ANALYSIS OF THE STELLY PLAN

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This paper discusses the current status of the Stelly Plan in four parts. Part I is a brief display of the pre-Stelly and post-Stelly tax conditions. Part II is a discussion of the aggregate fiscal effects on state government. Part III is a discussion of the distributional effects on different taxpayer groups and income levels. Finally, Part IV is a discussion of the fiscal notes associated with the basic proposals to reverse portions of the Stelly tax changes.

The Stelly Plan

Act 51 and Act 88 of the 2002 Regular Legislative Session enacted significant changes to the state personal income tax and general sales tax, respectively. Act 51 modified taxable income brackets and eliminated the state deduction for federal itemized deductions in excess of the federal standard deduction; increasing overall state income tax liabilities and collections. Act 88 eliminated the state sales tax on sales of food for home consumption and residential electric, natural gas, and water utilities; decreasing overall state sales tax collections. These provisions were adopted by the electorate on November 5, 2002, and became effective January 1, 2003, and have been commonly referred to as the Stelly Plan. The specific pre-Stelly and post-Stelly provisions follow below.

Income Tax Provisions

(A) Taxable Income Rate & Bracket - Single

Rate	Pre-Stelly (2002)	Post-Stelly (2003)
2%	$0 - $10,000	$0 - $12,500
4%	$10,000 - $50,000	$12,500 - $25,000
6%	over $50,000	over $25,000

Joint returns have bracket thresholds that double those shown above.

(B) Excess Itemized Deduction

Pre-Stelly (2002)	Post-Stelly (2003)
57.5%	0%

Sales Tax Provisions

Food For Home and Residential Utilities Sales Tax Rate

Pre-Stelly (2002)	Post-Stelly (2003)
4% through June 2002	2% from January 2003
3.9% from July 2002	0% from July 2003

Aggregate Effects
The table below displays the current estimated dollar effects on state personal income tax and general sales tax collections resulting from the Stelly tax changes. These estimates reflect the total tax collections changes, attributable to the Stelly Plan, from tax conditions in place immediately prior to the effectiveness of the Stelly tax changes (pre-Stelly brackets, 57.5% excess itemized deduction, 3.9% sales tax rate).

	FY03	FY04	FY05	FY06	FY07	FY08
Inc. Tax	$33.7 m	$224.5 m	$269.3 m	$258.9 m	$295.3 m	$305.9 m
Sales Tax	-$40.2 m	-$166.4 m	-$173.5 m	-$179.9 m	-$193.8 m	-$200.5 m
Net Chg.	-$6.5 m	$58.1 m	$95.8 m	$79.1 m	$101.5 m	$105.4 m

These estimates are based on the current personal income tax and general sales tax forecasting equations that attempt to control for or isolate (and thus measure) the shift up in collections observed in the income tax and the shift down in collections observed in the sales tax. While efforts were made to minimize the influence of the 2005 storms on the shift estimates, it is likely that some of the distortion associated with those storms is adding error to these estimates. That aside though, it seems clear that the income tax gains are exceeding the sales tax losses.

It should be noted though, that as with any estimates, different analytical techniques and/or analysis at different times can result in materially different results. For example, a similar econometric technique as utilized above was applied in the fall of 2004, after the finish of FY04. That analysis estimated the net combined tax effect for FY03 as -$20 million, and for FY04 as +$12.5 million. Utilizing exempt sales amounts for food and residential utilities reported on sales tax returns results in net combined tax effects that are, surprisingly, negative in all of the years FY03 – FY07.

Distributional Effects
The effects of the Stelly Plan on particular tax filer/household subsets and income classes are estimated with a personal income tax simulation model that currently processes actual tax return data for the 2004 tax year provided by the LA Department of Revenue, and incorporates consumer expenditure survey data for 2003/2004 reported by the U.S. Department of Labor, Bureau of Labor Statistics. From these datasets estimates are made of the direct state personal income tax effect and the sales tax savings likely to have been experienced by average households in each tax filer subset and income class. Throughout the analysis, as much Louisiana specific taxpayer/household information as possible was utilized. For example, consumer expenditures on food at home and residential utilities by household income groups for the southeast and the country as a whole were used to construct a function estimating these expenditures per person. The per person expenditure estimates were then multiplied by the average number of taxpayers and dependents reported on Louisiana tax returns in each filer subset and income class examined.

