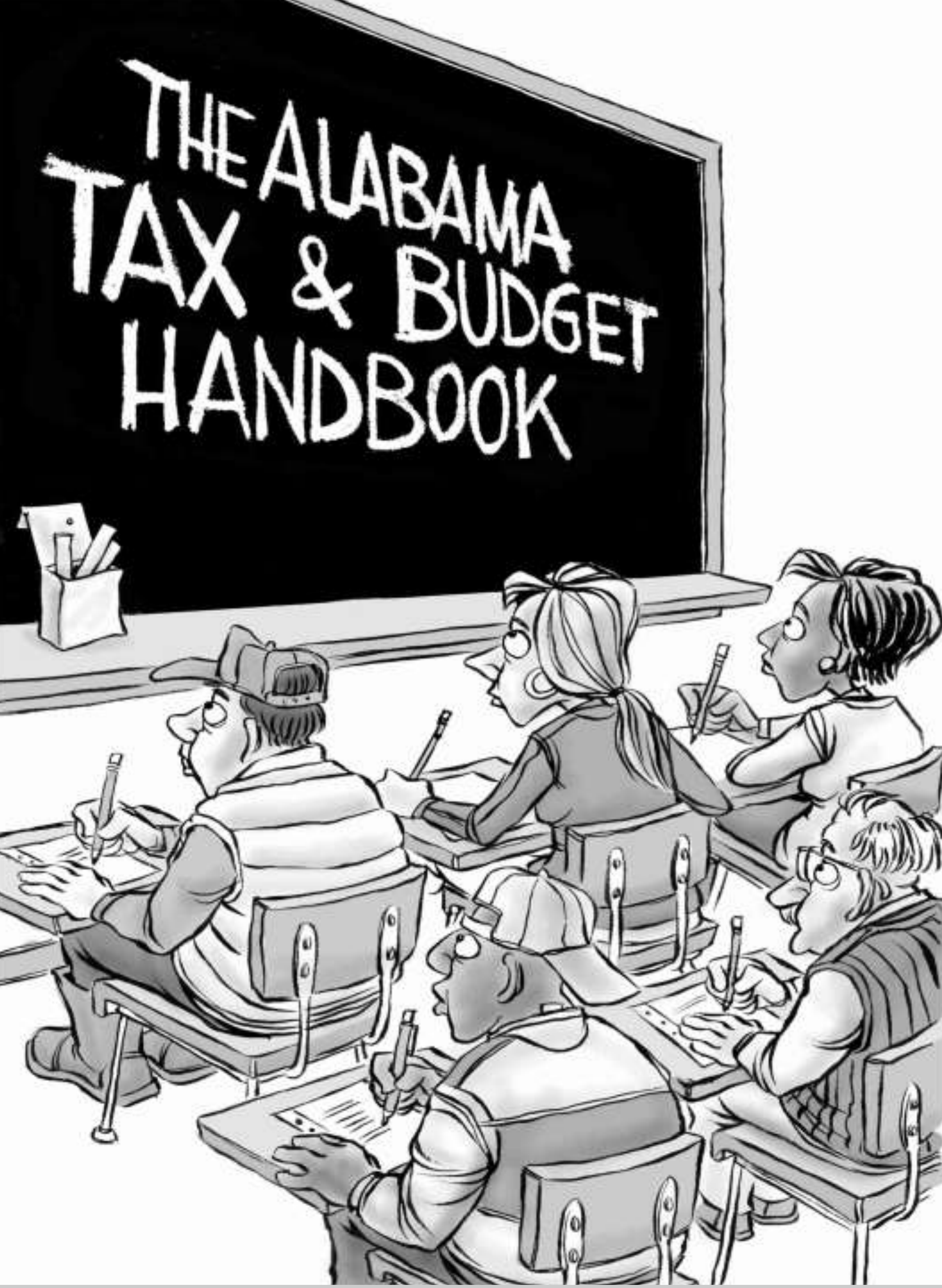

Arise Citizens' Policy Project

2nd Edition ◆ May 2015

About Arise Citizens' Policy Project

Arise Citizens' Policy Project (ACPP) is a nonprofit, nonpartisan coalition of 150 congregations and organizations dedicated to improving the lives of low-income Alabamians. ACPP analyzes current and proposed state policies and educates its members and the public on poverty issues.

ACPP envisions an Alabama…

… where all people have resources and opportunities to reach their potential to live happy, productive lives, and each successive generation is ensured a secure and healthy future.

… where all government leaders are responsive, inclusive and justice-serving, and the people are engaged in the policy-making process.

… where all people live with concern for the common good and respect for the humanity of every person.

The Alabama Tax & Budget Handbook
SECOND EDITION

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About this handbook

ACPP published the first edition of *The Alabama Tax & Budget Handbook* in 2005 together with VOICES for Alabama's Children to help educate the public about how our state's taxes and budgets work and how they affect our everyday lives. This second edition reflects the changes that have occurred in the decade since – and our ongoing commitment to building a better Alabama for all.

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Contents

Introduction

The common good

We're all in this together. All of us – regardless of age, health, wealth, background or location – depend on a network of services from our local, state and national governments. From garbage collection to fire protection, from roads to schools, from public health to public safety, our tax dollars support the daily upkeep of our common good.

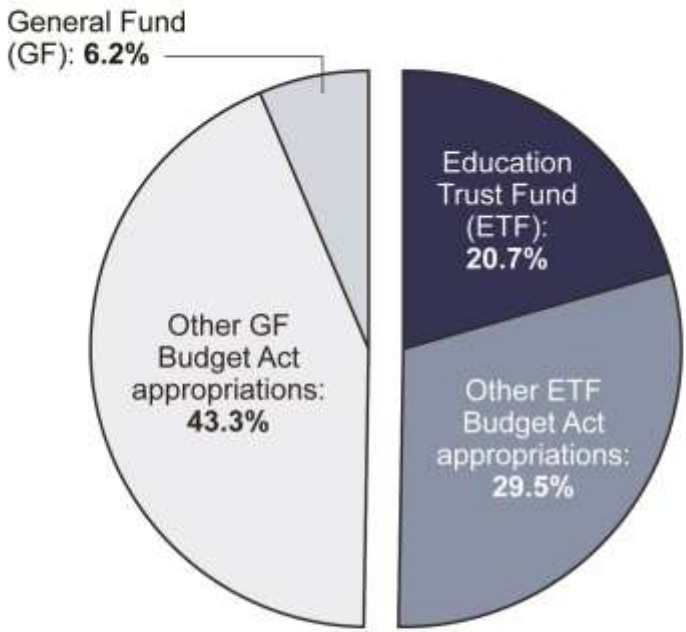
The 50 state governments are vital links in this network. It's a solemn trust: Each state is responsible for ensuring the safety, general well-being and education of its people. And each state government carries out this responsibility in its own way.

As Alabamians, many of us studied our state government in fourth grade and learned a little more about it in other classes. But until we're out making a living, paying taxes and voting, these lessons may seem disconnected from our everyday lives.

The Alabama Tax & Budget Handbook is designed to make that connection. The handbook breaks down state finances into basic functions that affect every taxpayer: What do our tax dollars pay for? How does state spending work? Where does the state get its money? It also looks at how those functions measure up – in relation to residents' needs and abilities, as well as the performance of other states. And it offers ideas for making Alabama's finances fairer, simpler, more adequate for meeting our needs, and more easily understood and visible to the public.

One state, two separate budgets

Of the Legislature's $29.1 billion total appropriations* for fiscal year (FY) 2014, about $14.6 billion came under the **Education Trust Fund (ETF) Budget Act** *(darker wedges)* for education-related services and $14.4 billion came under the **General Fund (GF) Budget Act** *(lighter wedges)* for all other services. Another $94 million in **tobacco settlement money** was appropriated separately under the Children First Trust Fund to GF and ETF agencies and to principal and interest payments on state debt. About 73 percent of total appropriations were earmarked, or set aside for a specific purpose, before lawmakers allocated them. Another 20.7 percent was designated for the ETF, though not earmarked for a particular purpose within it. Altogether, 94 percent of state revenue – everything outside the $1.8 billion General Fund – was restricted to some extent in how it could be spent.



General Fund (GF)	$1.8 billion	
Other GF Budget Act appropriations	12.6 billion	
Education Trust Fund (ETF)	6.0 billion	
Other ETF Budget Act appropriations	8.6 billion	
Children First Trust Fund appropriations	0.1 billion	*(not shown on chart)*
Total FY 2014 appropriations	**$29.1 billion**	

* In addition to state funds, the annual appropriation bills include federal funds sent to the state, "local" university funds (tuition, ticket sales, etc.), and some local tax revenues that local governments spend on schools.

Based on data from the Executive Budget Office

How does state spending work?

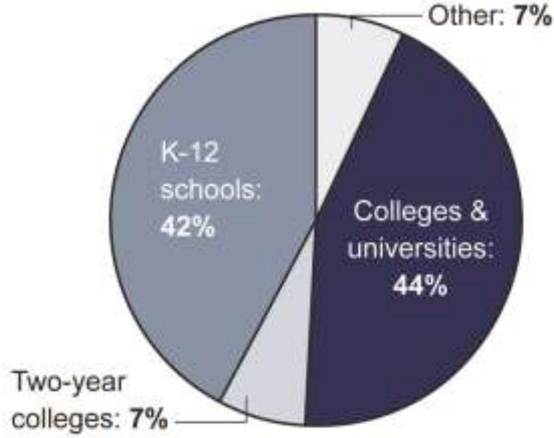
It takes large amounts of federal and state money to keep Alabama's vital services running from year to year. Most of this money flows through the State Treasury. State agencies use the Treasury like a bank account. State and federal dollars appropriated by the Legislature are deposited there, and each agency draws out the money that it's been authorized to spend. Every penny the state spends goes through a formal budget process that involves the Legislature, the governor and state agencies.

In most states, the legislature has fairly wide latitude in deciding how to spend the money that comes in from state taxes. But Alabama lawmakers' choices are much more limited. Over the years, Alabama voters have placed severe restrictions on how tax dollars are used by designating them (in constitutional amendments and statutes) for specific purposes. Though often described as a safeguard against misuse of state funds, this earmarking can prevent our legislators from creating a budget that adequately meets our needs for education, public safety and other services that improve lives and build Alabama's economy.

Each year, the Legislature authorizes all state government funding by passing two pieces of legislation: the Education Trust Fund (ETF) Budget Act, which funds education-related services, and the General Fund (GF) Budget Act, which funds everything else the state does. Both budgets include state tax revenues, other state revenues like fees and fines, and federal dollars. Each budget is divided into two parts: the smaller part controlled by the Legislature (discretionary funds) and the larger part set aside by law for particular uses (earmarked funds). All of the federal funds are considered earmarked, because the federal government, not the Legislature, decides where they are to be spent. Because every dollar in the ETF must be spent on education-related programs, only the General Fund (16 percent of state revenues and 6.2 percent of total appropriations) is not earmarked at all.

What the two budgets pay for

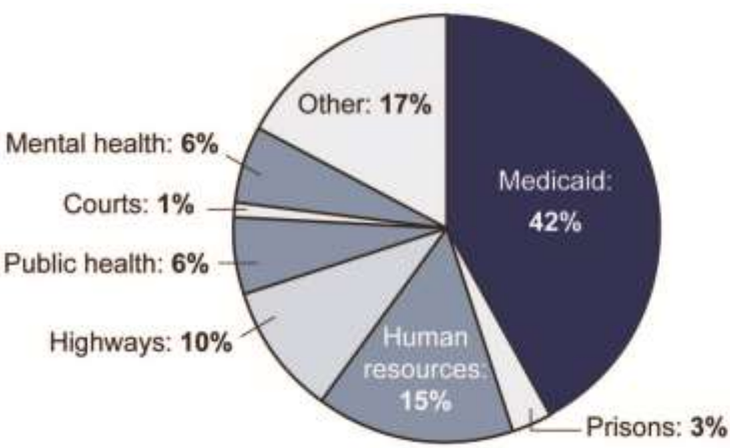
Education Trust Fund Budget Act – $14.6 billion in state, federal and local funds[1] approved by the Legislature for FY 2014:



[1] Local funds include required matching funds for K-12 Foundation Program and university funds generated by tuition, ticket sales, etc. The Legislature does not appropriate the bulk of local taxes used to fund K-12 school systems.

