

ECONOMY DOLLAR LOCAL  
HOW RATE BUDGET PERCENT  
SERVICES INCOME GOVERNMENT DEBT RECEIPTS  
Alabama  
FINANCE DEBT RECEIPTS  
RATE CORPORATE ANALYSIS PERCENT  
LOCAL % STATE  
TAXES LOWEST  
REVENUE MONEY  
REGRESSIVE  
BUDGET  
COMPARE  
2022  
ANALYSIS RETAIL SPENDING  
COMMERCIAL INDIVIDUAL  
CAPITAL % BRACKET COMMERCIAL  
BUDGET

*How Alabama Taxes Compare, 2022*

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**Public Affairs  
Research Council  
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## **How Alabama Taxes Compare, 2022 Edition**

Thomas Spencer, Senior Research Associate  
Eli Tylicki, Researcher Associate



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## Executive Summary

PARCA's *How Alabama Taxes Compare*, 2022 Edition, uses data published by the U.S. Census Bureau's Annual Survey of State and Local Finances to compare tax revenues across the state. This most recent set of revenue and expenditure data cover state and local fiscal years ending between July 1, 2019, to June 30, 2020, identified as the fiscal year 2020. That means the state of Alabama's data is from the fiscal year that ended September 30, 2019.

### Key Findings

- In 2020, Alabama had the nation's second-lowest state and local tax collections per capita.
- Alabama has the lowest per capita property tax collections in the nation.
- Alabama has among the highest sales tax rates in the U.S.
- Alabama is now the only state that allows state individual and corporate income taxpayers to fully deduct federal income taxes paid. That provides a tax advantage for high earners.
- Despite a recent change that provides some relief, Alabama beings taxing income at the lowest threshold in the U.S.

Alabama state and local taxes collections are low due to two factors: lower rates and a smaller resource base to tax. Alabama's Gross Domestic Product per capita, the total value of all goods and services produced, ranks in the bottom five of states, meaning we have a lower resource base to tax. However, these other states make a greater tax effort and, thus, generate more money to provide services.

This gap between Alabama and other states will not be so obvious when newly elected lawmakers convene in March to craft budgets for FY 2024. A strong inflationary economy, high employment levels, and a flood of federal relief have supplemented state spending and stimulated record levels of state and local tax collections in the most recent year.

But as proposals are floated to make changes to tax rates, it's important to understand the tax system in context, including a history of underinvestment compared to other states. Any changes should ensure adequate revenue, promote fairness and opportunity, and increase ease of collection and compliance.

This report explores Alabama's tax system in more depth and context.

## Introduction

For another year, Alabama had the nation's second-lowest state and local tax collections per capita in 2020, according to the PARCA's analysis of the U.S. Census Bureau's latest available data. Only Tennessee had lower state and local tax revenue per resident than Alabama. Tennessee's lottery provides an additional revenue source that, if counted, puts it ahead of Alabama.

That means Alabama state and local governments have less money than governments in other states to provide a competitive level of service. That's been the case since at least the early 1990s, when PARCA began making this comparison.

### Property Taxes

Alabama has the lowest per capita property tax collections in the nation.

Low property taxes benefit homeowners and owners of agricultural and timberland but present a challenge to local governments and schools needing to pay for adequate services. Across the country, property taxes provide a greater share of revenue and a more stable source of revenue. In Alabama, state and local governments are forced to rely on more volatile alternatives. Our aversion to property taxes, protected by the Alabama Constitution, leads to imbalance and inadequacy.

### Sales Taxes

Alabama has among the highest sales tax rates in the U.S.,<sup>1</sup> partly as a result of constitutional roadblocks to property taxes.

Alabama is one of only three states that applies the full rate of state and local sales taxes to groceries without an offset.<sup>2</sup> Because those with lower incomes spend a greater share of income on necessities covered by the sales tax, state and local taxes take a larger share of their income.

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<sup>1</sup> Janelle Fritts, "State and Local Sales Tax Rates, 2022," *Tax Foundation* (blog), Feb 3, 2022, <https://taxfoundation.org/2022-sales-taxes/>.

<sup>2</sup> "States Can Thoughtfully Implement Grocery Tax Reforms to Help Families and Improve Equity," Center on Budget and Policy Priorities, accessed November 22, 2022, <https://www.cbpp.org/blog/states-can-thoughtfully-implement-grocery-tax-reforms-to-help-families-and-improve-equity>.



## Income Taxes

Alabama's income tax is essentially flat, with the top rate of 5% applied to an individual's taxable income over \$3,000.

Alabama requires families in poverty to pay income taxes. No other state sets a lower threshold for paying income taxes than Alabama.

In most states, the income tax is used to provide some balance for the regressive effects of other taxes, providing credits to low-income households to offset sales taxes, for instance. Not in Alabama.

On the other hand, Alabama is the only state that allows taxpayers to completely deduct federal income taxes when calculating state taxes, a tax break that disproportionately benefits upper-income earners.<sup>3</sup> Other states that had this provision, like Iowa and Louisiana, have repealed it.

Federal deductibility also means that when federal taxes go up, state taxes go down and vice versa. When federal tax deductions and credits are raised, the state automatically takes back some of the benefit the federal tax change is intended to provide.

Flush times could allow Alabama to address years of chronic underinvestment compared to other states. Unacceptable conditions, like understaffed and crumbling prisons persist.

Alabama schools face a shortage of teachers at a time when sustained investment in improving instruction is critical. Signs of improved performance<sup>4</sup> have coincided with major increases in professional development and coaching in reading and math, investments that will need to be sustained.

Alabama has failed to take advantage of Medicaid expansion on affordability grounds. That's despite multiple studies, including one by PARCA and the Center for Economic Development and Business Research at Jacksonville State University,<sup>5</sup> that

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<sup>3</sup> Jared Walczak, "Federal Deductibility Is Distorting Tax Liability in Six States," *Tax Foundation* (blog), November 1, 2021, <https://taxfoundation.org/federal-deductibility/>.

<sup>4</sup> Thomas Spencer, "Despite Headwinds, Alabama Gains in 4th Grade Reading and Math," *Public Affairs Research Council of Alabama* (blog), October 28, 2022, <https://parcalabama.org/despite-headwinds-alabama-gains-in-4th-grade-reading-and-math/>.

<sup>5</sup> Khadijah Edwards and Ryan Hankins, "THE ECONOMIC IMPACT OF EXPANDING MEDICAID IN ALABAMA," 2022, Public Affairs Research Council of Alabama.

predict Alabama could actually save money and generate a positive economic impact by choosing to extend coverage to more Alabamians. Alabama's habit of earmarking taxes complicates lawmakers' ability to steer surpluses to areas of need, but it is within their power to do so.

## Alabama Taxes Compared: An Overview

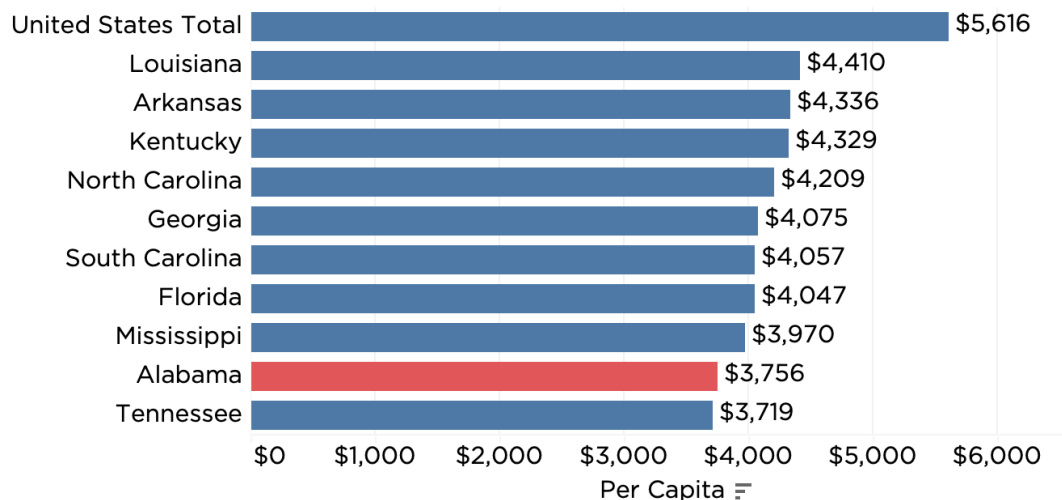
Each year PARCA analyzes data gathered by the U.S. Census Bureau in the Bureau's survey of state and local governments across the country. The report makes it possible to compare the revenue and expenditures of state and local governments across the 50 states.<sup>6</sup>

In PARCA's analysis of the data, state and local revenues are considered together, because states vary in how they divide responsibility between state and local governments for financing schools, highways, police, public health, prisons, arts and culture, and recreation.

In the discussion that follows, Alabama's per capita collections are compared with other Southeastern states. In general, Alabama's approach to government and taxation is more similar to other Southeastern states than to the governments in other regions.

**Figure 1. Total State and Local Taxes Collected Per Capita, 2020, Southeastern States and U.S. Average<sup>7</sup>**

### All Taxes, 2020



<sup>6</sup> US Census Bureau, "2020 State & Local Government Finance Historical Datasets and Tables," The United States Census Bureau, accessed October 28, 2022, <https://www.census.gov/data/datasets/2020/econ/local/public-use-datasets.html>

<sup>7</sup> This comparison considers tax revenues but does not consider lottery proceeds or other revenue generated through charges or fees.

Since the early 1990s, Alabama has maintained the lowest tax collections in the U.S. But beginning in 2018, tax cuts in Tennessee and economic growth in Alabama caused Tennessee to dip below Alabama's per capita collections. However, the most recent data indicates that Tennessee's tax revenues are climbing and are on track to surpass Alabama's.

In 2020, Alabama collected \$3,756 in per capita revenue. That's \$37 more than Tennessee. While it is not a tax, Tennessee does have a lottery that in 2020 provided \$73 per capita in proceeds available to spend on public purposes. If lottery revenue counted, Alabama would be behind Tennessee and even further behind other Southeastern states.

State and local tax collections are based on two fundamental factors: tax rates and the value of the tax base to which the rate is applied. Alabama combines low tax rates with a less valuable base of economic activity, yielding less in taxes per capita and less revenue for state and local government to provide services.

In previous periods of economic recession, Alabama's revenue has been quick to fall and slow to recover, due in part to the state's heavy reliance on sales and income taxes.

