ADVANCING

Georgia's 1930s Tax System to the Modern Day

Fair and Adequate Tax Reform for 21st Century Georgians

> *"It has been many years since there has been any systematic study of the State of Georgia's revenue structure, and there exists a need for such study today."*
>
> **— Legislation creating the 2010 Special Council on Tax Reform and Fairness for Georgians**

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Advancing Georgia's 1930s Tax System to the Modern Day: *Fair and Adequate Tax Reform for 21st Century Georgians*

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About the Georgia Budget & Policy Institute

The Georgia Budget & Policy Institute seeks to build a more prosperous Georgia. We rigorously analyze budget and tax policies and provide education to inspire informed debate and responsible decision-making, advancing our vision of a state in which economic opportunity and well-being are widely shared among all. GBPI is an independent, nonprofit, nonpartisan organization founded in 2004. Please visit www.GBPI.org for more information.

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- ***Solving Georgia's Fiscal Crisis Requires More Thoughtful Measures Than Cutting Public Structures*** (Sept. 2009)

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SUMMARY OF RECOMMENDATIONS TO THE COUNCIL

The recommendations in this report contain tax reform options that stress a workable combination of raising enough money to meet Georgia's needs, updating the tax system to reflect today's economy, keeping rates as low as possible, and tying the system more closely to ability to pay than it is now.

Georgia has the 19th most regressive state and local tax system[1]

Use Principles of Effective Tax Reform

Fairness

- Avoid shifting the tax obligation onto low- and middle-income Georgians
- Treat taxpayers in similar circumstances similarly

Adequacy

- Avoid changes that worsen the structural deficit
  - ✓Reform Georgia's tax system to immediately replace one-time funds in the budget that will be lost in FY 2012
- Ensure revenues grow with the economy and the demand for services

Consider These Tax Reform Options

Sales and Use Tax

- Broaden the base to cover more personal services
- Lower the rate
- Encourage collection from online retailers

Personal Income Tax

- Broaden the base by scaling back preferences
- Modernize brackets, rates, and standard deductions to reflect current income levels
- Create refundable credits to offset regressive sales taxes

Corporate Taxes

- Close corporate loopholes
- Evaluate and revise exemptions and credits
- Modernize the corporate net worth tax

Other Taxes

- Update cigarette and motor fuel excise tax rates
- Support the revival of the state credit for estate taxes

Make a Timeline

- Set the stage for further work if the goal of comprehensive tax reform is not fully reached in five months

Georgia has a $1.8 billion to $2 billion structural deficit[2]

INTRODUCTION

GEORGIA HAS...

1931
Corporate net worth tax rates

1937
Income tax brackets

1951
Sales tax base

1971
Motor fuel tax rate

1981
Standard deductions

1931-2010
Decades of special interest tax breaks

Georgia has a good tax foundation with diverse revenue streams, but it needs an update for 21st century incomes, spending habits, and economy.

Over the past half century, Georgia's tax system has struggled to raise sufficient revenue to meet the needs of a changing, growing state. The state and its economy are far different today than when the tax system was created, but the state income tax looks much like it did in 1937. The sales tax, adopted in 1951, has not kept pace with consumer spending trends that have shifted dramatically from goods to services. Further, the tax system has become riddled with exemptions and credits, and certain excise tax rates have fallen to among the lowest in the nation.

Even under a perfectly constructed tax system, revenues would have fallen sharply since 2008 because of the impact of the longest, deepest national recession since the Great Depression. The combined effects of the recession and inadequacies in the tax system caused Georgia's revenues to fall by 20 percent in two years. They are not expected to return to 2007 levels until 2015; however, demand for services has not fallen by 20 percent, instead the recession and Georgia's continued population growth is causing demand to rise. In the foreseeable future the state can expect to fall short of meeting its needs by $1.8 billion to $2 billion a year. [3]

The legislature created the Special Council on Tax Reform and Fairness in 2010, recognizing that "it has been many years since there has been any systematic study of the State of Georgia's revenue structure, and there exists a need for such study today." The legislation does not provide goals for the Council, however state leaders have since publicly charged the Council with recommending reform that specifically helps businesses and creates jobs. [4]

Although helping businesses and creating jobs is a boost for any state's economy, the narrowness of the mandate could serve to crowd out other important considerations in Georgia's tax system and the Council's objectives. Indeed, "business-friendliness" is a two-sided coin. On one side are demands to lower taxes as part of the effort to reduce businesses' costs.