ETF appropriations FY 2014, Executive Budget Office

General Fund Budget Act – $14.4 billion in state and federal funds for FY 2014:



"Other" includes services receiving 2% or less of appropriations each.

GF appropriations FY 2014, Executive Budget Office

How does state spending work? *(cont'd.)*

At the start of each regular legislative session, the governor submits a two-part (ETF and GF) budget proposal for lawmakers to consider. Debate on the budgets usually stretches over the entire session. The budget process spelled out in Alabama law requires the government to have a balanced budget. This means lawmakers can appropriate (or approve for use) only as much revenue as the state is projected to take in for a given fiscal year.

The annual Education Trust Fund Budget Act:

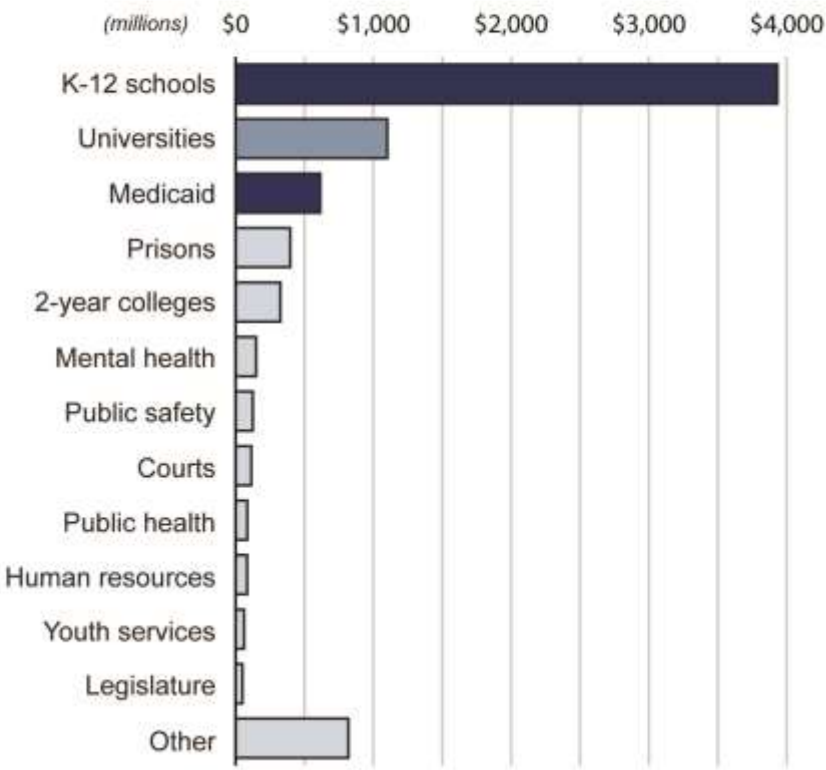
- provides financing for all state education spending;
- authorized spending a total of $14.6 billion in federal, state and local funds for fiscal year (FY) 2014 *(see footnote regarding local funds on chart at left)*; and
- can be used only for education. Most of it is earmarked for particular education expenses, but lawmakers have some discretion over which areas of education the rest is spent on. The Education Trust Fund (ETF), which is widely reported in the media, consists of this latter portion, plus state income tax revenues that are earmarked for K-12 teachers' salaries. The ETF amounted to $6.1 billion in state money for FY 2014. *(See graph on next page.)*

The annual General Fund Budget Act:

- provides financing for all non-education programs;
- authorized spending a total of $14.4 billion in federal and state funds for FY 2014;
- deals mostly with earmarked federal and state funds, including state gasoline tax revenues, which have been set aside for highways since 1952 under Amendment 93 of the state constitution; and
- includes the only state revenues that are not earmarked at all. This is the General Fund that is debated in the Legislature and widely reported in the media. It amounted to $1.8 billion in state money for FY 2014. *(See graph on next page.)*

What <u>state</u> dollars pay for: Things that benefit all of us

Education, health care, public safety and other vital services support economic growth and make our state a better place to live and work. Alabama spent <u>$6.1 billion</u> from the Education Trust Fund on K-12, colleges, universities and other education-related services in FY 2014. The same year, Alabama provided <u>$1.8 billion</u> in funding for Medicaid, mental health, courts and other non-education services from the General Fund. Of the total <u>$7.9 billion</u>, more than 60 percent of the funding went to K-12 schools and universities, easily exceeding the amount that went to Medicaid, prisons and other General Fund services. Here's a look at what state dollars supported:



Based on data from the Executive Budget Office

How does state spending work? *(cont'd.)*

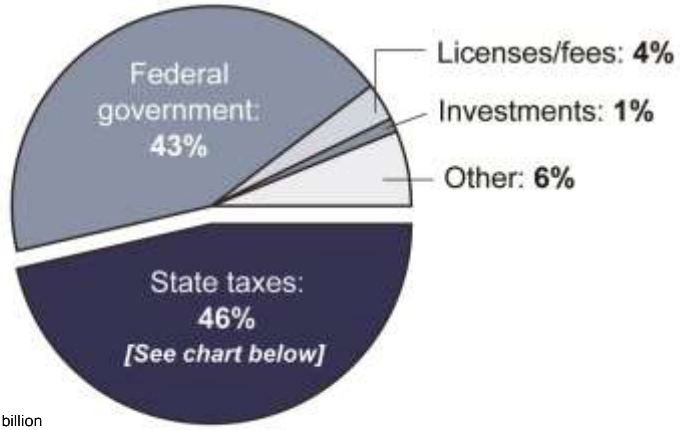
In passing the General Fund Budget Act each year, the Legislature is most concerned with the discretionary funds (dollars that are not earmarked) that make up what legislators refer to as the General Fund (GF). Even though this money amounts to only a small portion of total GF Budget Act spending, it's the portion that lawmakers are free to debate and divide up to help meet the state's many competing needs. The Legislature seeks input from agency leaders and the general public in assessing these needs.

When revenues fall below the amount needed to maintain services, the state must choose from a short list of options: find one-time revenue sources, tap reserve funds, cut services or raise taxes. The state constitution prohibits Alabama from using money in any earmarked account to pay for other services. *(Imagine not being able to use the money you budgeted for clothing to have a leaky roof repaired!)*

Most other states have a lot more flexibility in choosing how to allocate spending for different programs. Reducing earmarking would make Alabama's budgets much more responsive to changing needs and priorities. Most of the needed changes would require amending the constitution or writing a new one.

What Alabama takes in

State revenues by source, FY 2013[1]

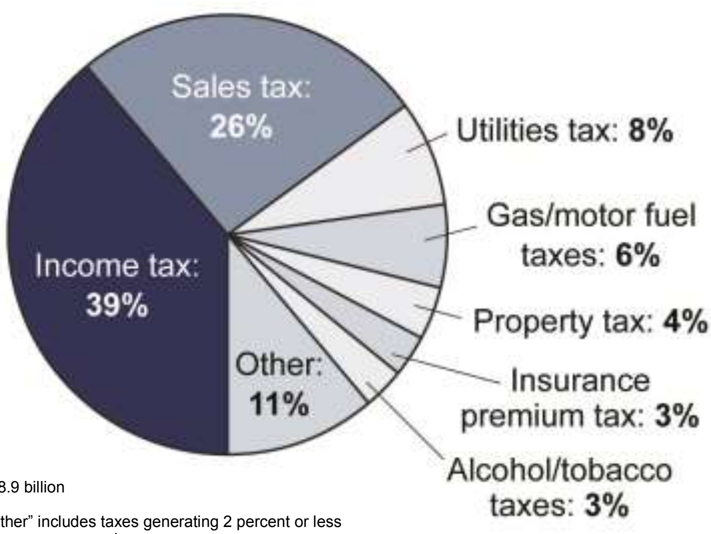


[1]Total $19.6 billion

Note: "Other" revenues include fines, forfeits, rents, royalties and sales.

Based on data from Comprehensive Annual Financial Report (2013), *Comptroller's Office*

State taxes collected, FY 2013[1]



[1]Total $8.9 billion

Note: "Other" includes taxes generating 2 percent or less of total tax revenues each.

Based on data from Comprehensive Annual Financial Report (2013), *Comptroller's Office*

Where does the state get its money?

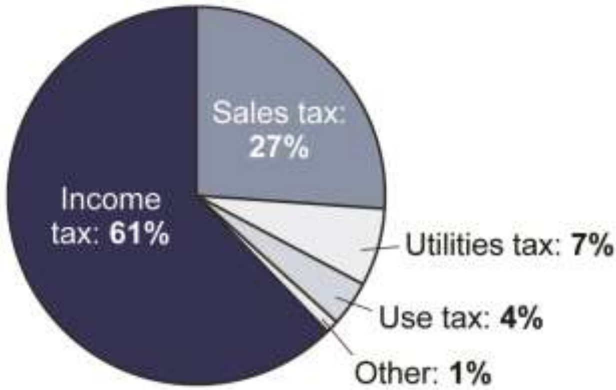
1. From us – Almost half of all the money the State of Alabama takes in every year comes from taxes and fees that individuals and businesses pay. The lower graph at left shows the share of this revenue that each state tax brings in. *(Note: <u>The graph does not include local tax revenues</u>, which in recent years have equaled a little less than half of the amount collected by the state. In Alabama, as in most other states, the property tax is mainly a local tax.)* For a look at how state taxes work, see p. 15.

2. From the federal government – More than 40 percent of Alabama's budget dollars ($2 of every $5 the state spends) comes from Washington. (This is higher than most other states. On average, states receive only a quarter of their budgets from the federal government.) These are dollars that the federal government provides to help the state support basic services like education, health care and transportation. Most federal grants require a state contribution: When Alabama spends a certain amount on a particular area, the federal government will provide a "matching" grant. The more the state spends, the bigger the federal match (up to a point).

   Because Alabama's state spending is so low, we often contribute little more than the minimum amount necessary to receive federal matching funds. In some areas, we forfeit the federal match altogether by failing to provide a state match. Most other states take better advantage of the match by contributing more state dollars to federally supported programs. *A prime example:* Alabama is one of only five states that provides no state money for public transportation. That means our state forfeits tens of millions of federal dollars every year. It's money that could support buses, trains, ride-sharing services and other efforts to help thousands of families stay connected. Even a modest state investment would help Alabama draw down tens of millions of federal dollars to help families get to work, the doctor's office or wherever else they need to go.

Most state tax revenues go into the ETF or General Fund

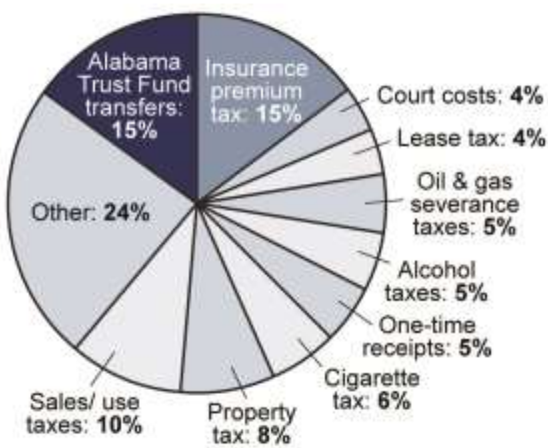
The two big taxes that grow with the economy flow to the **$6.1 billion Education Trust Fund** (ETF):



* "Other" includes taxes that produce less than 1 percent of total revenue each.
Note: Three mills of the 6.5-mill state property tax go into the Public School Fund ($152 million in FY 2014), which is administered separately from the ETF.

