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THE ECONOMICS OF ALABAMA'S PROPOSED TAX REFORM

*Roy Bahl**

I. INTRODUCTION

The time seems right for tax reform in Alabama. But while there exists a general feeling that the present revenue system is not getting the job done,¹ there is no consensus about what are the biggest problems to be fixed. To the most pragmatic, the issue is revenue shortfall at a time when public services are woefully inadequate, i.e., it is a revenue adequacy problem.² Some point to overly earmarked revenues being "allocated" to the wrong purposes.³ Still others see the principal issue as fairness: some sectors of the state population and economy receive preferential tax treatment while others must pay higher rates to cover the revenue cost of these preferences, and the present tax system is regressive and overly burdensome on the poor.⁴ Those who implement the system point to the complexities and ambiguities that result in higher administrative and compliance costs.⁵ Finally, there is the economic development view that the present tax system does not support the attraction and growth of industry as well as it should.⁶

The principal jobs of a tax reform commission are to decide what is most wrong with the present system, and then to propose a

* Professor of Economics and Director, Policy Research Center, Georgia State University.

1. See, e.g., REPORT OF THE ALABAMA COMMISSION ON TAX AND FISCAL POLICY REFORM 4 (1991) [hereinafter COMMISSION REPORT]; Tom Lindley, *Expert Takes State Taxes to Task for Favoring Higher Paid People*, BIRMINGHAM NEWS, Sept. 14, 1990, at 1A; *Toward Tax Reform?*, BIRMINGHAM POST-HERALD, Sept. 16, 1991, at A6. The Commission's report is reprinted as the Appendix to this issue, beginning at page 741.

2. PUBLIC AFFAIRS RESEARCH COUNCIL OF ALA., REP. NO. 9, RESOLVING THE STATE'S FINANCING PROBLEMS 2 (1990); COMMISSION REPORT, *supra* note 1, at 4.

3. See, e.g., COMMISSION REPORT, *supra* note 1, at 16.

4. See *id.* at 20-21.

5. See *id.* at 7.

6. See *id.* at 15-16.

general strategy and specific changes that will address the problems. This Article provides one view of how the Alabama Commission on Tax and Fiscal Policy Reform (the "Commission") performed these jobs, by evaluating the economic impact of the Commission's proposals.

II. THE SETTING FOR REFORM

The shape of a tax reform program is influenced by the political mood of voters, objective evidence of what is good and bad tax policy, subjective preferences of the reformers, and the economic setting in which the reform discussion occurs. In Alabama the economic setting has been one of tight state budgets, slow revenue growth, a long history of inadequate levels of public services, a tradition of low taxes, and a relatively heavy concentration of poor families in the state.⁷

This setting suggests that a tax increase would be part of the solution. Moreover, the presently low level of taxes suggests that a tax increase would be feasible without harming the state's competitive national position. On the other hand, to propose a tax increase would have obscured the Commission's fundamental mission—to propose a restructuring of the entire state system. This consideration led the Commission to keep to a revenue-neutral theme in its recommendations for tax structure changes.⁸ Indirectly, however, the Commission was influenced by the revenue needs issue in proposing a solution that would allow greater revenue growth over time.

An important underlying factor was the competitive position of Alabama in the nation. The statistical comparisons presented in Table 1 might be summarized as follows:

- Alabama is a poor state (less than 80 percent of average national per capita personal income), and its economy is growing more slowly than that of the rest of the United States.

7. PUBLIC AFFAIRS RESEARCH COUNCIL OF ALA., REP. NO. 9, RESOLVING THE STATE'S FINANCING PROBLEMS (1990).

8. See COMMISSION REPORT, *supra* note 1, at 3.

Table 1
Fiscal Profile of Alabama: 1989

	<u>Alabama</u>	<u>US</u>	<u>Alabama as a Percent of US</u>
Per Capita Personal Income	\$12,851	\$16,489	77.9
Percent Increase in Per Capita Personal Income, 1980-1989	53	55	96.4
<u>State and Local Government Expenditures:</u>			
Per Capita Total	\$2,860	\$3,588	79.7
Per Capita Education	\$934	\$1,063	87.9
As a Percent of Personal Income	22.3	21.9	101.8
Education Expenditures as a Percent of Personal Income	7.3	6.5	112.3
<u>State and Local Government Taxes:</u>			
Per Capita Total	\$1,238	\$1,887	65.6
ACIR Tax Effort Index (1986)	86	100	86.0
Taxes as a Percent of Personal Income	9.7	11.6	83.6
Per Capita Federal Aid	\$476	\$309	\$153
Debt Outstanding as a Percent of Personal Income	18.7	19.7	94.9
<u>State and Local Government Employment:</u>			
Employment per 10,000 Population	509.5	504.6	101.0
Average Monthly Earnings	\$1,743	\$2,114	82.4
State Government Expenditures as a Percent of State and Local Government Expenditures	48.6	45.4	107.0
State Government Revenues as a Percent of State and Local Government Expenditures	50.5	46.6	108.4

Sources: Bureau of the Census, U.S. Department of Commerce, *Government Finances: 1988-89*; Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Volume 2: Revenue and Expenditures 186-87* (1990).

Table 2

Percent Distribution of General Revenues: 1989

	<u>Alabama</u>	<u>US</u>	<u>Alabama as a Percent of US</u>
Income Tax	13.2	15.8	83.5
General Sales Tax	15.2	14.4	105.5
Property Tax	6.0	18.1	33.0
Motor Fuel	3.2	2.4	132.1
Other Taxes	13.1	9.0	145.5
Non-Tax Revenue	29.8	24.4	122.1
Federal Aid	19.5	15.9	122.6

Source: Bureau of the Census, U.S. Department of Commerce, *Government Finances: 1988-89*

Table 3

Percent Distribution of Alabama Income: By Source

	<u>1970</u>	<u>1989</u>
Wages and Salaries	67	58
Other Labor Income	4	6
Transfer Payments	11	17
Capital Income	12	13
Proprietorship Income	9	9

Sources: 1970 Data: Bureau of Economic Analysis, U.S. Department of Commerce, *Survey of Current Business* (Aug. 1972)

1989 Data: Bureau of Economic Analysis, U.S. Department of Commerce, *Survey of Current Business* (Aug. 1990)

- Per capita federal aid to Alabama state and local governments is well above the national average.
- State and local government expenditures are well below national levels.
- Debt outstanding relative to personal income is low by comparison to other states.
- State and local governments in Alabama employ more workers (per 10,000 population) than in the average state, but these workers are compensated at a rate nearly 20 percent below the national average.
- State government, as opposed to local government, dominates Alabama's fiscal system to a greater extent than in the average U.S. state.

Other important considerations were the present Alabama tax structure and how it differs from those in other states. The present reliance on various revenue sources is shown in Table 2, which indicates that Alabama is a relatively heavy user of general sales taxes, motor fuel taxes, and "other" taxes (including selective sales taxes). Perhaps the most noticeable difference from the rest of the nation is Alabama's lighter reliance on property and income taxes. The Commission faced a choice between moving Alabama's tax structure toward the balance suggested by the national average, or reinforcing the existing preference for a relatively heavy sales tax domination. The latter was chosen.⁹

III. PROBLEMS WITH THE PRESENT SYSTEM

Adam Smith's canons of taxation¹⁰ provide as good a basis for evaluating a tax system in 1991 as when they were laid down two centuries ago. The tax should be levied in a fair way; it should be neutral in its effects on economic decisions; taxpayers should be certain as to their liability; taxes should be administered at a reasonable cost; and revenues raised should be adequate to finance the desired level of expenditures.¹¹ However, while the canons provide a framework within which a reform commission might look for

9. *See id.* at 5.

10. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 777-79 (Edwin Cannan ed., Random House 1937) (1776).

11. *Id.*

problems, they do not point clearly to a single "best" tax structure. It is more a matter of trading between equity, neutrality, elasticity, and administrative cost. A present-day state tax commission must evaluate the tradeoffs among these objectives, weighing them against possible economic development effects, revenue needs, and the perceptions and desires of the voters.

The approach taken by the Commission was to review the common complaints about the Alabama system in the context of these normative characteristics of a good tax. What do the politicians, the various interest groups, and the public at large think is wrong with the tax system? Based on these perceptions, and on economic theory and administrative considerations, nine problem areas could be identified.

A. Taxes Are Too Low

One commonly held position is that taxes are too low in Alabama.¹² As a result, public service levels are seen to be deficient. As noted above, per capita state and local government expenditures in Alabama are among the lowest in the nation, and state and local government workers in Alabama are paid at rates well below those in other states.¹³ The consequences of inadequate public service levels are diminished long-run economic growth prospects of the state, and a lower quality of life for its residents. If infrastructure is not adequately maintained and expanded, industry will be deterred from seeking Alabama locations. Likewise, the failure to invest adequately in the development of human capital will retard economic development to the extent that the presence of a high-quality labor force is required. There is also the general issue of the quality of life in a state where there is relatively little investment in income-maintenance activities.

The solution seems clear enough: increase taxes and the size of the public expenditure budget. The tax burden is already quite low and could be increased substantially without jeopardizing the competitive position of the state. To illustrate this point, we can calculate that if Alabama had raised her level of taxes only to the national average (as a percent of income) in 1989, per capita ex-

12. See, e.g., *This Side of Heaven*, BIRMINGHAM NEWS, Jan. 2, 1992, at 6A.

13. See *supra* Table 1.

penditures could have risen by \$244 (nearly 9 percent) and would be only 8.6 percent below the national average.¹⁴

B. Taxes Are Too High

There are complaints in every state, Alabama included, that taxes are too high.¹⁵ The principal argument against high taxes is that industry location is discouraged, and resident firms are dissuaded from expansion.¹⁶

It would be difficult to support the argument that taxes are too high in Alabama. On average, Alabamians pay \$97 dollars in state and local government taxes for every \$1000 in personal income earned, whereas the average American pays \$116.¹⁷ The Advisory Commission on Intergovernmental Relations has estimated that Alabama made a tax effort in 1988 that was 16 percent below the national average.¹⁸ Even by comparison with its neighbors, Alabama is a low-taxing state.¹⁹

There is one sense in which the high tax argument might be supported. Tax *rates* may be higher than necessary because the *bases* that Alabama taxes are so narrowed by the tax laws and by preferential exemptions. Those who remain within the tax system—by virtue of how they earn their income, what they consume, how they hold their wealth, or simply their failure to gain preferential status—are subjected to higher rates so that the state may make its revenue target. The gap between the actual and potential tax base is dramatic. Only about 20 percent of real property value is taxed under the Alabama property tax, less than 60 percent of all consumption is subject to sales tax, and only about one-third of personal income is in the income tax net.²⁰ Clearly, nominal tax

14. See *id.* (This figure (\$244) is $\$12,851 \times (11.6\% - 9.7\%)$).

15. *Public Likes Tax Reforms, Within Limits*, BIRMINGHAM NEWS, Dec. 15, 1990, at 6A; *Say No to Sales Tax*, BIRMINGHAM POST-HERALD, Jan. 17, 1992, at A4.

16. See, e.g., Ted Bryant, *In Taxes, One Firm's Equality is Another's Millstone*, BIRMINGHAM POST-HERALD, Aug. 26, 1987, at B3 ("When a company goes in search of a new plant site, a major concern of executives is the tax cost of one area over another.").

17. See *supra* Table 1.

18. 2 ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, REP. NO. 17-169. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, REVENUES AND EXPENDITURES 187, Table 106 (1990) [hereinafter REVENUES AND EXPENDITURES].

19. *Id.*

20. These were estimates made by the Commission staff. Actually, they were not so much estimates as they were straight calculations. The numerators are actual collections of

rates would be markedly lower in Alabama if the tax bases were more broad.

C. *The Distribution of Tax Burdens Is Regressive*

It is widely believed that the distribution of tax burdens among Alabama families is regressive,²¹ i.e., the effective tax rate²² falls as income level rises. Most analysts would see either a proportional distribution (the effective rate is the same for all income levels) or a progressive distribution (the effective rate rises with income level) as more consistent with notions of justice in taxation.²³

But is the Alabama tax system regressive? It is very difficult to establish this point, and there have been few hard empirical analyses. In order to carry out such a study the incidence of each tax must be established, and establishing this calls for answers to some very difficult questions. In particular, are nonresidential property taxes and company income taxes ultimately borne by labor, borne by owners of the company, or fully shifted forward to consumers in the form of higher prices? Do the owners of the capital, or the consumers, live in-state or out-of-state? Once it has been decided which group bears the tax, it is necessary to allocate that amount across income groups according to earnings, capital income, consumption of various types of goods, and so on. Incidence studies are a most difficult proposition.

