

Big Piece of a Small Pie: Alabama's Tax Paradox

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If you talk to a low-income Alabamian about the state's tax system, you're liable to hear two things. One is a boast that the state has some of the nation's lowest taxes. The other is a complaint that, nevertheless, the person pays too much in taxes.

The statements may sound contradictory, but both are grounded in reality. The average share of income that Alabama's state and local governments require residents to pay in taxes is lower than in most other states, according to analyses of data from the U.S. Census Bureau and the Bureau of Economic Analysis. Even so, low-income Alabamians account for a larger share of tax revenues than their counterparts elsewhere. This fact sheet will examine an Alabama tax paradox: that low-income residents pay so much in taxes even as their state collects comparatively little money for the public services that can help make their lives better.

How to look at revenues across state lines

Every state's tax and budget system is different. Some states lean on **property taxes** to balance their budgets, while others rely more on **sales taxes** or **income taxes** to pay the bills. States also vary in their accounting procedures and the extent to which they ask local governments to provide and pay for schools and other services. These differences can complicate efforts to compare state and local financial figures.

The U.S. Census Bureau has developed a way to make state-by-state comparisons of these data. The bureau annually collects budget information from a sampling of local governments. Every five years, a full Census of Governments requests these data from all state and local governments. The bureau released the most recent full Census of Governments, conducted for **fiscal year (FY) 2006-07**, in September 2009.

The Census Bureau does not rank states in tax and revenue categories, but the data necessary to do so are available. One can calculate FY 2006-07 state and local tax and revenue levels for all 50 states using revenue and population information from the Census Bureau and personal income data from the Bureau of Economic Analysis. These rankings can be expressed on either a **per capita** basis or as a share of state residents' average personal income.

Keywords

Education Trust Fund (ETF) – the part of the state budget set aside for education-related programs.

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

fiscal year (FY) – an annual accounting period. Alabama's fiscal year runs from Oct. 1 through Sept. 30 of the following calendar year.

flat tax – a tax levied at the same rate on all levels of income.

General Fund – the part of Alabama's budget for non-education-related programs that the Legislature can allocate at its discretion.

income tax – a tax on earned income (salaries or wages) and unearned income (dividends, interest, etc.).

income tax threshold – the lowest income level at which people must pay income tax.

per capita – for each person; a way of expressing the distribution of a factor like cost, consumption or income equally across the population.

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

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

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

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

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

Disconnected: Incomes and taxes in Alabama

Whichever measure is used, Alabama has one of the nation's lowest levels of state and local taxes. In FY 2006-07, Alabama had the country's lowest state and local taxes per capita (\$2,909) and the nation's third lowest state and local taxes as a share of personal income (9.1 percent). Only New Hampshire and South Dakota had lower average percentages.

One cause of Alabama's low tax collections is the state's poverty rate, which long has topped the

national level. Because Alabama's population has lower personal incomes, a tax rate applied to Alabamians would raise less money per capita than the same tax rate would in wealthier states like New York or Ohio.

But a high poverty rate is not the only reason for Alabama's low standing in tax collections. Eight other states had lower average personal incomes than Alabama in FY 2006-07, but they all had higher average state and local tax rates as shares of personal income.

Much of that disparity exists because of Alabama's state and local property taxes, which were the lowest in the nation as a share of personal income in FY 2006-07. By that measure, the state also had the 35th highest income tax in FY 2006-07 of the states that tax incomes.

If Alabama's ranking in state and local taxes (now 48th) matched its ranking in personal income (42nd), that would mean millions of additional dollars flowing into the state's **Education Trust Fund (ETF)**, which is in its second straight year of **proration** because of the economic recession. It also would mean millions more for the state's **General Fund**, which receives money from a variety of taxes that grow slowly even in good economic times.