ETF revenue FY 2013; Legislative Fiscal Office

The **$1.8 billion General Fund** (GF) gets a hodgepodge of leftover revenues, most of them slow-growing:



* "Other" includes taxes that produce less than 1 percent of total revenue each.
Note: Earmarked taxes such as the gasoline tax (for roads and bridges) and the special whiskey tax (for Mental Health) do not go into the un-earmarked General Fund, but they are approved under the overall General Fund Budget Act.

GF revenue FY 2013; Legislative Fiscal Office

Where does the state get its money?
(cont'd.)

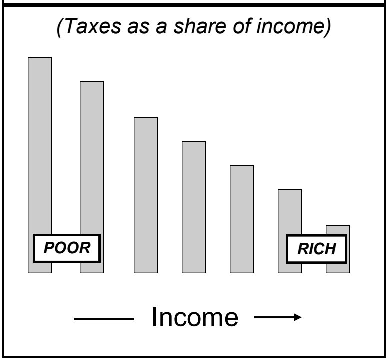
In Alabama, some state programs and services have more adequate funding than others. Tax revenues that grow with the economy (sales and income taxes) are earmarked almost entirely for the ETF. Other state services, under the GF, get the leftovers – an assortment of minor taxes, interest and fees that grow at a sluggish rate. The slow growth keeps services like Medicaid and corrections permanently shortchanged as costs continue to grow. There's also a disadvantage to the ETF's reliance on sales and income taxes: In bad years, they can shrink. Many states set aside money in good years in a rainy day fund to help them in bad years. Alabama has created such funds by drawing from the Alabama Trust Fund – which gets revenue from oil and gas drilling – and by using money that exceeds the ETF spending cap under the Rolling Reserve Act.

Alabama's frequent budget crises point to a deeper problem that can't be fixed with short-term measures: The state doesn't have enough money each year to support state services adequately. This built-in shortfall is called a structural deficit. A more adequate tax system would bring in enough revenue to help prevent shortfalls and give legislators more leeway to respond when they occur.

The structural deficit shows how our state's fiscal system has failed to keep up with changing times. In the budget crisis of 1933, the Legislature began dealing with revenue shortfalls by using proration, or cutting current spending (except for teacher and state employee salaries) across the board. By requiring the governor to use proration to avoid deficit spending, the law spares legislators tough decisions on which services should bear the brunt of cuts. For schools, the effect can be dramatic: Ordered in June to cut $10 million in spending for the budget year that ends Sept. 30, a system may be forced to choose between replacing the worn-out roofs or replacing the old math books. *Alabama has used proration 18 times in the past 40 years.* The state has borrowed from the Alabama Trust Fund during recent difficult budget years. In addition to $161 million drawn from its rainy day fund, the GF borrowed another $145 million per year for three years starting in 2012. These loans must be repaid during the next 20 years.

Measuring tax fairness

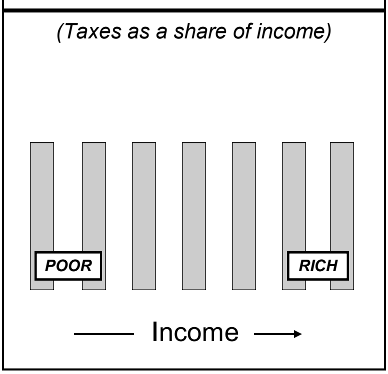
Regressive taxes



***Regressive* = The less you make, the higher % of your income you pay in taxes.** Widely agreed to be unfair.

Example: Alabama's general sales tax

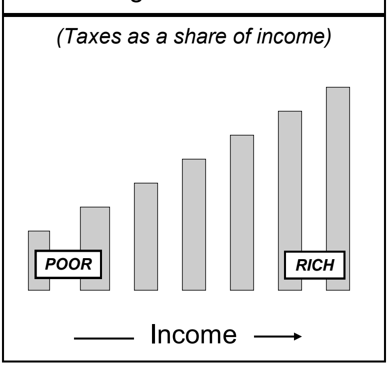
Proportional taxes



***Proportional* = Everyone pays same % of income, no matter how much they earn.** Some call it equal treatment, but poor people feel the biggest pinch.

Example: Alabama's individual income tax

Progressive taxes



***Progressive* = The more you make, the higher % of your income you pay in taxes.** Considered by many to be the fairest distribution of tax impact; can offset effect of regressive sales tax.

Example: Georgia's individual income tax

How do state taxes work?

As we've seen, Alabamians contribute to the cost of state services by paying taxes on their income, purchases, property and business operations. The remainder of this handbook will explain the basic principles of tax policy and examine the nuts and bolts of Alabama taxes.

Most people would probably agree that taxes should be "fair." But what does tax fairness look like? From the vantage of our own individual budgets, fairness may seem to be "lower taxes for me." From the vantage of the common good, however, economists have developed some basic tools for measuring tax fairness.

The charts at left illustrate three ways that any given tax can affect the total pool of taxpayers:

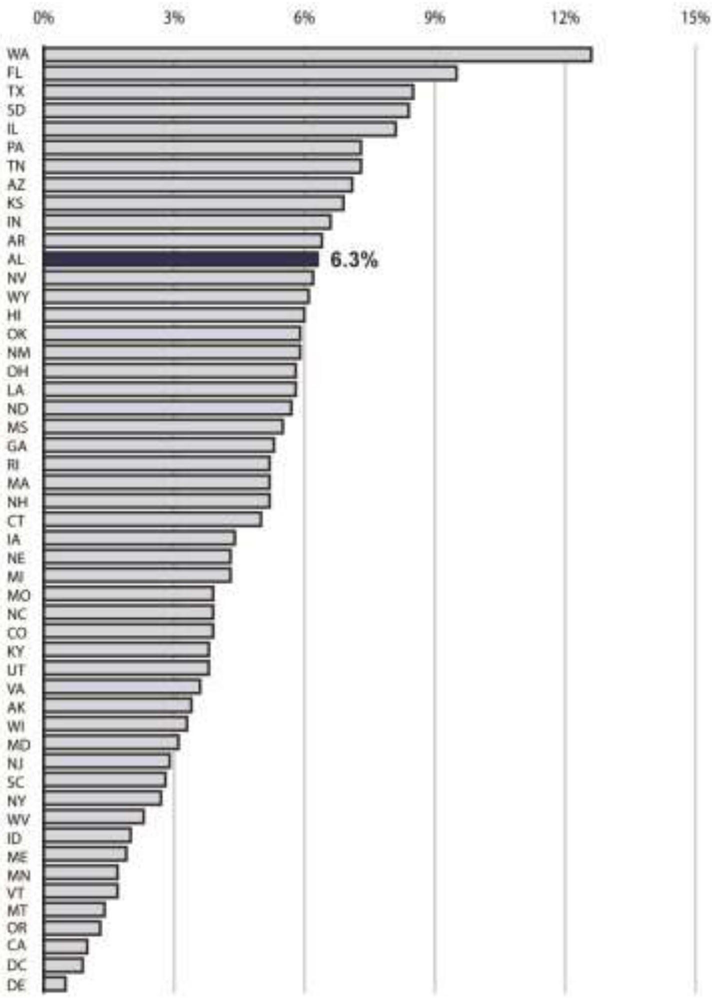
- A regressive tax requires people who make less money to pay a bigger share of their income than people who make more.
- A proportional tax (or flat tax) takes the same percentage of income from everyone, regardless of how much they earn.
- A progressive tax requires people who make more money to pay a bigger share of their income than those who make less.

Most people would consider a tax system to be unfair if those who earned less paid a higher percentage of their income in taxes than those who earned more. But that's exactly how regressive taxes work. They reduce the standard of living of low- and middle-income families, while affluent families are not similarly affected. The sales tax is a regressive tax, because people with low incomes spend most of their income on goods that are taxed. Property taxes are somewhat regressive, because home values are higher in relation to income at the low end of the scale. Alabama's regressive tax system taxes low-income families deeper into poverty while demanding less of wealthy people, who have enjoyed the vast majority of the state's income growth in recent decades.

Some people believe a proportional structure is fair. They argue that if everyone pays the same share of income in taxes, then everyone is treated equitably. But this view ignores the fact that

Upside down: Alabama's taxes are more regressive than most

Institute on Taxation & Economic Policy's Tax Inequality Index:
(The higher the state's percentage, the more regressive its tax system is)



Institute on Taxation and Economic Policy, Who Pays?, *5th ed. (2015)*

How do state taxes work? *(cont'd.)*

taking the same share of income from a low- or middle-income family as from a high-income family results in vastly different consequences for each. For those who must spend most or all of their monthly income for basic necessities, even a low tax can have a large impact on daily life. For wealthier taxpayers with more discretionary income, a tax at the same percentage will not have the same impact. Alabama's income tax is close to proportional.

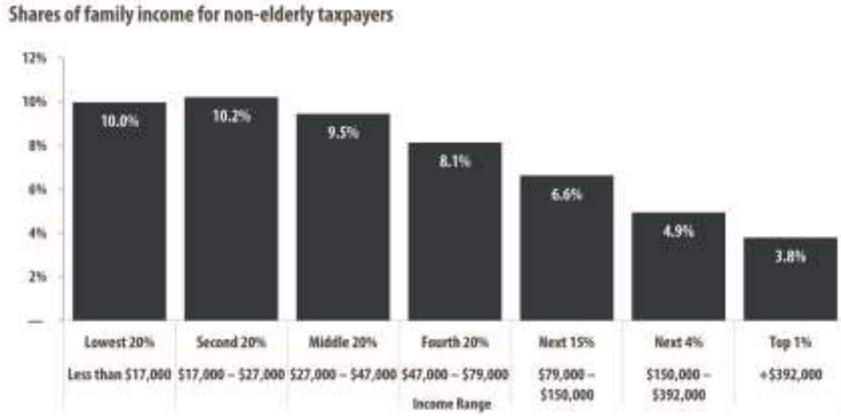
Progressive taxes are the fairest taxes. Families who struggle to make ends meet can be exempted entirely by providing all taxpayers with an exemption large enough to cover the basic cost of living. Tax rates also can be graduated – meaning they rise along with income – so that middle- and high-income families pay taxes fairly related to what they can afford. At both the state and federal levels, personal income taxes can be, and typically are, designed to be progressive taxes.

All state tax systems are different. But government leaders, economists and citizen advocacy groups have identified several principles that mark a healthy tax system:

- *Fairness* – Does the tax system require people to contribute to the cost of public services on the basis of their ability to pay?
- *Adequacy* – Does the tax system raise enough money, in the short run and the long run, to finance needed public services? Does earmarking prevent revenues from being spent as needed?
- *Simplicity* – Does the tax system have confusing tax loopholes? Is it easy to understand how our state's taxes work and to file a basic income tax return?
- *Transparency* – Is information about the tax system readily available to the public? Can taxpayers see that all businesses and individuals pay a fair share?

By these measures, what kind of health rating does Alabama's tax system deserve? Read on to find out how our tax system compares to those of other states and how each tax affects the whole system. Spoiler alert: We have a lot of work to do.