The Public Affairs Research Council of Alabama²⁴ has undertaken one such study of the Alabama system.²⁵ This study analyzed the distribution of burdens of sales, individual income, and residential property taxes—those taxes borne directly by payers—and thus bypassed the thorny problem of the incidence of

each tax and the denominators are, respectively, the total value of real property in the state, total state consumption expenditures, and the total state personal income.

21. COMMISSION REPORT, *supra* note 1, at 2, 4.

22. The effective tax rate is the ratio of taxes actually paid to personal income.

23. If it is assumed that the marginal utility of income diminishes, then higher income families will have to pay a greater share of their income in taxes in order to incur the same sacrifice as lower-income families. This is one justification for arguing that progressive tax rates are necessary for vertical equity.

24. The Public Affairs Research Council of Alabama is a nonprofit corporation. Its address is 315 Samford Hall, Samford University, Birmingham, AL 35229.

25. PUBLIC AFFAIRS RESEARCH COUNCIL OF ALA., REP. NO. 7, CONSIDERATIONS IN REFORMING ALABAMA'S TAXES (1990).

taxes on company income and business property. In an empirical analysis of the distribution of tax burdens in four cities, the researchers found that state and local taxes in Alabama were highly regressive.²⁶ They noted, "The tax burden on \$100,000 income is about 20% lower than on \$15,000 income."²⁷ However, the inclusion of business income, franchise, and property taxes in this analysis would have lessened this estimate of the regressivity.

D. The Tax System Is Not Neutral in Its Effects on Economic Choices

When a tax system offers a different treatment to some types of economic activities than to others, economic choices may be affected in the direction of the allocation of more resources to the lightly taxed activity. The extent of the reallocation, and therefore the extent to which the tax system interferes with the market, depends on the elasticity of substitution²⁸ between the two activities. Even if the differential tax treatment does not cause a significant reallocation of resources, it imposes a horizontal inequity in that two individuals or businesses or inputs in a "similar" position face different tax liabilities.

The Alabama tax system is characterized by such non-neutralities. The following are examples:

- Companies chartered in Alabama (domestic companies) face a different tax regime than those chartered in other states (foreign companies).²⁹
- Two families can have the same level of income and wealth, but because they hold their assets in different forms they are subject to different levels of tax. The real property tax

26. *Id.* at 2.

27. *Id.*

28. The elasticity of substitution is a measure of the ease with which one input may be substituted for another.

29. COMMISSION REPORT, *supra* note 1, at 13-14; *see* ALA. CODE § 40-18-31 (1985) (corporate income tax); *id.* §§ 40-14-40 to -41 (Supp. 1991) (franchise tax for domestic and foreign corporations). Financial institutions and insurance companies are subject to an excise tax, with the tax on foreign corporations based on assets used in Alabama. *See id.* §§ 40-16-1 to -8 (1985 & Supp. 1991) (financial institution excise tax); *id.* §§ 27-4-2 to -11 (insurance premium tax).

is levied on land and some other tangible property but not on intangibles.³⁰

- Two corporations can have the same payroll and the same level of value-added, but quite different liabilities under the present company income tax and franchise tax.
- Real estate taxes on tracts of equal value may differ dramatically depending on how the property is used.³¹

E. Revenue Growth Is Inelastic

States desire a tax system that grows in step with expenditure requirements—the necessary tax revenue growth should be automatic. If this happens, there is no need for the legislature and the governor to go to the voters with rate increases or base-broadening measures to cover budget deficits. The trick is to define the “right” rate of revenue growth and then to design a tax structure that gives this growth. One common way to define a target growth is by reference to the growth in state personal income. For example, if state and local government expenditures grow approximately in proportion to the growth in personal income, this would imply a needed revenue growth about in proportion to increases in personal income. The ratio of the percent change in tax revenue to the percent change in personal income is referred to as the “revenue-income elasticity.”

The revenue elasticity of a tax system can be low for one of several reasons. One is that the faster-growing components of income are not being fully taxed. The exclusion of the consumption of services from the Alabama sales tax³² is such a source of inelasticity. Another reason is that an income tax may have a flat rate, hence there is no bracket creep that would lead to a higher elasticity. Third, the property tax base may not be current, i.e., the growth in assessed value may not match the growth in full market value. Fourth, some of the tax base may be specific rather than ad valorem, e.g., the gasoline tax is based on the number of gallons

30. COMMISSION REPORT, *supra* note 1, at 10-13.

31. See ALA. CONST. art. XI, § 217, amended by *id.* amend. 325; COMMISSION REPORT, *supra* note 1, at 10.

32. See ALA. CODE § 40-23-1 (Supp. 1991) (restricting “gross receipts” to “tangible personal property” for tax purposes); COMMISSION REPORT, *supra* note 1, at 8.

sold rather than on the value of gasoline purchased.³³ Finally, a state tax system may be partially indexed for inflation, which would lower the elasticity.

The revenue-income elasticity has been estimated for Alabama to be about 1.0 for the 1981-89 period.³⁴ That is, tax revenue increased about in proportion to personal income over this period. However, since these estimates take into account tax rate, base, and administrative changes, it is reasonable to presume that the built-in elasticity of the system was less than unity during the period. Moreover, the evidence from this study indicates that the elasticity of the tax system declined during the 1980s.³⁵

F. The Present System Is Complicated and Ambiguous

Many have argued that the present tax system in Alabama is overly complicated and that the law is unclear, and this gives rise to an arbitrary treatment of taxpayers.³⁶ The result is that administrative costs are higher than they need be, as are compliance costs. Arbitrary treatment also leads to horizontal inequities in the system, and a loss of taxpayer confidence. Moreover, the more difficult the system is to administer, and the more arbitrary the law, the greater the chance for successful tax avoidance and evasion.

There are many examples of the problems caused by the complexity of the tax code:

- Because the state income tax base and the federal income tax base are different, there is uncertainty as to tax liability and litigation is often required to resolve differences.³⁷

33. See ALA. CODE §§ 40-17-2, -31, -220 (1985 & Supp. 1991) (taxes on diesel fuel, gasoline, and motor fuel).

34. See Center for Business & Economic Research, Univ. of Ala., *Elasticity of Alabama's Tax Receipts: 1981-1989*, Special Rep. No. 90-2, Table 2 (Oct. 1990).

35. See *id.*

36. See, e.g., COMMISSION REPORT, *supra* note 1, at 7, 8, 10, 14 (criticizing various state taxes as complex and unfair).

37. *Id.* at 7.

- The sales, use, and leasing taxes are separate statutes³⁸ and have different administrative rules³⁹ even though they are intended to tax similar transactions.
- Local governments can impose gross receipts taxes on sales and services provided both inside and outside their jurisdiction limits.⁴⁰ This tax has been challenged in the courts (and upheld),⁴¹ but it raises the possibility that a given transaction may be the subject of tax by more than one local jurisdiction.⁴²

G. Local Government Taxation

Local governments in Alabama use a more diverse structure of taxes than do local governments in most states. Cities, counties, and school systems rely on property taxes, sales taxes, occupation taxes, and the local share tax to finance their budgets.⁴³ In particular, sales and property tax bases vary widely across local governments, with the result that there are wide disparities in spending and public service levels. Among cities, for example, per capita expenditures range from a high of \$1,141 in Hoover to a low of \$312 in Phenix City.⁴⁴ Among school systems, the range in local support per pupil was from \$113 to \$1537 in 1987.⁴⁵

Local government taxation practices undermine the ability of the state to structure the overall tax system to achieve the goals of equity, efficiency, and administrative ease. Local sales tax rates, for

38. ALA. CODE §§ 40-23-1 to -38 (1985 & Supp. 1991) (sales tax); *id.* §§ 40-23-60 to -88 (use tax); *id.* §§ 40-12-220 to -227 (leasing tax).

39. *See id.* §§ 40-23-31, -83, 40-12-224 (1985) (containing the enabling provisions for regulations).

40. *See McElrath Poultry Co. v. State Dep't of Revenue*, 332 So. 2d 383, 386 (Ala. Civ. App. 1976).

41. *McElrath*, 332 So. 2d at 386.

42. *See id.*

43. *See* COMMISSION REPORT, *supra* note 1, at 17-18.

44. PUBLIC AFFAIRS RESEARCH COUNCIL OF ALA., REP. NO. 5. THE FINANCES OF ALABAMA'S LARGEST CITIES 7 (1989).

45. PUBLIC AFFAIRS RESEARCH COUNCIL OF ALA., REP. NO. 4. LOCAL SUPPORT FOR PUBLIC SCHOOLS IN ALABAMA 7 (1989). *See generally* Randall D. Quarles, Comment, *Education in Alabama: Is There a Right to the Three R's?*, 43 ALA. L. REV. 133 (1991) (containing discussion of disparity in school funding).

example, may increase the state rate by a considerable amount.⁴⁶ Local sales and excise taxes present a serious compliance problem for business, and local gross receipts taxes have the potential for serious duplication since they are levied on transactions that may occur outside the boundaries of the taxing jurisdiction.⁴⁷

H. Earmarking Is Excessive and Inefficient

One of the most controversial features of the Alabama tax system is the extent to which it is earmarked.⁴⁸ By the mid-1980s, 89 percent of Alabama's tax revenues were earmarked, making it the highest earmarking state in the United States.⁴⁹ Much of the revenue from the sales tax and the income tax is dedicated to the education trust fund,⁵⁰ and the tax on motor fuels is dedicated to highway expenditures.⁵¹

In studying tax reform in another heavily earmarked state, the Nevada tax commission's staff questioned whether the primary justifications for earmarking were still persuasive.⁵² The staff asked:

- What is the rationale for earmarking?
- What is the relationship between earmarking and the design of a high quality tax system?
- Do the historical reasons that explain earmarking still hold true in the economy of the 1990s?⁵³

The same questions could be posed for Alabama, perhaps with the same answers. The primary justification for earmarking is to link program benefits to a particular revenue source, as in the case

46. See, e.g., PUBLIC AFFAIRS RESEARCH COUNCIL OF ALA., REP. NO. 5, THE FINANCES OF ALABAMA'S LARGEST CITIES 3 (1989) (reporting municipal sales tax rates of up to 3%). The state levies a 4% retail sales tax. ALA. CODE § 40-23-2(1) (Supp. 1991).

47. See *supra* notes 40-42 and accompanying text.

48. See COMMISSION REPORT, *supra* note 1, at 16. See generally IRA W. HARVEY, A HISTORY OF EDUCATIONAL FINANCE IN ALABAMA, 1819-1986, at 393, 408-15 (1989) (discussing the history and status of earmarking funds for education).

49. HARVEY, *supra* note 48, at 409-11.

50. See ALA. CODE § 40-23-35 (Supp. 1991) (earmarking sales tax); *id.* § 40-18-58 (1985) (earmarking income tax).

51. *Id.* § 40-17-13 (1985).

52. See *Earmarking Tax Revenues*, in A FISCAL AGENDA FOR NEVADA. REVENUE OPTIONS FOR STATE AND LOCAL GOVERNMENTS IN THE 1990s, at 149 (Robert D. Ebel ed., 1990).

53. *Id.* at 150.

of dedicating all motor fuel revenues to the road fund.⁵⁴ This justification does not hold, however, in the dedication of general revenues to a particular function.⁵⁵ In the case of general revenues, such dedication is justified on grounds of gaining public support for a particular tax or charge. The notion is that people are willing to pay higher taxes for services they value.⁵⁶ Finally, earmarking might be justified as necessary to guarantee a minimum level of support for a particular service.⁵⁷

One key argument against earmarking is that it limits the flexibility of the legislature to allocate resources among competing government functions.⁵⁸ It also limits the legislature's ability to review the efficiency with which public funds are used.⁵⁹ Another problem is that any tax restructuring carries with it an automatic reallocation of expenditures.⁶⁰ Thus, the revised tax structure must accommodate not only good policy, but also the dedication of revenues from each source.

I. Economic Development May Be Discouraged by the Tax System

Those interested in attracting new investment to Alabama decry the tax structure as a negative influence. This argument consists of a number of strands. The most commonly heard is that higher taxes discourage industry from choosing an Alabama location. Underlying this position is the argument that lower taxes will increase profits and make Alabama a better choice for a new plant site or an expansion.

