

Analyzing Georgia's Tax Reform Proposal

By Kelly McCutchen

Starting Point: The Tax Council's Final Report

When the Tax Council submitted its final recommendations, the fiscal impact had not been fully calculated. Fiscal conservatives worried this was a large tax increase, even though the Tax Council emphasized their goal of making the proposal revenue neutral. The intent of the Council was for lower tax rates to offset additional revenue.

When the final fiscal analysis was presented, it showed an immediate reduction to an income tax rate of 4 percent would still result in excess revenues of almost \$1 billion¹ -- enough to reduce income tax rates to approximately 3.5 percent. Given this fact, it is not surprising that despite forgoing several new taxes, the new proposal calls for an income tax rate of 4.5 percent.

The Number One Goal: Economic Growth

The growth rate of per capita personal income in Georgia over the last decade is next to last in the nation. We clearly need something to give our economy a jolt. Economists tell us reducing income tax rates is the best policy solution to stagnant growth. This clearly works at the national level, but how about the state level? The Federal Reserve Bank study below is one of many studies showing that income tax rate reduction is a good policy for state tax reform.

In examining the impact of average tax rates and marginal tax rates on income growth over the period of 1961-1992, the Federal Reserve Bank of Atlanta concluded, "**relative marginal tax rates have a statistically significant negative relationship with relative state growth.**" It further found that state and local tax rates "have temporary growth effects that are stronger over shorter intervals and a permanent growth effect that does not die out over time." The study states, "If growth is a policy objective, one should, at the very least, assess whether tax policies are out of line with other states. **If long-term growth rates seem too low relative to other states, lowering aggregate state and local marginal tax rates is likely to have a positive effect on long-term growth rates.** This likelihood is greater if the reduction in marginal tax rates is sustained rather than temporary."²

Changes in the personal income tax also impact small businesses. Ninety-three percent of small businesses are organized as "pass through" or "flow through" entities – sole proprietorships, partnerships, Limited Liability Companies (LLCs) or Sub-Chapter S corporations. These entities are not subject to state or federal corporate income taxes; their net income is passed along to the owners who pay personal income tax on that income. These businesses produce over half of the business net income in the nation.³

This means that a reduction in the personal income tax rate is a tax cut for entrepreneurs and the majority of small businesses in Georgia. In fact, many of the taxpayers who appear "rich" are in fact small

¹ "Estimated Change in Tax Liability of Tax Reform Council's Proposals," (David L. Sjoquist, Sally Wallace, Laura Wheeler, Ken Heaghney, Peter Bluestone, and Andrew Stephenson), March 2011, http://aysps.gsu.edu/frc/files/Brief_229.pdf

² "Do State and Local Taxes Affect Relative State Growth?" Zsolt Becsi, Federal Reserve Bank of Atlanta, *Economic Review*, March/April 1996, <http://www.frbatlanta.org/filelegacydocs/ACFD5.pdf>

³ http://www.ustreas.gov/press/releases/reports/07230_r.pdf, page 16, Chart 3.1

business owners recognizing a one-time windfall of revenue from selling their business. This is often the nest egg that will provide for their retirement. There are many anecdotes of small businesses moving to Florida just before their sale to avoid Georgia's 6 percent income tax rate.

Many recommendations from the Tax Council's plan have been removed in this proposal, but the most important part – the reduction in the personal income tax rate – remains.

Changes in the New Proposal

The Tax Council's recommendations were absolutely correct from an academic perspective. They followed the advice of tax experts and economists and aligned the recommendations to proven tax principles. Political consideration was not their concern. However, in order to pass a bill it must pass political muster. As a result, the Joint Committee appears to have removed several of the recommendations due to a lack of consensus.

Below are the major recommendations NOT included in the new proposal and their estimated fiscal impact:

Tax Council Recommendations Excluded from Current Proposal	Fiscal Impact In Millions
Eliminate Retirement Income Exclusion (at 4.5% rate)	- \$540
Eliminate Exemption for Food for Home Consumption	- \$463
Add Sales Tax to Selected Services	-\$252
Reduce Corporate Income Tax Rate to 4%	\$224
Increase Cigarette Tax to \$68 cents per pack	<u>- \$114</u>
Total Fiscal Impact	-\$1,145

Losing these additional revenues causes the personal income tax rate to increase to offset the loss of revenue.

Changes to the Personal Income Tax

The Tax Council recommended moving Georgia to a flat income tax. The six current brackets will be reduced to one lower rate of 4.5 percent, a reduction of 25 percent. The marriage penalty inherent in the current tax code is also eliminated. Eliminating exemptions and deductions simplifies the code for taxpayers and broadens the tax base. For most people who are able to put all of their savings into a tax-free account like an IRA or 401(k), this flat tax essentially becomes a consumption tax. (Income less Savings = Consumption.)

The Tax Council recommended eliminating the standard deduction, itemized deductions and personal exemptions. They also recommended reducing the dependent exemption from \$3,000 to \$2,000 per dependent. To offset the loss of these exemptions and deductions, the Tax Council recommended replacing Georgia's existing low-income tax credit with a larger credit. This recommendation was kept in place.

It appears that there was still a concern about the impact on low- and middle-income families being impacted by the loss of itemized deductions and the lower dependent exemption.

To offset this impact, the final proposal includes an allowance of up to \$17,000 of itemized deductions for married filing joint and head of household families, which is phased out from income levels of \$75,000 to

\$92,000. (The cap and the phase out levels are 50 percent lower for single and married filing separate filers.) In addition, a dependent credit of \$150 per dependent was added, also with a phase out.

Does \$17,000 in itemized deductions cover most low- and middle-income Georgians? According to Georgia Department of Revenue data, 90 percent of Georgia taxpayers have incomes below \$100,000. Although the 10 percent of higher income taxpayers with incomes above \$100,000 will receive the greatest benefit from the reduction in the tax rate, they will also lose their itemized deductions, which account for 43 percent of the total.

The largest itemized deduction is mortgage interest. According to the latest data from the Census Bureau, the median value of owner-occupied homes in Georgia is \$160,100.⁴ Based on data from the IRS, the average mortgage interest deduction for incomes of less than \$100,000 is \$9,155. The same data shows the average charitable contribution is \$3,083 and the average property tax paid is \$1,979.

Average Itemized Deductions Georgia Families with Income Less Than \$100,000 (IRS data, 2008)	
Mortgage interest	\$9,155
Charitable contributions	\$3,083
Property taxes paid	<u>\$1,979</u>
	\$14,218

The \$17,000 limit is sufficient to cover these basic expenses. For those with itemized deductions greater than \$17,000, they would pay 4.5 percent on the amount above \$17,000. This additional tax would be somewhat offset because it is deductible from federal income tax. As more income is taxed at the lower 4.5 percent rate, the savings will start to offset any additional taxes paid on the lost itemized deductions.