The less you make, the more you pay: Alabama state & local taxes



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income Range	Less than $17,000	$17,000 – $27,000	$27,000 – $47,000	$47,000 – $79,000	$79,000 – $150,000	$150,000 – $392,000	$392,000 or more
Average Income in Group	$11,000	$21,600	$35,600	$60,700	$102,900	$206,500	$1,050,400
Sales & Excise Taxes	**7.5%**	**6.8%**	**5.7%**	**4.5%**	**3.4%**	**2.0%**	**1.0%**
General Sales—Individuals	3.9%	3.7%	3.2%	2.6%	2.0%	1.2%	0.6%
Other Sales & Excise—Ind.	1.9%	1.8%	1.3%	0.9%	0.6%	0.4%	0.2%
Sales & Excise on Business	1.7%	1.6%	1.3%	1.0%	0.7%	0.4%	0.2%
Property Taxes	**1.5%**	**1.3%**	**1.2%**	**1.1%**	**1.1%**	**1.2%**	**1.0%**
Property Taxes on Families	1.4%	1.3%	1.2%	1.1%	1.0%	1.0%	0.5%
Other Property Taxes	0.0%	0.0%	0.1%	0.1%	0.1%	0.2%	0.5%
Income Taxes	**1.0%**	**2.1%**	**2.6%**	**2.8%**	**2.8%**	**2.6%**	**2.6%**
Personal Income Tax	1.0%	2.1%	2.6%	2.8%	2.7%	2.5%	2.4%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%
Total Taxes	**10.0%**	**10.2%**	**9.6%**	**8.5%**	**7.2%**	**5.9%**	**4.6%**
Federal Deduction Offset	*–0.0%*	*–0.0%*	*–0.2%*	*–0.3%*	*–0.6%*	*–0.9%*	*–0.9%*
OVERALL TOTAL	**10.0%**	**10.2%**	**9.5%**	**8.1%**	**6.6%**	**4.9%**	**3.8%**

Note: Graph and table show 2015 Alabama tax law at 2013 income levels.

Institute on Taxation and Economic Policy (2015)

How does Alabama's tax system measure up?

Alabama's tax structure is among the nation's most unfair, according to the latest *Who Pays?* analysis of the tax systems in all 50 states. (See *whopays.org* for the full report.) The *Who Pays?* calculation includes both state and local taxes and leaves out senior citizens, who often are taxed differently. If you compare Alabama's chart at left with other states' charts in *Who Pays?*, ours stands out:

- We rely heavily on regressive sales taxes. We have high rates. We tax groceries, which account for a huge share of low-income households' spending. And we tax few services, which people with higher incomes tend to buy more often.
- Our income tax is the least progressive in the nation. It's almost flat, so it doesn't offset our steeply regressive sales tax. We're better off there than states without an income tax, like Florida and Texas, but not by much. And our nearly flat income tax is even less fair than the flat taxes used in some states, largely because of our generous tax breaks for the highest earners.

The result for Alabama is an upside-down tax system in which the less you make, the more you pay. The lowest-paid fifth of Alabamians pay 10 percent of their incomes in state and local taxes, while the top 1 percent pay just 3.8 percent. This is the bottom line after wealthier taxpayers deduct state income tax on their federal returns. Adding to the disparity, Alabama is one of only three states with a full federal income tax deduction on state income taxes. This tax break's benefits flow disproportionately to rich households.

All four legs of our state tax system need repair. Alabama made our income tax slightly less regressive in 2006, but it remains mostly flat. Our sales taxes remain high, taxing low-income workers deeper into poverty. Our property taxes have changed little since the end of segregation. And our corporate income taxes have numerous loopholes that allow many of the wealthiest corporations operating in Alabama to pay nothing. The following sections look at each of these taxes – how they work, how they measure up and how we could improve them.

Feeling the pinch

Alabama's nearly flat income tax can't offset our regressive sales taxes. As a result, the lowest-paid 20 percent of Alabama earners pay more than twice the share of their incomes in state and local taxes that the top 1 percent pay. It's an upside-down tax system: It reduces the consumer spending that fuels economic growth and makes it harder for low- and middle-income Alabamians to get ahead.

How does Alabama's income tax work?

A 1933 amendment to the Alabama Constitution authorized the state to create a tax on personal income and set a limit of 5 percent for the tax rate. The Legislature enacted that tax in 1935, establishing three income tax rates that are still in place today:

- Yearly taxable income of less than $500 is taxed at 2 percent;
- Income from $500 to $2,999 is taxed at 4 percent; and
- Income of $3,000 and above is taxed at the top rate, 5 percent.

Like most states, Alabama uses exemptions and deductions to **exclude everyone's most basic costs of living from taxation.** This is especially important to low-income taxpayers, for whom this small amount is a very large share of income. But our exemptions and deductions are much lower than in most other states.

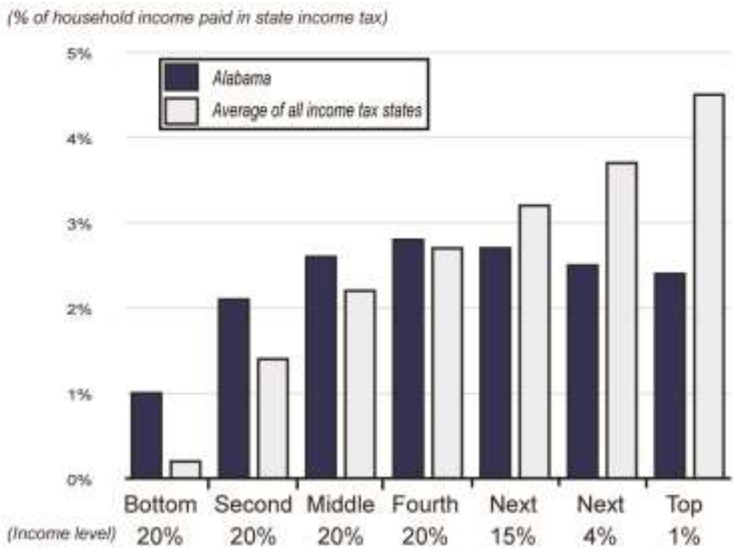
The 1935 law set personal exemptions that are still in place: $1,500 for single adults and $3,000 for married couples. The 1935 law also set a dependent deduction that didn't increase until 2006. The standard deduction, for taxpayers who don't itemize deductions, was added in 1951 and raised in 1982 and again in 2006. Taxpayers itemize if their deductions exceed the standard deduction. *(See chart on next page for Alabama's deductions by income level.)*

A 1965 amendment allows a deduction for federal income tax payments. This gives higher-income earners a special break, because they can deduct more from their Alabama taxes than those who earn a lower income and pay less federal tax. Alabama forgoes about a fifth of its potential income tax revenue because of this lopsided deduction, and 80 percent of the tax break's value goes to the highest-paid 20 percent of taxpayers.

Alabama also allows Social Security contributions to be deducted. In theory, this should help low-income people, who pay a higher share of their income toward Social Security. The catch is that the deduction is available only to those who itemize deductions, which excludes most low- and middle-income people.

Starts high, ends low: Alabama's upside-down income tax

For low-income Alabamians, the state income tax is much higher than in other states. But for the highest earners, it's much lower:



Institute on Taxation and Economic Policy (2015)

Better, but still work to do

In 2006, Alabama increased its income tax threshold – the income where one begins to pay income tax – from $4,600 to $12,600 for a family of four by expanding deductions to the levels below. Even so, our state still taxes low-income families deeper into poverty.

Income level	Standard deduction	Dependent deduction
Below $20,000	**$7,500**	**$1,000**
$20,000 to $30,000	**Phase down**	**$500**
$30,000 to $100,000	**$4,000**	**$500**
$100,000 and above	**$4,000**	**$300**

How does Alabama's income tax measure up?

Most states define their income tax by statute, meaning their legislatures can change it. But major parts of Alabama's income tax are written into our constitution, which is much harder to change.

Ideally, an income tax should be the most progressive tax, because it's the easiest one to structure to help offset regressive taxes. When it was set in 1935, Alabama's graduated system of income tax rates was very progressive. That year, when the state began taxing incomes of $3,600 or more for a family of four, teachers earned around $500. Only about 7,000 people (less than a quarter of 1 percent of the population then) earned enough to be taxed. But since then, the system hasn't kept pace with inflation.

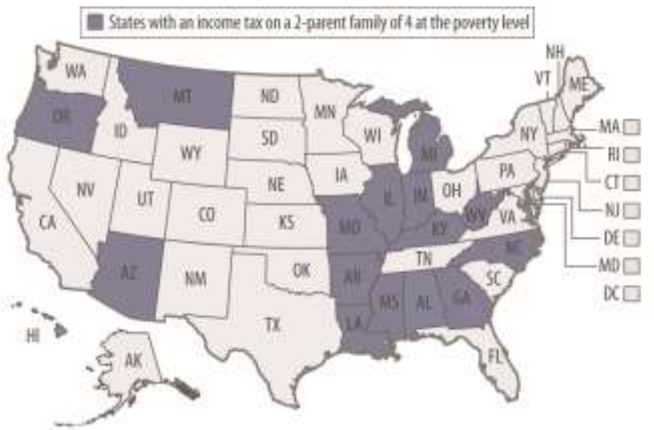
Most states have made sure that people below the federal poverty line **don't have to pay income taxes.** Alabama begins taxing a family of four at an income of $12,600. It's an improvement from the pre-2006 level (just $4,600), but it's still barely more than half of poverty-line wages ($24,008 in 2014). Alabama's income tax threshold is the nation's lowest. By contrast, Mississippi doesn't start taxing such a family until they make $19,600 per year.

In Alabama, low- and high-income families pay at the same rate: 5 percent on taxable income of $3,000 and above. Nearly two in three Alabama families paid at the top rate in 2015. No other state imposes an income tax nearly as high as Alabama does on a two-parent family of four at the poverty line. Alabama's income tax on such a family in 2014 was $618. That family pays no federal income tax, and in all but 15 other states, this family would not pay state income tax at all. The main reason: our out-of-date deductions.

Our standard and dependent deductions are far below those in most other states. Alabama's standard deduction for individuals ($2,500) is less than half of the federal one; the maximum for couples ($7,500) is barely more than half. Neither is tied to inflation. The same goes for the state's dependent deduction and personal exemption: Both are worth half of their federal counterparts, and neither increases with inflation.

Which states tax low-income families deeper into poverty?

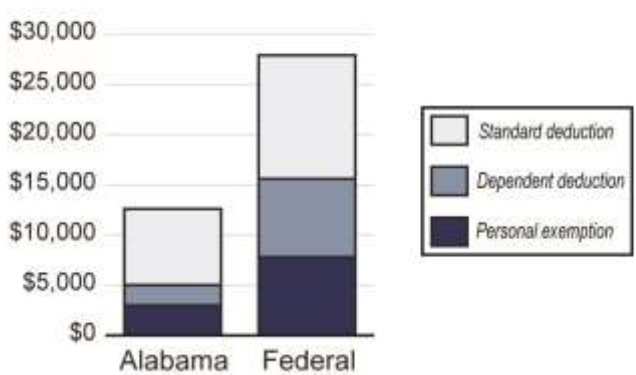
Alabama is one of 16 states where a two-parent family of four at the poverty level owes state income tax. The amount such a family owes in Alabama ($618 in 2014) is about $300 higher than anywhere else.



Based on data from the National Center for Children in Poverty, "Taxing the Poor" (2014)

Anatomy of a tax threshold

The tax threshold – the income where one begins to pay income tax – is a sum of tax deductions and exemptions. Here's how it worked on Alabama and federal taxes in 2015 for a two-parent family of four:



How could we improve our income tax?