A second position is that economic development is more likely to be discouraged by the Alabama tax system because taxes are too low. Inadequate public services and a poor education system will keep industry away because production costs will be higher than in states where, for example, the road system is better, the supply of water and energy is uninterrupted, and the labor force is better

54. *Id.* at 161.

55. *Id.*

56. *See id.* at 161-62.

57. *See id.* at 162 (stating that in order to meet the logical linkage test, the service would have to be eliminated but for the earmarking).

58. *See id.* at 162-63.

59. *See id.* at 163.

60. *See id.* at 163-64.

trained. Public services also may enhance the general quality of life, which is also thought to influence location choices.

Another view is that the *structure* of taxes, as much as the level of taxes, is the important determinant. According to this view, taxes borne by capital in the form of lower profits (business income taxes and business property taxes) discourage industry location. Taxes on highly paid company executives, in particular high marginal individual income tax rates, are to be avoided. Personal taxes—borne by middle- and low-income workers, consumers, and homeowners—are less of an issue.

Finally, there is the argument that the important issue is whether the business community can have confidence in the ability of the Alabama state government to plan the state's fiscal future. The position here is that businesses can live with higher taxes if they receive adequate public services, but they cannot live with a large measure of uncertainty about taxes or the availability of essential services. If the state has a chronic budget deficit, the state will continually be revising either the taxes that it applies to business or the services that it provides for business, or both. Fiscal uncertainty is not part of a good business climate.

Many studies have been conducted to estimate the effectiveness of fiscal variables in influencing the location decisions of firms.⁶¹ The overwhelming consensus from these analyses is that variations in the tax rate and the provision of subsidies are not important determinants.⁶² The only case in which taxes are deemed important is when a state's taxes are very much out of line with other states. Based on the results of these studies, Alabama's very low level of taxes would not seem to be a major factor in industry location.

IV. OBJECTIVES OF THE REFORM

Given this menu of problems, the Commission could have embraced many different objectives to guide its work. There really was a choice. A reform program bent towards economic develop-

61. See, e.g., Michael Wasylenko, *Empirical Evidence on Interregional Business Location Decisions and the Role of Fiscal Incentives in Economic Development*, in *INDUSTRY LOCATION AND PUBLIC POLICY* 13, 17-21 (Henry W. Herzog, Jr., & Alan M. Schlottmann eds., 1991) (presenting a tabular summary of such studies).

62. *Id.* at 13.

ment objectives would look quite different from one designed primarily to improve vertical equity, and different yet from one focused on administrative improvements. Essentially, the Commission settled on fairness in taxation as the primary goal.⁶³ "[B]roaden the tax base and lower the rates" became the underlying strategy.⁶⁴ Other states, in different economic circumstances and with different fiscal structures, have chosen to emphasize different objectives in developing alternative reform measures. Louisiana, for example, which is dependent on mineral revenues, placed heavy emphasis on revenue stability.⁶⁵ Minnesota, which derives nearly half of all tax revenues from a complicated and progressive-rate individual income tax, held simplification as a major concern in considering a restructuring of the individual income tax.⁶⁶

V. REFORMING ALABAMA'S INDIVIDUAL INCOME TAX

The individual income tax provides about 13 cents of every tax dollar in Alabama.⁶⁷ But the tax has become outdated in form, and its present impact is neither fair nor equitable. The tax is mildly progressive;⁶⁸ nevertheless, it is not progressive enough to counter the regressivity of the sales and excise taxes. Moreover, the filing threshold is set so low that many families who are exempt from the federal income tax must pay Alabama income tax.⁶⁹ A particular problem is the deductibility of the federal income tax from the state tax base.⁷⁰ This lessens the progressivity of the state tax, causes the distribution of tax burdens and the revenue yield in Alabama to be affected by changes in federal rules, makes the true basis of taxation unclear in the minds of taxpayers, and causes Al-

63. See COMMISSION REPORT, *supra* note 1, at 2-3.

64. See *id.* at 2.

65. See James A. Richardson, *Paying for State Government in Louisiana: Considering the Alternatives*, in LOUISIANA'S FISCAL ALTERNATIVES 353, 356-58 (James A. Richardson ed., 1988).

66. Emil M. Sunley & Mary M. Walz, *Simplification of Minnesota's Personal Income Tax*, in 2 FINAL REPORT OF THE MINNESOTA TAX STUDY COMMISSION, STAFF PAPERS 101, 101 (Robert Ebel & Therese McGuire eds., 1986).

67. See *supra* Table 2.

68. PUBLIC AFFAIRS RESEARCH COUNCIL OF ALA., REP. NO. 7, CONSIDERATIONS IN REFORMING ALABAMA'S TAXES 3 (1990); COMMISSION REPORT, *supra* note 1, at 6.

69. COMMISSION REPORT, *supra* note 1, at 6-7.

70. *Id.* at 7.

abama to levy a higher nominal rate in order to raise a particular amount of revenue. It is also true that the tax is complicated because differences between the federal and state income tax bases cause uncertainty and increase administrative and compliance costs, including the cost of litigation to resolve some of the ambiguities.⁷¹

The Alabama individual income tax does add to the elasticity of the tax system. It is estimated that for the 1980-89 period, a 10 percent increase in personal income in the state led to a 10 percent increase in total taxes, but a 13 percent increase in individual income tax revenues.⁷² Nevertheless, the revenue elasticity of the Alabama income tax is below that of most other states.⁷³

The Commission recommended a sweeping reform. Under this proposal, the individual income tax would be levied on federal adjusted gross income (AGI) at a flat rate of approximately 4 percent.⁷⁴ The proposal would allow only two deductions: the standard deduction and personal exemptions. Both would be tied to the federal amounts.⁷⁵ This structure assures families who are not required to file federal income tax returns that they will not be required to file Alabama returns.⁷⁶ Alabama taxpayers would not be allowed to take itemized deductions or to deduct the federal income tax.⁷⁷

The construction of the proposal, and the way one would evaluate it, must center on four key policy issues: the desirability of adopting the federal base, the right federal base to adopt, the appropriate rate structure, and whether to allow deductibility of federal income taxes.

A. Using the Federal Base

The policy choice facing the Commission was whether the state income tax base would be defined by the legislature or by the

71. *Id.*

72. See Center for Business & Economic Research, *supra* note 34, table 2.

73. See *id.*

74. Ala. H. 1107, 1991 Reg. Sess. §§ 5-6 (introduced July 29, 1991) [hereinafter Proposed Income Tax].

75. *Id.* § 9; COMMISSION REPORT, *supra* note 1, at 7.

76. COMMISSION REPORT, *supra* note 1, at 7.

77. See Proposed Income Tax, *supra* note 74, § 9; COMMISSION REPORT, *supra* note 1, at 7.

federal government. The Commission came down on the side of using the federal base⁷⁸ and prescribed that no deductions be given beyond the standard deduction and personal exemptions.⁷⁹ Strong arguments cited by the Commission support this decision.

- The actual base of taxation will be clearer. This presumes that, as the Commission observed, “[t]he average person understands the federal income tax base better than he understands the state income tax base. People are more willing to pay a tax they understand [or think they understand] than one they do not understand.”⁸⁰
- Using the same base for state and federal income tax will make the tax system simpler to administer and will reduce compliance costs.⁸¹
- Shifting responsibility for defining the tax base to the federal level makes income tax policy in Alabama less subject to politics. The legislature will be more prone to change tax rates, which affect all taxpayers, than to provide special preferential treatment.⁸²

The arguments against using the federal base are also strong. Perhaps the strongest is that the State legislature, and not the Congress, should define the base of taxation for the Alabama income tax. Defining that base is the legislators’ responsibility as elected representatives of the people of Alabama. When one accepts the federal base, she takes a step in the direction of saying that we trust our own scoundrels even less than we trust the ones in Washington. Another point is that it is hard to imagine that the legislature—so used to giving deductions—could be dissuaded from tinkering with the base. The danger is that legislators would accept the AGI concept, but would erode the base by giving political tax preferences and thereby foul the improved system.

A corollary to this set of arguments is that adoption of the federal base will make Alabama tax liability susceptible to discretionary changes introduced at the federal level. The case for such coupling grows weaker when Congress acts irrationally in re-

78. See COMMISSION REPORT, *supra* note 1, at 7.

79. Proposed Income Tax, *supra* note 74, § 9; COMMISSION REPORT, *supra* note 1, at 7.

80. COMMISSION REPORT, *supra* note 1, at 7.

81. See *id.*

82. See *id.*

forming the federal income tax, and when the goals for federal tax reform depart from Alabama's objectives.

B. Which Federal Base?

Once it has been decided to use the federal base, there are three possible federal tax bases: AGI, taxable income, and tax liability. The Commission recommended AGI, with federal exemption levels but no further deductions.⁸³ This proposal has the very attractive features of being simple and understandable and allowing a lower nominal rate, one well within the Alabama Constitution's 5 percent maximum.⁸⁴

The alternate choice, taxable income, accepts the federal definition of deductions. This has the advantage of removing another layer of decisions where the legislature might be tempted to give preferential treatment, but it has the disadvantage of making the state subject to the federal definition of both the base of the income tax *and* the deductions that the federal government chooses to allow or disallow. Another major disadvantage of the taxable income approach (versus AGI) is that it would require a higher nominal rate to raise the same amount of revenue. Hence the 5 percent rate limit could be binding.

A third choice is to piggyback onto the federal income tax by stating Alabama tax as a percent of federal tax liability. The very considerable advantages here are simplicity and lower administrative cost. If the state chose this form of tax and followed certain federal guidelines, the federal government would bear the cost of administration.⁸⁵ Compliance costs would also be reduced considerably as only one return would be required for all individuals and businesses, and a unified field and desk audit program could be instituted. But there are major disadvantages to this version of conformity:

- A substantial number of state employees involved in administering the Alabama income tax would become federal employees or be dismissed.

83. Proposed Income Tax, *supra* note 74, § 9; COMMISSION REPORT, *supra* note 1, at 7.

84. COMMISSION REPORT, *supra* note 1, at 7; see ALA. CONST. amend. 25.

85. The state need only adopt the tax liability which the federal government sets, then take a percentage.

- The federal government might be lax in enforcing the state income tax since the federal government has little to gain by increasing its efforts.
- The federal government's tax objectives would be accepted more than under any other form of conformity, i.e., the federal base and rate structure would be used to determine Alabama income tax liability.
- The tax base would be so narrow that either the 5 percent rate limitation would have to be removed or less revenue reliance on the individual income tax would have to be accepted.

The best choice among these three possible conforming bases depends on what the state most wants to achieve. The "right" choice for Alabama depends on identifying this objective and on estimating the potential impacts of the alternatives. All have the sovereignty drawback to varying degrees, and all would have the simplicity advantage.

Unfortunately, the Alabama Commission did not have the luxury of a thorough quantitative analysis of the three options. The Arizona Tax Commission staff did carry out such an analysis and concluded that both the progressivity and the revenue-income elasticity of the state income tax would be most enhanced by using federal taxable income as the state base.⁸⁶ The revenue-income elasticity would be 1.58 under the taxable income base but only 1.28 under the federal AGI base.⁸⁷ It follows from this result that if Alabama chose the AGI base, revenue yield would be more stable across the business cycle and would require the lowest nominal rate.⁸⁸ Progressivity in the distribution of tax burdens was found to be considerably greater under the federal taxable income base than under a flat-rate tax on AGI.⁸⁹

86. See Daniel Feenberg et al., *The Personal Income Tax, in STATE AND LOCAL FINANCE FOR THE 1990S: A CASE STUDY OF ARIZONA* 59, 71-72 (Therese J. McGuire & Dana W. Naimark eds., 1991).

87. *Id.* at 71-73.

88. AGI is a broader base than taxable income, so a lower rate on an AGI base would produce as much revenue as a higher rate on taxable income. Since fluctuations in income produce greater changes in taxable income than AGI, the latter would be a more stable base.