The tables below summarize the estimates in terms of the numbers and shares of tax filer/households that are estimated to have received a net or combined income and sales tax decrease, and those that are likely to have received a net tax increase. The federal adjusted gross income range cut-off ranges are also shown. Up to those ranges tax decreases on average occurred. Above those ranges tax increases on average occurred. To increase the confidence of these estimates, average tax cuts that were smaller than all others by an order of magnitude were excluded from the tax decrease totals, and were included in the tax increase totals. A likewise adjustment was made for similarly small average tax increases.

All Resident Filers	Number Tax Dec.	Share	Up To FAGI	Number Tax Inc.	Share
Single	409,864	70%	see below	176,000	30%
Joint	362,081	61%	see below	234,924	39%
Head	315,268	77%	see below	91,945	23%
	1,087,213	68%		502,869	32%

Non-Itemizers	Number Tax Dec.	Share	Up To FAGI	Number Tax Inc.	Share
Single	406,184	83%	$25k-$30k	84,652	17%
Joint	305,501	80%	$60k-$70k	75,779	20%
Head	310,599	85%	$25k-$30k	54,089	15%
	1,022,284	83%		214,520	17%

Itemizers	Number Tax Cut	Share	Up To FAGI	Number Tax Inc.	Share
Single	3,680	4%	$5k-$10k	91,348	96%
Joint	56,580	26%	$50k-$60k	159,145	74%
Head	4,669	11%	$20k-$25k	37,856	89%
	64,929	18%		288,349	82%

Read the tables above as follows:
-- 80% (305,501) of non-itemizers filing joint returns had FAGI up to $60,000 - $70,000 and received a net combined tax decrease, on average.
-- 74% (159,145) of itemizers filing joint returns had FAGI over $50,000 - $60,000 and received a net combined tax increase, on average.

Note that in any income class receiving a tax decrease, on average, there can be particular tax filers with tax situations so different from the average of the class that they received a net tax increase. Likewise, in any income class receiving a tax increase, on average, there can be particular tax filers with tax situations so different from the average of the class that they received a net tax decrease. These possibilities are ameliorated somewhat, but not completely eliminated, by excluding the small average tax decrease or increase filer counts from the totals of filers receiving tax decreases or increases.

A few more details about the distribution of the tax changes between the broad groups of itemizers and non-itemizers can be readily generated, and are displayed in the tables below. The first table displays the shares of the total income and sales tax changes experienced by each of the two broad groups, itemizers and non-itemizers.

	Share of Income Tax Increase	Share of Sales Tax Decrease
Itemizers	89%	31%
Non-Itemizers	11%	69%

Since a large share of the income tax increase (89%) was experienced by itemizers, a group that comprises about 20% - 25% of all filers in any particular year, it is interesting to see how concentrated was the income tax increase experienced by this group. The table below displays the partial distribution across income classes of the income tax increase experienced by the itemizer group. It shows that a majority of the income tax increase experienced by this filer group (57%) was concentrated in the top 25% of this group, by FAGI range; albeit, the top 25% of income in this group starts at about $90,000 - $100,000 of FAGI.

	Share of Itemizer Income Tax Increase	Up To and Above These FAGI Ranges
Top 1%	6%	$450,000 - $600,000
Top 5%	18%	$180,000 - $200,000
Top 10%	31%	$120,000 - $160,000
Top 25%	57%	$90,000 - $100,000

Finally, the distribution across income classes of the itemizer group is displayed in the table below in terms of a simple concept of the "middle class"; the middle 60% of the income distribution. As seen below, the middle 60% of itemizer filers experienced a less than proportionate share of the tax increase experienced by the itemizer group as a whole.

	Share of Itemizer Income Tax Increase	FAGI Ranges
Bottom 20%	2%	Up to $30,000
Middle 60%	34%	$30,000 - $100,000
Top 20%	64%	Above $100,000

Tables of distributional impact by filer subsets and income class are attached. Two sets of tables are included; one for non-itemizers and one for itemizers. Each set includes a table summarizing all the filers in the set (All Filing Status'), and then each set includes a table for each of the three filing status' examined (Single, Joint, Head-of-Household filers). For each of thirty FAGI income classes the average FAGI, number of returns, state income tax liability dollar change, food and utility sales tax dollar change, net combined tax dollar change, and net combined percent tax change are shown. The immediate pre-Stelly and post-Stelly conditions are also described on each table.