On the other, however, are the desires shared by businesses and others for a state-of-the-art transportation network, a smooth-functioning court system to handle disputes, a trained workforce, quality K-12 and college education, and many other tax-funded initiatives and services crucial to helping businesses thrive and attracting highly qualified workers to our state. In the face of a multi-billion-dollar structural deficit, reforming Georgia taxes must address ways to meet the state's current and future needs — not just keep down costs to businesses in ways that could be "penny-wise but pound foolish."

The Council also has the profound responsibility to prevent shifting the cost of meeting the state's obligations more heavily onto those least able to pay, as well as the imperative to reconsider policies which already do so. Today, the farther down the income scale a household is, the greater share of its earnings go to state and local taxes.

The recommendations in this report contain tax reform options that stress a workable combination of raising enough money to meet Georgia's needs, updating the tax system to reflect today's economy, keeping rates as low as possible, and tying the system more closely to ability to pay than it is now. None of these goals are mutually exclusive. Georgia can make a number of changes that, taken together, ensure the state can fairly raise adequate funds to pay for the crucial public investments that expand opportunity for families and businesses.

BUDGET AND TAXES: WHAT ARE WE PAYING FOR?

Georgia will spend more than 80 percent of the FY 2011 state budget on education, healthcare, and public safety; therefore, the size of the state budget is overwhelmingly driven by these three policy areas.

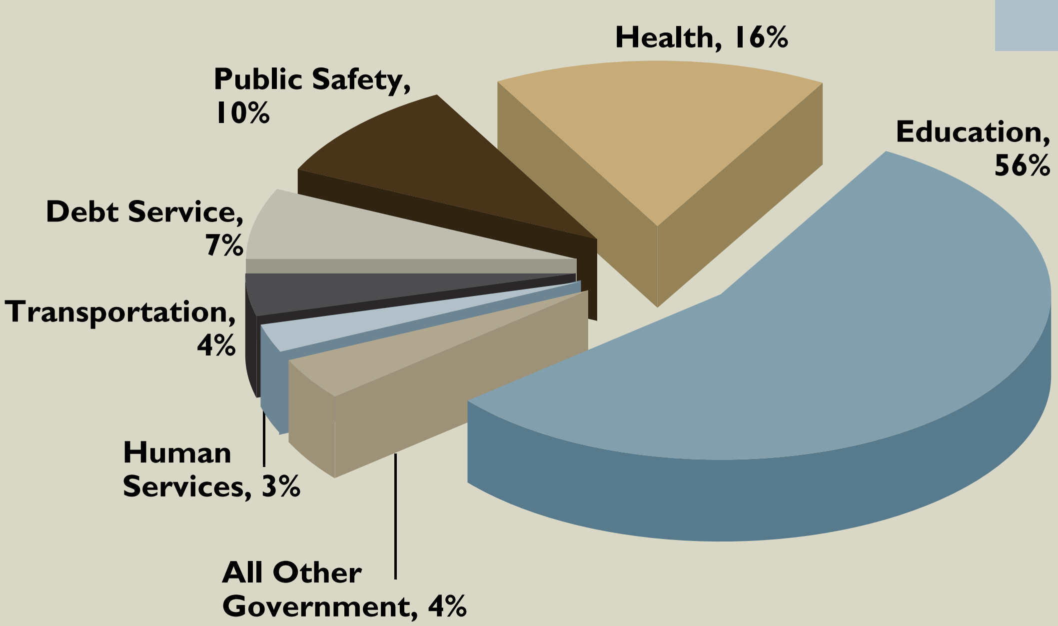
Georgia's overall population, as well as the specific populations that state government serves, such as school children and prisoners, will continue to increase dramatically. In addition to meeting the needs of sheer increased numbers of Georgians, the state has urgent existing needs, such as bringing our education, mental health, and transportation systems, among others, up to national standards.