There is a concern that limiting itemized deductions might limit charitable deductions. We believe this is unlikely. First, we believe that most people donate because they support the charity, not to receive the tax deduction. Second, if they are motivated by the tax deduction, the impact of the state income tax deduction is minimal compared to the federal tax deduction. Third, the top marginal rate was reduced by 22 percentage points during the Reagan tax reforms, but charitable donations increased despite this large disincentive. What drives charitable giving is economic growth – and that is the goal of this tax reform.

Flat Tax Winners and Losers

Without access to actual Georgia tax return data it is very difficult to get precise estimates, but we are able to make some general projections based on aggregate data. Under this new plan, our projections show everyone who takes the standard deduction on their federal form will be better off. For itemizers, it depends on the amount of itemized deductions and their income level. Our best estimate is 85 percent of Georgians will pay about the same or less under this proposal than under the current income tax code.

The biggest impact will be on taxpayers with large itemized deductions. Itemized deductions complicate the tax code and require more recordkeeping by taxpayers. Itemized deductions also pick winners and losers by causing families that have made different spending decisions to pay much higher taxes than other families with the same income. Currently, 20 states do not allow itemized deductions, including the

⁴ [2005-2009 American Community Survey 5-Year Estimates](#), Georgia Fact Sheet, U.S. Census Bureau

9 states with no income tax, and four states put limits on itemized deductions. Arizona is currently debating eliminating itemized deductions.⁵

Given the economic inefficiency of itemized deductions, we support the reduction. However, the new proposal strikes a fair balance by allowing a reasonable amount of itemized deductions for low- and middle-income taxpayers, even though a pure consumption tax would not allow these exemptions.

Revenue Neutral

The proposal is about as close to revenue neutral as possible. Except for the estimates for the income tax changes, the cost of the other major changes are not materially different from the Tax Council's projections, but have simply been updated to FY2012. The projected loss on the changes to the personal income tax are in a range, so the final estimates contain a range of possible values. The range almost perfectly distributed around being slightly revenue positive and slightly revenue negative. The differences are less than 0.05 percent of total revenues.

Proposed Tax Reform Changes	Fiscal Impact In Millions
Apply Communications Service Tax, eliminate local taxes and eliminate sales tax on capital investment	\$195
Apply sales tax to casual sales excluding immediate family members	\$151
Apply sales tax to automobile repair services	\$46
Eliminate sales tax on energy used in manufacturing	-\$163
Change in agriculture exemptions	-\$4
Adopt a Flat Personal Income Tax and reduce the rate to 4.5%	<u>-\$214 to -\$232</u>
Net Revenue Change	-\$7 to \$11

Removing the Sales Tax on Energy

This is something that both Democratic and Republican legislators have tried to accomplish for over a decade. Not only is it bad tax policy to tax a business input, but being one of only 14 states to tax this large expense has dramatically hurt Georgia's competitiveness in manufacturing. None of our neighboring states fully tax energy used in manufacturing – it is totally exempt in every state except for North Carolina, which uses a reduced rate. This reform is critical to allowing us to attract and keep high-wage manufacturing jobs.

Removing the Sales Tax on Telecommunication Investment

Consumers say they want fewer dropped cell phone calls, more high definition channels and faster Internet speeds. These benefits are directly related to the amount of private capital investment by telecommunication companies in Georgia. Paradoxically, Georgia applies a sales tax on telecom capital investment. As with taxing energy in manufacturing, this is bad tax policy and hurts our competitiveness. When telecom companies are deciding how to deploy their investment capital, we want Georgia to be at the top of their list.

In exchange for this sales tax exemption, a new Communications Services Tax would apply a 7 percent sales tax to all television and telephone services at the retail level. The proposal eliminates hidden taxes

⁵ "New Analysis of Arizona Income Tax Reform," <http://www.taxfoundation.org/news/show/27145.html>

and fees at the local level, increasing transparency for consumers. Local governments would be held harmless because they will receive a portion of the new retail sales tax.

Our tax code does not reflect the dramatic change in technology and services available today in telecommunications. Currently, consumers buying a functionally equivalent service are faced with dramatically different tax rates. Traditional telephone users pay 10 percent tax, subscribers telephone service from cable companies pay 7 percent, cell phone users with basic plans pay 7 percent, cable video subscribers pay 5 percent and satellite video subscribers pay no tax. Some of the “fees” paid by traditional telephone and cable companies are supposedly used by local governments for maintenance of the right of way, although many local governments admit there are few unreimbursed costs associated with right of way maintenance.

Our recent study, “Communications Tax Reform: Emerging Technologies that Promote Investment and Customer Choice,” discusses this issue in depth.⁶

Telecommunications is critical to Georgia attracting jobs, both in urban and rural areas. Telecommuting, telehealth, digital learning and other technologies can help Georgia overcome many challenges, but are dependent upon high bandwidth and reliable service. Removing barriers to investment and encouraging competition is good policy. It is also good policy to make taxes transparent to the consumer and to tax similar services in a similar and fair manner.

Sales Tax on Services

The appropriate sales tax base is all consumer purchases, whether they are a good or a service. However, there are many issues to consider including competition with other states, ease of compliance and ease of administration.

The largest untaxed services are housing and health care. The likelihood of passing a tax on either at this time is remote.

Other professional services, such as attorneys, consultants, architects, programmers and financial advisors certainly have a strong lobby, but the biggest challenge is more practical. If we tax financial advisors, for example, it would be very simple to shift your business to a financial advisor in another state. So instead of getting new tax revenue, we would damage our existing industry. (Our shortsightedness in banking regulation helped shift the leadership in the banking industry from Georgia to North Carolina, but that is another story.)

For services like lawn care, landscaping and barber shops, the challenge is administration and compliance burdens. Most of these entities would have to start collecting sales tax and send in monthly sales tax payments. Not only would this be burdensome on the small businesses, but it would also be very difficult for the Department of Revenue to ensure compliance. This is not impossible, but the Joint Committee appears to feel this was not the right time to extend the sales tax to these services.

What is left in this process of elimination is automobile repair. Consumers are already paying sales tax on their motor oil and air filter when they get an oil change. It is simple for the automobile repair shop to just apply the sales tax to the entire bill rather than separating out parts and labor. These shops are already filing sales tax payments, so the burden is minimal. From a collection perspective, they are already “in the system.”

⁶ [“Communications Tax Reform: Emerging Technologies that Promote Investment and Customer Choice,”](http://gppf.org/article.asp?RT=8&p=pub/GovernmentReform/IATelecom101105.htm)
By Eric Tresh, November 5, 2010,
<http://gppf.org/article.asp?RT=8&p=pub/GovernmentReform/IATelecom101105.htm>

Casual Sales of Motor Vehicles, Boats and Planes

Georgia is one of three states with a state sales tax that do not tax casual sales of motor vehicles, boats and airplanes. Taxing a used good is not good tax policy because the tax from the original sale is built into the sales price. However, if the policy decision is to tax these used assets, then it should be applied fairly. It should not matter whether you buy a car from a automobile dealer, a broker or a friend, the same sales tax should be applied. The proposal makes an exception for transfers to immediate family members.