89. Feenberg, *supra* note 86, at 71-73.

C. A Flat-Rate Structure

The Commission recommended a flat-rate income tax,⁹⁰ and estimated that "a rate in the range of 3.8 to 4.2 percent would be revenue neutral."⁹¹ There is considerable merit to the flat-rate approach, but it is always a controversial issue:

- It gives the appearance of being regressive. This is not so. It really is a two-rate tax: zero percent and the flat rate. Up to the level at which people begin to pay, the tax is very progressive. The higher the personal exemption and standard deduction, the more progressive the tax is because those below the floor pay no tax. Above the floor, however, the tax becomes proportional because the nominal tax rate does not increase with income level. Simulations of a proposed flat tax rate for Arizona demonstrated that it can be progressive, though less so than an equal yield, graduated rate levied even on a narrower base.⁹²
- A flat rate takes away part of the bracket creep, i.e., the so-called inflation tax. An indexed exemption level would take away the rest of it.
- A flat-rate tax can literally be filed on a postcard. It might even eliminate the need for a tax table, and withholding would be simplified.⁹³

A drawback to a flat-rate tax is that it implies a lower income elasticity. There is neither bracket creep nor an inflation tax, and tax revenue would grow faster than personal income only if the basic exemption level were not indexed. This would be the case in Alabama.⁹⁴ Still, it would be reasonable to assume that individual income tax revenues would grow more slowly under the reformed system than under the present system.

90. Proposed Income Tax, *supra* note 74, § 5; COMMISSION REPORT, *supra* note 1, at 7.

91. COMMISSION REPORT, *supra* note 1, at 7.

92. Feenberg, *supra* note 86, at 71-75. Another author argues that more progressivity can be built in by applying a single, higher marginal rate to high income taxpayers, and this will not compromise the other desirable features of the flat-rate tax. JONATHAN KESSELMAN, RATE STRUCTURE AND PERSONAL TAXATION: FLAT RATE OR DUAL RATE? 13, 66-67 (1990).

93. Some commentators contend that a flat-rate, broad-based federal income tax could be filed on a postcard. ROBERT E. HALL & ALVIN RABUSHKA, LOW TAX, SIMPLE TAX, FLAT TAX 32-52 (1983).

94. See Proposed Income Tax, *supra* note 74, § 9.

D. Federal Income Tax Deductibility

The Commission recommended disallowing the deductibility of federal income taxes from the state income tax base.⁹⁵ There is a good case for this. Deductibility of federal taxes makes the state income tax more regressive.⁹⁶ It makes the growth in state income tax revenues more susceptible to changes in federal tax policy. It is in effect a subsidy from the average-income Alabama taxpayer to the higher-income Alabama taxpayer, and it increases the complexity of the state income tax system.

Critics of the Commission's proposal may raise the issue that a deduction for federal income taxes allows Alabama residents to avoid double taxation. Federal income tax payments are not available for a resident to spend or save, so the payments do not represent an increased ability to pay state taxes. This argument is flawed. If federal taxes are to be deductible as a legitimate "cost," then the benefits received from the federal services should be added back to income. Surely the latter constitute an addition to a taxpayer's ability to pay. If the value of federal benefits received is equal to or greater than the federal tax paid, then disallowing the federal tax deduction is justified.⁹⁷

VI. SALES, USE, AND LEASING TAXES

There are significant shortcomings in Alabama's sales, use, and leasing taxes. The taxes in their present form are unfair, regressive, and unnecessarily complex. The Commission described several important problems in the following way:

- By far the largest of these taxes is the sales tax. It was designed originally as a broad-based tax on commodity consumption. But consumption patterns have changed, and services, virtually exempt from the sales tax base, now account for nearly half of all consumption. Because the present base is defined so narrowly, all

95. COMMISSION REPORT, *supra* note 1, at 7; Philip Rawls, *Tax Plans Would Cut State Revenue*, BIRMINGHAM POST-HERALD, Jan. 8, 1992, at A1; David White, *Lawmakers Plan on Riding Reform to Higher Taxes*, BIRMINGHAM NEWS, Jan. 12, 1992, at 19A, 21A.

96. Simulations of the effect of eliminating the federal tax deduction for the Arizona income tax found that the system became more progressive and the revenue-income elasticity increased, but the differences were slight. See Feenberg, *supra* note 86, at 73.

97. For a good discussion of the pros and cons of allowing federal tax deductibility, see Sunley & Walz, *supra* note 66, at 111-13.

consumers must pay a higher rate (as high as nine percent in some local areas).

- Low-income families who spend a large fraction of their incomes for food are hit particularly hard by the sales tax, while high-income families who spend heavily for certain services are subject to a lower effective rate. The Commission estimates that a representative family of four with a \$100,000 income pays less than three [2.78] percent of its income in sales tax, while a comparable family with a \$15,000 income pays more than 5 percent.
- The tax is complex. The sales, use, lodgings, and leasing taxes are separate statutes and have different administrative rules even though they are intended to tax similar transactions. This makes compliance more costly and administration more difficult.⁹⁸

Tax complexity also leaves loopholes for tax avoidance. Also, there is a fourth problem which the Commission Report did not mention. Because most elements of service consumption are excluded from the tax base, revenues from the sales tax grow more slowly than state personal income.

A. Commission Recommendations

The Commission recommended that the sales tax “be substantially restructured and broadened.”⁹⁹ The most important change would be to include all services in the tax base. Doing so would substantially broaden the tax base, allowing for a reduction in the rate.¹⁰⁰ All services would be subject to the sales tax. This would include repair services, personal care services, construction, computer programming, and professional services including health and legal services. The only exemption, for services to be resold,¹⁰¹ is necessary to prevent double taxation.

Broadening the base in this manner permits a rate reduction from the present 4 percent state rate¹⁰² to a revenue-neutral state

98. COMMISSION REPORT, *supra* note 1, at 8-9; see PUBLIC AFFAIRS RESEARCH COUNCIL OF ALA., REP. NO. 7, CONSIDERATIONS IN REFORMING ALABAMA'S TAXES 2 (1990).

99. COMMISSION REPORT, *supra* note 1, at 9.

100. See Ala. H. 1111, 1991 Reg. Sess. § 5 (introduced July 29, 1991) [hereinafter Proposed Transaction Tax]; COMMISSION REPORT, *supra* note 1, at 9.

101. See Proposed Transaction Tax, *supra* note 100, § 6(b)(6).

102. ALA. CODE § 40-23-2 (Supp. 1991).

rate of 3 percent.¹⁰³ A combination of the rate reduction and the inclusion of services in the tax base, it is hoped, would take much of the regressive sting out of the sales tax. The proposed reform would decrease the sales tax paid by a so-called representative family with a \$15,000 income by \$50, whereas it would increase the tax paid by a \$100,000 family by \$119.¹⁰⁴

The Commission proposed to combine the sales, use, and leasing taxes, and to rewrite the statutes.¹⁰⁵ It was argued that this would clean up the law, eliminate some ambiguities that have led to double taxation, and remove some loopholes that have led to abuses.

B. Evaluation

The most important issues surrounding the restructuring of the sales tax have to do with the exemptions that would be permitted. This analysis of the potential impacts of the Commission proposals centers on exemptions.

1. *Food*.—Perhaps the most controversial issue in sales tax policy is whether or not to exempt food. The argument for exempting food from the sales tax is made on equity grounds. Taxing food makes the sales tax more regressive because lower-income families spend a greater proportion of their income on food than do higher-income families. In Arizona it was estimated that the average food expenditure burden of low-income families was four times that of high-income families.¹⁰⁶ In Minnesota the burden on low-income families was estimated to be three times greater than that on their wealthier counterparts.¹⁰⁷ Clearly, the taxation of food increases the regressivity of the sales tax.

There are also good arguments for taxing food, as is proposed by the Alabama Commission.¹⁰⁸ One is that in order to give the

103. See Proposed Transaction Tax, *supra* note 100, § 4; COMMISSION REPORT, *supra* note 1, at 9.

104. COMMISSION REPORT, *supra* note 1, at 9.

105. *Id.*

106. Helen F. Ladd & Dana Weist, *General Sales Taxes, in STATE AND LOCAL FINANCE FOR THE 1990s: A CASE STUDY OF ARIZONA*, *supra* note 86, at 117, 135-36.

107. John L. Mikesell, *Retail Sales and Use Taxation in Minnesota*, in 2 FINAL REPORT OF THE MINNESOTA TAX STUDY COMMISSION, STAFF PAPERS *supra* note 66, at 155, 169-72.

108. COMMISSION REPORT, *supra* note 1, at 9.

food exemption to the poor, food consumed by the non-poor must also be exempted. Another is that the exemption implies a big revenue loss. Third, there are some administrative difficulties associated with exempting food. Fourth, the regressivity of the food tax is somewhat offset by the exemption of food consumed with food stamps.

States have treated this issue differently.¹⁰⁹ Of the forty-six states with general sales taxes, nineteen now tax food (for home consumption), while twenty-seven do not tax food.¹¹⁰ Only two of the twelve Southeastern states exempt food from the sales tax.¹¹¹ Some states (Hawaii, New Mexico, North Carolina) tax food but provide a credit against the income tax to reduce the regressivity.¹¹² The credit is only available to those with incomes below a certain level.¹¹³ The argument against the food credit is that some who are due the rebate, but have incomes below the taxable income floor, may not apply.

2. *Motor Fuels and Motor Vehicles.*—Two major elements of the consumption tax base, gasoline and motor vehicles, receive differential treatment under the present sales tax.¹¹⁴ An appropriate policy question is whether this differential treatment should be continued.

Because gasoline is taxed at a specific rate per gallon,¹¹⁵ it is treated differently than other items of consumption, which are taxed at a fixed percentage of value. The result is that gasoline tax revenues do not grow with inflation or with increased expenditures on gasoline. This has prompted some to call for changing the gasoline tax to an ad valorem basis.

There are reasons why this is a good idea. First, it would make the revenue base more elastic, and as gasoline prices rose, substantial revenue would be generated to use for public services or to provide relief from other taxes. A second argument is that the gas

109. 1 ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, REP. NO. M-169, SIGNIFICANT FEATURES OF FISCAL FEDERALISM, BUDGET PROCESSES AND TAX SYSTEMS 70-72 table 24 (1990) [hereinafter BUDGET PROCESSES AND TAX SYSTEMS]

110. *Id.*

111. *Id.* at 71.

112. *Id.* at 70-73.

113. *Id.*

114. See ALA. CODE §§ 40-17-2, -220 (1985 & Supp. 1991) (gasoline tax); *id.* § 40-23-101 (Supp. 1991) (motor vehicles).

115. See *id.* § 40-17-2 (1985).

tax might be viewed as a benefit charge for the use of roadways. What better way to pay for highways and streets than with a tax on those who use gasoline? Under present (and proposed) earmarking arrangements, increased motor fuel taxes would mean more funding for transportation services in the state. Third, automobiles and trucks generate social costs in the form of pollution and congestion, and so a higher gas tax would seem to be in order to gain some payment for these social costs. More generally, there would seem to be no good reason to exclude gasoline from the general consumption tax base. Most states tax alcohol under both an excise and a sales tax,¹¹⁶ and there seems no justification for treating motor fuels (and cigarettes) differently.

There are also arguments against this proposal. First, if gas prices go down, so would revenues. The proposal would convert the tax on motor fuels to an unstable source of revenue, tied to uncontrollable international events. Second, the gasoline tax would be even more regressive on an ad valorem basis (assuming that low-income drivers do not consistently use fuel-efficient cars).