Any effort to reform the tax code must take into account the existing and emerging needs of Georgia residents, answering the question:

Do we have a tax system that fairly raises the adequate revenues to meet the state's desired public policy priorities?

Figure 1

82% of State Dollars Fund Education, Health, and Public Safety



Reform that keeps revenues at the current, insufficient level does not meet the principle of adequacy. Revenue neutrality cannot be a goal of reform when revenues are down 20 percent from two years ago. ***Consider what revenue neutrality would have meant if the Tax Reform Council gave recommendations in 2007 rather than 2011.***

Broad bases are the ideal components of tax systems. Broad tax bases ensure that the obligation for paying for state services is spread as wide as possible with the lowest rate. In contrast, a shrinking base, whether due to a changing economy or additional tax breaks to certain groups, means the cost of services falls to fewer individuals and businesses which then are taxed at a higher rate.

Beyond broad bases, however, there are several principles that guide tax policy, including adequacy, fairness, economic neutrality, and simplicity. Georgia's current tax system does not adequately meet the state's needs, while recent changes have diminished its fairness to Georgians even further; therefore, this report will pay particular attention to reforms that increase both adequacy and fairness.

ADEQUACY

This Council's charge to reform Georgia's tax system is complicated by the fact that it is starting from an inadequate revenue base. The state cannot meet its considerable current or upcoming obligations. Revenues have dropped significantly since 2008 and are not projected to return to pre-recession levels until 2015. [5] Some of this problem is due to the Great Recession, but it is also the result of a shrinking tax base due to:

- a changing economy that is increasingly service-based rather than predominately manufacturing-based as it was when the system was conceived, and
- decades of special interest tax cuts, among other causes.

Georgia faces a $1.8 billion to $2 billion structural deficit. [6]

Given our dire fiscal situation, it is not practical, nor responsible, for Georgia to approach tax reform with the goal of revenue neutrality. At a minimum, we need to ensure that tax reform immediately replaces the one-time funds currently in the budget. **Reform should then enable our revenue base to grow with the economy and the demand for services.**

WHERE GEORGIA STANDS TODAY …

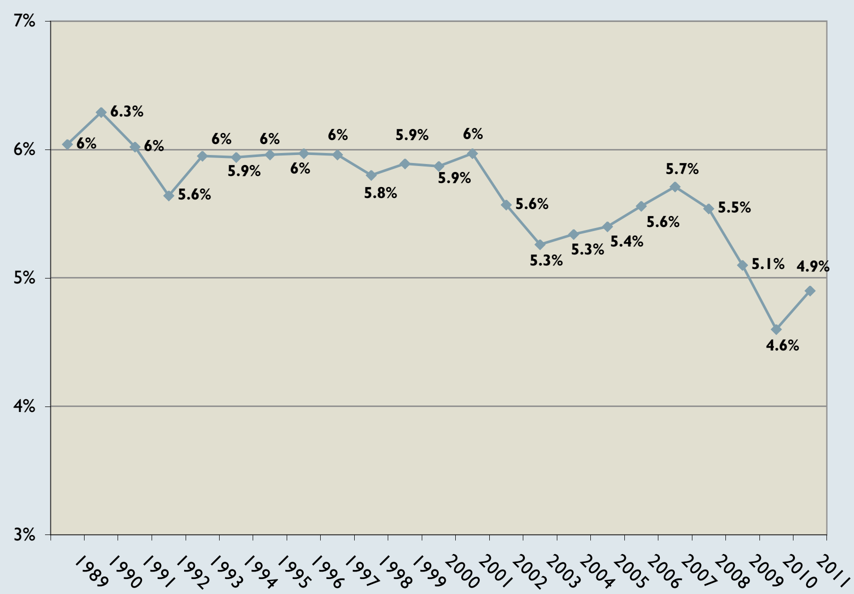
- Georgians are paying a declining share of income to state services. (See Figure 2)
- Georgia has a structural deficit of $1.8 billion to $2 billion. [7]
- Georgia ranks in the bottom 10 of states for revenues it collects and expenditures it makes for state services. [8]