Corporate Income Tax and Corporate Tax Credits

The Council recommended eliminating or reforming all corporate income tax credits. Eliminating the tax credits would have broadened the corporate tax base enough to allow for a reduction in the corporate tax rate from 6 percent to 4 percent.

There were strong feelings on all sides of the corporate tax credit debate. Credits like the Film Tax Credit and others are currently being debated in states across the country. The primary question is, "Would companies that took these credits have come to Georgia anyway?" and if not, is the state getting a good return on its investment? We need to make sure that each of these credits receives an objective cost-benefit analysis.

This proposal delays any action on corporate tax credits. As a result, it also keeps the corporate income tax rate at 6 percent rather than reducing it to 4 percent as recommended by the Tax Council.

Sales Tax Exemptions

The Tax Council correctly argues that the taxation of business inputs is very poor tax policy. As a result, they recommend making existing exemptions for business inputs permanent.

In addition, the new proposal keeps the Tax Council's recommendations for streamlining and simplifying existing exemptions. The proposal replaces six listed exemptions specific to manufacturing and mining with a single umbrella exemption, replacing twelve pages of regulations. A single, comprehensive exemption for inputs to the production of agricultural products replaces twenty-two separate, outdated and overlapping exemption items from the current code. It also limits access to exemptions to agriculture businesses that achieve a certain threshold level of revenue, which eliminates sales tax exemptions for "hobby" farmers. These changes will greatly reduce compliance costs for agricultural businesses.

Regarding consumer services, the Tax Council suggested taxing services that are taxed in 20 or more states and sunsetting all other exemptions related to non-business purchases. A tax reform modeled along the lines of the FairTax would tax all personal consumption at the retail level. This would result in a broader and faster growing sales tax base. However, it appears the Joint Committee feels that Georgia is not ready to make that big of a shift at this time.

Georgia should avoid placing sales taxes on business purchases, but should continue to regularly evaluate the exemptions on consumer purchases.

Impact on Local Governments

There is very little impact on local governments. The income from the communications services tax is designed to offset the loss of local fees and taxes. The local sales tax base is expanded by the taxation of casual automobile sales and automobile repair labor, but is almost completely offset by the decrease due to the exemption for energy used in manufacturing.

Summary

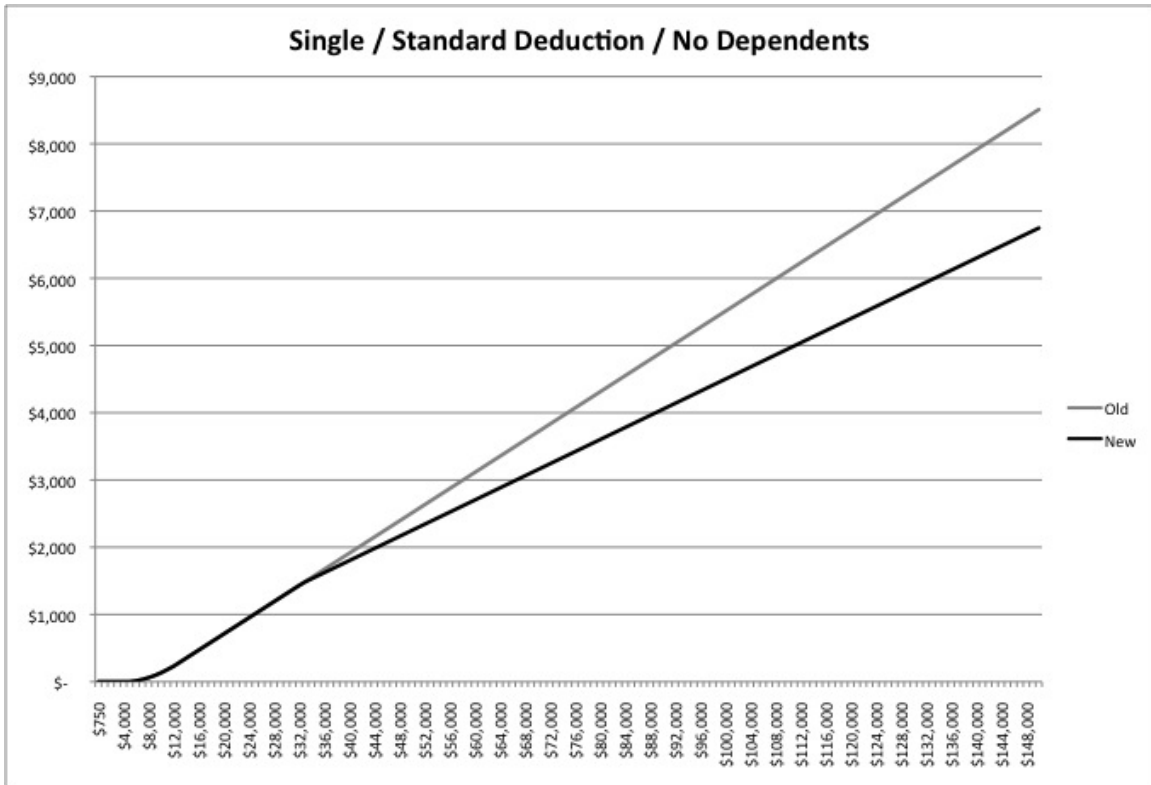
Among the Guiding Principles of the Tax Reform Council was a tax structure that was growth enhancing, efficient, stable, clear and fair and equitable. The Council said a good tax system: Creates as few distortions in economic decision-making as possible; has broad tax bases and low tax rates; has few exemptions and special provisions; promotes equity through transfers, subsidies and tax credits rather than by having tax rates increase with income, (through progressive tax rate structures); taxes consumption rather than income in order to encourage saving and investment; and keeps tax rates low because taxes reduce the quantity or level of activity of the thing that is taxed.

Although scaled back, the new proposal meets these criteria. The proposal is a pro-growth reform that will encourage more savings and investment, higher wages, more jobs and more economic opportunity for our citizens. For our traditional industries of mining, manufacturing and agriculture, it simplifies the tax code, reduces compliance costs and removes a large barrier to our competitiveness with other states by removing the sales tax on energy. For our industries of the future, the plan encourages job creation in Georgia and investment in our telecommunications infrastructure by removing the sales tax on capital investment. Finally, to attract and retain innovative startup companies and the high-wage jobs they create, the plan lowers the personal income tax rate by 25 percent.