Because much of Alabama's income tax structure is spelled out in the constitution, changing it would require changing the constitution. If Alabama's income tax more closely followed the system of exemptions and deductions used at the federal level and in many other states, working families would have more money available to spend. That would boost the economy and improve their quality of life. The following proposals would help modernize our income tax and make it fairer:

- INCREASE the personal exemption from $1,500 to $3,900;

- INCREASE the standard deduction from $7,500 to $12,200 per couple;

- INCREASE the dependent deduction from $1,000 to $3,900 per child;

- LINK these dollar amounts to the federal levels, so that Alabama's deductions and exemptions keep pace with annual increases in the cost of living;

- CREATE a state earned income tax credit (EITC) pegged at 10 percent of the federal EITC amount to help low-income working families make ends meet and to help offset the regressive effects of Alabama's high sales taxes;

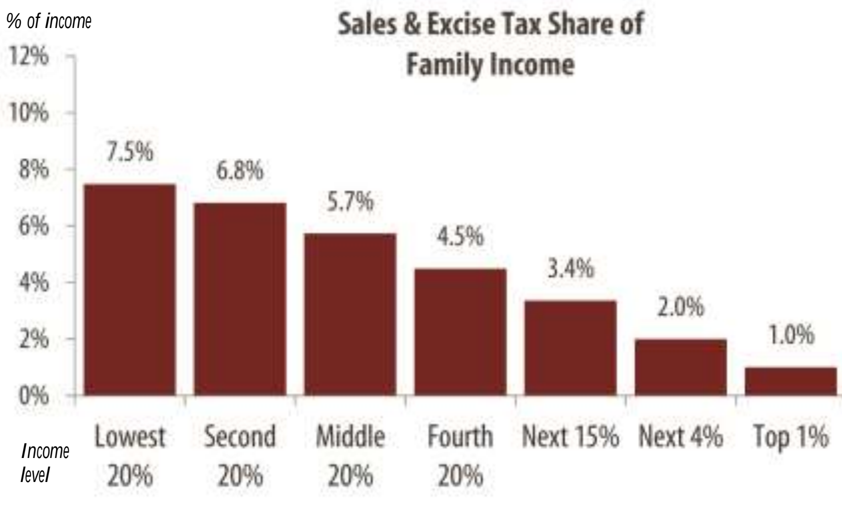
- ELIMINATE **the state's federal income tax deduction,** a lopsided tax break that disproportionately benefits high-income taxpayers, to help pay for the improvements above; and

- CREATE a new rate structure: 6 percent on income above $200,000 per couple ($100,000 for singles) and 5 percent below that level.

Sales taxes: The key driver of Alabama's upside-down system

Should the rich pay at a lower tax rate than everyone else? Most Alabamians would answer with a resounding "no," yet that's exactly the result that our state's tax system produces. Families at low and middle incomes in Alabama pay more than twice the share of income in state and local taxes that the top 1 percent do.

By far the biggest cause of that trend is our state's overreliance on sales taxes. They apply to a wide range of consumer goods, including necessities like food and clothing, and the tax on a $20 item is the same whether you make $20,000 or $20 million. *(See p. 28 for more on Alabama's grocery tax.)* As a result, the sales tax takes the biggest bite out of the budgets of low-income families, who must spend most of what they make on items subject to sales tax just to get by.



Note: Graph shows 2015 Alabama tax law at 2013 income levels.

Institute on Taxation and Economic Policy (2015)

How does Alabama's sales tax work?

The Legislature established the current state sales tax in 1939 at 2 percent on retail sales of tangible personal property (like clothing, appliances, toys, food and over-the-counter drugs). The sales tax is defined by statute rather than the constitution, meaning the Legislature can increase it without a vote of the people. Twenty years after it was introduced, the tax was increased to 3 percent and expanded to include entertainments. The most recent change came in 1963, when it was raised to 4 percent.

The state also levies some special sales taxes (in the form of excise taxes, privilege taxes and use taxes) on certain products, including gasoline. Special sales taxes on products considered to be vices, such as tobacco and alcohol, often are called "sin taxes." Over the years, the Legislature has found it easier to justify increases in this kind of tax than in the general sales tax. By contrast, Alabama always has taxed cars at a lower rate (2 percent).

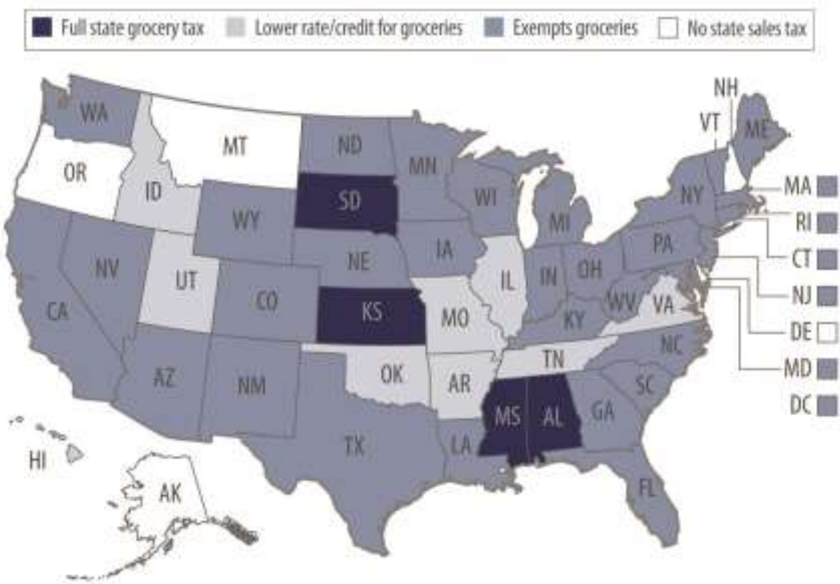
Most Alabamians also pay municipal (or city) and county sales taxes to support services ranging from schools to parks to police. Local governments set the rate for these taxes but must follow state law in specifying what to tax. Combined municipal, county and state sales taxes range from 7 percent in Allgood (Blount County), Banks (Pike County) and Kansas (Walker County) to 10.5 percent in Fort Deposit (Lowndes County). The Legislature has granted municipal and county governments the authority to increase sales taxes without a vote or even a hearing. (For most counties, this applies only to sales taxes used for schools.) The lack of recent change in the general sales tax at the state level masks a big trend toward gradual, less visible hikes in local sales taxes.

In theory, sales tax applies to all retail transactions – that is, purchases by the final consumer. In Alabama, this means purchases of goods and entertainment but not the services that account for an increasing share of consumer spending. Like almost all states, Alabama exempts some "essentials" like rent and prescription drugs. But we apply the full sales tax to food and clothing.

Taxing survival: Alabama is 1 of 4 states to tax groceries fully

It's an exclusive list, but Alabama shouldn't be proud to be on it. Alabama is one of only four states with no tax break on groceries. Of the 45 states with a general sales tax, 32 exempt groceries entirely, and nine others either charge a reduced tax rate or offer a tax **credit** to help low-income families offset grocery tax payments.

By taxing groceries, Alabama adds up to 10 percent to the cost of a basic necessity of life. That hurts the economy by leaving shoppers with less money to buy meat, vegetables and other products. It hurts working families by making it harder for them to get ahead. And it hurts Alabama by fueling an upside-down tax system that requires low- and middle-income people to shoulder too much of the cost of education, health care and other public services that benefit us all.



Based on ACPP review of data from the Center on Budget and Policy Priorities and the Institute on Taxation and Economic Policy (2015)

How does Alabama's sales tax measure up?

It's a myth that the sales tax is less "painful" than other taxes just because we pay it in small bits, unlike once-a-year property and income tax payments. In fact, the sales tax is the most regressive of the three major taxes (income, property and sales), because it consumes a much greater portion of the household budget for low- and middle-income families than for high-income families.

Alabama's state sales tax rate – 4 percent – is lower than that of most states. However, when you add in local sales taxes, the combined sales tax rate (averaging 8.5 percent) is among the nation's highest. Combined sales taxes in Alabama provide nearly half of all state and local revenue, the 10th highest share nationwide.

Our sales tax continues to apply almost entirely to goods and entertainment, even as spending patterns shift more toward services. Low-income families pay a sales tax on laundry detergent, while wealthier families can get their clothes dry-cleaned tax-free. Luxury services like manicures, house cleaning, or a day at the spa are not taxed either. Growth of "remote sales" also has hurt the sales tax base, the value of goods to which the tax applies. Federal law effectively prevents states from taxing Internet and mail-order purchases from businesses with no physical presence in the state.

Only a few states still tax groceries. Alabama is now one of four states – along with Kansas, Mississippi and South Dakota – to tax groceries fully without any rebates for low- and middle-income families. *Think about it:* In Pensacola, $100 of food costs $100, but in Montgomery, it costs $110!

Fortunately, sales taxes don't apply to food bought with food assistance under the Supplemental Nutrition Assistance Program (SNAP), also known as food stamps. But SNAP benefits cover only a portion of grocery purchases for most families who receive them. Low-income families must pay for the rest of their food out of pocket – and Alabama taxes those groceries fully.

Small change?

How could we improve our sales tax?

As the most regressive of the three major taxes, the sales tax works best when balanced by a progressive income tax. That's a problem in Alabama, because our nearly flat income tax does not come close to offsetting the regressive sales tax. The best way to reduce the sales tax's impact on low- and middle-income families would be to make our income tax and local property taxes fairer.

Two other changes could make Alabama's sales tax better:

- REMOVE or REBATE the sales tax on groceries and other necessities of life. Like Georgia, Alabama could remove the state portion of the sales tax on food but leave the local tax in place to help fund local services like police and fire protection. Exempting necessities can make the sales tax fairer, but there's a catch: In a state like Alabama, where low taxes already keep state services scraping the bottom, reducing sales tax revenues by hundreds of millions of dollars would starve our schools of even more funding. Removing the sales tax on necessities would require other changes to cover the revenue loss. Another way to make the sales tax less regressive would be to offer a sales tax rebate on food purchases by people below a certain income instead of a general exemption.

- MODERNIZE the sales tax to reflect new patterns of buying. Reform at the state level could broaden the tax base to include a range of personal and professional services while lowering the 4 percent rate. Applying the sales tax to online or catalog purchases from out-of-state businesses would require Congress to change federal law. Alabama could help urge such a change by implementing the Streamlined Sales Tax Agreement, a multi-state effort to simplify state sales tax laws. *(For more information, visit* streamlinedsalestax.org*.)*

Property tax arithmetic, lesson 1

Q. What's a mill?

A. A mill is 1/10 of a cent. A 1-mill tax is a $1 tax per $1,000 of value.

Q. Why doesn't a 1-mill tax on a $100,000 house work out to $100?

A. Because the tax office doesn't apply the tax to the market value of the house. They use an assessment ratio to figure the assessed value, and then they subtract the homestead exemption:

Appraised value of house:	$100,000
Times home assessment ratio (10%):	x .10
Assessed value of house:	$10,000
Minus homestead exemption:	- 4,000
Value of house for tax purposes:	**$6,000**

Q. Is that why our property taxes are so much lower than in every other state?

A. It's not just the assessment ratio. Alabama also has low local millage rates. The big part of your tax bill is the local share, yet your local property tax is unusually low compared to other parts of the country:

State property tax: .0065 x $6,000 =	$39
Sample local tax (40 mills): .04 x $6,000 =	+ $240
Sample combined property tax on $100,000 house in Alabama =	**$279**

Q. But why do I hear that our state property tax is high?

A. Typically, property taxes are local taxes. Property taxes at the state level are rare. Our 6.5-mill state tax is low, but it's higher than zero. And even if the state portion is only one-seventh of your property tax bill, that's still more than in states where it's zero.

How do Alabama's property taxes work?

The Alabama Constitution of 1901 established a property tax of 6.5 mills to fund state government. That was 30 years before our state had income or sales taxes. More than a century later, the state property tax rate has not increased.

Property tax is applied to real estate, motor vehicles and boats as a millage rate*.* A mill is 1/10 of a cent, so a 1-mill tax amounts to $1 of tax per $1,000 of taxable property value. Three mills of the revenue from Alabama's 6.5-mill state property tax is earmarked for the Public School Fund, which helps pay for school construction projects, while the rest supports other services.