## **Economic context**

The data in the FY 2020 are the first to pick up on the economic disruptions caused by the Covid 19 pandemic, though for Alabama this survey does not include that time period. In 46 states, the state 2020 fiscal year 2020 began in July of 2019 and ended in June of 2020. Alabama and Michigan begin the fiscal year in October. The Census survey uses Alabama's state and local data for the fiscal year ending in Oct. 2019 in the most recent data release.

Consequently, for most states, this is the first survey year in which the economic disruptions of the Covid 19 pandemic affected tax collections. However, Alabama's state and local revenue and expenditure data is pre-pandemic.

Comparing the Census survey 2020 data with 2019 results, Alabama among the 24 states that reported an increase in tax collections over the period. The rest of the state saw posted a decline in collections, something that is relatively rare.

Despite the widespread decline, Alabama's rankings in per capita state and local tax collections were generally consistent with rankings in prior years. Alabama continues to lag behind almost all other states in total per capita collections.

Table 1. Alabama Rank in Per Capita Tax Collections, 2018, 2019, 2020.

	2018	2019	2020
All Taxes	49	49	49
Property	50	50	50
Individual Income	36	36	35
Corporate Income	28	30	25
Sales and Gross Receipts	27	30	25
General Sales	30	32	31
Selective Sales	15	18	16
Alcoholic Beverages	3	3	3
Public Utilities	4	5	5
Motor Fuel	27	32	20
Tobacco Products	37	37	37
Other Selective Sales	31	31	32
Motor Vehicle Licences	44	43	43
Other Taxes	29	30	29

Property taxes are the lowest per capita, individual income tax collections rank 35<sup>th</sup> out of the 43 states (plus D.C.) that assess income taxes.

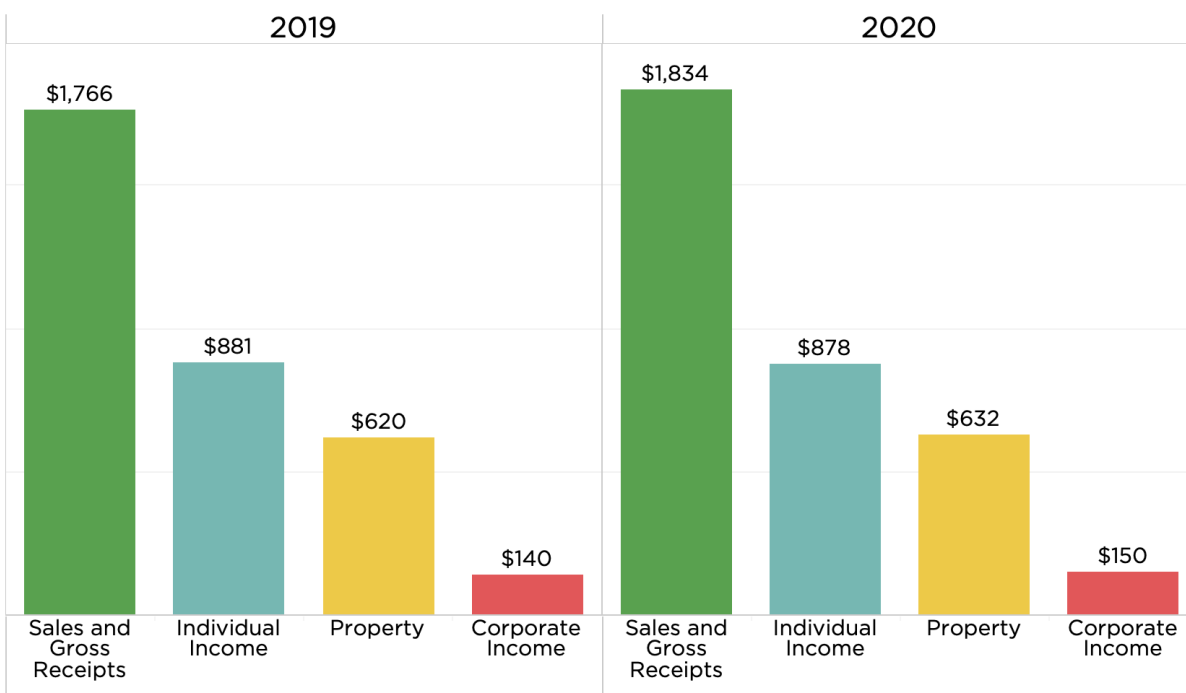
Though Alabama's sales tax *rates* are among the nation's highest, many services are not taxed, and wealth is lower. Thus, revenue from the sales tax is about average for the U.S.

In two categories, Alabama ranks in the top 10 for per capita collections: alcoholic beverages and public utility taxes.

## How Alabama Taxes Compare

In 2020, Alabama state and local governments collected \$3,756 per resident through sales, property, income, and an array of other taxes. That's up from \$3,677, in 2019, a gain of \$79. Alabama's per capita tax collections increased in all major categories, reflecting a growing economy, despite the economic disruptions of the pandemic.

Figure 2. Change in Alabama Per Capita Tax Collections, 2019-2020, Source: U.S. Census Bureau.



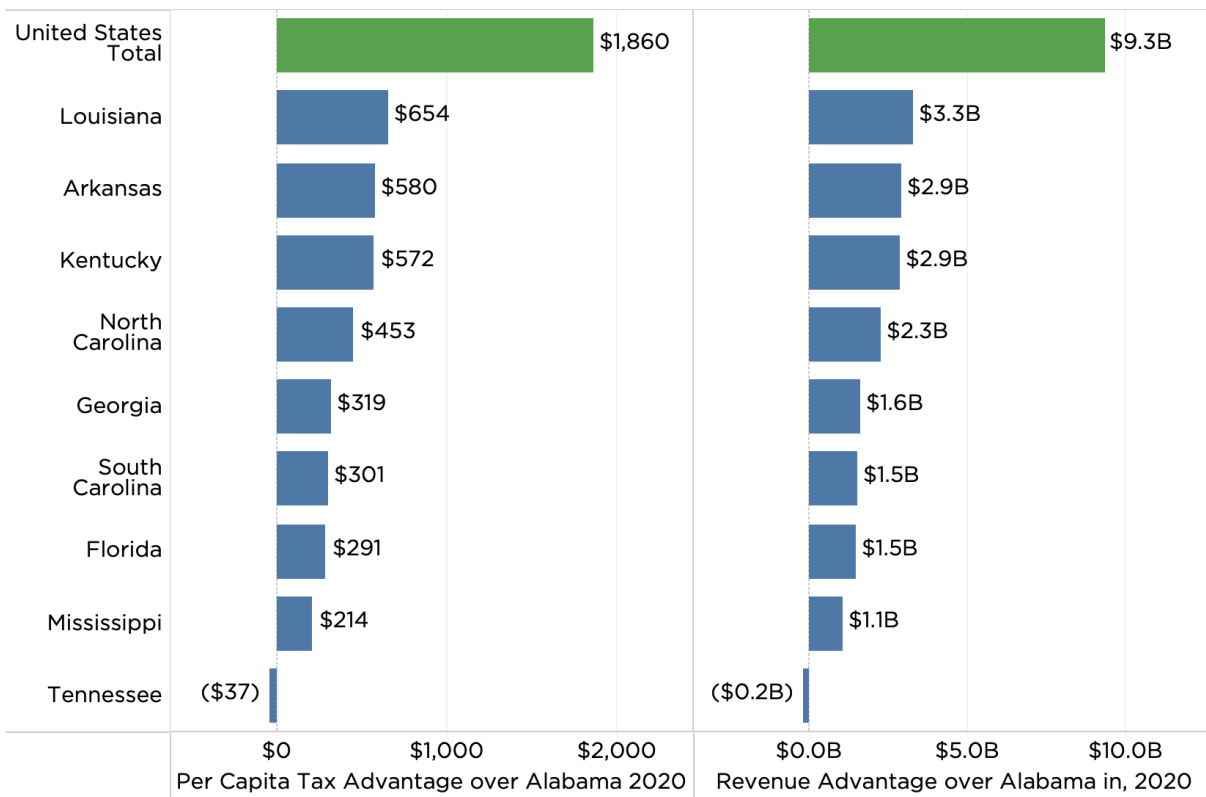
For Southeastern states, the average per capita rate was \$4,091, \$335 per resident higher than Alabama. The median value for U.S. states was \$5,210 per capita, \$1,454 more per resident than Alabama. The data for 2020 is the most recent year available.

Alabama's gain in per capita tax collections between 2019 and 2020 ranked fourth out of the 10 Southeastern states, trailing Tennessee, South Carolina, and Kentucky.

Figure 4 presents two sets of comparisons: 1) the per capita advantage enjoyed by other Southeastern states over Alabama and 2) the revenue advantage that level of taxation provides those other states.

The revenue advantage is each state's per capita tax advantage multiplied by Alabama's population. In other words, if Alabama's tax system produced the same level of revenue per capita as the comparison state, Alabama would have that much more to spend on providing services to its residents.

Figure 3. Southeastern States' Per Capita Tax Collection and Revenue Advantage Over Alabama, 2020



For instance, with the same tax base and tax rates as Louisiana, Alabama would bring in an additional \$3.3 billion in taxes. If Alabama collected taxes at the same per capita rate as South Carolina, Alabama would have an additional almost \$1.5 billion to spend. Mississippi, a state with less wealth and economic activity, nevertheless collects \$214 more per capita than Alabama.