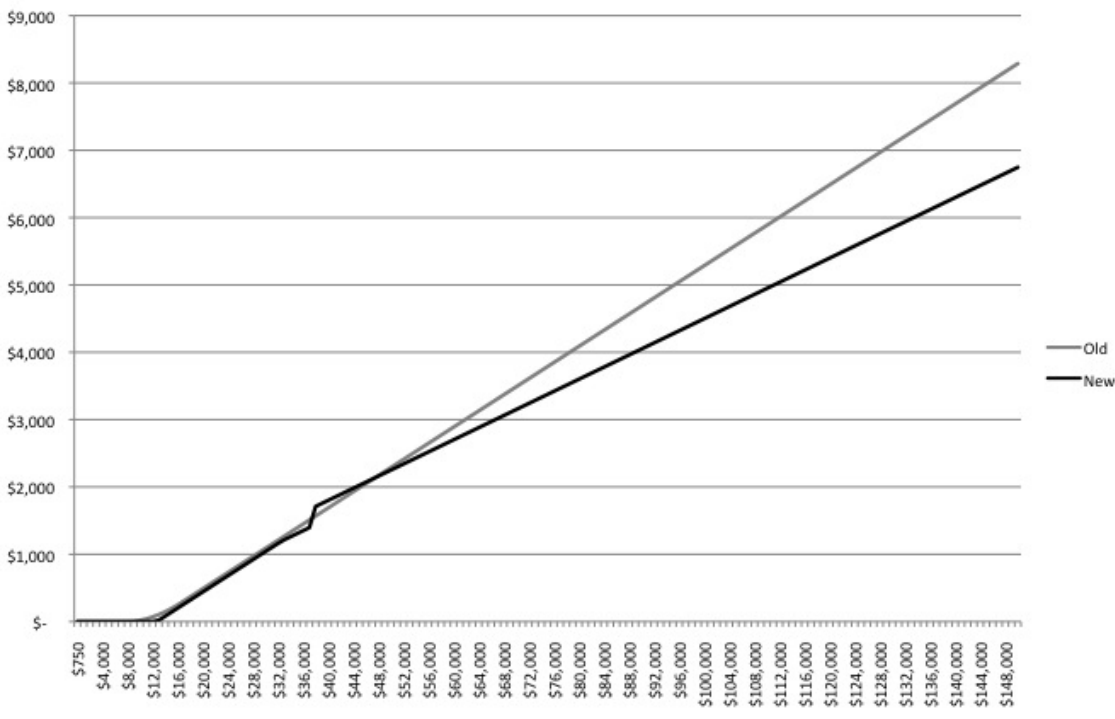
While the big picture of moving to a flat tax is outstanding economic policy, there are taxpayers who will pay higher taxes. Most Georgians will see small changes, but taxpayers with large itemized deductions will no longer be able to shelter the majority of their income. For families facing a small increase in next year's taxes, the next time they get a raise, work more overtime or take a better paying job, they will get to keep more of the money they have earned.

The opportunity to make significant changes to tax policy comes along rarely. We have a narrow window of opportunity and this plan meets all the criteria to move Georgia forward.

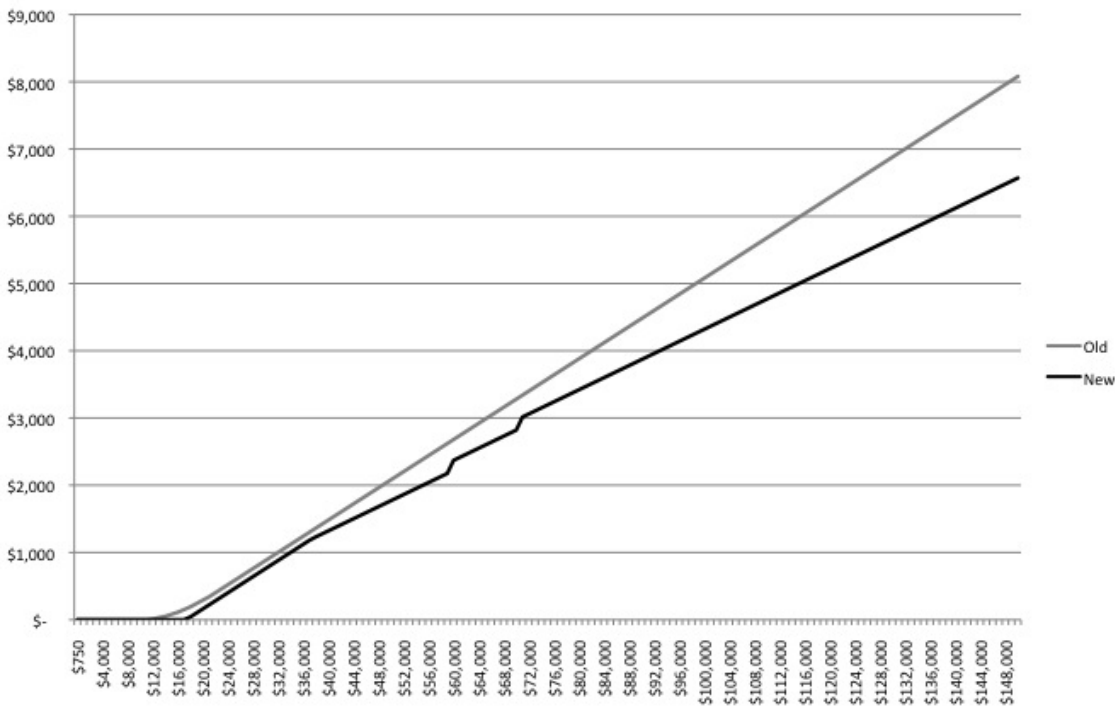
Appendix: The following tax charts show how the flat tax will impact various families at different incomes. The vertical axis represents personal income taxes and the horizontal axis represents Georgia adjusted gross income.

