is 22 cents per gallon; the average gasoline gas for Texas, Arkansas, and Mississippi is 20.2 cents per gallon. In both cases the average gasoline tax in these two groups of states is very close to Louisiana's rate of 20 cents per gallon. However, nationwide the average tax rates are slightly higher, at 24 cents per gallon.

An increase in the gasoline tax from 20 cents per gallon to 24 cents per gallon would be compatible with good tax policy since the tax is similar to a user's fee. It would not drive many people from the market; it would provide additional revenues of $120 million; and, it would be assigned to those persons using the streets. Given that the gasoline tax is dedicated to the transportation trust fund, it is appropriate to connect any tax changes in the gasoline tax to any suggestions for highway maintenance and additional infrastructure.

It would also be appropriate to initiate a study connecting the demand for highway maintenance with the appropriate method of funding such maintenance if the current tax sources cannot provide sufficient revenues. This would be the time to rethink the way in which we pay for the use of roads and highways in Louisiana given that fuel efficiency is improving steadily and the gasoline tax does not account for inflationary trends.

Summary of Recommendations

TAX	RECOMMENDATIONS
Sales and Use Tax	1. Expand the sales tax base to include additional personal services and review and sunset sales tax exemptions classified as others. 2. Move towards a single collector and single audit authority through a joint state and local authority to be consistent with the Streamlined Sales and Use Tax Agreement. 3. Move towards a unified sales tax base for state and local governments, allowing local jurisdictions to continue to tax food for home consumption and prescription drugs. This unification should be accomplished by eliminating optional local exemptions and limiting state exemptions, as determined by a new Local Sales Tax Commission in consultation with the state.
Personal Income Tax	1. Lower tax rates while preserving the distribution of tax burdens. 2. Eliminate federal deductibility and excess itemized deductions. 3. Limit tax credits allowed to other states to potential tax liability in Louisiana. 4. Repeal net capital gains exclusion. 5. Examine and review other major exclusions including those for retirement, social security, and others. 6. Place a moratorium on new tax credits. 7. Maintain but allow the state EITC to be decoupled from the federal EITC. 8. Establish a sunset date for all others to be eliminated unless re---enacted.

TAX	RECOMMENDATIONS
Corporate and Franchise Taxes	1. Lower the top corporate tax rate. 2. Eliminate federal tax deductibility. 3. Enact an addback statute for the corporate tax. In the longer run, move to a system of combined reporting. 4. Move to single sales apportionment for most business entities except for specialized industries where it is not appropriate. 5. Move to market sourcing for services for apportioning business income. 6. Eliminate the corporate franchise tax or cap it at a low level and have it apply to all business entities. 7. Reduce or eliminate carryback period. Maintain carryforwards.
Property Taxes	1. Maintain but not increase the homestead exemption 2. Reduce the Industrial Property Tax Exemption from 100 to 80 percent and limit the exemption to one seven year period. Require parish endorsement for any exemptions.
Exemptions and Tax Credits	1. Limit the inventory credit to 75 percent. Work towards phasing out the property tax on inventories, with appropriate revenue replacement. 2. Convert the motion picture tax credit to an expenditure program subject to annual appropriation. 3. Eliminate the Enterprise Zones program and limit and reform the Quality Jobs programs
Mineral Taxes	1. Eliminate horizontal drilling exemption 2. Designate revenues from the Tuscaloosa Marine Shale field for a permanent trust fund 3. Examine and review the relative taxation of oil and natural gas, with a goal of re---aligning relative tax rates as appropriate. Review other exemptions.
Excise Tax	Align the excise on alcohol, tobacco and motor fuels to national or regional averages.