Most states have stayed with a specific excise tax and exempt motor fuels from the sales tax.¹¹⁷ There are a few exceptions. Rhode Island does levy an ad valorem tax on gasoline at 11 percent of wholesale price.¹¹⁸ Georgia levies a part of its gasoline tax on an ad valorem basis.¹¹⁹ Alabama has a state rate of 11 cents,¹²⁰ with local rates of from 1 to 4 cents per gallon.¹²¹ The median U.S. state rate is 16 cents per gallon.¹²² The average rate for the other nine Southeastern states (excluding Alabama, Georgia and Florida) is 17.5 cents per gallon.¹²³ The Commission did not recommend a change in the basis for taxing gasoline.¹²⁴

The Commission did recommend, correctly, that automobiles should lose their present preferential treatment and be taxed at the general rate.¹²⁵ There are good arguments to do this. It would

116. See BUDGET PROCESSES AND TAX SYSTEMS, *supra* note 109, at 84 table 30.

117. *Id.* at 83 table 29.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. See *id.*

124. See Proposed Transaction Tax, *supra* note 100, § 6.

125. *Id.* § 16; COMMISSION REPORT, *supra* note 1, at 9.

be a significant revenue raiser, allowing relief from some other, perhaps less desirable, tax base. Higher-valued cars are a sign of ability to pay, and so higher-income people would pay more dollars in tax. The present practice of "[t]axing automobiles at a lower rate than necessities such as food and medicine is objectionable on grounds of equity and fairness."¹²⁶

Nevertheless, there are reasons to criticize the proposal. Some will argue that it is regressive, because cars are a necessity. Another issue is whether the tax would leave Alabama's rate out of line with that in surrounding states and therefore encourage a leakage in purchases of automobiles. This does not seem a strong argument. The use tax would capture out-of-state purchases, and in any case, even the 4 percent rate would not compromise Alabama's competitive position. The purchase tax in Alabama (at 2 percent state and zero local) is presently on the low side in the region: Florida, 6 percent state, zero local; Georgia, 3 percent state, 1 percent local; Mississippi, 3 percent state, zero local; Louisiana, 4 percent state, up to 5 percent local; and Tennessee, 5.5 percent state, up to 2.75 percent local.¹²⁷

3. *Machinery and Other Inputs.*—Machinery is taxed, though at a preferential rate of 1.5 percent, under the current state sales tax.¹²⁸ The principal targets of this tax are manufacturing, mining, and quarrying. Machinery purchased under an industrial development bond issue is exempt.¹²⁹ The Commission proposed extending the machinery exemption to all industries.¹³⁰

There is good economic justification for this proposal. Machinery is an intermediate good, an input, and therefore it should not be taxed. If it is taxed, the levy will be pyramided forward in the production and distribution process and lead to a price distortion for final output. However, if the final output is not taxed, then there *may* be a case to tax the inputs. In many industries that would be affected by the exemption, there is no tax on final output in Alabama. Also weighing against exempting machinery inputs are

126. COMMISSION REPORT, *supra* note 1, at 9.

127. See BUDGET PROCESSES AND TAX SYSTEMS, *supra* note 109, at 90-96 table 82.

128. ALA. CODE § 40-23-37 (1985); COMMISSION REPORT, *supra* note 1, at 9.

129. COMMISSION REPORT, *supra* note 1, at 9.

130. See Proposed Transaction Tax, *supra* note 100, § 6(b)(3); COMMISSION REPORT, *supra* note 1, at 9.

the lost revenue from such an exemption and the absence of any great clamoring for tax reduction in this area.

Perhaps a more important issue is what to do about the taxation of inputs in general. The rule under the present system is that raw materials should not be taxed, i.e., an intermediate good is exempt if it becomes part of the final product.¹³¹ The Commission did not recommend a change in this principle.¹³²

From the perspective of good tax policy, however, there would seem little justification to continue the special treatment of raw materials only. If the principle is to avoid double taxation by exempting material inputs, then all input purchases should be exempt. But, while there can be little question about this being good policy in terms of making the tax system neutral with respect to economic decisions, there is a revenue loss to be reckoned with. It was estimated that in Arizona the exemption of all presently taxable business purchases would reduce sales tax revenues by 20 to 30 percent.¹³³ The Alabama Commission did not have firm estimates on this.

4. *Services.*—The greatest potential for broadening the sales tax base and lowering the rate is to bring services into the tax. This is true in Alabama and in all other states. However, this route to base broadening is controversial because it raises new questions about proper objects of taxation, e.g., health services, advertising, legal and accounting services, and brokerage fees. Special interest groups and wary taxpayers in general are quick to point to the Florida debacle as a reason to stay away from the taxation of services.¹³⁴ However, it should be noted that many states have

131. See ALA. CODE § 40-23-62 (1985 & Supp. 1991); COMMISSION REPORT, *supra* note 1, at 9.

132. See Proposed Transaction Tax, *supra* note 100, § 6; COMMISSION REPORT, *supra* note 1, at 9.

133. See Ladd & Weist, *supra* note 106, at 135.

134. Florida enacted a comprehensive tax on services in 1986 only to have the law repealed six months later. See Laird G. Graeser, Sales Tax on Services: An Idea Whose Time Has Come? 5 (June 20, 1990) (unpublished manuscript, on file with the *Alabama Law Review*). Though sound in concept and administratively feasible, the tax fell because it could not find a strong political constituency in the face of a heavy media attack (the media were brought into the tax under the services base). For a good discussion, see James Francis, *The Florida Sales Tax on Services: What Really Went Wrong?*, in THE UNFINISHED AGENDA FOR STATE TAX REFORM 129, 129-52 (Steven D. Gold ed., 1988).

brought a broad range of services into their sales tax base in recent years.¹³⁵ Among the arguments in favor of taxing services are:

- The rationale for taxing services is strong.¹³⁶
- Services are the fastest growing component of consumption.¹³⁷ Their taxation would substantially increase the revenue elasticity of sales taxes. If the service base is not taxed, Alabama will have to levy an ever higher rate on commodities.
- Some services are consumed proportionately more by higher-income families. Adding these services to the sales tax base will make the overall tax system more progressive.
- Taxing services can be revenue productive, and can give some latitude for lowering the burden on other sectors of the economy.

In fact, it is difficult to find a good economic reason for excluding services from the sales tax base. But a blanket inclusion of services in the base would be new territory for the Alabama revenue department, and several thorny administrative and legal issues would need to be resolved.

The Alabama Commission proposed the full taxation of all services for final consumption.¹³⁸ It also proposed a compensating reduction in the sales tax rate.¹³⁹ This proposal conforms to the maxims for a "good tax," and it is consistent with the Commission's objective of broadening the base and lowering the rate. The impacts of enacting this broad-based sales tax on revenue performance and on the economy could be substantial. They include:

- Improved fairness, since all consumption now would be taxed at the same rate. A consumer's tax burden would be based on the value of his purchases and not on their composition.

135. Graeser, *supra* note 134, at 4-5.

136. *Id.* at 5-8.

137. See COMMISSION REPORT, *supra* note 1, at 8.

138. See Proposed Transaction Tax, *supra* note 100, § 5; COMMISSION REPORT, *supra* note 1, at 9.

139. See COMMISSION REPORT, *supra* note 1, at 9. Under revenue neutrality, the Commission estimated that the state sales tax rate could fall by 1%. *Id.* If the legislature chose to increase overall revenues with the sales tax, the rate would not rise by as much with services included as it would otherwise.

- Potentially a greater revenue elasticity, since some services are among the fastest growing elements of consumption. The actual effect depends on which services are taxed, because there is a substantial variation across types of services. An Illinois study demonstrated that the revenue elasticity from taxing personal services was low while that from taxing business services was high.¹⁴⁰ The Alabama Commission proposed taxing all services purchased at final consumption, including professional services.¹⁴¹ It is a reasonable proposition that the revenue-income elasticity should rise well above its present level of about 0.9.¹⁴²
- Less regressivity to the sales tax, since (a) luxury services would be taxed and (b) the increased burden of taxation on necessary services would be partly offset by a lower general sales tax rate.¹⁴³ Again, the issue is whether all services would be included, as the Commission proposed for Alabama. If so, the result will be a more progressive sales tax. If only certain personal services are taxed, the regressivity of the present system will not be lessened.¹⁴⁴

On the negative side of the ledger, the administrative and legal costs of setting up the system could be considerable because Alabama's present taxation of services is not very extensive. The Federation of Tax Administrators lists 171 items of service consumption potentially includable under a broad-based sales tax,¹⁴⁵ and Alabama taxes only thirty-one of these.¹⁴⁶ By another measure of the broadness of the sales tax base, an index of base coverage,

140. John L. Mikesell, *Income Elasticities of State Sales Tax Base Components*, 17 Q. REV. ECON. & BUS. 83, 90-91 (1977).

141. COMMISSION REPORT, *supra* note 1, at 9; see Proposed Transaction Tax, *supra* note 100, § 6 (not including professional services among the exemptions).

142. See Center for Business & Economic Research, *supra* note 34, table 2 (stating that the present elasticity for sales taxes is 0.9). The conclusion about elasticity rising is the author's own.

143. See William F. Fox & Matthew Murray, *Economic Aspects of Taxing Services*, 41 NAT'L TAX J. 19, 29 (1988); Perry D. Quick & Michael J. McKee, *Sales Tax on Services: Revenue or Reform?*, 41 NAT'L TAX J. 395 (1988).

144. Fox & Murray, *supra* note 143, at 31.

145. FEDERATION OF TAX ADM'RS, SURVEY OF THE STATES, SALES TAXATION OF SERVICES 1-7 (1990).

146. *Id.* at 7. Among neighboring states, Florida taxes 53 of these items, Georgia 31, Louisiana 48, Mississippi 67, and Tennessee 66. *Id.* at 7, 14, 21.

Alabama ranks thirtieth among the fifty states and the lowest of the ten Southern states.¹⁴⁷

Another drawback is that political opposition would be potentially very strong and widespread. Physicians, lawyers, accountants, and the media would all be brought into the tax base under this proposal.¹⁴⁸

VII. INDUSTRIAL DEVELOPMENT SUBSIDIES

Industrial development subsidies that relieve businesses of sales and property taxes are a tax expenditure that appears to cost the State of Alabama about \$40 million per year.¹⁴⁹ The authority to grant these incentives is quite decentralized, and it is not clear that their award is based on careful analysis of the potential contribution to state economic development.

The reform choices facing the Commission were to patch up the present practice or to abolish it. The first choice was to stay with the present system, but provide for a more strict state evaluation of the costs and benefits of each subsidy program and for a strict monitoring of the tax implications of such programs. The second choice was to abolish such preferential treatment in favor of a generally lower tax rate for all firms.

There are good arguments to abandon these subsidies altogether:

- They impose a revenue cost that must be made up with a higher rate on firms not receiving preferential treatment, or with a higher rate on some other tax base (income or sales). If the revenue structure is regressive in general, then the financing of these subsidies is regressive.
- There is no evidence that these subsidies have stimulated industrial development in the state.

147. *Sales Tax Issues*, STATE POL'Y REP., May 1988, at 12, 12-13 table 2. The index of the coverage of the base is the ratio of taxes actually paid to those that would be paid if all consumer purchases were taxed. *Id.* at 13.

148. See generally Francis, *supra* note 134 (discussing broad-based opposition to Florida's taxation of services).

149. Legislative Fiscal Office, *Estimates of State-Local Tax Losses From Industrial Exemptions in Alabama 6* (October 1990) (unpublished manuscript, on file with the *Alabama Law Review*).

- The subsidies are available to chosen firms rather than to all firms presently in operation in the state. This means that the state government sets itself up as an expert in picking winners. Many would argue that states do not have a good record at picking winners and that a generally lower rate for all firms would be a better alternative in that it would let the market do the picking. When subsidies are eventually removed, firms that are not truly “winners” will not make it.
- Whenever a tax program is developed on a subjective basis, it is open to abuse. It is much better to have objective tax rules such as a prescribed base and rate, or a general subsidy program that is allocated by some objective formula.

On the other side are arguments that the industrial subsidy programs are a net benefit to the state: a tax expenditure that should be made. These arguments would go as follows:

- The subsidies do create new investment and jobs in the state. There is some evidence to indicate that they are at least a “tiebreaker.”¹⁵⁰ These additional investments lead to increased taxes that more than offset the tax relief, and therefore the program is costless.
- The availability of subsidies to firms considering expansion or location in the state is a signal that the state is trying to create a good business climate. The importance of this signal goes far beyond the specific jobs created by the program.

No good, hard evidence in Alabama supports a definitive choice between these reform options. There does not seem to be much evidence from analyses in other states that taxes make a great deal of difference in the location choice. They might be a tiebreaker within some regions,¹⁵¹ but even here the evidence is weak. It would seem hard to argue that an increase in taxes in Alabama, which are now very low by comparison to the region and the nation, could be a significant deterrent. The most recent study of tax effort shows Alabama taxing at a level 16 percent below the

150. COMMISSION REPORT, *supra* note 1, at 19.

151. *See id.*

national average, after adjusting for its low taxable capacity.¹⁵² Only four states make a lower effort.¹⁵³

The better way to go about studying this issue is to ask what the state has gotten from its tax investment in these programs. How many jobs and at what cost per job? How much tax loss, and who paid for these subsidies? What has happened to the subsidized industries when the tax breaks were eventually removed? All of this evidence would have put the Commission in a position to ask and answer the question of whether this tax expenditure is worth more than the alternative of a lower rate.