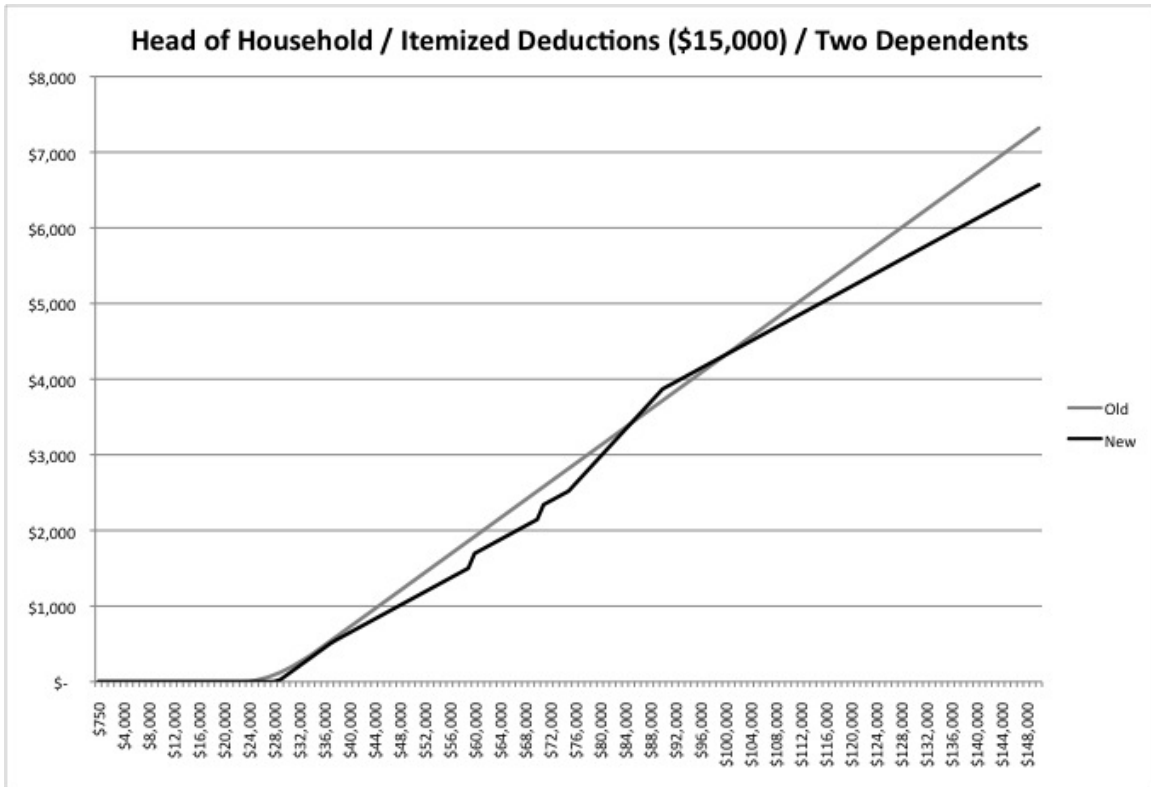
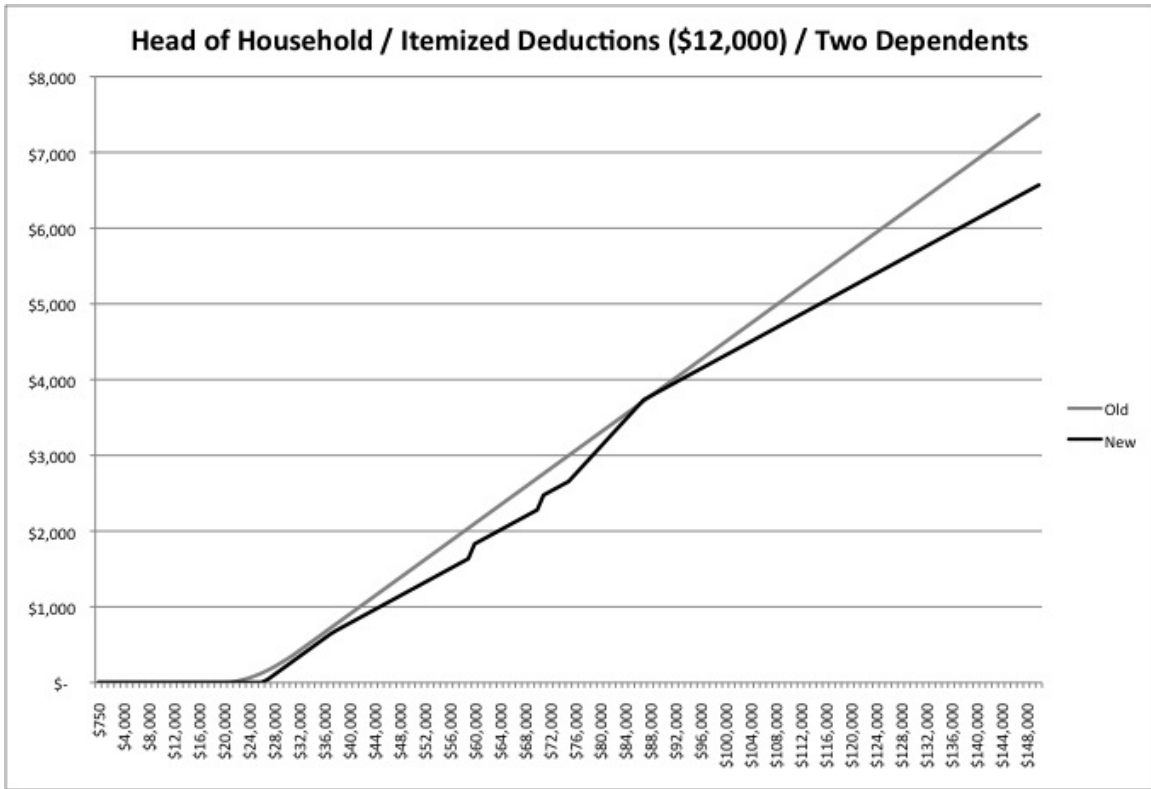