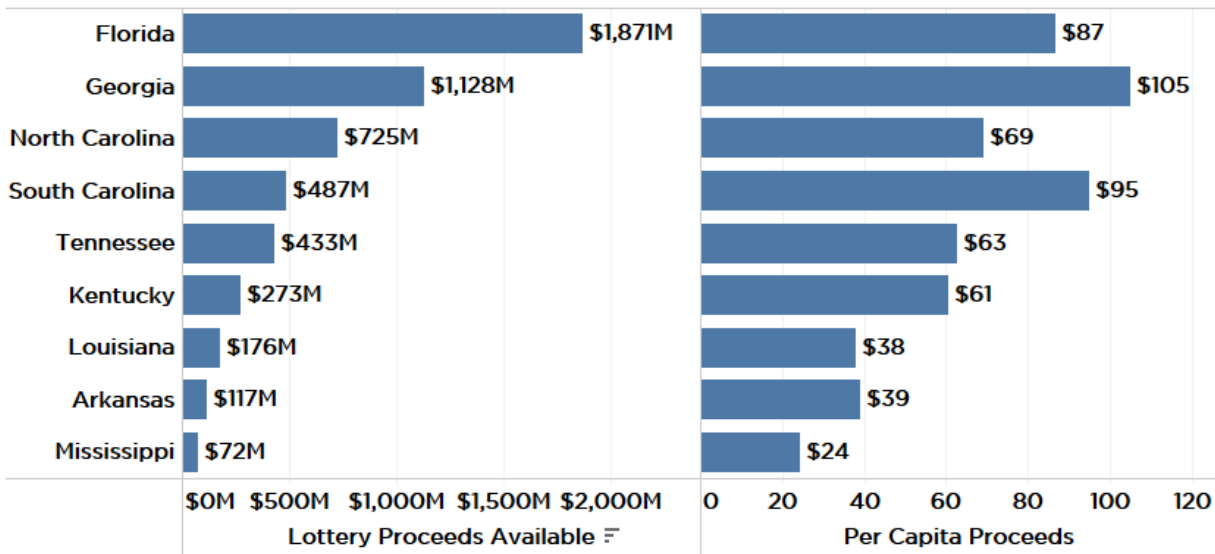
***If Alabama collected taxes at Mississippi's rate, the state would have an additional \$1.1 billion to fund education, health care, highways, public safety...***

If Alabama collected taxes at Mississippi's rate, state and local governments would have an additional \$1.1 billion in state dollars to fund education, health care, highways, public safety, and the broad spectrum of state and local services governments provide. Alabama had long held the title of the lowest state and local taxes per capita in the U.S. But in 2019 Tennessee slipped behind Alabama. In 2020, Alabama's lead over Tennessee diminished to \$37 per capita.

It should be noted that Tennessee has at least one source of revenue Alabama does

not: a lottery.<sup>8</sup> In 2020, Tennessee’s lottery provided almost \$500 million to spend on education-related programs. That includes college scholarships for Tennessee students.

Figure 4. Lottery proceeds and proceeds per capita, Southeastern states, 2020<sup>9</sup>



<sup>8</sup> All Southeastern states provide a lottery. Alabama doesn’t. These revenues are not included in the analysis. State taxes on other forms of gambling, like casino operations, are included in the comparison.

<sup>9</sup> US Census Bureau, “2020 Annual Survey of State Government Finances Tables,” Census.gov, accessed December 1, 2022, <https://www.census.gov/data/tables/2020/econ/state/historical-tables.html>.



## Alabama's Low Per Capita Tax Revenues

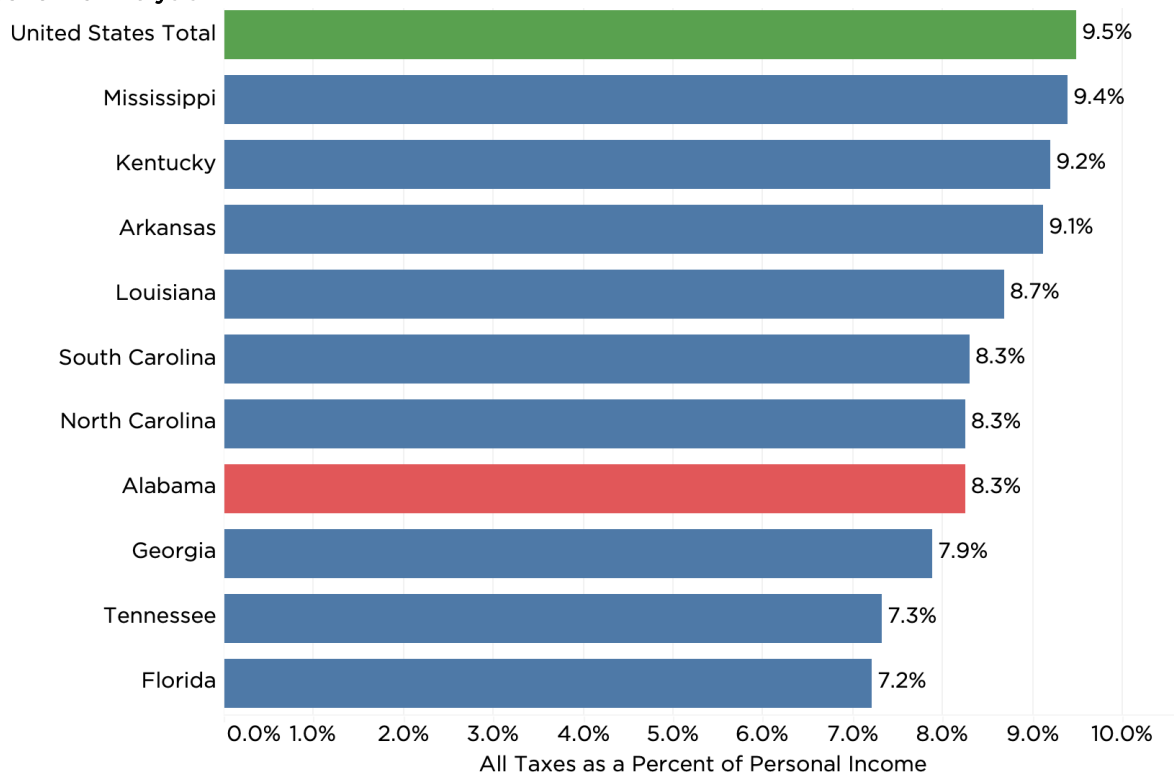
Our low tax revenue per capita results from two primary factors: lower tax rates than most other states and a smaller wealth base than most other states.

*Alabama has tax rates that are lower than most other states and a base of wealth that is smaller than most.*

### Taxes as a Percentage of Personal Income

Comparing total personal income to the total of state and local taxes collected, Alabama ranks No. 41 in the country, with state and local tax collections amounting to 8.3% of state residents' total personal income. This is an improvement in rank, but not in percentage. During 2019, Alabama was ranked No. 45 with the same figure of 8.3%.

Figure 5. Taxes as a Percent of Personal Income, 2020. Source: Census Bureau and U.S. Bureau of Economic Analysis.<sup>10</sup>



<sup>10</sup> U.S. Bureau of Economic Analysis, "SAINC1 Personal Income Summary" Retrieved Oct. 29, 2021, [https://apps.bea.gov/iTable/iTable.cfm?reqid=70&step=30&isuri=1&major\\_area=0&area=xx&year=2019&tableid=21&category=421&area\\_type=0&year\\_end=-1&classification=non-industry&state=0&statistic=1&yearbegin=-1&unit\\_of\\_measure=levels](https://apps.bea.gov/iTable/iTable.cfm?reqid=70&step=30&isuri=1&major_area=0&area=xx&year=2019&tableid=21&category=421&area_type=0&year_end=-1&classification=non-industry&state=0&statistic=1&yearbegin=-1&unit_of_measure=levels)

The states ranked below Alabama have a higher personal income per capita than Alabama, so despite collecting less as a percentage of total personal income, all those states, except Tennessee, raise more revenue per capita than Alabama. They can produce high tax revenues with less tax effort.

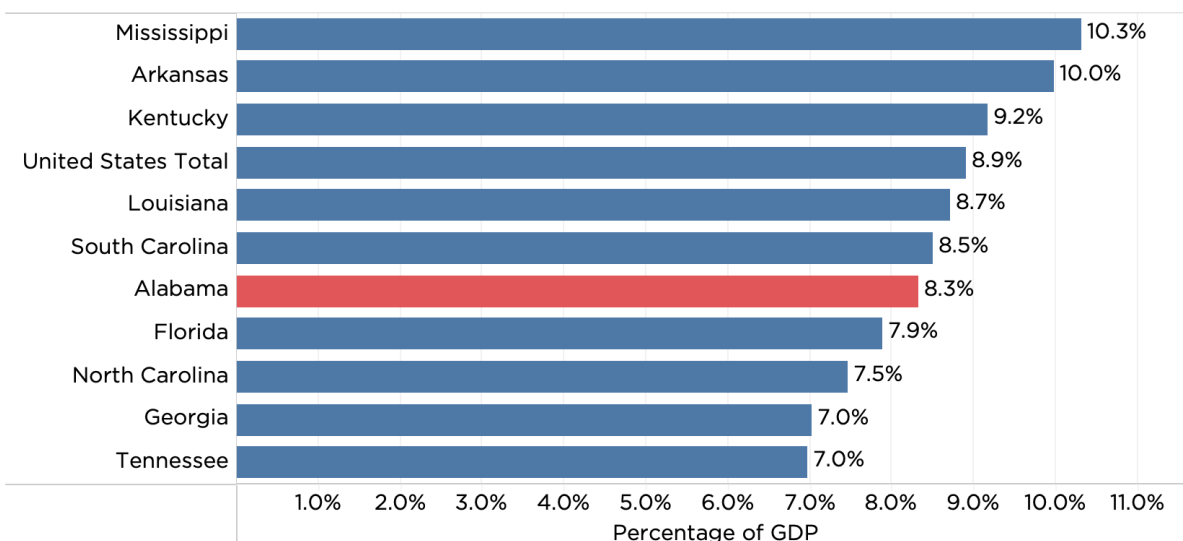
Mississippi's total personal income is lower than Alabama's, but its state and local government tax collections equaled 9.4% of Mississippi's total personal income for 2020. Because of that greater tax effort, Mississippi state and local governments have more to spend on a per capita basis than those in Alabama.

## Tax Burden as a Percent of GDP

Another way of measuring the tax burden is to calculate tax collections as a percentage of each state's gross domestic product (GDP), a measure of economic output.

Alabama tax collections amount to 8.3% of its GDP. The U.S. average for state and local taxes as a percentage of GDP for 2020 was 8.9%. Alabama ranks No. 35 in taxes as a percentage of GDP.

Figure 6. Taxes as a Percentage of GDP, 2020. Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis.<sup>11</sup>



As with the personal income measure, states like Georgia, North Carolina, and Florida have a higher economic output level than Alabama on a per capita basis. Thus, those states can tax at a lower percentage of economic activity and still yield higher tax revenues.

<sup>11</sup> "<https://Apps.Bea.Gov/Itable/Itable.Cfm?ReqID=70&step=1>," accessed December 6, 2021, <https://apps.bea.gov/itable/iTable.cfm?ReqID=70&step=1>.

## What We Choose to Tax

While a state's tax base and tax rates are primary drivers of the total revenue collected, a state's tax system is also affected by the mix of taxes it applies.

Every state has a unique blend of taxes. Most states depend on some combination of the three principal tax sources: income, property value, and sales transactions (what we earn, own, and buy).