In the absence of such hard evidence, the Commission recommended a series of measures to tighten the rules for granting the industrial exemptions.¹⁵⁴ The key features in the recommendation were to limit the authority of industrial development boards to grant exemptions,¹⁵⁵ to require evaluation of the costs and benefits of each proposed subsidy by an independent state agency,¹⁵⁶ to require that education taxes be paid by incentive firms,¹⁵⁷ and to treat the tax incentives as a component of the total package of incentives offered to a firm that proposes to locate or expand its operations in Alabama.¹⁵⁸

VIII. LOCAL GOVERNMENT

The fiscal structure of local governments is properly within the scope of concern of a state tax reform commission. There are three important issues to be raised in evaluating the present system and proposing a reform. The first is the expenditures that local governments are required to cover, and the gap between the amount they are called on to spend and the revenue bases they have available. Do they need additional revenue? Second, what will be the role of local governments in the fiscal system of Alabama? Do they provide essential services? Should they be allowed to give subsidies or to tax at rates that might harm the competitive advan-

152. REVENUES AND EXPENDITURES, *supra* note 18, at 187, table 106.

153. *Id.* (The four states are New Hampshire, Nevada, Florida, and Tennessee.).

154. See COMMISSION REPORT, *supra* note 1, at 19-20.

155. *Id.* at 19.

156. *Id.* at 19-20.

157. *Id.* at 20.

158. *Id.* at 19.

tage of the state? Should their taxation criteria consider the same principles that the Commission considered? Should they be concerned with using the tax system for redistributive purposes? Third, how much fiscal autonomy should local governments be given? Which taxes should they have control over, what are the limits on this control, and what are the criteria for identifying the proper fiscal responsibility for local governments?

The Commission focused on the latter two sets of questions, and limited its concern to taxation matters. Expenditures were considered only in connection with earmarking.¹⁵⁹ The Commission recommended a considerable reduction in the taxing powers of local governments. The proposal has two major components:

- Require all local governments to assess property at full market value, but to roll back the property tax rate to a revenue-neutral level.¹⁶⁰
- Require local governments to adopt the state sales tax base, but permit local option in the choice of an additional tax rate of up to 3 percent.¹⁶¹

There is strong justification for this proposal, even though it must be accomplished at the cost of reducing the discretion of some local governments in shaping their budgets. Nevertheless, it is not possible to separate issues dealing with the division of taxing powers between the state and local governments from those involved in devising a general tax reform that achieves the Commission's objectives. The criteria set for the tax program—adequacy of yield, fairness in the distribution of burdens, administrative ease, lower compliance costs, and the promotion of economic development—require an understanding of the joint impact of state and local government taxes.

In the area of tax structure, one cannot hope to choose a proper state tax rate without considering the rate that local governments will impose. For example, the state proposal to broaden the sales tax base and lower the sales tax rate could be compromised if local governments introduced compensating rate increases. The Commission's proposal to limit local tax rates is a step in the direction of controlling the overall rate. Fairness is also an impor-

159. *See id.* at 16-17.

160. *Id.* at 18-19.

161. *Id.* at 18.

tant consideration as regards the relationship between tax reform and local government financing. If fairness means horizontal equity, i.e., equal treatment of those in equal situations, the Commission's recommendations are in the right direction. If local governments were allowed to freely adjust the sales tax rate, then two things could happen to the fairness norms. The first is that the tax burden on all residents, including those with low incomes, would be higher in areas where the local government has chosen higher rates. In other words, the overall tax burden on lower-income families may not turn out to be at the level the Commission envisioned when it set rates and bases for the reformed state tax structure. Second, local autonomy with respect to sales tax rates would inevitably lead to a higher cost of living and of doing business in one county or city than in another. The proposed local option sales tax, even with a limit, would still allow for some disparity among jurisdictions, but it would not be so great as under the present system. And to some extent, these disparities are perfectly acceptable if accompanied by better public services.

The Commission's recommendation to require all local governments to adopt the state tax base would lead to a major administrative improvement in sales taxes. Further, the proposed extension of the sales tax base to include services would not be feasible if local governments were given latitude to define the objects of taxation.

IX. BUSINESS TAXES

The present method of taxing business in Alabama is a system of four taxes: the corporate income tax,¹⁶² the corporate franchise¹⁶³ and shares taxes,¹⁶⁴ the financial institution excise tax¹⁶⁵ (which financial institutions pay in lieu of the corporate income tax); and the insurance premium tax¹⁶⁶ (which insurance companies pay in lieu of the corporate income tax).

This combination of business income and business property taxes is similar to that levied in a number of other states. The cor-

162. ALA. CODE §§ 40-18-1 to -58, -160 to -173 (1985 & Supp. 1991).

163. *Id.* §§ 40-14-40 to -57.

164. *Id.* §§ 40-14-70 to -74 (1985).

165. *Id.* §§ 40-16-1 to -8 (1985 & Supp. 1991).

166. *Id.* §§ 27-4-1 to -11 (1986 & Supp. 1991).

nerstone is the corporate income tax, which is thought to reflect the ability of a company to pay tax. Inclusion of the franchise tax component is usually justified on grounds that it provides broader tax coverage of the business sector, and it permits exporting some of the tax burden to residents in other states for benefits they have received in Alabama. If there were no franchise tax in Alabama, one might be able to argue that there are a great many companies in the state that pay no business tax. They are either unprofitable, or they can use various transfer pricing mechanisms to show no Alabama profits and therefore no Alabama income tax liability. This would be unfair because these companies use state government services, and other companies, perhaps using the same services, do pay income taxes.

A. *Problems with the Present System*

The present approach to business taxation is subject to a number of problems, and there appears to be widespread dissatisfaction among taxpayers. The following are the more or less common perceptions about the failings of the present business tax system.

First, it is not fair in that it does not treat all businesses the same. The corporate income tax, the franchise tax, and the insurance premium tax do not treat foreign and domestic corporations the same.¹⁶⁷ Corporations and unincorporated businesses are also treated differently, with the latter subject to a lower level of taxation.¹⁶⁸ The share of total business sales which are generated in the unincorporated sector has risen dramatically in the 1980s.¹⁶⁹ By the late 1980s, unincorporated businesses accounted for over 40 percent of all sales in the service sector.¹⁷⁰

Second, the corporate income tax and the franchise tax are both complex in structure and frequently avoided.¹⁷¹ Third, as the Commission noted, "the present system has spawned numerous

167. COMMISSION REPORT, *supra* note 1, at 14.

168. *Id.*

169. Gerald H. Miller, *Virtues of a State Value-Added Tax*, in THE UNFINISHED AGENDA FOR STATE TAX REFORM, *supra* note 134, at 227, 230.

170. *Id.*

171. COMMISSION REPORT, *supra* note 1, at 14.

lawsuits challenging the constitutionality of various taxes," thereby raising administrative costs.¹⁷²

B. Proposed Reforms

The Commission's recommendations deal with some of these problems, but the present structure is essentially retained. The major changes proposed are for the corporate income tax to be based on the federal taxable income¹⁷³ and for the federal income tax deduction to be eliminated.¹⁷⁴ It was not recommended that the corporate franchise tax be repealed, but it was proposed that it be substantially restructured.¹⁷⁵ The proposed reform would require all corporations and limited partnerships to pay on the basis of capital employed.¹⁷⁶ It would increase the minimum franchise tax from \$50 for domestic corporations and \$25 for foreign corporations to \$250 for all corporations and limited partnerships.¹⁷⁷ It would also eliminate the annual permit fee and repeal the shares tax.¹⁷⁸

The proposed reform would repeal the financial institution excise tax and tax financial institutions under the corporate income tax.¹⁷⁹ The Commission proposed to retain the premium tax as the principal means of taxing insurance companies.¹⁸⁰ The Commission also wished to employ a uniform rate structure, placing foreign and domestic companies on common ground.¹⁸¹ The proposal offers reduced rates to companies concentrating investment and operations in Alabama.¹⁸²

172. *Id.*; see also John Smith T, Comment, *Alabama's Franchise Tax: An Affront to the Equal Protection Clause, Notwithstanding White v. Reynolds Metals Co.*, 43 ALA. L. REV. 111 (1991) (discussing the disparate tax treatment of foreign and domestic corporations).

173. Proposed Income Tax, *supra* note 74, § 42; COMMISSION REPORT, *supra* note 1, at 14.

174. COMMISSION REPORT, *supra* note 1, at 14.

175. *Id.* at 15-16.

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*; see *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985) (holding that charging foreign corporations a higher premium tax violates equal protection).

182. COMMISSION REPORT, *supra* note 1, at 15.

C. Evaluation of the Proposed Reform

The Commission's proposed reforms are more piecemeal than comprehensive. The present system is essentially retained but the proposal attempts to eliminate some of its most undesirable features. Put in its best light, the reform could be judged a significant improvement in Alabama's tax treatment of business. The proposed reform meets the revenue neutrality goal of the Commission. The revenue gains from elimination of the deduction for federal income taxes would be used to pay for the rate reductions on the corporate franchise tax. This proposal would move Alabama's business taxes in the direction of greater reliance on income taxes. The structural realignment also has important implications for future revenue growth in that the base of the tax becomes more income elastic because corporate income responds more to economic growth than does the book value of company assets. But at the same time, this approach makes state tax revenues more unstable because company income moves with the business cycle to a much greater extent than does the base of the franchise tax.

Elements of this reform will improve the neutrality, or fairness, in the system. Perhaps most importantly, it eliminates the discriminatory treatment of foreign and domestic corporations,¹⁸³ and treats financial institutions the same for tax purposes as nonfinancial businesses.¹⁸⁴ As the Commission noted, "Removing the tax penalty on out-of-state investors sends a signal of an improved business climate in Alabama."¹⁸⁵

Advocates of this proposal will argue that the reform will enable the state to realize economic development benefits. The reduced franchise tax and the elimination of the penalty on foreign corporations will attract industry and encourage investment by firms already in Alabama. It would be difficult to argue that any such effect would be more than marginal. The franchise tax reductions would be financed by income tax increases under the Commission's revenue-neutral plan, and the incidence of both taxes falls heavily on owners of capital.

The proposed reform does offer a clear improvement in the area of administration. The cost associated with implementing the

183. *Id.* at 16.

184. *Id.*

185. *Id.*

proposed system would be less than that of the present system, because it clears up some ambiguities in the law, adopts the federal base, and eliminates the distinction between domestic and foreign firms. Such reforms would reduce the litigation costs—numerous lawsuits have challenged the constitutionality of various taxes¹⁸⁶—as well as the compliance cost.

The less enthusiastic view is that the Commission proposals do not address the fundamental problems, but only provide a temporary patching of a fundamentally flawed system. The underlying problem is that the state has not decided what it wants to accomplish with the business tax system. The following are the commonly discussed objectives for business taxation:

- It is a charge for benefits received from state-provided services.¹⁸⁷ A corporate income tax does not satisfy this objective. Some firms will be out of the tax net because they have, or can show, little taxable Alabama income. These firms may be users of government services—because they have large plants, large numbers of employees, and considerable land—but this may not be reflected in their income tax base.
- It is a tax on companies according to their ability to pay.¹⁸⁸ This objective is confused because of the shifting of the income tax to owners of capital, labor, and consumers. In the absence of knowledge about the incidence of the tax, it would be difficult to make the ability-to-pay argument.
- It is a way to export taxes to residents of other states.¹⁸⁹ For example, shareholders of publicly held firms may reside in other states, and will bear part of the company tax in the form of reduced dividends, and consumers will bear part of the tax in the form of higher prices. But of course, the latter will happen only if the Alabama company has some form of monopoly power or is willing to lose some of its market share. There may be great political appeal to the

186. See, e.g., *White v. Reynolds Metals Co.*, 558 So. 2d 373 (Ala. 1989), *cert. denied*, 110 S. Ct. 2602 (1990).

187. See, e.g., William Oakland, *Business Taxation in Louisiana: An Appraisal*, in *LOUISIANA'S FISCAL ALTERNATIVES*, *supra* note 65, at 159, 168-69.

188. *Id.* at 165-66.

189. *Id.* at 166-68.

tax exporting argument, but there are relatively few opportunities to export.

- It is a way to raise revenues in a hidden way, and to allow lower rates on direct taxes on individual incomes, sales, and property.¹⁹⁰

The Commission's proposal satisfies the goal of providing a "hidden" tax at a reasonable administrative cost, but fails as a charge for benefits received from state services. It is not neutral in that all beneficiaries do not pay: businesses which do not make profits and unincorporated businesses are left out of the system. It is simpler than the present system, but all corporations still must deal with both the income and the franchise tax.