Single / Itemized Deductions (\$6,000) / No Dependents

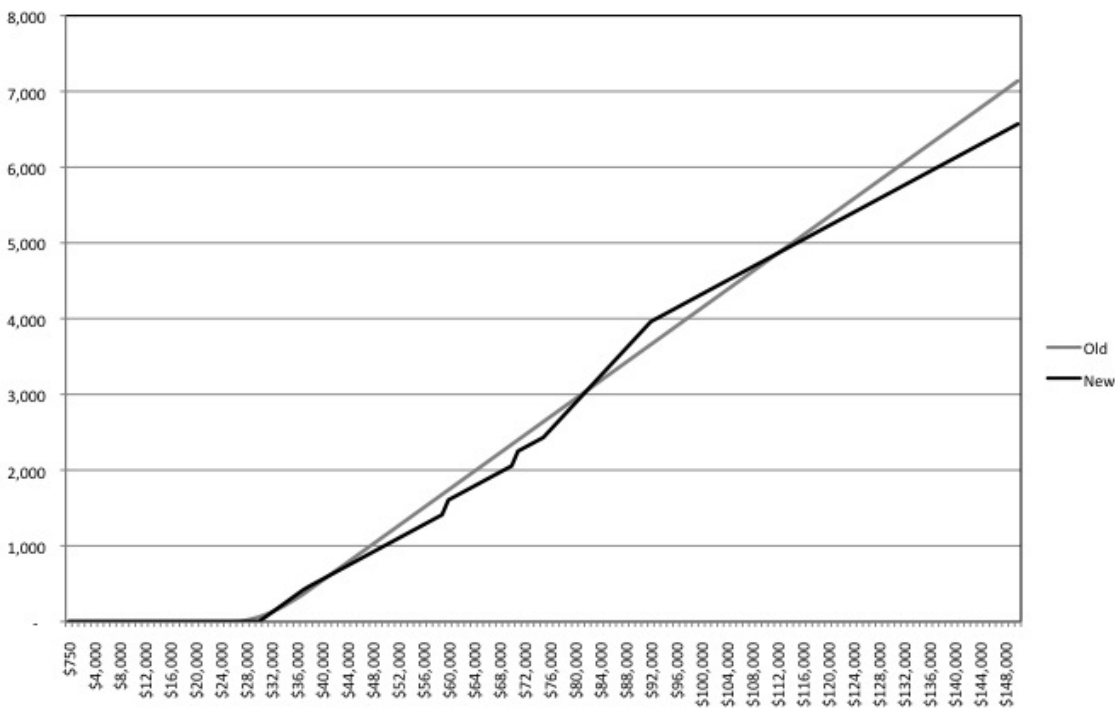


Head of Household / Standard Deduction / Two Dependents