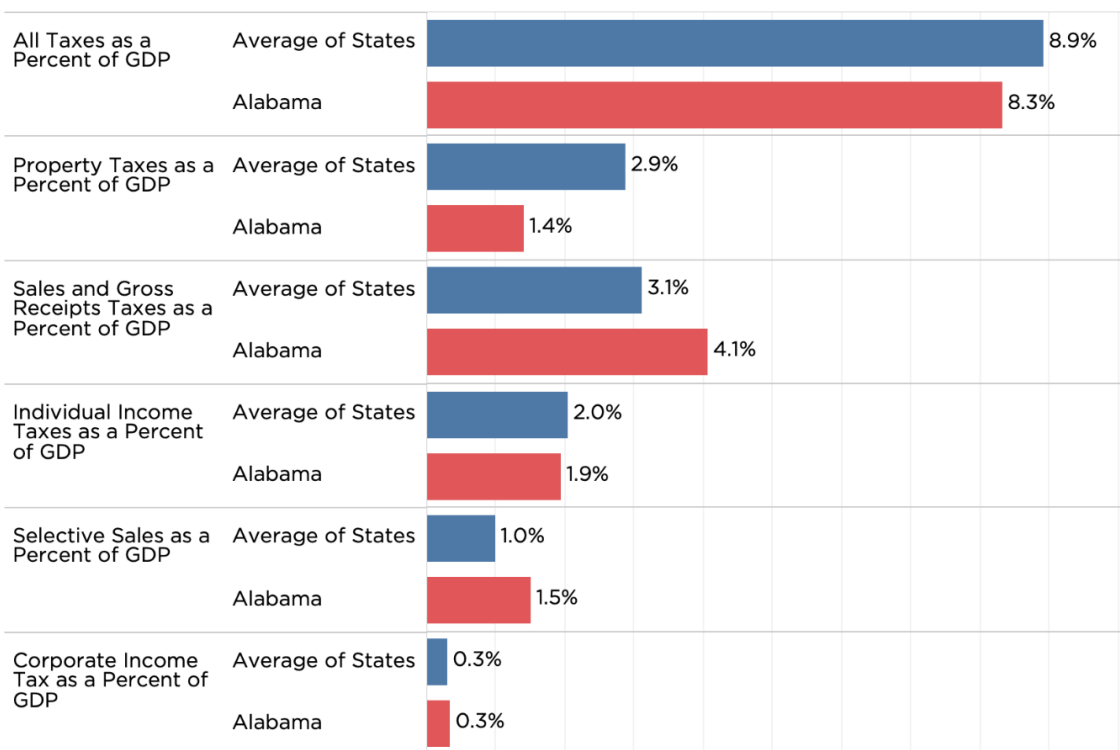
A tax system that is balanced among these three sources promotes fairness and stability.

### Alabama's Tax System Is Not Balanced

Figure 7 compares Alabama's tax mix to that of the average U.S. state. The relative share of each tax is expressed as a percentage of GDP. Alabama's overall tax burden is lighter, a smaller share of GDP, than the average U.S. state.

**Figure 7. Types of Taxes and Gross Domestic Product, Alabama and U.S. Compared, 2020.** Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis.

State and Local Taxes as a Percent of GDP

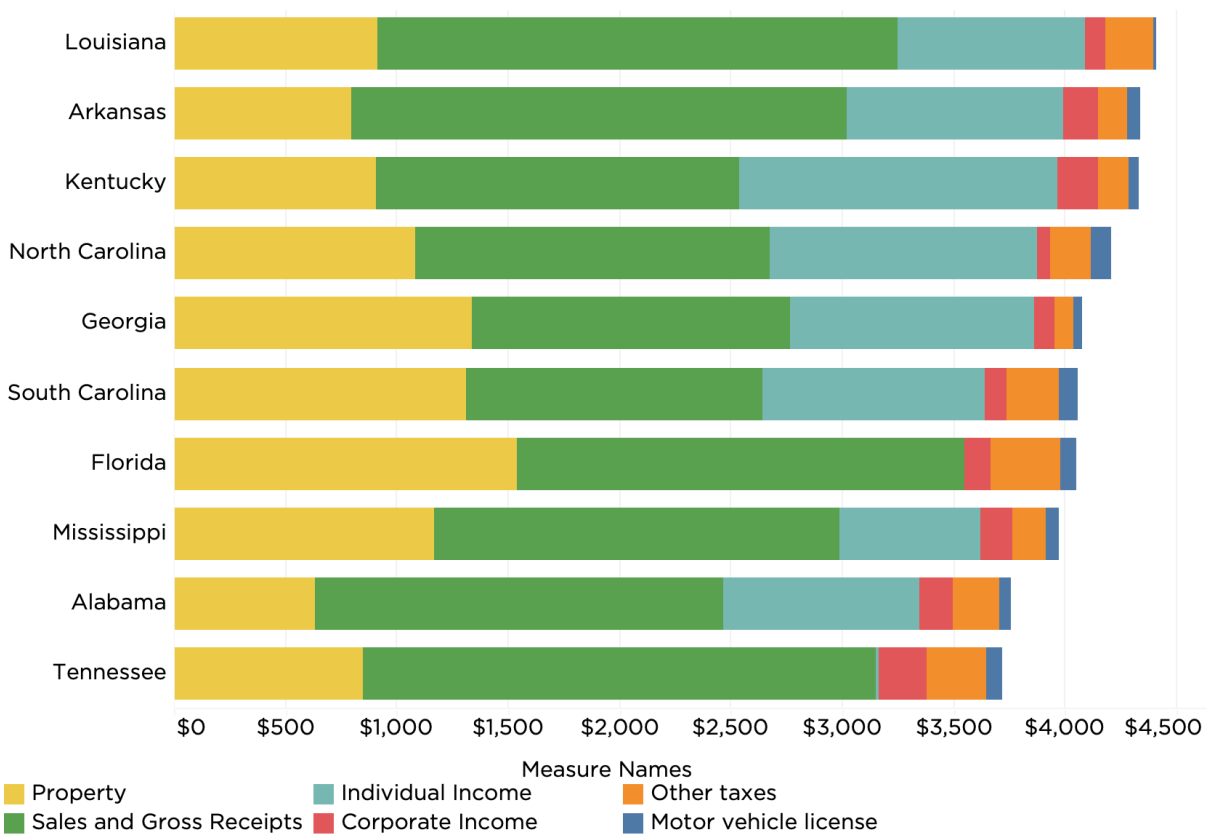


State and local property taxes are particularly low. As a percentage of GDP, Alabama's property taxes equal only 1.4% of GDP, compared to 2.9% in the average state. Alabama's per capita property tax collections could be doubled and still be below the U.S. average.

On the other hand, Alabama's sales and gross receipts tax is a higher share of GDP than the average state, indicating that Alabama depends more heavily on sales taxes to produce tax revenue than most states. That includes selective sales taxes, which, as represented by the green bars in the chart below, are also disproportionately relied on by Alabama governments.

Figure 8 compares Alabama's state and local tax mix with other Southeastern states, expressed on a per capita basis. The chart shows the different blend of taxes each state uses to produce total state and local tax revenues.

**Figure 8. Mix of Taxes Per Capita in the Southeast, 2020, by tax source.** Source: U.S. Census Bureau, PARCA Calculations.



The portion of the bar representing Alabama's property taxes, colored yellow, is shorter than the yellow section in any other state, reflecting lower per capita tax collections overall.

Alabama never catches up to other states, except one: Tennessee. Alabama's individual income tax provides enough to offset Tennessee's higher per capita property, sales, and corporate income tax collections.

Meanwhile, other states exhibit their own unique mixes. Florida does not have an income tax but makes up for it with high property and sales tax collections per capita.

*Florida compensates for no income taxes with higher per capita property and sales tax collections.*

## **The Tax Mix: A Balancing Act**

Although Alabama collects less in state and local taxes per resident than almost every other state, that does not guarantee low taxes for all. Because of the imbalance in the tax structure, taxes fall more heavily on some groups than others.

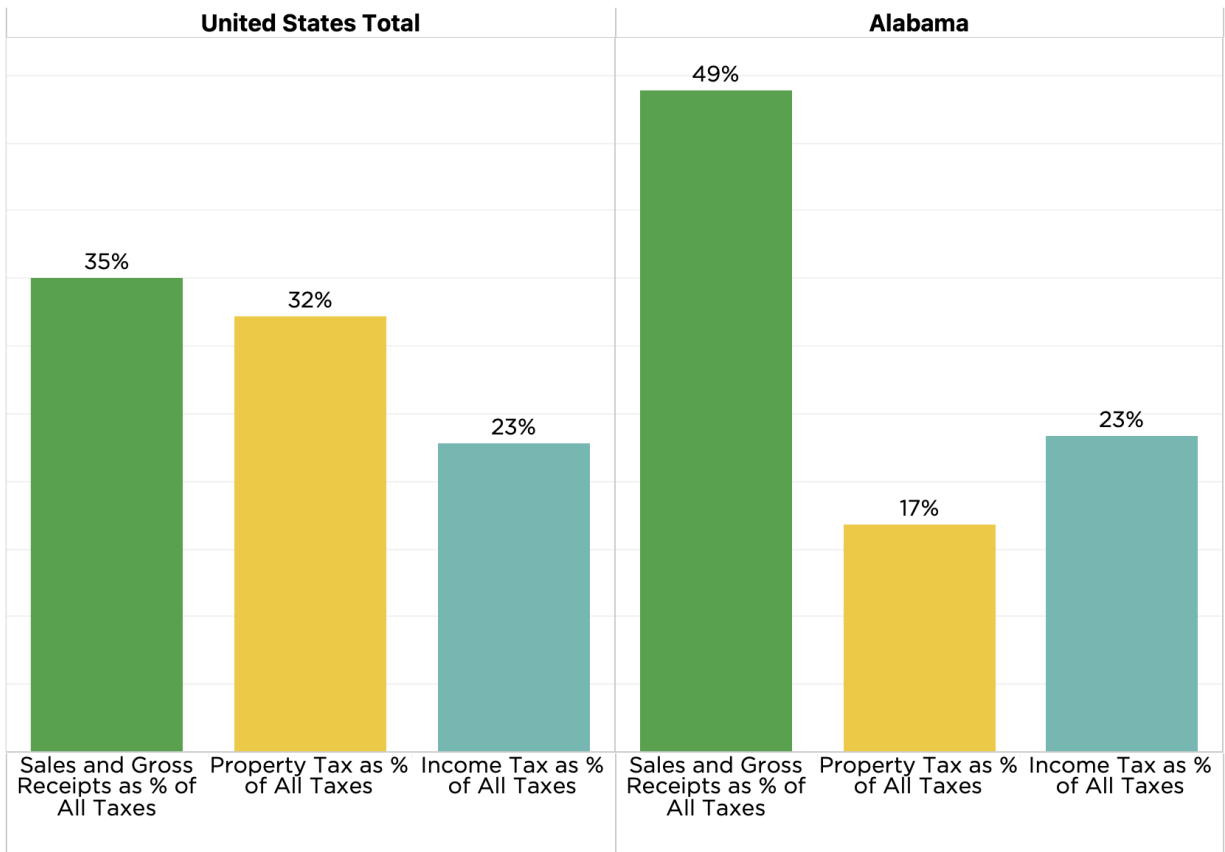
A sound tax structure avoids placing too heavy a burden on any particular group. Most states take measures to protect households with low incomes from taxation to encourage economic advancement.