The 6.5-mill state property tax is a small part of your property tax bill. The larger part is your local property tax, which pays for schools and local government. In 2011-12, local property taxes generated 87 percent of total property tax revenues in Alabama. Local property taxes (excluding the state one) vary widely depending on where you live, ranging from 17.5 mills in rural Marion County to 92.5 mills in Mountain Brook. Even so, Alabama's average local property taxes are the lowest in the country.

By state law, each school district must have at least a 10-mill local tax for education. Three in four districts already were at or above the 10-mill level in 2006 when Alabamians voted to require the rest of the districts to ensure this minimum local contribution to K-12 education.

Local governments regularly assess the value of property for both state and local tax purposes. The assessed value is the portion of the appraised value (or fair market value) that the government uses to calculate the amount of property tax. *(See chart at left.)*

Property tax arithmetic, lesson 2

Q: Do businesses really pay more tax on their properties than I pay on my home?

A: Yes. Suppose your block had a $100,000 owner-occupied house, a $100,000 child care center and a $100,000 electrical substation.

Value of $100,000 house for tax purposes *(see lesson 1)*:	**$6,000**
Value of $100,000 center for tax purposes (assessment ratio for businesses is 20%):	**$20,000**
Value of $100,000 substation for tax purposes (assessment ratio for utilities is 30%):	**$30,000**

Q: What if the house isn't owner-occupied?

A: Rental property is taxed as business property, so it doesn't qualify for a homestead exemption. A $100,000 rental home would be worth $20,000 for tax purposes. Compare that to the $6,000 for an owner-occupied home. Landlords are free to pass the cost of property tax on to the tenant in higher rents, though that might not be possible in more competitive rental markets. Some states offer a rebate to renters to offset these indirect taxes.

How do Alabama's property taxes work? *(cont'd.)*

Alabama taxes property at only a fraction of its value. Since the so-called Lid Bill capped property tax collections in 1978, the state has used the following system of property classifications for assessing taxes:

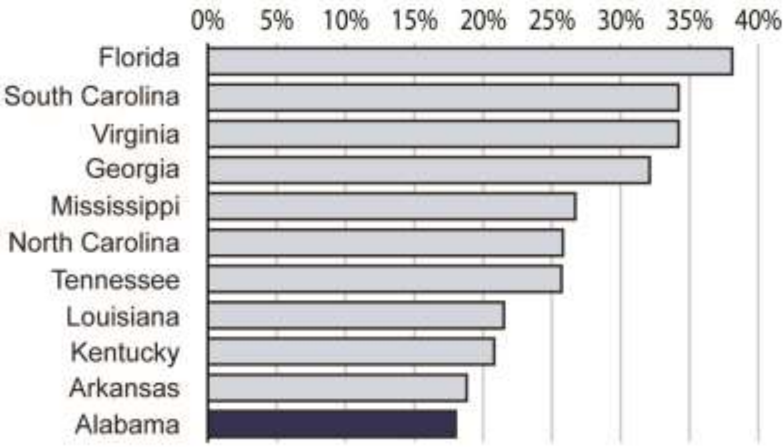
- Utility company property is assessed at 30 percent of fair market value;
- commercial property is assessed at 20 percent;
- individually owned vehicles are assessed at 15 percent; and
- farms, timberland and owner-occupied residential property are assessed at 10 percent. Huge corporate farms and timber holdings are treated the same as 100-acre family farms. The homestead exemption spares from property taxes (except countywide school taxes and school district taxes) the first $4,000 of an owner-occupied home's assessed value (an amount equal to $40,000 of appraised, actual value).

If Alabama taxed residences at their full value, a 1-mill tax on a $100,000 house would be $100. But the state taxes homes on only 10 percent of their value, so a $100,000 home is assessed at a taxable value of $10,000. *(See "lesson 1" chart on p. 32.)* The homestead exemption lowers the tax even further, meaning you don't pay on the first $4,000 of the amount subject to tax.

Alabama has numerous property tax exemptions for seniors and people who are blind or disabled. In fact, some Alabamians who are aged 65 and over or who have disabilities pay no property tax at all. Senior married couples who have a gross income of less than $12,000 are exempt from all state and county property taxes on their homestead and up to 160 acres of land. Alabamians who are blind or permanently disabled are exempt from all property taxes.

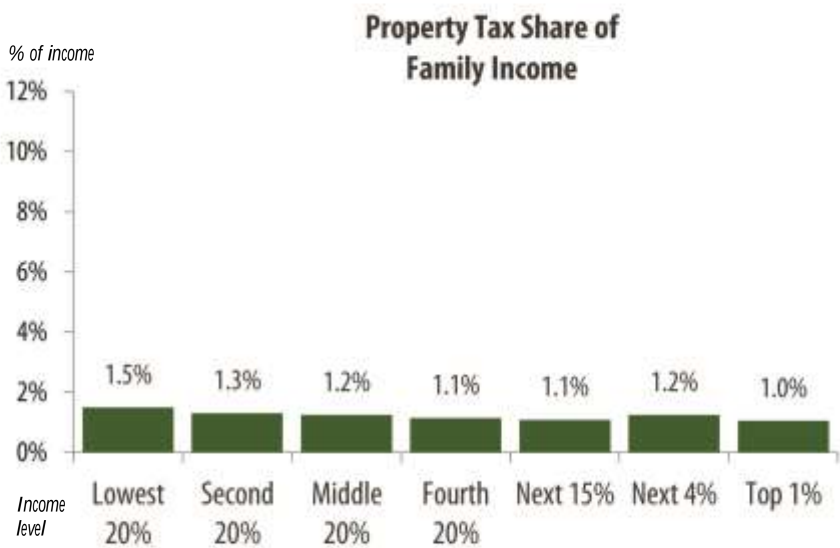
They're <u>how</u> low, again?

State and local property taxes as a share of total taxes:



Federation of Tax Administrators, based on U.S. Census Bureau data (2012)

Property taxes in Alabama are low and essentially flat:



Note: Graph shows 2015 Alabama tax law at 2013 income levels and assumes tenants pay property tax through rent.

Institute on Taxation and Economic Policy (2015)

How do Alabama's property taxes measure up?

The average Alabama property owner pays the lowest combined local and state property taxes in the United States. In fact, the average combined taxes could double and *still* be below the national average. There are two main reasons for this ranking:

1. **Alabama's agricultural property tax breaks are poorly** targeted. In the 1970s, rapid expansion of commercial and residential development increased the value of rural land near cities and towns. To keep property taxes on farms from skyrocketing, the Legislature created a set of formulas to assign discounted values based on current use of land. Alabama's current use formulas allow landowners to pay far less than they would in other states. The maximum value per farm acre (for the best land) is $532 – unchanged since 1982. The maximum value per timber acre is $708. In most surrounding states, the maximum value per farm acre is more than $1,000.

   Alabama's agricultural landscape has changed in the last 40 years. Today, owners of giant corporate farms and timber holdings benefit from discounts designed to protect smaller farmers. Alabama's 22 million acres of timberland make up more than 70 percent of the state's land area but bring in less than 2 percent of state property tax revenues, according to calculations based on a study by University of Alabama law professor Susan Pace Hamill. *That's less than $1 per acre on average!* As a result, rural counties often lack the school funding that more reasonable property taxes would provide.

2. **Alabama's constitution makes it hard to raise property** taxes at the local level, while it is easy for local districts to increase sales taxes. Wealthy landowners and industrialists built barriers into the state's 1901 constitution to shelter property from adequate taxation. Those barriers still exist, and the Lid Bill of 1978 made them even tougher.

Family values

How could we improve our state property tax?

Keep in mind: Alabama's combined state and local property taxes are the lowest in the nation. To fill the resulting funding gap, many communities have high sales taxes, which make our tax system more regressive. We need a better approach.

The reforms below would help restore balance to Alabama's upside-down tax system. Large landholders would pay more, while small-scale farmers would pay less. And Alabamians' overall property taxes still would remain below the regional average.

- INCREASE overall property tax rates. Raise the minimum local millage rate for schools to 20 mills, and tax utility property as business property.

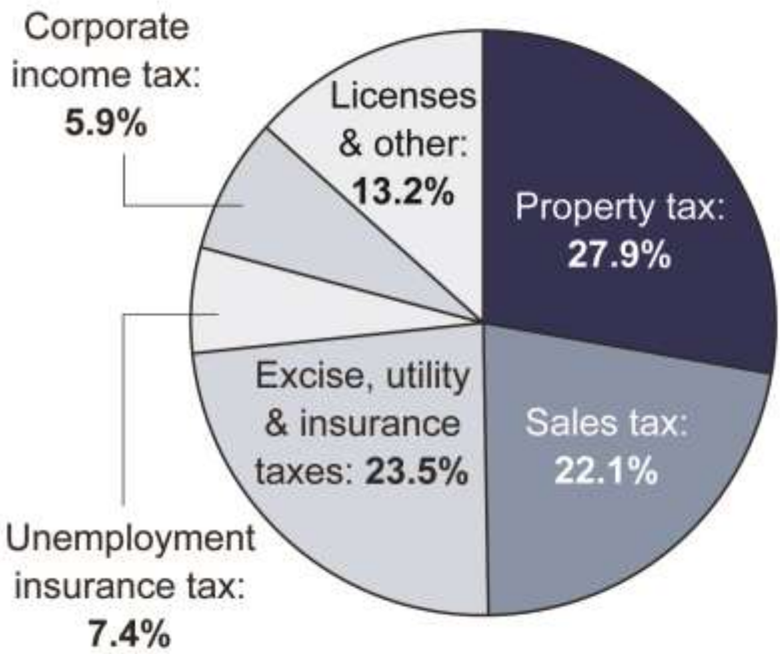
- PROTECT low-income homeowners by increasing the homestead exemption. Spare the first $50,000 of a home's value from state taxes – a 25 percent increase in protection.

- PROTECT small-**scale farmers by creating a "**farmstead exemption**."** This could be done by increasing the homestead exemption for a farmer's home, or by creating a farmstead exemption that would protect average-sized family farms (the average Alabama farm size in 2012 was 206 acres), or by creating a new farmstead exemption for up to $150,000 of specified improvements (such as irrigation systems).

- ADJUST current use formulas to make them fairer. Increase current use values by about 20 percent. Limit current use to the most valuable 2,000 acres of a taxpayer's land, as Georgia does, and tax the remainder at fair market value. That way, we would not be giving to big corporate farms and big paper companies a tax break designed to protect small family farms.

What taxes do businesses pay?

Types of state and local business taxes in Alabama
(as a share of total business taxes paid in FY 2013)



Based on 2014 estimates by Ernst & Young, LLC

How does Alabama tax businesses?

Business taxes provide the important "fourth leg of the stool" of our tax system. Alabama's business taxes were restructured in 1999 after courts ruled the old system unconstitutional because it taxed out-of-state companies at a higher rate. Today's structure relies on two taxes:

- The corporate income tax is a 6.5 percent tax on the taxable profits of corporations doing business in Alabama. (Like all states, Alabama is barred by federal law from taxing all of the income of multistate companies. Each state uses apportionment rules – based on the share of business activities that take place in the state – to divide these companies' profits into in-state and out-of-state portions.) In place of the income tax, insurance companies pay taxes on premiums. Utility companies pay both income taxes and taxes on gross receipts.