Another problem with the proposed reform is that while the shift to reliance on the corporate tax would indeed create a more income-responsive revenue growth, it would also result in a more unstable flow of revenue. This is because company income moves with the business cycle to a much greater extent than does the base of the franchise tax. Gerald Miller points out the potential severity of this problem by noting that during the 1983 recession, total state taxes increased by over 5 percent but corporate income taxes fell by 6 percent.¹⁹¹ Ten of the fifteen largest states that impose a corporate income tax had absolute declines during that period.¹⁹²

Having offered this critique, it also must be said that it is difficult to find a business tax regime that will stand up better against these norms. The Commission considered replacing or supplementing the income tax and franchise tax with a value-added tax, similar to that levied in Michigan.¹⁹³ In the end, this was rejected because the concept itself was too unfamiliar, and because the time and resources available to the Commission did not allow it to gather sufficient information to properly evaluate the possibility of such a sweeping reform.¹⁹⁴

190. *Id.* at 165.

191. Miller, *supra* note 169, at 229.

192. *Id.*

193. COMMISSION REPORT, *supra* note 1, at 15. Michigan's experience with its value-added tax is reviewed in Robert J. Cline, *Should States Adopt a Value-Added Tax?*, in THE UNFINISHED AGENDA FOR STATE TAX REFORM, *supra* note 134, at 235, 240-44.

194. COMMISSION REPORT, *supra* note 1, at 15.

The replacement of the corporate income and franchise taxes with a value-added type tax, however, is a possibility that perhaps should be given more consideration.¹⁹⁵ The value-added tax base is essentially gross receipts less the cost of goods purchased (including capital goods). Viewed from the income side, it is the sum of payments to capital (profits), land (rents), and labor (payrolls).

The broad base captures all kinds of firms (incorporated and unincorporated), and is an excellent way to bring service producers into the tax base. Its revenue flow would be more stable than that of an income tax. As to economic development, one might note that this is a tax of the future (or, in the case of Europe, it is the tax of the present), and its use might offer Alabama some needed image advantages. Because the base of the tax is broad, it can be levied at a low nominal rate, which offers some political advantages. Administrative costs could be lower by comparison with the present system. Assessment, collections, audit, and compliance could, after the initial learning period, be simplified by a single business tax.

There are some important disadvantages to a value-added tax:

- The tax would be levied on firms regardless of whether they show Alabama profits. Some would see this as unfair (though it is also a characteristic of the franchise tax component of the present system).
- The establishment of such a tax involves a heavy administrative setup cost. This might be criticized as an inefficient investment in tax administration unless the tax is intended to have a greater revenue role than business taxes do under the present regime.
- There would be political problems with introducing a new and different tax. Selling it to the business community and the general public would be a big problem. Some firms would perceive that they would face a substantial increase in taxes—firms in the service and retail sectors and unin-

195. A state-level value-added tax has been called for by many leading authorities on state and local government finance, *see, e.g.*, Miller, *supra* note 169, at 227, and has been given serious consideration in several recent state tax reform efforts. *See, e.g.*, William Oakland & James A. Richardson, *A Layman's Guide to the Value-Added Tax, in LOUISIANA'S FISCAL ALTERNATIVES*, *supra* note 65, at 182.

corporated businesses are examples¹⁹⁶—and would likely be strong and vocal opponents of a value-added tax.

- The value-added tax would be more regressive than the present business tax system. The franchise and income taxes are both borne partly (mostly) by owners of capital and therefore are somewhat progressive, but a value-added tax may be partly shifted forward to consumers and backward to labor, and therefore is less progressive.
- Coordinating a value-added tax with a state retail sales tax would be difficult.
- To lessen the regressivity of the overall system, the individual income tax rate structure would need to be graduated, and this would be another hard sell to the public.
- Finally, and perhaps most important, there is the problem of how to treat interstate commerce under a state value-added tax.

X. PROPERTY TAXATION

Alabama's current property tax presents major problems. Its rate is very low by national standards, and it is levied under a complex structure. One way to compare the level of property taxation is to look at the average effective rate on single-family homes with FHA-insured mortgages, as reported by the Advisory Commission on Intergovernmental Relations. For 1987, the latest year available, the national average was 1.15 percent of full value, the high rate was 2.38 percent in New Jersey, and Alabama's rate was 0.39 percent.¹⁹⁷ Only Louisiana's was lower.¹⁹⁸

The classification system provides different rates of property taxation for different property types.¹⁹⁹ Lower rates apply to homeowners, forest lands, and farmers.²⁰⁰ Higher rates apply to commercial property.²⁰¹ The highest rates govern utility property.²⁰² The present system assesses homes, farms, and timberland

196. See Oakland & Richardson, *supra* note 195, at 186.

197. BUDGET PROCESSES AND TAX SYSTEMS, *supra* note 109, at 102-03, table 34.

198. *Id.*

199. COMMISSION REPORT, *supra* note 1, at 10.

200. ALA. CODE § 40-8-1 (Supp. 1991); COMMISSION REPORT, *supra* note 1, at 10.

201. ALA. CODE § 40-8-1; COMMISSION REPORT, *supra* note 1, at 10.

202. ALA. CODE § 40-8-1; see COMMISSION REPORT, *supra* note 1, at 10.

at 10 percent of market value.²⁰³ Homeowners also receive the homestead exemption, which shelters up to \$4,000 in assessed value from taxes.²⁰⁴ The present system assesses commercial and industrial property at 20 percent,²⁰⁵ double the rate on farm, timber, or residential property of equal value. Utility property is subject to a 30 percent rate,²⁰⁶ which is triple the rate imposed on homes, farms, and forest land. Utility companies pass these extra taxes along to consumers in higher utility bills.²⁰⁷

The classification system narrows the tax base and dampens the revenue yield. Homes comprise half the total value of Alabama's property.²⁰⁸ Farms add 10 percent, and timberland another 6 percent.²⁰⁹ Therefore, 66 percent of Alabama's property value lies in the lowest assessment classification.²¹⁰ Classification also increases the already difficult task of property tax administration. The assessor must decide not only on value but on how to classify property, and taxpayers may bring classification as well as valuation appeals.²¹¹ It is generally recognized that property classification is not a component of a high-quality property tax system.²¹²

Another facet of the present system is current use assessment.²¹³ This feature permits farm and timberland owners the choice of being taxed at a value determined by a formula instead of at an appraised market value.²¹⁴ Many feel this feature is unfair.²¹⁵

203. ALA. CODE § 40-8-1; COMMISSION REPORT, *supra* note 1, at 10.

204. ALA. CODE § 40-9-19 (Supp. 1991); COMMISSION REPORT, *supra* note 1, at 10.

205. ALA. CODE § 40-8-1 (Supp. 1991); COMMISSION REPORT, *supra* note 1, at 10.

206. ALA. CODE § 40-8-1; COMMISSION REPORT, *supra* note 1, at 10.

207. COMMISSION REPORT, *supra* note 1, at 10.

208. *Id.*

209. *Id.*

210. *Id.*

211. See ALA. CODE § 40-7-45 (1985) (pertaining to assessment and valuation appeals); ARLO WOOLERY, PROPERTY TAX PRINCIPLES AND PRACTICE 121-22 (1989).

212. See WOOLERY, *supra* note 211, at 121-22.

213. ALA. CODE § 40-7-25.1 (1985); COMMISSION REPORT, *supra* note 1, at 10.

214. See ALA. CODE § 40-7-25.1 (1985); COMMISSION REPORT, *supra* note 1, at 10.

215. See COMMISSION REPORT, *supra* note 1, at 10.

A. *Commission Recommendations*

The Commission recommended abolishing the classification system and assessing all property at 100 percent of its full market value.²¹⁶

With the change in the assessment ratios, the Commission proposed to roll back the tax rate to maintain the same total revenue.²¹⁷ This would change the tax rate from 6.5 mills to 1.1 mills.²¹⁸ The proposal would also change local rates.²¹⁹ The homestead exemption would be raised from \$4,000 to \$40,000 to provide a hold-harmless net tax exemption for homeowners.²²⁰

The Commission suggested creating an actual use valuation for homes, farms, and timberland.²²¹ The assessor would determine the actual use value by comparative analysis of market sales of similar property used for the same purpose rather than by formula.²²² Upon a change in use, however, the property would be subject to recapture.²²³ The tax savings (in nominal dollars) from actual use valuation for the five prior years would be collected.²²⁴

B. *Evaluation of the Reform*

One should separate evaluation of the basic merits of the Commission's property tax proposals from evaluation of their popularity. Property tax reform is always politically explosive, and even a move to better property tax policy—as the Commission's plan clearly represents—is a tough sell. One might think of two

216. Ala. H. 1106, 1991 Reg. Sess. sec. 4, § 40-8-1(a) (introduced July 29, 1991) [hereinafter Proposed Ad Valorem Tax]; COMMISSION REPORT, *supra* note 1, at 11.

217. COMMISSION REPORT, *supra* note 1, at 11.

218. *Id.*

219. *Id.*

220. Proposed Ad Valorem Tax, *supra* note 216, sec. 6, § 40-9-1(b)(1) (The bill was apparently misnumbered, as this is the second subsection (b) of § 40-9-1. Presumably, it should be subsection (c).); COMMISSION REPORT, *supra* note 1, at 11;

221. Proposed Ad Valorem Tax, *supra* note 216, sec. 1, § 40-7-25.1(b); COMMISSION REPORT, *supra* note 1, at 11.

222. Proposed Ad Valorem Tax, *supra* note 216, sec. 1, § 40-7-25.1(e)(1)(b), (2)(b), (3); COMMISSION REPORT, *supra* note 1, at 11.

223. Proposed Ad Valorem Tax, *supra* note 216, sec. 3, § 40-7-25.3(a); COMMISSION REPORT, *supra* note 1, at 12.

224. Proposed Ad Valorem Tax, *supra* note 216, sec. 3, § 40-7-25.3(b); COMMISSION REPORT, *supra* note 1, at 12.

reasons why the property tax is so unpopular.²²⁵ The first is that it is a tax on accrued wealth, rather than on income. People are asked to pay now on a gain they will realize later. Understandably, they are not too thrilled about this. By comparison, an income tax or a sales tax reaches money that taxpayers already have. The second reason for opposition is that property assessment is subjective rather than objective. A sales tax is levied on the price of the purchase and an income tax is levied on wages, and in most cases there is little dispute about the base of the tax. But a property tax is based on an estimate of what you could sell the house or the land for if you were to sell it. Taxing people on such a subjective base does not cause them to have great confidence in the tax—and virtually everyone can believe they are not treated fairly.

Though political considerations may be overriding in the case of the proposed property tax reform,²²⁶ the recommendations when judged by economic norms are a step in the direction of better taxation. The way to begin thinking about how best to reform the property tax in Alabama is by answering the question: What role does this tax play in the overall system of state and local government financing? One answer is that it is a tax on wealth, and it fills a gap that the income and consumption taxes do not cover. That is, if we did not have a property tax, some property-rich individuals would escape tax even though their capacity to pay is substantial. We therefore need a property tax to have a balanced and fair system. If this argument is accepted, then one needs to be sure that the property tax is a good tax on property wealth and that it is part of a tax system that offers equal treatment to all forms of wealth: real property, other fixed assets, and intangibles.

A second answer is that the property tax is a proper revenue source for local governments. It is a fair way to finance local services. Local residents benefit from the education services, parks, streets, etc., provided by local governments, and it is not too far-fetched to say that they benefit roughly in proportion to the value of their property. Many public services actually drive up property values (better schools and roads, for example). It is not unreasonable for the government to ask beneficiaries to pay for some of the

225. See Robin Démonia, *Alabama Taxes: Hell or Heaven?*, BIRMINGHAM NEWS, Dec. 31, 1991, at 1A, 12A.

226. See David White, *Panel Rebuffs Major Property Tax Reforms*, BIRMINGHAM NEWS/BIRMINGHAM POST-HERALD, Jan. 11, 1992, at 1A.

unearned increments to their land value. Finally, it can be argued that local government officials can be made more accountable if local voters see the link between the services they receive and the property tax they pay.

In this context, the proposed Alabama reform has several desirable features. Most important, the elimination of classification would increase the fairness of the tax system by treating all types of property equally.²²⁷ The tax on property would be the same whether the property is owned or rented, business or residential, farmland or land used in business.

However, a number of adjustments in tax liability would occur, and some would be painful. The property tax on homes, farms, and forestland, all of which now pay less than their share, would increase.²²⁸ The proposal will reduce taxes on utility property, and direct the Public Service Commission to reflect this reduction in lower utility rates.²²⁹ Commercial property taxes would not change substantially. The Commission estimated that the proposed reform "would increase taxes by \$20 for a representative family with \$15,000 income while it would increase taxes \$263 for a representative family with \$100,000 income."²³⁰ Therefore, the reform contains some progressivity.