### **Property Taxes**

Alabama's state and local property tax collections are lower than any other state, creating an imbalance in the state's tax system.

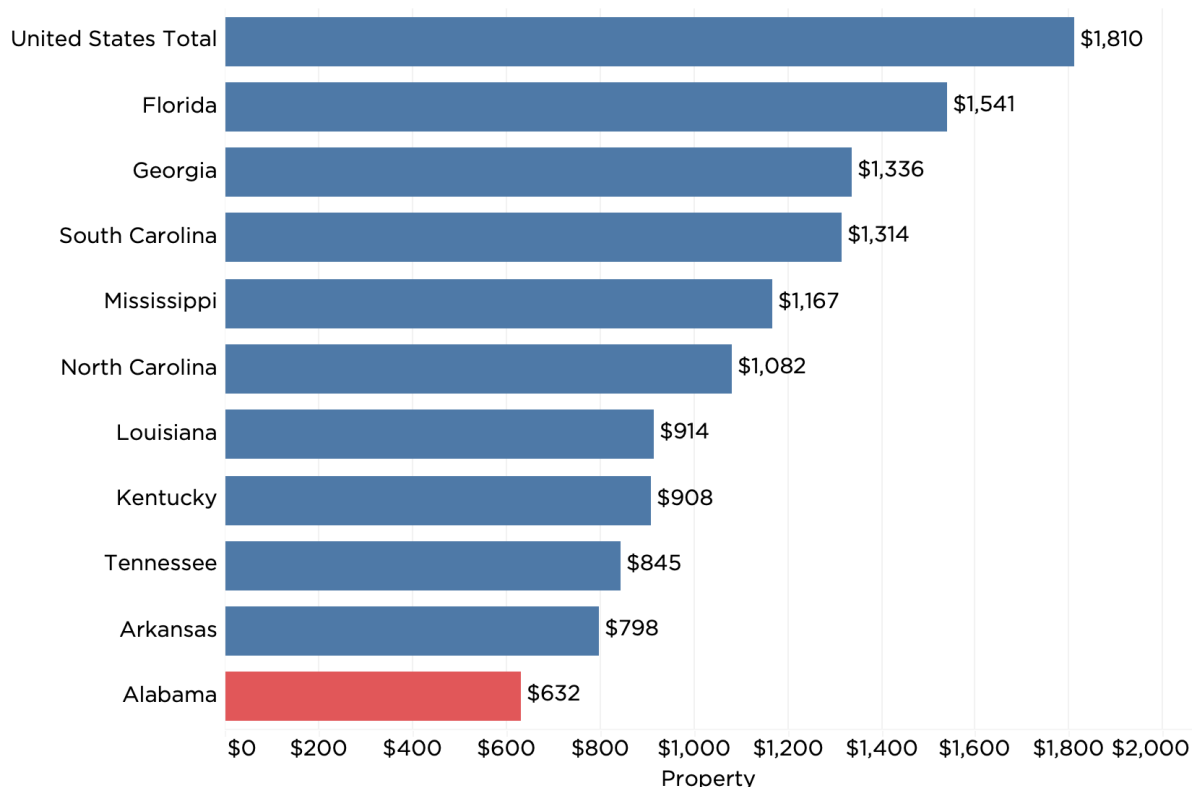
When all state and local revenue across the U.S. is considered, property taxes generate 32% of revenue, second to sales and gross receipts, and ahead of income taxes. In Alabama, property taxes account for only 17% of state and local revenue and rank third behind income and sales taxes.

Figure 9. Principal tax sources as a percentage of state and local tax revenues, all states vs. Alabama, 2020. Source: U.S. Census Bureau, PARCA Calculations.



Alabama's property taxes are low not only in comparison to all states but also in comparison to peer states in the Southeast.

**Figure 10. Per Capita State and Local Property Tax Collections, 2020. Source: U.S. Census Bureau, PARCA Calculations.**



The mechanisms for raising property taxes embedded in the Alabama Constitution make raising rates or adequate revenue through the property tax difficult. Local property tax increases must be recommended by a local government body, approved for the ballot by the state legislative delegation, and voted on by the affected voters.

Even if voters approve a rate change, Alabama's constitutional property tax classifications and caps hold down the amount of revenue generated. That is particularly true in communities with limited commercial property, where the land is mostly in homes or in agriculture.

Alabama's low property taxes primarily benefit those who own homes, farms, and timberland. Those properties are taxed on just 10% of their value. Their property tax bills are further reduced through homestead exemptions and valuations based on the current use of the property rather than current market prices for the land and buildings.

Meanwhile, taxes on commercial and industrial property are double that of residences or farms because that property is taxed on 20% of its value. Property owned by utilities is taxed on 30% of its value, three times the residential or agricultural property rate.

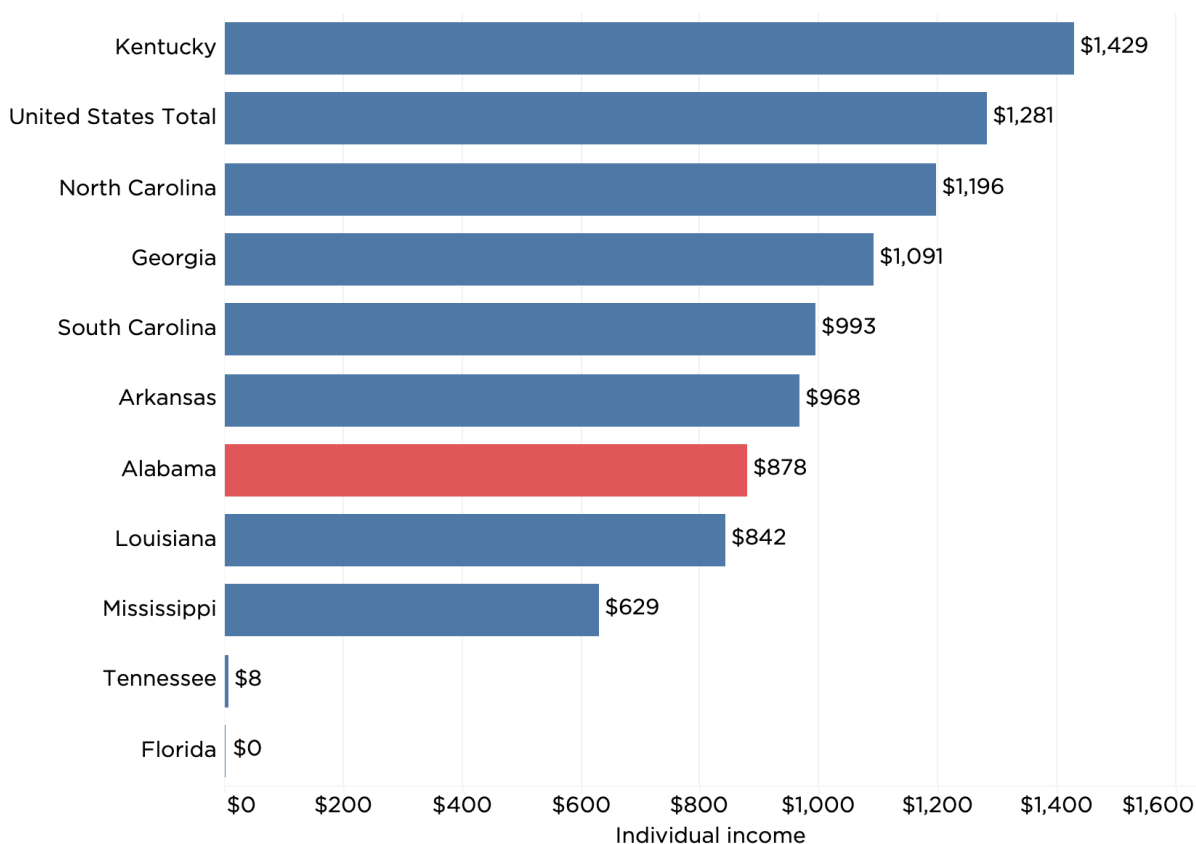
Under the current property classification system, an increase in property tax rates would be borne more heavily by businesses and utilities. Increases would also likely be passed along to consumers and to renters, since apartments are considered commercial property. And higher tax bills for utilities would likely be passed along to ratepayers.

## Income Taxes

In 2020, Alabama's income tax revenue per capita ranked 35th out of the 43 states that collect income taxes.

*In 2020, Alabama's income tax revenue per capita ranked 35th out of the 43 states that collect income taxes.*

Figure 11. Per Capita State and Local Individual Income Tax Collections, 2020. Source: U.S. Census Bureau, PARCA Calculations.



In many states, the income tax is progressive, applying a higher rate to individuals with higher income levels. The income tax can serve as a balance against the regressive nature of other taxes.

However, in Alabama, several features of the tax work to interfere with the progressive nature of the tax. It sets the lowest threshold for taxing income in the U.S., requiring poverty-level families to pay income taxes. And it gives an unusual



break to high-income earners: It allows a full deduction for federal income tax paid. That's a break that does nothing for low-income Alabamians but is generous to high earners. Allowing the deduction for federal income taxes results in \$689 million less in state income tax collections.<sup>12</sup> Alabama is the only state to allow both individuals and corporations to fully deduct federal income taxes paid when calculating state income taxes.

## History

Alabama's income tax was created in the depths of the Great Depression and at the time only applied to the wealthy. Authorized by a 1933 Constitutional amendment, Alabama income tax has just three tax brackets that closely resemble the brackets set up in the 1935 enabling legislation.

- The first \$500 of income is taxed at 2%
- Income between \$500 and \$2,999: 4%
- Income above \$3,000: 5%

Those tax brackets were supposed to create a progressive income tax that rises in percentage terms as the taxpayer's ability to pay rises. But, because the brackets have undergone only minor adjustment, they are almost meaningless today.

Also unchanged are the personal exemptions of \$1,500 for single adults and \$3,000 for married couples, created by the 1935 law that implemented the tax.