- The business privilege tax is a tax on the company's net worth. In Alabama, this tax is capped at $15,000 a year. *(That's a problem. See p. 43 to learn why.)*

Businesses pay other taxes, as well:

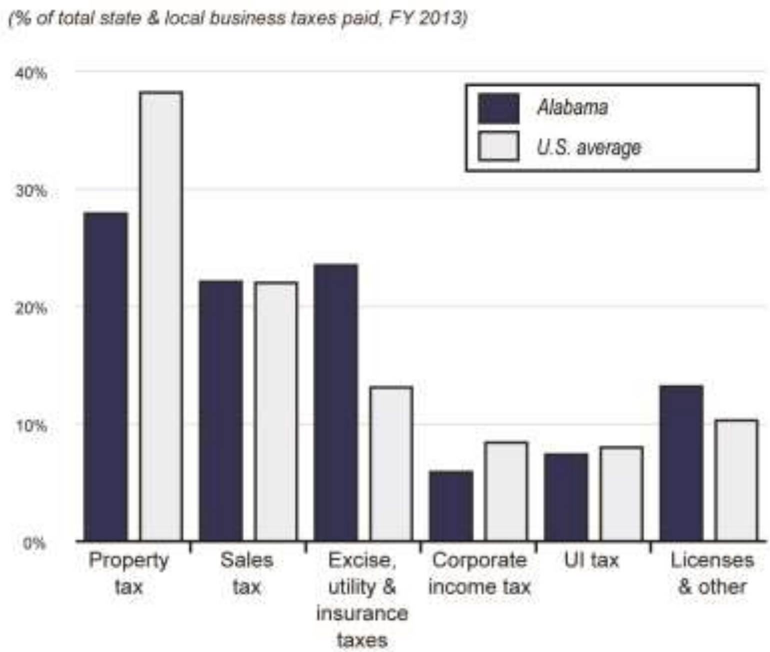
- About a fifth of the tax dollars that businesses pay are for state and local sales taxes on items purchased for their own use or consumption. The sales tax does not apply to "inputs to production" or goods offered for resale. For example, Alabama taxes the pizza, but the restaurant does not pay tax on flour. Businesses pay an excise tax on motor fuels for business use.

- Businesses pay at least twice the rate of property tax that homeowners pay. Business property is taxed on 20 percent of appraised value, and utility property is taxed on 30 percent.

- **Businesses contribute to employees'** payroll taxes for unemployment, worker compensation and disability insurance.

How we compare nationally

Alabama business taxes: Much more reliant on excise taxes, less reliant on property taxes



Based on 2014 estimates by Ernst & Young, LLC

This graph reveals some striking ways in which Alabama's business taxes differ from national patterns:

- Alabama is sharply *below* average in its reliance on the property tax for business tax revenues.
- We are sharply *above* average in our use of business excise (e.g., motor fuel) taxes and gross receipts (e.g., utility and insurance premium) taxes.
- Alabama's corporate income tax accounts for a lower share of its business tax revenues than the national average. Nearly two out of three corporations operating in Alabama pay no corporate income tax to the state, according to Gov. Robert Bentley.

How do Alabama's business taxes measure up?

Alabama's corporate income tax has declined in recent years. The tax is down 11 percent as a share of state revenues since 2005, when this handbook first appeared.

A major cause of the decline is a growing number of corporate tax loopholes. Some of these are federal, affecting Alabama's tax collections because the two are linked by state law. But Alabama provides many special business tax breaks of its own. For example, Alabama is one of only three states (along with Iowa and North Dakota) to let corporations deduct all of their federal income taxes from state taxable income. This lowers the effective tax rate (the tax as a share of profits) dramatically. So the effective rate on Alabama profits is closer to 4.2 percent than the statutory 6.5 percent rate.

Alabama businesses also benefit from many tax breaks created not by lawmakers but through creative corporate accounting. As a result, highly profitable companies can manage to pay no income taxes. For example, Exxon made $89 million in Alabama in 2003 but paid no taxes because it deducted payments to itself from taxable income. Lowes, McDonald's and Abercrombie & Fitch all reduced their Alabama income taxes in the same manner, Alabama Department of Revenue records show.

Alabama is one of 25 states that levy a business privilege tax. But Alabama, unlike most of them, caps the tax. Companies above the cap pay taxes on a lower share of their net worth – an advantage of being big! Because it's based on net worth instead of profits, the privilege tax is less sensitive to economic changes than the income tax – and less susceptible to tax avoidance techniques.

There's a lot we don't know about the decline of Alabama's corporate income tax revenues. Without effective disclosure policies, it's impossible to say for sure why collections have declined or what policies could generate needed revenue fairly.

Alabama's incentive plan

How could we improve our business taxes?

A number of changes to Alabama's business taxes could make them fairer and increase the amount of money for vital services, which businesses benefit from as much as individuals and families:

- REMOVE the deduction for federal income tax payments and drop the corporate income tax rate to 6 percent. (The current 6.5 percent rate really amounts to 4.2 percent when you factor in the deduction for federal income tax payments.)

- PHASE IN changes to bring property tax levels on utilities in line with the rate on other businesses.

- RAISE the cap on the business privilege tax so the wealthiest corporations will compete more fairly with smaller ones. Even with this change, Alabama's business tax levels would remain below those of most other states.

- ADOPT combined tax reporting for businesses and their subsidiaries. By treating a company and all of its related enterprises as one taxpayer, Alabama could keep a business from deducting payments to its own subsidiary from its state taxes. This change also could prevent corporations from shifting taxable in-state earnings to other states to avoid Alabama taxes.

- DECOUPLE **Alabama's business taxes from the federal tax** code so that tax breaks given by Congress do not automatically apply to state business taxes. This would allow the Legislature to decide for itself if a particular tax break is good for Alabama.

- LIMIT tax incentives for luring companies to Alabama. Many companies rank tax breaks low among the reasons they choose to locate in a state, but still they bargain for the best incentive plan they can get. Numerous studies show the most effective incentives are a skilled workforce, a good education system and other quality-of-life measures. Large corporations should pay their fair share to support those investments.

Conclusion

Solutions for the long haul

Alabama can move forward by changing its outdated, imbalanced approach to raising revenue. Our current approach is not helping workers get ahead, and it's not adequately funding education, health care and other vital services that help make widely shared prosperity possible. Our first step toward change is to adjust how we think about the economy.

We have been battered by hard times recently, but we must resist thinking of our economy like the weather. You can't prevent a drought; you can only adjust to it. Alabama's economy, by contrast, can respond to changes we decide to adopt.

Our economy is more like a game with decision-makers who set the rules we all play by. Sure, if $100 worth of groceries cost $110 in Alabama, workers could adjust by buying less food for their families. But as a society, we need to question the rules: Why are we taxing the necessities of life in the first place? Why does Alabama still have so many obsolete rules that were set back in 1901?

Alabama's out-of-date rules are holding us back. Our schools, already poorly funded, struggle to do the same job with less money. The same goes for health care, courts and prisons. They fall victim to a tax system that can't keep pace with ordinary cost growth.

Why does our tax system fall short? Because it gets most of its **money from taxpayers whose incomes aren't growing.** The wage gains of low- and middle-income workers barely keep pace with inflation. Meanwhile, the income gains of recent decades have gone to the highest-paid fifth of Alabamians. They make 57 percent of the income but pay only 44 percent of the state and local taxes. That shortfall is why our schools, courts and health systems struggle to meet our population's needs. If the group with 57 percent of the income paid 57 percent of the taxes, Alabama could afford to strengthen the services that make our state a better place to live.

New rules: What to watch for in new tax proposals

We can use four criteria to assess plans to improve Alabama's taxes:

#1: *Fairness: Does it lower taxes for those who pay too much and increase taxes for those who pay too little?*

• **Will high**-income people and companies pay their share? Most Alabama workers pay twice the share of income that the top 1 percent pay in state and local taxes. For decades, many business leaders proposed a fairer mix of revenue options. In 1992 and again in 2003, they set a basic goal: The poor will pay less; we will pay more. It's past time to fix Alabama's upside-down tax system.

• Will the plan tax poor workers deeper into poverty? President Ronald Reagan saw this as a fundamental test. Hurdles in Alabama's constitution make it hard to raise new revenue through income or property taxes. But it's easy to increase sales taxes, driving "the least of these" deeper into poverty and forcing them to shoulder an even greater share of the cost of the public services that benefit us all.

#2: *Adequacy: Does it meet the needs of a growing population?*

• **Does the plan help end the state's perennial deficits?** Simply put, will it pay the bills? Year after year, lawmakers learn the General Fund faces yet another massive shortfall. Stagnant income sources can't keep pace with rising costs. As fuel-efficient vehicles use less gas, gas tax revenues shrink, even as the cost of road repair grows. One way to keep up with the changing times would be to extend our sales and use taxes to cover the services that account for an increasing share of consumer spending.

• Does the plan allow flexibility to address changing needs? As technology evolves and population grows, Alabama must be able to keep up. Lately, we've been falling behind. Can our schools educate our children properly when we still haven't restored the funding cut during the Great Recession? Can one of the nation's most limited Medicaid programs adequately serve an aging population? Can our overcrowded prisons house twice as many people as they were built to accommodate? If we want a better tomorrow, we need to invest in it today.

Solutions for the long haul *(cont'd.)*

#3: *Simplicity:* *Can people file a basic tax return?*

• Is it easy to understand how taxes work? As lobbyists push new tax measures, our income tax form gets more complicated. Key principles can keep the system simpler. For example, that's why Alabama has a uniform statewide list of items subject to sales tax.

• **Does our tax system have confusing loopholes?** A hodgepodge of tax breaks for some but not others makes our system inefficient. Worse yet, legislators sometimes create preferences for certain industries without revealing who would benefit.

#4: *Transparency:* *Can we see that everyone pays a fair share?*

• Does the budget process let the public follow the money from tax collection through spending? Citizens should set the rules to ensure everyone pays a fair share in taxes. Do a legislator's community service grants benefit a favored few, or do they meet important needs? We can decide if a detailed list is available online.

• **Does it require the state to list tax breaks?** Alabama's budgets reveal our values and priorities. But tax breaks pushed through by powerful lobbyists can be virtually invisible. In states with a detailed report on all of the state's tax breaks, the public can weigh the value of a million-dollar tax break against a million-dollar spending item.

Bottom line: Does our government reflect our values?

We need public services and policies to meet the needs of our people. We create governments to promote the common good, to do together what we can't accomplish alone – educating and protecting and building and planning. If we hope to move forward, we have to change our broken, upside-down approach to taxes and budgets. By getting involved, citizens can require their leaders to be responsive to the needs in our communities. Our children deserve to inherit a government that gives everyone a voice, an economy that offers everyone a chance, and an Alabama that works for all.

Alabama Tax & Budget Glossary

This glossary includes keywords used in *The Alabama Tax & Budget Handbook*, as well as other terms commonly encountered in tax and budget debates. Terms that are *italicized* in the definitions are defined elsewhere in this glossary.

act – a *bill* that has become *law*.

ad valorem – a Latin phrase meaning "according to value." *See* property tax.

adjusted gross income – total annual earnings after subtracting certain expenses (such as qualified retirement contributions) but before subtracting *deductions* and *exemptions*. *Compare* taxable income.