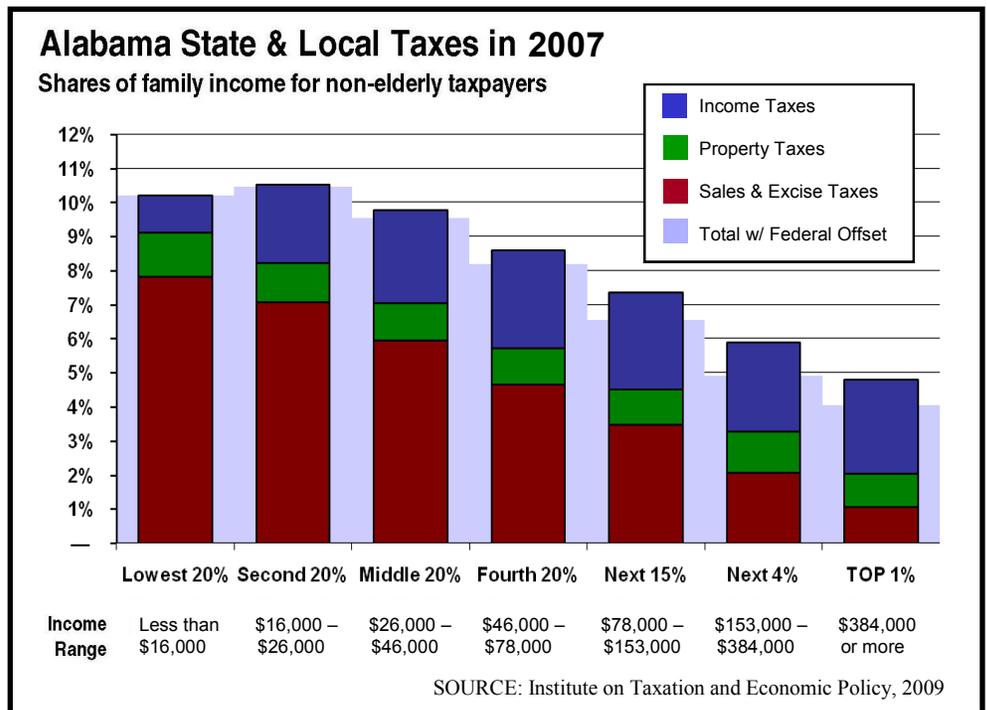
Making less but paying a larger share

Alabama's average state and local tax level may be low, but taxes are not low for everyone. The state's lowest-income residents pay more than twice as much of their income in state and local taxes as the highest-income residents do, according to a 2008 study by the Institute on Taxation and Economic Policy (ITEP), a nonprofit research group in Washington, D.C. For example, ITEP found that for the top 1 percent of earners, Alabama's income tax is the country's third lowest. But for the state's bottom fifth of earners, the income tax is the nation's third highest, ITEP found.

Regressive taxes like the sales tax and excise tax play big roles in the state tax system's imbalance. In FY 2006-07, Alabama had the nation's 21st highest sales taxes as a share of personal income. The state's

sales taxes also are more regressive than in most parts of the country because Alabama is one of only two states that still fully tax groceries with no discount or rebate. (Mississippi is the other.)

Many states partially offset the regressive nature of sales taxes with progressive taxes like the income tax. But in Alabama, the income tax effectively is a **flat tax**, because the top rate applies to all taxable income above \$6,000 for married couples. That leaves almost 80 percent of families paying at the top rate, ITEP



found. And though the state lifted its **income tax threshold** for a family of four from \$4,600 to \$12,600 in 2006, Alabama's income tax on a family of four at the poverty line (\$483 in 2008) is the nation's highest. That family pays the top rate, but unlike the highest earners, it cannot deduct hundreds of thousands of dollars in federal income taxes paid – a full deduction allowed in only two other states (Iowa and Louisiana).

Alabama's tax system did not take its present shape overnight, and changes will not come overnight either. But until the state reforms its ways of collecting revenue, the paradox at the heart of its tax system will remain: Alabama will continue to saddle its low-income families with a high tax bill, and it will continue to bring in less money than most other states for public services like education and health care that benefit everyone.

This fact sheet was prepared by policy analyst Chris Sanders. It may be reproduced with acknowledgment of Arise Citizens' Policy Project, Box 1188, Montgomery, AL 36101; (800) 832-9060; arisecitizens.org.