That meant married couples with \$3,000 of taxable income didn't pay income taxes. In 1935, personal per capita income was only \$216.<sup>13</sup> Thus, very few married couples or individuals made enough to be subject to the tax. In 1935, only 7,000 Alabamians earned enough to owe income tax, one-quarter of 1% of the population.<sup>14</sup>

A standard deduction was added later. In 2022, legislation raised the standard and dependent deductions shielding the first \$13,500 in income for a family of four from income taxes.

Since then, other states have continued to adjust their exemptions and standard

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<sup>12</sup> REPORT ON ALABAMA TAX EXPENDITURES, Legislative Services Agency, Fiscal Division. February 2022. [https://alison.legislature.state.al.us/2022\\_Tax\\_Expenditure\\_Report](https://alison.legislature.state.al.us/2022_Tax_Expenditure_Report)

<sup>13</sup> U.S. Bureau of Economic Analysis and Federal Reserve Bank of St. Louis, Per Capita Personal Income in Alabama [ALPCPI], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/ALPCPI>, December 6, 2021.

<sup>14</sup> Alabama Arise, "The Alabama Tax & Budget Handbook," *Alabama Arise* (blog), May 2, 2015, <https://www.alarise.org/resources/the-alabama-tax-budget-handbook/>.

deductions. Alabama continues to tax income at the lowest level threshold in the United States.<sup>15</sup>

In 2020, an Alabama family of four with income at the federal poverty threshold (\$25,701 in 2020) would pay \$674 income taxes. The legislative change in 2022 decreases that tax bill to \$565.

In most states, that family would not owe income taxes. In at least 19 states, that family would have received a tax credit payment designed to offset the burden of other taxes and to help support the family.

Similarly, the federal government has increasingly pursued a policy of leaving earned income in the hands of low-income households. The federal Tax Cut and Jobs Act of 2017 replaced exemptions and standard deductions with one larger standard deduction, a deduction that adjusts for inflation.

In 2022, a couple filing jointly will have \$25,900 of earnings shielded from federal income taxes through the standard deduction. In addition, the federal system adds a \$2,000 per child tax credit. And in addition to that, qualifying low-income families with children can receive money back through an Earned Income Tax Credit of up to a maximum of \$6,935.

***Taking into account exemptions and standard deductions, an Alabama family of four begins paying income taxes on anything earned over \$13,500.***

While Alabama does little to spare low-income households from the income tax burden, it provides a break that primarily benefits high-earning households. Alabama allows taxpayers to deduct the full amount they pay in federal income taxes. Due to changes last year in Iowa and Louisiana, Alabama is the only state where federal income taxes are fully deductible.

Since upper-income taxpayers pay a greater percentage of income in federal taxes, those higher earners get a larger break on Alabama income taxes. Meanwhile, the federal government has much larger deductions and exemptions, so the lowest-income workers pay little to no federal income taxes.

The deductibility of the federal income tax also creates unintended consequences.

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<sup>15</sup>“NCCP | 50-State Policy Tracker,” accessed November 22, 2022, <http://www.nccp.org/tools/policy/>

When federal taxes go down for individuals, their state taxes go up.

The income tax rate and the deductibility of federal income taxes are both embedded in the Alabama Constitution, so any change to the rate would require an amendment to the constitution.

Alabama can change the standard deduction legislatively and create a system of credits, if desired. Some states offset the effect of the sales tax on food by effectively paying back low-income families for the taxes they paid on groceries and medications. This is a method of compensating for the regressive nature of the sales tax, which takes a greater share of income from low-income households. It is a more targeted way to create balance than eliminating the sales tax on groceries for everyone.

## **Sales Tax**

Partly because of the difficulty of raising property taxes, Alabama state and local governments have developed a heavy reliance on the sales tax.

Alabama's sales tax rates are among the highest in the country. According to calculations by the Tax Foundation, Alabama has the fifth highest combined state and local tax rates in the country.<sup>16</sup>

And unlike many other states, Alabama's sales tax applies to groceries and medications. Alabama is one of three states that continues to apply sales tax fully to food purchased for home consumption without providing any offsetting relief for low- and moderate-income families.<sup>17</sup>

***Alabama state and local governments have developed a heavy reliance on the sales tax***

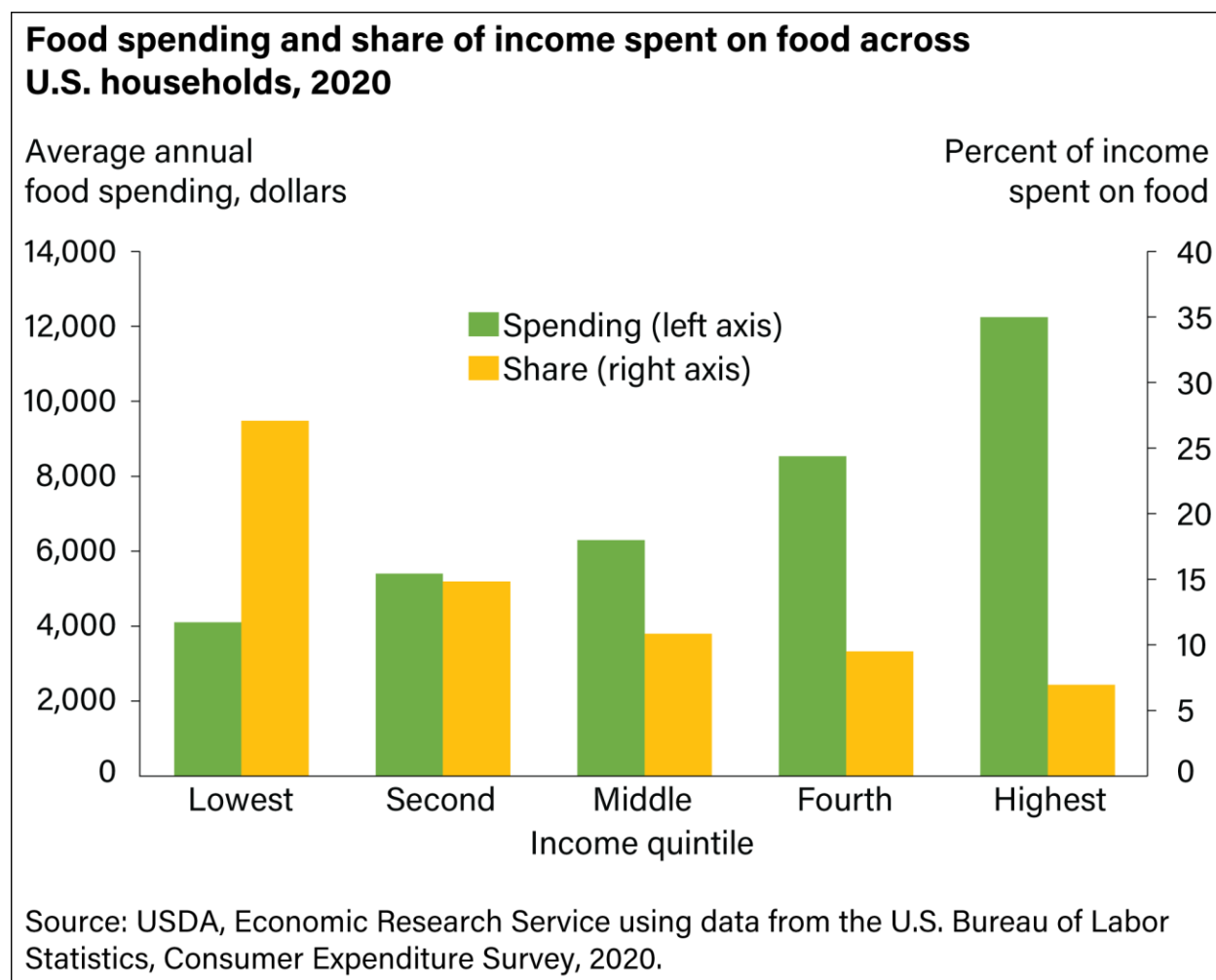
Because low- and moderate-income families spend a greater share of their incomes on basic necessities, a greater share of those families' incomes goes to paying state and local taxes.

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<sup>16</sup> Janelle Fritts, "State and Local Sales Tax Rates, Midyear 2022," *Tax Foundation* (blog), July 19, 2022, <https://taxfoundation.org/state-and-local-sales-tax-rates>.

<sup>17</sup> "States Can Thoughtfully Implement Grocery Tax Reforms to Help Families and Improve Equity."

Figure 12. Percentage of income spent on food, by income level, USDA estimate

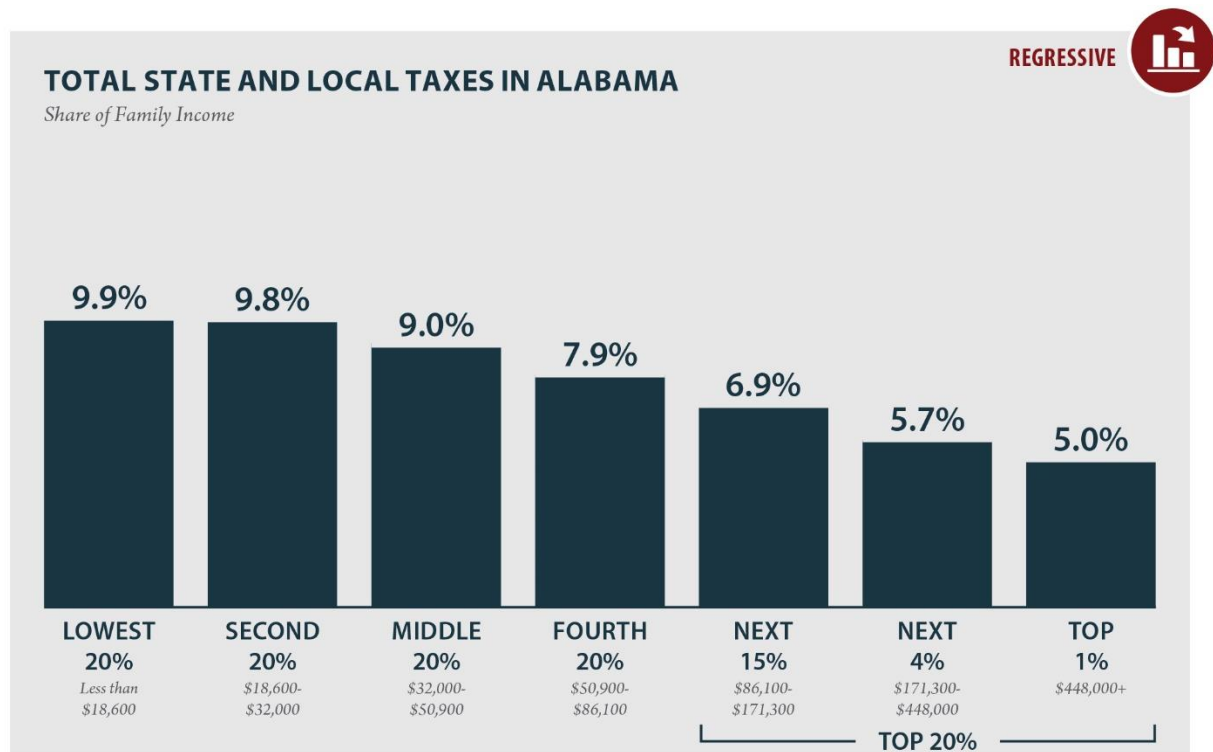


Alabama's high sales taxes contribute to the regressive nature of our tax structure. According to an analysis by the Institute on Taxation and Economic Policy, Alabama's tax system is the 18th most regressive state and local tax system in the nation.<sup>18</sup>

Under a regressive tax system, the poor pay a greater share of their income in taxes than the wealthy.