In general, the tables reflect that at low levels of income net tax decreases were experienced while at higher levels of income net tax increases were experienced. Since actual tax filer information is being utilized throughout the tables, anomalies will occur, especially at the very low and the very high income classes, and in the head-of-household filer status group.

For all the tax filers/households represented on each table the combined percent tax change pattern is generally the same. Once average tax increases begin to occur moving up the income classes, the percent tax increases rise and then fall off. This occurs for non-itemizers because the state income tax increase for them was limited to no more than $450 for single filers and $900 for joint filers by virtue of the fixed rates and bracket changes. For itemizers however, the dollar amount of state income tax increase is not capped and steadily increases as you move up the income classes. In terms of net percent change in the combined taxes though, itemizers also experience a drop off of percent increases, but more gradually than non-itemizers, because, as large as their income tax increases may be, they become smaller relative to the overall income tax liabilities of higher and higher income households. In addition, federal tax law limits itemized deductions at higher income levels, meaning less excess itemized deductions exist to be subject to state taxation. This limitation in federal law is currently being phased out, and will not be effective from tax year 2010. This may contribute somewhat to higher percentage tax increases for higher income itemizers.

However, many itemizers experience somewhat lower federal tax liabilities as a result of their higher state income tax liabilities. For each dollar of state income tax increase, federal tax liabilities can decrease by 10% - 35% depending on what marginal federal tax bracket a taxpayer is in (10%, 15%, 25%, 28%, 33%, and 35% in tax year 2004). This analysis has not attempted to explicitly calculate this federal tax offset to the state tax increase, but approximate shares of itemizer filers that can offset portions of their state income tax increase is provided in the table below.

% of State Increase Offset	10	15	25	28	33	35
Share of Itemizers	9%	49%	31%	5%	4%	2%

The first row is the marginal federal tax rates in effect for the 2004 tax year, and represents the amount of federal tax reduction available for each dollar of state income tax increase that is included in federal itemized deductions. The second row is the share of itemizer returns that fall into each of these federal marginal tax rate categories, and represents the share of itemizer returns that can have their state income tax increase offset by a federal tax reduction equivalent to each associated federal marginal tax rate percentage. For example, 9% of the itemizer returns can have up to 10% of each dollar of state income tax increase offset by that amount of federal tax reduction. Since itemized deductions are limited at higher incomes, it is most reasonable to view this as the maximum federal tax offset available to itemizers. However, as mentioned above this limitation is currently being phased out, and will not be effective from tax year 2010. At that point, the full federal tax offset represented by federal marginal tax rates will be available to all itemizer filers.

It should also be realized that any proposal that reduce state income taxes on itemizer filers will result in somewhat higher federal tax liabilities for those filers that itemize. Every dollar of state income tax reduction is dollar less itemized deduction on their federal tax returns. Thus, federal tax liabilities will greater by the dollar amount of state tax decrease multiplied by the federal marginal tax rate applicable to the filer (10%, 15%, 25%, 28%, 33%, or 35%). In the context of state income reductions, the table above displays the share of itemizer returns (row 2) that can have their state income tax decrease offset by a federal tax increase equivalent to each associated federal marginal tax rate percentage (row 1). For example, 9% of the itemizer returns can have up to 10% of each dollar of state income tax decrease offset by that amount of federal tax increase.