Alabama Department of Revenue – state agency that administers tax programs and collects taxes. The federal tax authority is the *Internal Revenue Service.*

appraised value – an expert opinion of the current market value of a property.

appropriation – an amount of money approved by the Legislature for a certain purpose. *See also* conditional appropriation; supplemental appropriation.

assessed value – a tax assessor's determination of property value, based on *appraised value* and lowered in Alabama by a *property classification* factor.

assessment ratio – a formula set by law to determine the portion of a property's *appraised value* that is subject to tax. *See also* property tax.

balanced budget – an income and spending plan for which projected income is equal to or greater than projected spending. Alabama law requires the Legislature to balance the budget every year.

bill – a proposed piece of legislation to be considered by the Legislature for passage (or enactment) into *law*. *See also* act.

budget – a spending plan for a *fiscal year*. *See also* governor's budget proposal.

budget deficit – the amount by which *revenues* fall short of *expenditures* in a given period, usually a *fiscal year.*

budget surplus – the amount by which *revenues* exceed *expenditures* in a given period, usually a *fiscal year*.

business privilege tax – a tax on the net worth of companies doing business in Alabama. The business privilege tax replaced the franchise tax in 1999.

cigarette tax – a privilege tax and *use tax* on the sale, storage or distribution of cigarettes by wholesalers and retailers, and purchase by consumers.

community service grant – funds appropriated for legislators to distribute to programs and schools in their districts.

competitive bidding – a process in which prospective vendors submit price quotations on a particular job for the buyer (such as state government) to compare. *Compare* no-bid contract.

conditional appropriation – an amount of money approved by the Legislature for a particular purpose only if funds become available later in the *fiscal year*.

corporate income tax – a tax on the net income of a corporation located in Alabama or deriving income from sources within Alabama.

credit (also called *tax credit*) – a direct, dollar-for-dollar reduction in taxes owed. A credit reduces the amount of tax owed on income, while a *deduction* reduces the amount of income that is subject to taxation.

current use – the valuation of certain qualifying properties at a reduced amount based upon their use as farmland or timberland.

decouple (also called *de-link*) – to break the connection between a state's tax code and certain provisions of the federal tax code.

deduction (also called *tax deduction*) – an expense (such as a charitable gift or mortgage interest) subtracted from *adjusted gross income* while figuring *taxable income*. *Compare* credit. *See also* itemized deduction; standard deduction.

dependent – a person, usually a family member, who is supported financially by another person.

dependent deduction – an amount excluded from *taxable income* in Alabama to help offset a taxpayer's cost to support a child or other *dependent*. On federal *income tax* returns, this reduction is claimed through a *personal exemption*.

earmarking – the practice of setting aside – through constitutional provision or statutory law – *revenues* from particular sources for particular purposes.

earned income – money received in payment for a job or through self-employment and reported to the *IRS* and the state for tax purposes.

earned income tax credit *(EITC*; also called *earned income credit* or *EIC)* – a refundable *credit* for low-income taxpayers who earn income above a given amount. "Refundable" means taxpayers get the full amount of the credit no matter the size of their tax bill. State EITCs often are set at a percentage of the federal EITC and can help offset the *regressive* effects of *sales taxes*.

Education Trust Fund *(ETF)* – state *revenues* set aside for public education and related services at all levels. *Compare* General Fund.

Education Trust Fund Budget Act – annual legislation that provides the spending plan for federal, state and some local *revenues* set aside for education. *Compare* General Fund Budget Act.

estate tax – a tax imposed on the property held by an individual at the time of his or her death, before any transfer to heirs. Alabama's estate tax technically is still on the books but effectively ended in 2005.

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

Executive Budget Office *(EBO)* – a division of the state's Department of Finance that prepares the *governor's budget proposal*, administers legislative *appropriations*, estimates *revenues* for budget preparation, and assists in drafting appropriation bills.

exemption – a portion of income on which no tax is imposed – usually intended to help shield the basic costs of living from taxation. *See also* farmstead exemption; homestead exemption; personal exemption.

expenditure (also called *outlay*) – money paid to purchase goods or services.

farmstead exemption – a proposed tax code provision that would exempt a certain share of *assessed value* for calculating *property tax* on an owner-occupied farm. *See also* homestead exemption.

federal funds (also called *federal dollars*) – U.S. government money approved by Congress to support a program or project.

federal income tax deduction – a *deduction* that allows taxpayers to write off their federal income tax payments on their state *income taxes*. Alabama is one of only three states to allow a full federal income tax deduction.

federal match (also called *matching funds*) – federal money that is available for a state program if the state contributes a certain amount of money, according to a formula.

federal poverty measure (informally called the *poverty line*) – a U.S. government standard used to classify people as "poor." There are two versions: *poverty thresholds* and *poverty guidelines*. Both versions vary with family size and ages.

fee – a fixed charge for a privilege or service.

fiscal note – an analysis of how a bill would increase or decrease the *revenues* available to fund state or local services. The *Legislative Fiscal Office* prepares fiscal notes for the Alabama Legislature.

fiscal year *(FY)* – an annual accounting period. Like the federal fiscal year, Alabama's fiscal year runs from Oct. 1 through Sept. 30 and is designated by the calendar year in which it ends. For example, fiscal year 2021 will start in October 2020.

gasoline tax – an *excise tax* on the sale, consumption or distribution of gasoline.

General Fund *(GF)* – state *revenues* that are not *earmarked* and that provide for most public services except education. *Compare* Education Trust Fund.

General Fund Budget Act – annual legislation that provides the spending plan for federal and state *revenues* supporting all non-education programs.

governor's budget proposal – a suggested allocation of state money that the governor presents to the Legislature by the second legislative day of each *regular session*.

graduated tax – a type of *progressive tax* in which the *tax rate* is higher as the value of the taxed income or item increases.

growth revenues – taxes and fees that grow as the economy expands. *Income taxes* and *sales taxes* often are cited as examples of growth revenues.

homestead exemption – a provision in the tax codes of Alabama and other states that reduces the *assessed value* of a primary residence by a set amount for the purpose of calculating *property tax. See also* farmstead exemption.

household income – annual income of all people living in the same residence.

income tax – a tax on *earned income* and *unearned income*.

inflation – growth in the price level, measured as an annual rate.

Internal Revenue Service *(IRS)* – the federal agency responsible for collecting taxes and administering tax programs. Alabama's state tax authority is the *Alabama Department of Revenue*.

itemized deduction – an individual expense (such as mortgage interest, charitable gifts or payments for medical services) that lowers *taxable income*. Taxpayers itemize if their *deductions* exceed the *standard deduction*.

law – a legal document (constitution, *act*, regulation, ordinance, etc.) that sets rules governing a particular activity.

Legislative Fiscal Office *(LFO)* – a nonpartisan state agency that provides objective information about tax and budget matters to Alabama legislators.

legislative session – a period when the Legislature meets, either in *regular session* or in *special session*.

levy – to impose a tax or fee on a person, business or other entity.

license – permission granted by an authority to engage in a certain activity, often for a *fee*.

Lid Bill – a 1978 amendment to the Alabama Constitution that lowered the *assessment ratio* for farm, forest and residential property to 10 percent of *appraised value*, established a *current use* provision, and capped the amount of *property tax* that can be collected overall.

local tax – a tax imposed by a local government to fund services such as water treatment, fire protection and garbage collection.

matching funds – *See* federal match.

median income – the income level at which half of a given area's families or households earn less and half earn more. *Compare* per capita.

Medicaid – a health insurance program, funded by federal and state governments and operated by the state, for people with incomes below a certain level – primarily children, seniors, and people with disabilities in Alabama. *Compare* Medicare.

Medicare – a federal health insurance program for seniors and for people with disabilities. *Compare* Medicaid.

mill – one-tenth of a cent. A one-mill tax is equivalent to $1 per $1,000 of value.

millage rate – the number of *mills levied* by a locality or state on property within its authority.

motor vehicle tax – a *license* tax or registration *fee* on each motor vehicle operated on the public highways of a state.

no-bid contract – a contract, agreed to without a *competitive bidding* process, for a government agency to purchase goods or services.

occupational tax – a tax or *license* fee that some municipalities *levy* on the incomes of people who work there, regardless of where they live.

payroll tax – a tax on wages that is used to finance unemployment insurance, worker compensation, disability insurance, *Social Security* and *Medicare*.

pension – a retirement plan paid for in part or in whole by the employer.

per capita – for each person; a way of expressing the distribution of cost, consumption, income or taxation equally across the population. *Compare* median income.

personal exemption – an amount excluded from the *taxable income* of any taxpayer who cannot be claimed as a *dependent* by another taxpayer.

poverty guidelines – standards issued by the U.S. Department of Health and Human Services to measure eligibility for certain federal programs. The guidelines are based on the *poverty thresholds* but are simpler and more current.

poverty line – *See* federal poverty measure.

poverty thresholds – standards issued by the U.S. Census Bureau to estimate the number of people living in poverty. The thresholds, issued in late summer for the previous calendar year, are more detailed than *poverty guidelines*.

progressive tax – a tax that requires people who make more money to pay a bigger share of their income than those who make less. A tax can be made progressive by the use of graduated rates, *exemptions*, *deductions* or *credits*. *See also* graduated tax; *compare* regressive tax.

property classification – a set of categories of real estate defined by state law for the purpose of assigning property tax *assessment ratios*.

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

proportional tax (also called *flat tax*) – a tax *levied* at the same rate on all levels of income. *Compare* graduated tax; progressive tax; regressive tax.

proration – the process of cutting agency budgets equally across the board when *revenues* fall short of expectations.

quadrennium – the four-year term of office for Alabama's executive officers (governor, lieutenant governor, et al.) and members of the Legislature.

rainy day fund – money set aside in a budget or borrowed from a government account for emergency use.

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

regular session – the annual period when the Alabama Legislature meets – limited to 30 meeting days within a period of 105 calendar days beginning in the first quarter of the year.

revenue – money collected by a government from the public in taxes and fees.

Rolling Reserve Act – a 2011 state law that limits *Education Trust Fund* spending based on average *revenue* growth in prior budget years. Revenue in excess of the spending cap goes toward an account designed to prevent *proration* or toward capital expenses like school bus purchases or school building repairs.

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

Self-Sufficiency Standard – a measure of income necessary for meeting a family's basic needs without public or private subsidies. (The standard was developed by Professor Diana Pearce of the University of Washington, in conjunction with Wider Opportunities for Women.)

sin tax – a tax *levied* on products or activities that many consider to be vices, such as cigarettes, liquor or gambling.

Social Security – a social insurance program that provides most of the nation's workforce with retirement, disability and survivor benefits.

SSI *(Supplemental Security Income)* – a federally funded disability program for adults and children that provides monthly cash benefits and eligibility for *Medicaid*. It is based on a person's need for financial support.

special sales tax – a tax charged on certain goods or activities that is higher than the normal *sales tax*.

special session – a convening of the Legislature, limited to 12 meeting days within 30 calendar days, called by the governor for a specific purpose. Any measures not included in the "call" require a two-thirds majority vote to pass.

standard deduction – a fixed amount that taxpayers who do not *itemize deductions* can subtract from *adjusted gross income* to lower their *taxable income*.

structural deficit – the inability of a government's *revenue* system to keep up with normal cost increases resulting from factors like inflation and population growth. The *General Fund* budget has had a structural deficit for decades.

supplemental appropriation – an amount of money approved by the Legislature to meet current needs that were not met in the budget passed in an earlier session.

tax – an amount charged by a government on income, goods, property, services or activities to help pay for public services like education and public safety.

tax base – the total value of income, goods, properties, services or activities subject to a particular tax or group of taxes.

tax capacity – potential *revenue* if businesses and individuals in Alabama were taxed at the average rate of other states.

tax expenditure – potential *revenue* forgone through tax *credits* and *exemptions*.

tax expenditure report – a detailed list of *revenues* that the state forgoes through tax breaks for businesses and individuals.

tax rate – the percentage of a given level of income or value paid in taxes.

tax rebate – an amount returned to the taxpayer to reduce the total taxes paid. For example, some states provide a rebate to low-income taxpayers for *sales taxes* paid on food.

tax threshold – the lowest income level subject to the *income tax*.

taxable income – amount of income subject to *income tax* (after subtracting all *deductions* and *exemptions*). *Compare* adjusted gross income.

tobacco settlement money – funds paid to most states by the five major tobacco companies as a result of the 1998 Master Settlement Agreement, intended to recoup medical costs of treating tobacco-related illnesses.

transparency – a budgeting principle that enables taxpayers to see clearly where tax dollars come from and how they will be spent.

unearned income – income (such as dividends, interest or rental fees) that does not result directly from the recipient's labor. *Compare* earned income.

use tax – a tax on goods bought outside a locality or state for use inside it. The use tax is equivalent to a *sales tax* on such goods. It is commonly discussed in the context of Internet or mail-order purchases.

withholding – a portion of an employee's earnings that an employer sends directly to the government as partial payment of the person's taxes owed for the current year.

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