<sup>9</sup> <sup>18</sup> "Who Pays? 6th Edition," ITEP, accessed December 5, 2021, <https://itep.org/whopays/>

Figure 13. State and local taxes as a percentage of income, by income quintile. Source: Institute on Taxation and Economic Policy



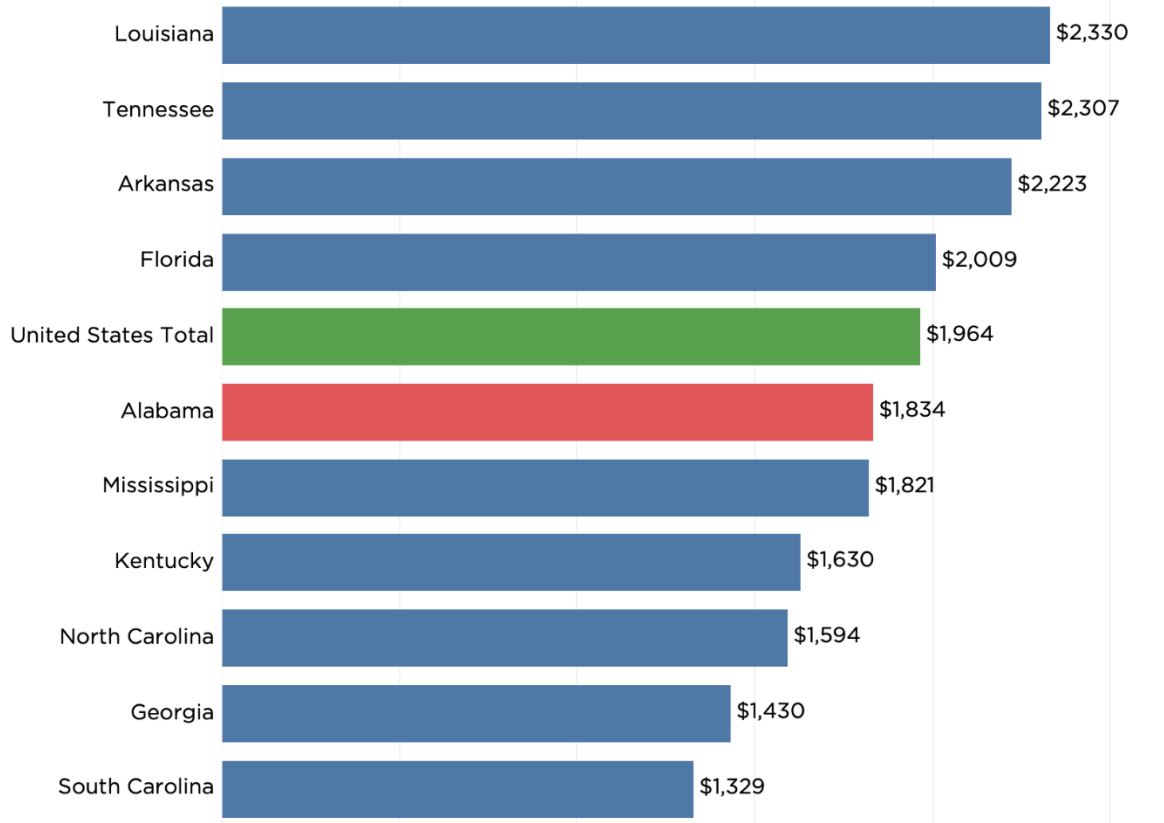
Alabama's per capita state and local sales tax collections rank 31st among the 50 states, despite high sales tax rates. Alabama's sales taxes are not as productive as other states' because of the smaller base of economic activity and because Alabama's sales tax is narrow compared to most states.

Alabama applies its tax to almost all sales of goods, but it does not apply the tax to most kinds of business, professional, computer, personal, and repair services. In recent decades, a greater share of economic activity has shifted toward the consumption of such services. According to a survey conducted by the Federation of Tax Administrators, Alabama taxes 42 out of 176 categories of services.<sup>19</sup> The median state applies the sales tax to 60 different services.

Other states also allow more forms of gambling than Alabama and apply a tax to that activity, bolstering the sales and gross receipts taxes in those states.

<sup>19</sup> Alt, R. (2017, August. Updated Jan. 2018). Sales Taxation of Services, Retrieved Oct. 30, 2020, from <https://www.taxadmin.org/sales-taxation-of-services>.

Figure 14. Per Capita Sales and Gross Receipts, 2020. Source: U.S. Census Bureau, PARCA Calculations.



From 2018-2020, the United States total per capita sales and gross receipts went from \$1,871 to \$1,964 (+93). Alabama's went from \$1,723 to \$1,834 (+111).

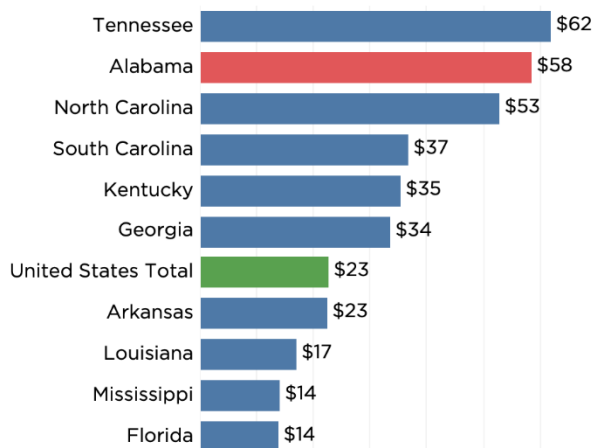
States, including Alabama, are pursuing various options for broadening the sales tax to capture the sales activity transacted on the Internet. Those transactions have, up until recently, been generally off-limits to taxation. In 2015, Alabama created the Simplified Sellers Use Tax, which captures some of the sales tax revenue from online sales. Further changes to that law were made in 2018. In June 2018, the U.S. Supreme Court issued a ruling that bolstered states' abilities to tax online sales. Since then, taxes on online sales have continued to climb, with \$185 million collected in FY2020, \$257 million in FY2021, and \$311 million in 2022. This tax source was particularly important during the pandemic, as consumers increasingly turned to online shopping and delivery.

## Selective Sales Taxes

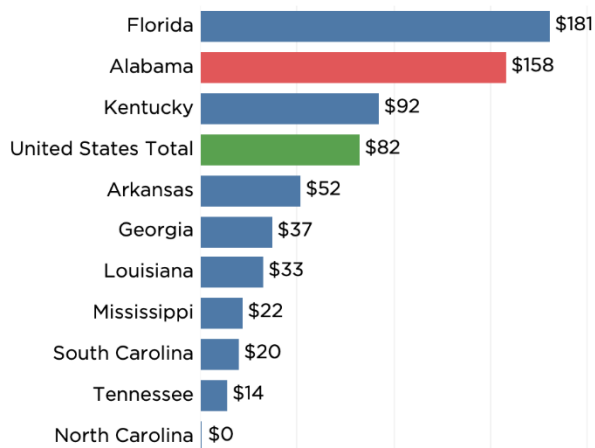
Alabama governments sometimes turn to selective sales taxes to avoid passing a general tax increase. For example, Alabama ranks high in per capita collections of taxes on alcoholic beverages (No. 3 in the U.S.) and public utilities (No. 6 in the U.S.).

**Figure 15. Per Capita Selective Sales Collections in the Southeast, 2020. Source: U.S. Census Bureau, PARCA Calculations.**

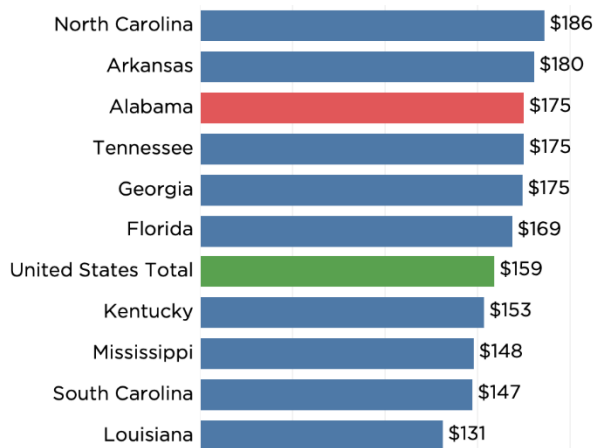
**SS: Alcoholic Beverages, 2020**



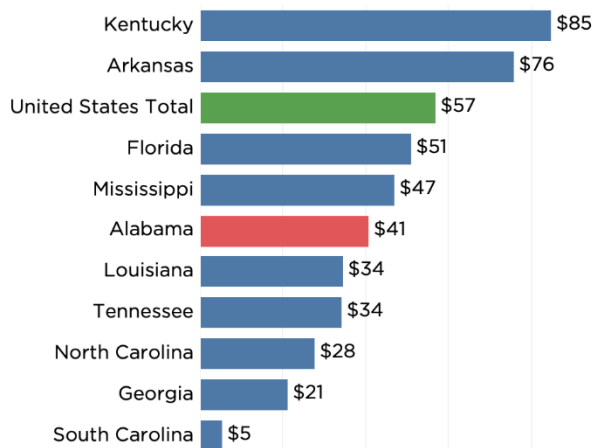
**SS: Public Utilities, 2020**



**SS: Motor Fuel, 2020**



**SS: Tobacco Products, 2020**



In 2020, Alabama ranked No. 20 in per capita state and local tax collections on motor fuel. It was previously ranked No. 32. From 2019 to 2020, while the nation stayed mostly the same, Alabama's collections on motor fuel increased from \$144 to \$175 due to increased tax rates.<sup>20</sup>

Even after the tax increase, Alabama's per-gallon tax rates remain below the national

<sup>20</sup> "Gasoline Tax," accessed December 2, 2022, <https://www.api.org/oil-and-natural-gas/consumer-information/motor-fuel-taxes/gasoline-tax>.

average, as does Alabama's current price per gallon.<sup>21</sup>

In 2020, per capita revenue on tobacco products ranked No. 37 in the U.S. Alabama's state-level tax rate on cigarettes remains relatively low, at 67.5 cents a pack, ranking No. 41 among U.S. states. This is no change from 2019. According to the Campaign for Tobacco-Free Kids, the median tax rate among states is \$1.91 per pack.<sup>22</sup>

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<sup>21</sup> "AAA Gas Prices," accessed December 2, 2022, <https://gasprices.aaa.com/>.