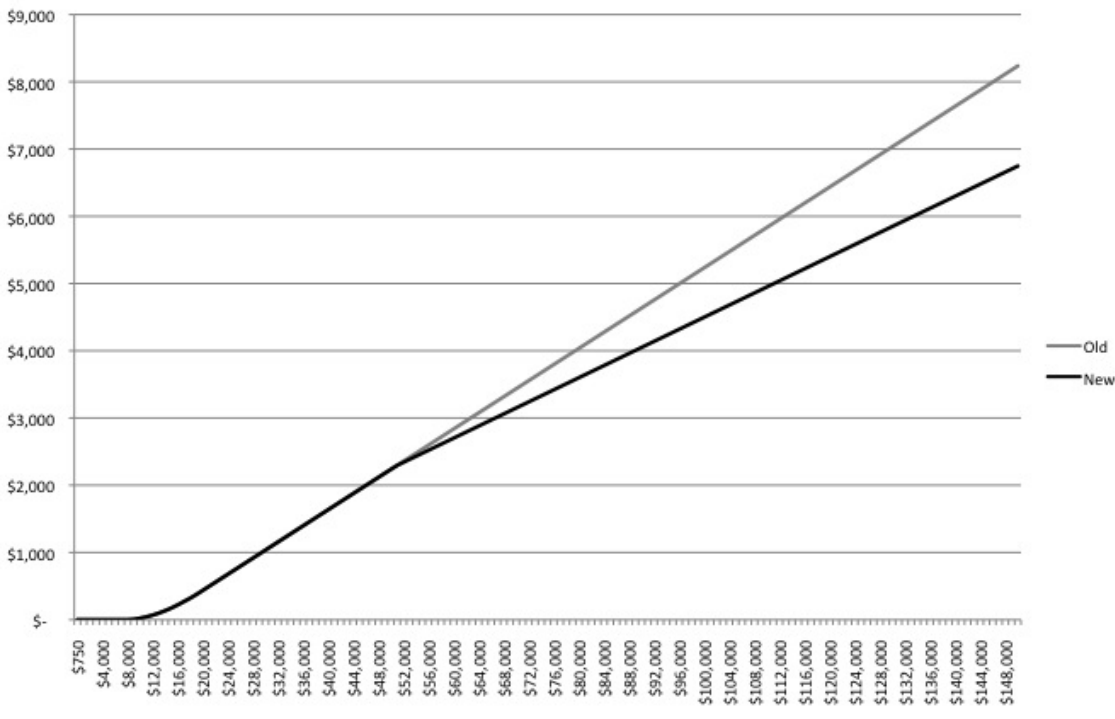


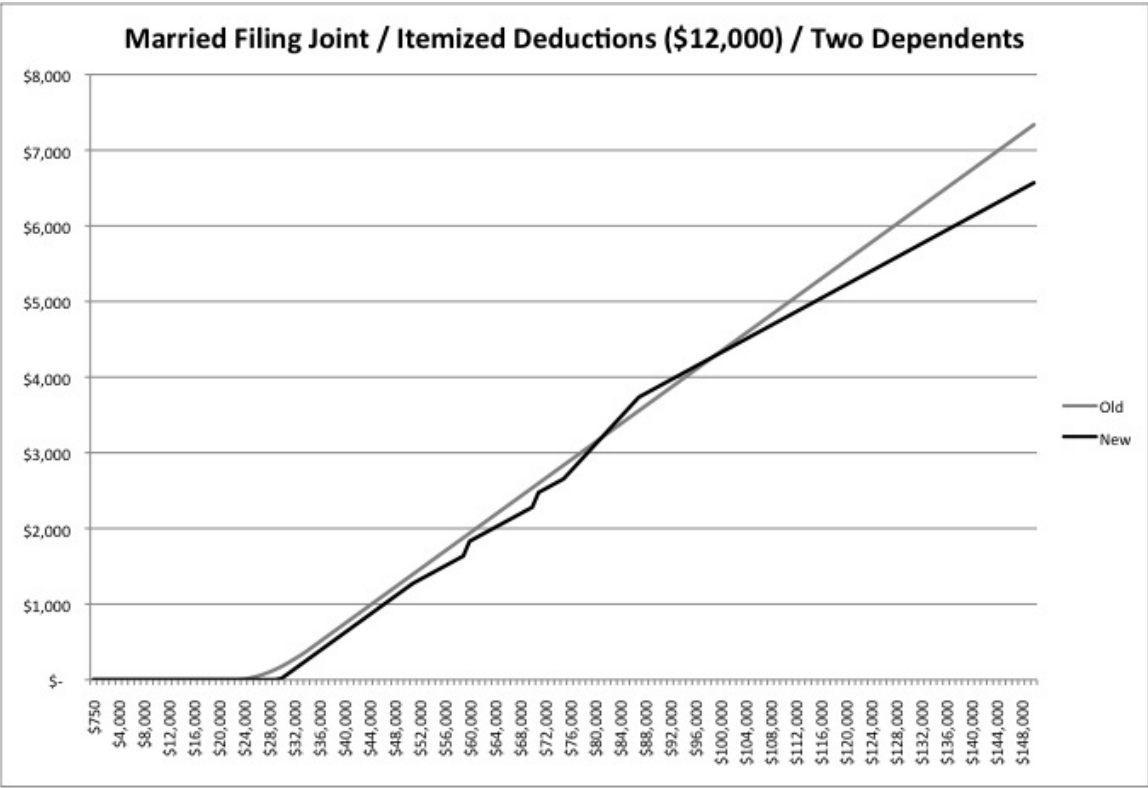
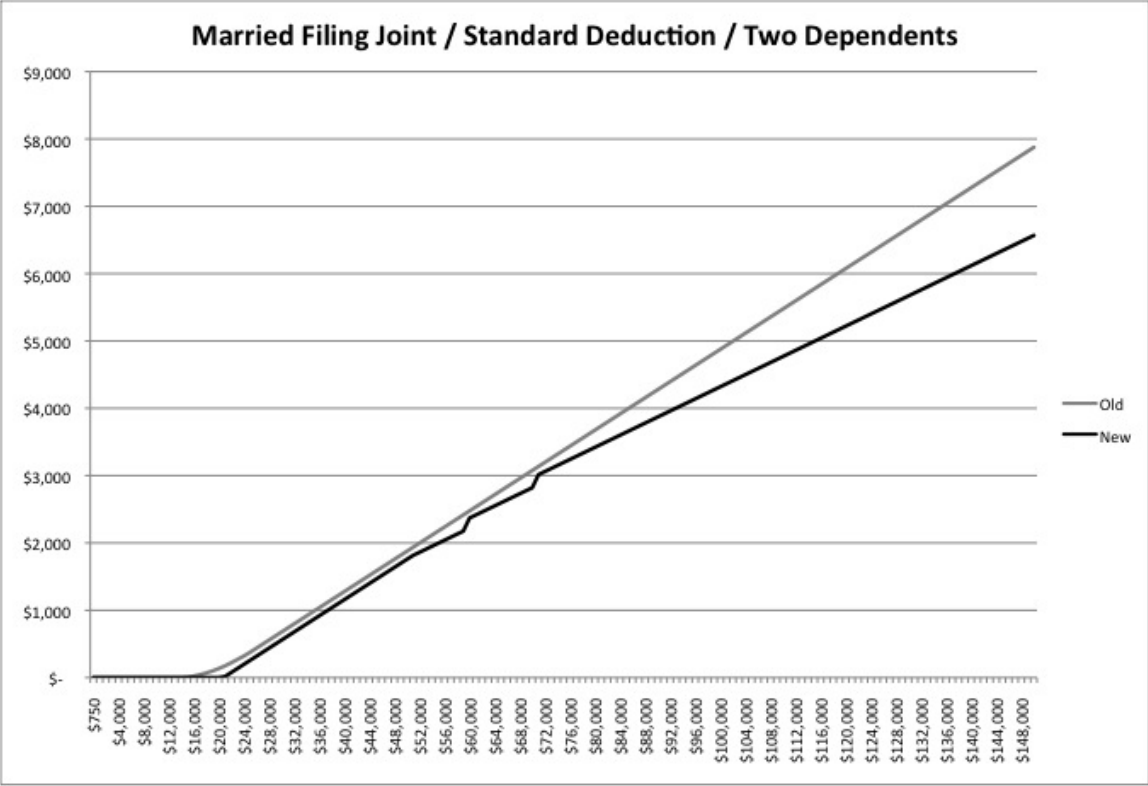