Eliminating classification also would ease the administrative demands on those responsible for assessment and collection. There would no longer be a need to classify each property, so one motivator of assessment appeal—and tax avoidance—would be cut off.

This set of proposals also has its problems. First, the adjustment period would be difficult, especially for those local governments that are heavily reliant on nonresidential property tax revenues. The Commission's recommendation may not contain adequate provisions for these local governments to recoup the lost revenues even if this were politically feasible.²³¹

227. See COMMISSION REPORT, *supra* note 1, at 11.

228. *Id.* at 12.

229. *Id.*

230. *Id.*

231. Local governments will have some latitude to make upward discretionary adjustments in their property tax rates. The Commission recommended that local governments be given special freedom to make those adjustments in the first two years after the rollback. Proposed Ad Valorem Tax, *supra* note 216, sec. 5, § 40-8-2(b); COMMISSION REPORT, *supra* note 1, at 18-19.

A second problem is the assessment at actual rather than potential use. Though there is a provision for a five-year recapture of taxes if the property is eventually sold into a higher use (for example, timberland being sold for subdivision use),²³² the recapture is proposed to be in nominal dollars. That is, it amounts to a tax-free loan from the state to the seller equivalent to the interest that could have been earned on the unpaid amount of tax. This could be a considerable inducement to hold land at suboptimal use. A better proposal would have been a recapture in current dollars.

XI. THE TAXATION OF INTANGIBLES

A special problem arises with respect to the taxation of intangible property. Under present law, intangible property in Alabama is not taxed effectively.²³³ Property taxes are not assessed on stocks and bonds,²³⁴ and bank deposits are exempt.²³⁵ This is not unusual. Bell and Bowman report that in 1986, only thirteen states allowed local property taxation of intangible assets, and only three (Idaho, Kansas, and Tennessee) could provide information on the aggregate assessed value of such assets.²³⁶ The reason why intangibles are not taxed more heavily is partly due to the difficulty of administration. Others argue that to tax intangibles is improper because these assets represent claims on real property that have already been reached by the property tax.

Advocates of the taxation of intangibles take the position that it is possible to administer a tax on intangible property, and moreover, that the exclusion of intangibles creates a serious inequity in the tax system.²³⁷ The intuitive justification for the intangibles tax is fairness. "Just as a farmer is taxed on the value of his farm, an urban investor should be taxed on the value of his stocks and bonds."²³⁸ Another problem is that by forgoing the taxation of in-

232. Proposed Ad Valorem Tax, *supra* note 216, sec. 3, § 40-7-25.3(b).

233. COMMISSION REPORT, *supra* note 1, at 12.

234. *Id.* (noting that stocks and bonds are statutorily subject to taxation, but the tax is not assessed); see ALA. CODE § 40-14-70 (1985).

235. ALA. CODE § 40-9-1(1) (Supp. 1991).

236. Michael E. Bell & John H. Bowman, *Property Taxes*, in LOCAL GOVERNMENT FINANCE: CONCEPTS AND PRACTICE '85, 94 (John E. Petersen & Dennis R. Strachota eds., 1991).

237. See, e.g., Paul L. Menchik, *The Intangibles Tax*, in MICHIGAN'S FISCAL AND ECONOMIC STRUCTURE 619, 622-23 (Harvey E. Brazer & Deborah S. Laren eds., 1982).

238. COMMISSION REPORT, *supra* note 1, at 12.

tangibles, one of the fastest-growing components of personal income is excluded from the tax base. The result is that the real estate tax rate must be higher to compensate for the revenue loss. Moreover, since capital income seems to be concentrated in the higher income brackets, the exclusion of intangibles passes up an opportunity to make the tax system more progressive.²³⁹

The Commission recommended that a property tax be imposed on intangibles held by individuals.²⁴⁰ This would be a state tax that local governments could not impose.²⁴¹ The rate would be merely one mill (a tenth of a penny on each dollar of value).²⁴² The state would administer the tax in connection with the personal income tax.²⁴³ With a \$100,000 exemption, the tax would affect only those taxpayers having substantial wealth in intangible property.²⁴⁴

The principal argument for levying this tax is fairness. It provides for taxation of wealth held in both real and intangible forms. But the rate differentials between the real property tax and the intangibles tax are quite large under this proposal—perhaps so large that relatively little may be gained from the more effective taxation of intangibles. The revenue yield is expected to be quite small—about \$25 million per year, compared with about \$95 million from the state property tax²⁴⁵—and the administrative costs would be quite high.

XII. CONCLUSIONS

Whether or not the Commission's proposals pass political muster, they offer a plan that would make the state tax system simpler, more fair, less likely to distort market decisions, more income elastic, and more in tune with the modern Alabama economy. While most recent changes in the tax code have been driven by

239. Menchik, *supra* note 237, at 623-24.

240. COMMISSION REPORT, *supra* note 1, at 12; *see also* Ala. H. 1110, 1991 Reg. Sess. (introduced July 29, 1991) [hereinafter Proposed Intangibles Tax].

241. *See* Proposed Intangibles Tax, *supra* note 240, § 8; COMMISSION REPORT, *supra* note 1, at 12-13.

242. *See* Proposed Intangibles Tax, *supra* note 240, § 4; COMMISSION REPORT, *supra* note 1, at 13;

243. Proposed Intangibles Tax, *supra* note 240, § 9(b); COMMISSION REPORT, *supra* note 1, at 13.

244. *See* Proposed Intangibles Tax, *supra* note 240, § 6; COMMISSION REPORT, *supra* note 1, at 13.

245. *See* COMMISSION REPORT, *supra* note 1, at 13.

short-term revenue needs, or by the influence of special interest groups, the Commission's plan calls for a major restructuring that would broaden the overall coverage of the tax system.

There is an emphasis in the Commission report. It reflects the members' reading of state economic needs and of the tradeoffs that voters, special interest groups, and the legislature would be willing to make. The emphasis is clearly on fairness, with an eye toward protecting the competitive economic position of the state. The theme that cuts through all of the recommendations is to broaden the base and lower the rate. The Commission did not take on the task of identifying a higher or lower revenue target for the state budget and held itself to a revenue-neutrality constraint.

A. *Comprehensive Reform*

The reform program is more comprehensive than piecemeal in that it calls for one-time, major changes in most taxes in the system. The sales tax base would be extended to cover all services; property tax classification would be abolished; the individual income tax base would be changed to federal adjusted gross income; local governments would lose some of their control over setting sales tax rates; and earmarking would be largely eliminated. Virtually every taxpayer in the state would immediately face a different tax regime, and tax liabilities would change by large amounts in some cases. Few if any states have proposed so ambitious a one-time reform in recent years.

The comprehensive approach has the advantage of having many different winners and losers for each specific reform. The Commission proposed to lower taxes on those who carry too heavy a burden under the present system, and to offset this by raising taxes on those who are now paying less than their fair share. To determine the effect of the reform, a taxpayer would, for example, have to balance his tax increases from the sales tax on services and higher property taxes against his tax reductions from the lower income and sales tax rates. A specific reform, standing alone, may have less chance for success because its losers may outnumber the winners. The elimination of property tax classification is a good example.

A piecemeal or gradual approach is safer. It places less burden on the legal and administrative system because it does not ask for

major changes in the objects of taxation. And if the changes are relatively minor, they may not stir enough political opposition to kill the proposals in the legislature. The weakness, of course, is that not much gets changed by the piecemeal route. The gradual approach implicitly assumes that the present system is not so bad after all, and only needs a little fine-tuning.

The feeling of the Commission, and apparently that of many state taxpayers, is that the present system is in need of an overhaul and nothing short of comprehensive reform will do the job.

B. Overall Effects

If the Commission's proposals were to be fully accepted, the Alabama tax structure would change markedly. Consumers would see the reformed system as simpler and more understandable. The individual income tax base would be the same as the federal base, with a single flat rate, and all consumption would be taxed. The reformed program would be more fair in that all properties would be assessed at full value irrespective of how they are used or whether they are real estate or intangibles; businesses would be treated the same irrespective of whether they are incorporated in Alabama; and consumers of services, food, and commodities would pay the same sales tax rate.

The reformed system would be more revenue elastic, i.e., revenues would respond more to personal income growth than they do now and therefore would provide a basis for spending more to improve public services. Including all services in the sales tax base, replacing franchise with company income taxes, and eliminating federal tax deductibility would all act to increase the elasticity of the overall tax system. The other side of this story, however, is that the revenue system would be more unstable. Just as revenues would increase more rapidly in times of economic growth, they would fall more rapidly during economic downturns.

There would be little change in the vertical equity of the system. Tax burdens are distributed regressively under the current system and would continue to be under the proposed system. The inclusion of all services under the sales tax would probably lessen the regressivity somewhat, as would the reduction of the sales tax rate, but the move to a flat-rate income tax and the elimination of

property tax classification would probably offset this. On balance, there likely would be little change in the regressivity of the system.

The Commission's proposals, if fully enacted, would alter the sovereignty of state lawmakers in determining their fiscal structure. The magnitude, or even the direction, of this change is unclear. On the one hand, the adoption of the federal income tax base would reduce the sovereignty of the legislature in shaping income tax liability, and the limits on local sales taxation would compromise the sovereignty of local government officials. On the other hand, the elimination of earmarking would give the legislature substantially more discretion on the expenditure side, and the disallowance of federal tax deductibility would eliminate a federal policy influence on state income tax liability.

There is no evidence that the Commission's proposals would compromise the economic development position of the state. In fact, the rationalization of the tax structure, the removal of much of the franchise tax burden (which is reported to be a particularly obnoxious tax), and the lower sales and income tax rates could enhance Alabama's position. Perhaps most important, the enactment of a thoughtful tax reform could boost investor confidence in the ability of the state to plan its fiscal future.

Finally, the reformed tax system would be less complex and easier to administer and comply with. The use of the federal tax base and the elimination of federal deductibility would greatly simplify compliance with the income tax. Eliminating the differential treatment of foreign and domestic firms and abolishing the property tax classification system would likewise simplify the assessment process and compliance procedures. The services tax would pose additional complications, but these should subside after an initial adjustment period.

C. Shortcomings

In some areas the Commission's proposals, and its process, do not measure up as well. A major problem was the inadequate provision for staff work to support the discussions and evaluations of the Commission. Much of the empirical evidence on which a recommendation might have turned was simply not available. Some estimates of revenue and of effects of various provisions on vertical equity were more guesswork than they should have been.

A second flaw in the process was that the Commission's mandate did not include the expenditure side of state fiscal policy. This led the Commission (correctly) to focus on a revenue-neutral restructuring. But there are several areas where expenditure needs are essential considerations. For example, the tax restructuring implies a different revenue elasticity than the present system. But this new elasticity should have been arrived at from an estimate of future expenditure needs. Another area where expenditures should have been considered is local government, where the Commission made recommendations that clearly will affect the ability of local governments to finance services. But these recommendations were made without evidence of the expenditure needs of local governments and therefore without a fiscal plan to get them through the adjustment period.

As to the proposals for tax restructuring, the point could be made that some major problems were left untouched or were not properly addressed. The biggest of these were in the area of business taxation. The shift to a corporate income tax leaves many businesses—consumers of state services—outside the tax net. Among the most problematic from the point of view of fairness are those with substantial activity in the state but no Alabama taxable profits, and unincorporated businesses. The Commission also failed to recommend that all business purchases be exempt from tax. It missed the opportunity to eliminate industrial development subsidies in favor of a lower overall tax rate, even though the available evidence suggested that the subsidies program was subject to considerable abuse.

Despite these omissions, adoption of the Commission's recommendations would greatly improve the state tax system. The specific proposals need to be fine-tuned based on quantitative evidence of revenue and burden impacts, and a careful implementation plan should be developed. The changes proposed are so great that a phased approach would have to be considered in order to lay the basic legal, administrative, and taxpayer information groundwork. The Alabama recommendations are brave ones—the Commission attacked many of the sacred cows of state and local government taxation. Homeowners, physicians and other health care providers, attorneys, the media, and elected local officials all can find major hits on their self-interests in the proposals. For this reason, the odds of political success are low. But such a

reform package, with its basic message of the need to broaden the tax base, will likely be before legislatures in most states before this decade is over.