<sup>22</sup> "STATE CIGARETTE EXCISE TAX RATES," Campaign for Tobacco Free Kids, accessed December 9, 2021, <https://www.tobaccofreekids.org/assets/factsheets/0097.pdf>.



## Alabama Spending Compared

In the same survey of state and local tax revenues, the Census Bureau also collects data on the amounts spent by state and local governments. Each state divides responsibilities differently between state and local governments. Because of that, this analysis considers both state and local spending together. And as with the comparison of tax revenues, overall spending is divided by the state's population to arrive at a per capita calculation.

These expenditure figures include other non-tax state revenues, like fees, fines, charges, and lottery proceeds. They also include money that the federal government provides to state and local governments.

Some spending categories include federally funded assistance and subsidies based on the number of people in poverty in the state or in enrolled in a school. Since Alabama has higher poverty rates, federal support helps benefit Alabama's spending in those categories.

Similarly, public spending on hospitals and higher education is mainly supported through non-tax revenue. Hospital and higher education revenue primarily come from charges to students and patients, from federal support, donors, and investments, not from state or local taxes.

Alabama has more public universities than most states and draws in a disproportionate share of students from out of state to those public universities, which helps explain why Alabama ranks high on per capita expenditures on higher education.

Similarly, Alabama has a disproportionate share of health care delivered by public hospitals. Alabama ranks No. 8 in the U.S. for the percentage of hospitals

**Table 2. Alabama Rank in State and Local Per Capita Expenditures, 2020.**

Expenditure	Rank
Sewerage	49
Judicial and legal	47
Transit	45
Libraries	45
Elementary & secondary education	44
Corrections	44
Natural resources	42
Highways	42
Public welfare	41
Fire protection	40

Police protection	38
Insurance benefits and repayments	37
Health	35
Parks and recreation	34
Housing and community development	33
Interest on debt	32
Employee retirement	32
Protective inspection and regulation	30
Veterans' services	16
Assistance and subsidies	16
Liquor store expenditure	15
Higher education	14
Sea and inland port facilities	10
Hospitals	3

Aside from the categories mentioned above, Alabama's state and local spending is in the bottom tier of states.

For example, despite having one of the highest incarceration rates in the country, Alabama spends less per capita on its judicial and legal system and its correction system than most states.

Alabama provides no state funding for public transit, leaving communities reliant on local and federal funds alone. Spending on K-12 education also lags other states, particularly in the amount of revenue generated at the local level, thanks primarily to property tax restrictions.

## **How Alabama Manages Its Money**

The state has made progress in managing its spending. Historically, Alabama's tax structure has produced a roller-coaster effect: high revenues during periods of growth and sharp contractions during downturns. Better budgeting and saving policies have protected against that historical volatility in recent years.

Also, in the past, faster-growing taxes were fed into the Education Trust Fund, while the General Fund, which pays for non-education agencies, subsisted on taxes that were slow to grow.

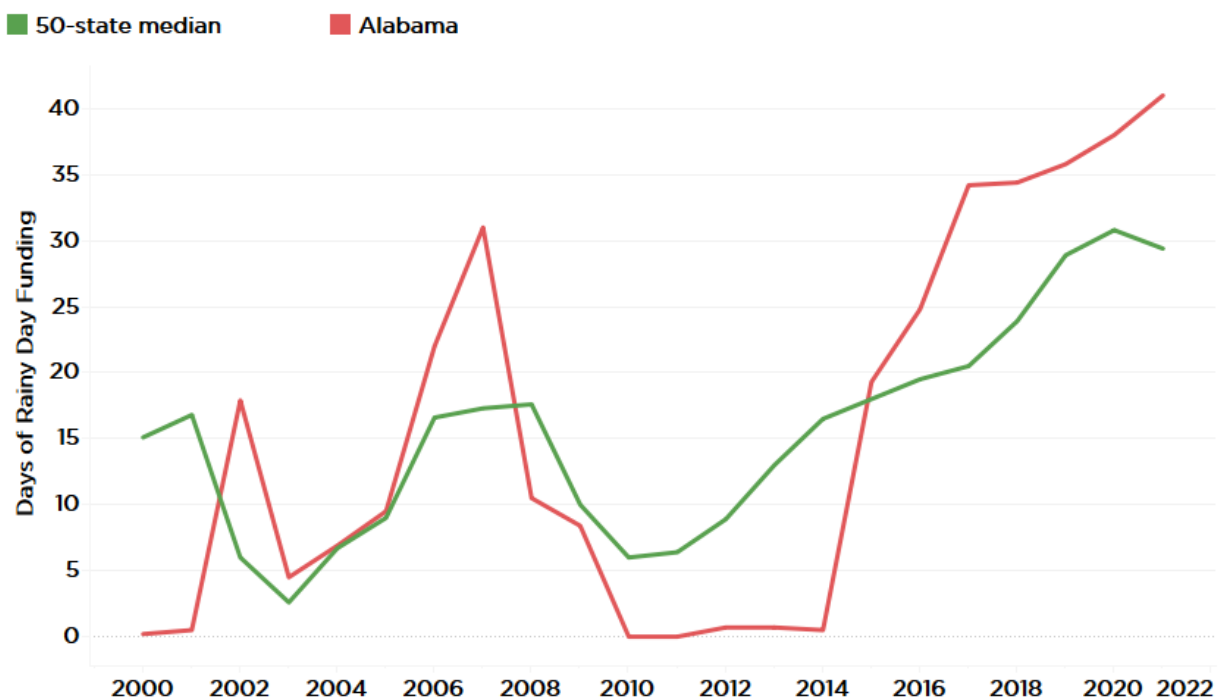
That artificial constriction of revenue in the General Fund is related to Alabama's habit of earmarking taxes by law for particular purposes. That gives the Legislature little discretion to move money as needs change. Consequently, the General Fund was frequently in crisis, with no cash available to pay for growing expenses like Medicaid and prisons.

Recognizing the problem, legislators have shifted some growing tax sources into the General Fund. That includes sending 75% of the tax on online sales, the Simplified Sellers Use Tax, to the General Fund. The result of that change and others like it has been that the General Fund and Education Trust Fund have grown at roughly the same rate for the past several years.

Also, another legislative innovation, the 2011 Rolling Reserve Act, has restrained overspending during flush years while at the same time strengthening state reserves that are available to tap if the economy falters.

Alabama's Rainy Day Funds now contain enough money to cover government operations for 41 days—that's well over the previous peak of 31 days, a level reached before the Great Recession. Those Rainy Day Funds were completely drained during the Recession but almost have been fully repaid, with over \$1 billion now available in case of a downturn. The national median for Rainy Day funds is 29 days. Alabama's current total is the 16<sup>th</sup> highest in the U.S.<sup>23</sup>

Figure 16. Number of Days the Government could operate on Rainy Day Funds. Source: Pew Charitable Trusts.



<sup>23</sup> "Fiscal 50: State Trends and Analysis," accessed December 3, 2021, <http://pew.org/1Etrxxk>.

## Conclusion

Though state finances were slow to recover from the Great Recession, Alabama's leadership has made changes to the tax system that have increased stability, transferred some growth taxes to the General Fund, and rebuilt depleted state reserve funds.

Economic growth in Alabama has allowed Alabama's tax system to become more productive. More revenue is generated by an expanding number of people in the workforce earning better wages.

However, we still collect less in state and local taxes per capita than any state besides Tennessee.

Though comparative figures are not yet available, all states likely experienced a surge in tax collections in FY 2021 and FY 2022 due to federal relief and stimulus and due to inflation, which increases the cost of purchases and thus the amount of sales tax collection. Inflation and the scarcity of labor has driven up wages as well. Since Alabama depends disproportionately on sales tax to fund state and local government, Alabama governments are seeing larger-than-normal surges in revenue.

It is important to remember that the current situation is unusual and temporary. It is an opportunity to make investments aimed at remedying chronic deficits. Any adjustments made to the tax system should address the inequities, adequacies, and inefficiencies in the current tax system.



# Public Affairs Research Council of Alabama

## WHO WE ARE

The Public Affairs Research Council of Alabama is a nonpartisan research organization focused on helping state and community leaders make better-informed public policy decisions.

## WHAT WE BELIEVE

State and community leaders make better-informed decisions when provided with unbiased, nonpartisan data and resources about the topics they care about the most.

## HOW WE WORK

We conduct *nonpartisan research* on issues affecting the people of Alabama so state and community leaders, and others, can make better-informed decisions based on facts, not rhetoric.

We *independently evaluate* the efficacy of public programs and services.

We offer technical and research assistance for public and nonprofit partners to help them integrate the use of *accurate data* into their work.

We engage in *meaningful dialogue* with state and community leaders and others on the topics Alabamians care about the most.



## WHY WE MATTER

There are many groups and organizations vying for the attention of state and community leaders. It's often hard to identify what's real from alternative facts and partisan-leaning talking points. Our founders started the Public Affairs Research Council of Alabama more than three decades ago to counter the rising tide of misinformation. They recognized then, and it remains true today, that emotional appeals and fiery rhetoric often lead to indecision and false choices.

### Major Projects

PARCA's research informs major policy debates of the day and is relied upon by policymakers and policy organizations across the spectrum.



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205-726-2972



info@parcalabama.org



@PARCA.AL



@parcalabama



@parcalabama



**Public Affairs  
Research Council  
of Alabama**

P.O. BOX 293931  
800 LAKESHORE DRIVE  
BIRMINGHAM, ALABAMA 35229  
205-726-2482

[PARCALABAMA.ORG](http://PARCALABAMA.ORG)