Head of Household / Itemized Deductions (\$18,000) / Two Dependents

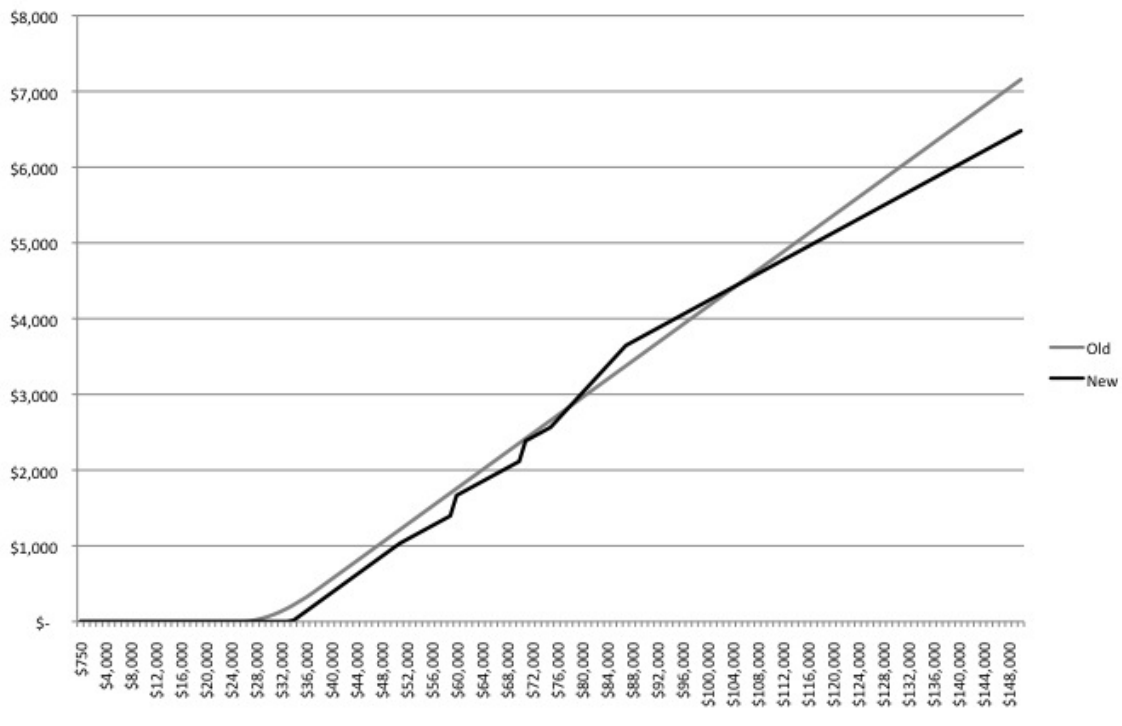


Married Filing Joint / Standard Deduction / No Dependents

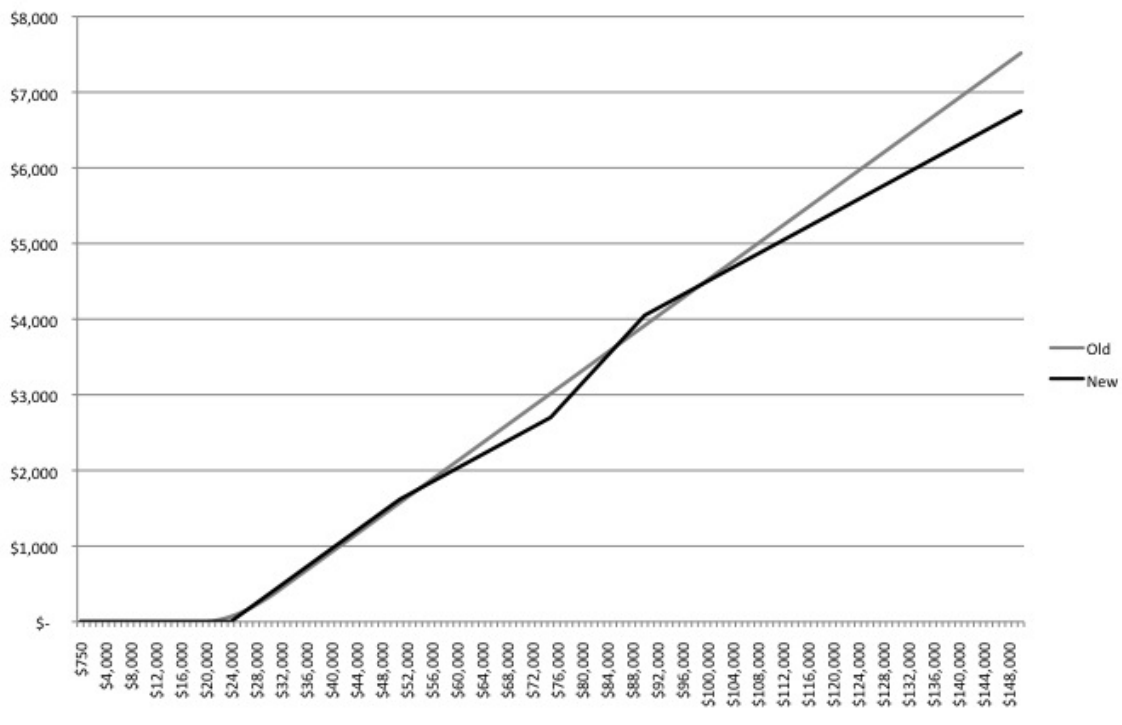




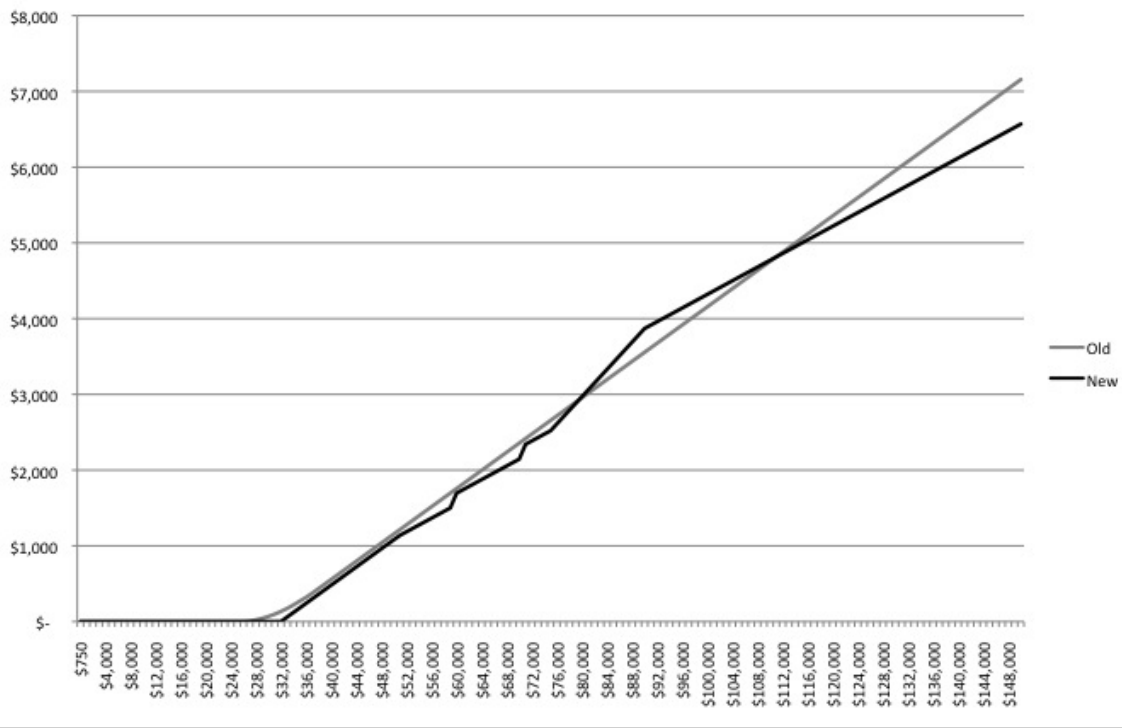
Married Filing Joint / Itemized Deductions (\$12,000) Three Dependents



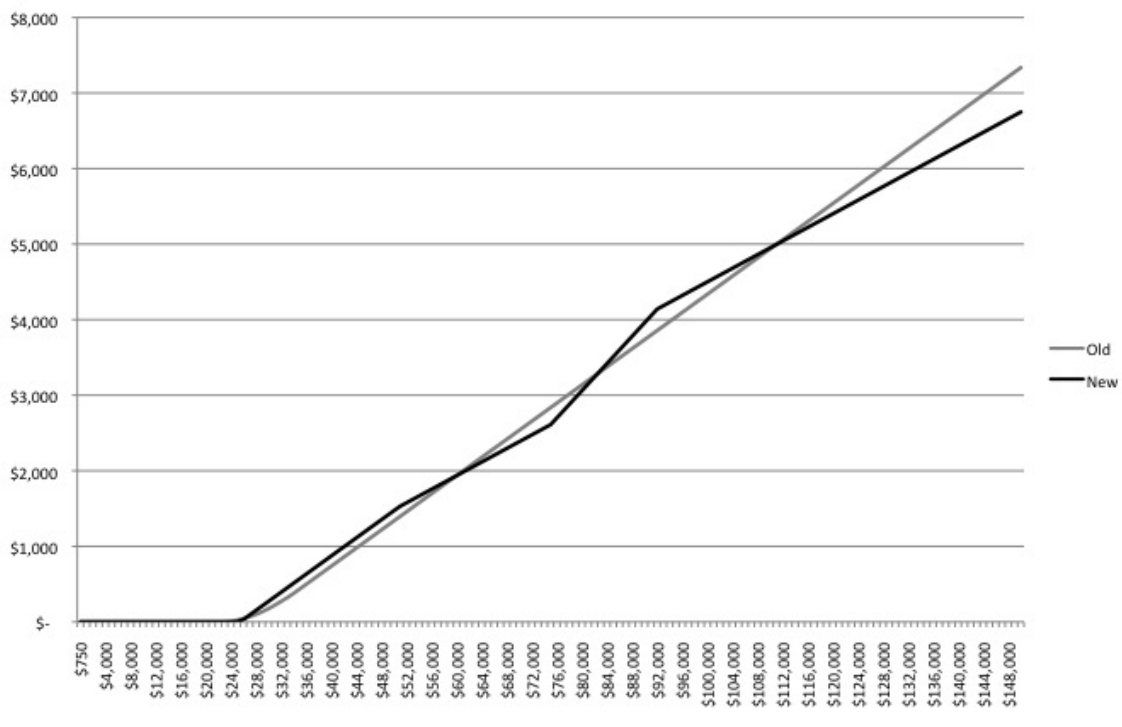
Married Filing Joint / Itemized Deductions (\$15,000) / No Dependents



Married Filing Joint / Itemized Deductions (\$15,000) / Two Dependents



Married Filing Joint / Itemized Deductions (\$18,000) / No Dependents



Married Filing Joint / Itemized Deductions (\$18,000) / Two Dependents