Finally, the federal alternative minimum tax (AMT) can also work to limit the ability of itemizers to offset a portion of their state income tax increase through their federal itemized deductions. By denying certain taxpayers the ability to deduct a variety of items at the federal level (state income tax liabilities are a major factor here), the AMT can prevent affected taxpayers from realizing the federal tax offset discussed above. However, for the 2004 tax year examined and so long as Congress continues its pattern of short-term patches to the reach of the AMT, it is not yet affecting a large number of Louisiana taxpayers. In 2004, about 18,000 Louisiana returns were affected by the AMT (less than 1% of all returns but 4.5% of itemizers). The affected returns were concentrated in the income group with over $100,000 of FAGI (32%) and especially in the group with over $200,000 of FAGI (48%). Even in those income groups, most returns were not affected by the AMT; 6% of all returns and 8% of itemizers in the $100,000 - $200,000 group, and 35% of all returns and 39% of itemizers in the $200,000+ group. As shares of total Louisiana returns, these two groups are fairly small; about 5.4% of all returns and 18.6% of itemizers are in the $100,000 - $200,000 group, and 1.4% of all returns and 5.8% of itemizers are in the $200,000+ group. Even with the series of temporary patches Congress has passed, the number of returns affected by the AMT has crept up each year, and if you are one of these taxpayers your ability to offset your state income tax increase is likely to be limited or eliminated. However, in Louisiana’s case, the AMT is not yet affecting a large enough group of taxpayers to consider it as negating the federal offset potential in general.

Finally, as an aside on the effects of the AMT, to the extent it results in greater federal tax liabilities for affected taxpayers, it results in lower state tax liabilities for those taxpayers. This occurs because Louisiana filers are allowed to deduct their federal tax liability on their state returns, lowering their state taxable income and state tax liabilities. Thus, a small portion of the federal tax offset denied to taxpayers affected by the AMT is itself offset by reduced state liabilities resulting from the state deductibility of federal tax liabilities.

Fiscal Notes

The majority of the legislation intended to reverse the income tax changes of the Stelly Plan involves three basic proposals:

a) returning the 4% and 6% brackets to their pre-Stelly thresholds
b) allowing a 100% excess itemized deduction
c) both the bracket and deduction reversals

The table below displays the state revenue reductions associated with each of these proposals.

	FY08	FY09	FY10	FY11	FY12
Brackets	-$320m	-$335 m	-$281 m	-$293 m	-$306 m
Itemized	-$270 m	-$288 m	-$309 m	-$333 m	-$359 m
Both	-$546 m	-$577 m	-$552 m	-$586 m	-$622 m

The two proposals separately do not sum to the same amount as providing both bracket changes and the deduction change because of the interaction between these two changes on itemizer returns. The tax reduction to itemizers from the bracket expansion is greater when only a bracket expansion is implemented because the bracket expansion subjects more income to lower taxation (income left in the tax base because excess itemized deductions are not allowed). When both bracket expansion and excess itemized deductions are implemented together, the bracket expansion subjects less income to lower taxation (income is removed from the tax base by allowing excess itemized deductions).

These estimated fiscal effects are fairly large; probably larger than expected, for the following reasons:

a) The Stelly Plan actually expanded the bottom 2% bracket, cutting the tax in half on up to $2,500 of income for single filers and up to $5,000 of income for joint filers. This reduced tax on a portion of income of approximately 75% of all filers. The bracket change proposals retain the current bottom bracket at the expanded post-Stelly thresholds. Thus, these proposals do not offset the overall tax reduction provided by a tax increase on a portion of income, as the Stelly Plan offset its overall tax increase with a tax decrease on a portion of income. This factor is worth $83 million - $94 million in the FY08 estimates.
b) The Stelly Plan eliminated excess itemized deductions from a baseline where 50% had already been denied in tax years 2000 and 2001, and 42.5% was denied in tax year 2002, immediately preceding the first year of the Stelly provisions (2003). The reversal proposals restore 100% of excess federal itemized deductions from a current baseline where no deduction is allowed at all. This factor is worth $157 million in the FY08 estimates.
c) The 2007 effective tax year for these proposals is five years after these provisions were last contained in the state's tax law (tax year 2002), with economic and revenue growth occurring over this period. The fiscal estimates start with a simulation of tax year 2004 liabilities (growth built in from the 2002 tax year) and then growth must be applied from 2004 to the 2007 effective tax year (13.1% to

19.1%) and throughout the fiscal note horizon (4.1% to 7.4% per year). This factor is worth $29 million - $70 million in the FY08 estimates.

d) Finally, the Revenue Department indicates that it is likely to adjust withholding tables for proposals involving bracket changes since all taxpayers are affected. Assuming a one-quarter lag in taxpayer response to these changes, a withholding transition effectively shifts a quarter of withholdings into each of the first two fiscal years of the fiscal note horizon. This factor is worth $57 million - $66 million in the FY08 estimates.