Figure 2

Georgia's Revenues Are Not Keeping Pace

State Revenues as a Percent of Personal Income

Source: Georgia Budget & Policy Institute; data from the Bureau of Economic Analysis and Georgia Governor's Budget Books




Courtesy of Georgia Archives, Vanishing Georgia collection, cob183

Expectations for public structures such as schools are much different today than they were in this 1930s photo, as illustrated by this pre-computer Cobb County classroom.

FAIRNESS

A fair or equitable tax system treats taxpayers in similar circumstances similarly (horizontal equity) and considers taxpayers' ability-to-pay (vertical equity).

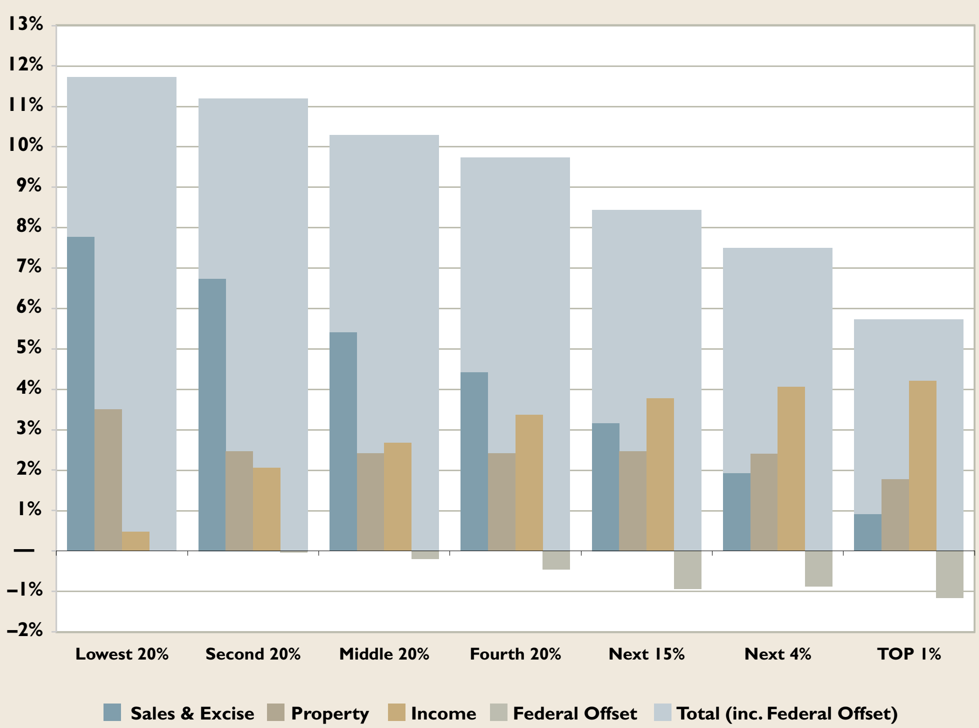
WHERE GEORGIA STANDS TODAY …

- State and local sales, income, and property taxes combined are regressive — in other words, they take a higher share of income from the poorest Georgians (see Figure 3).
- Georgia has the 19th most regressive state and local tax system in the nation, primarily due to the regressive sales tax. [9]
- Georgia provides preferential tax treatment to certain groups and corporations, which diminishes horizontal equity. For example, a 65-year-old couple with $70,000 of retirement income pays no state income taxes, while a 60-year-old couple with $70,000 of earned income pays $3,400. Likewise, exemptions and credits distort the tax obligation of certain corporations compared to those which do not receive the favorable treatment.

Figure 3

Georgia State & Local Taxes in 2007

Shares of Family Income for Non-Elderly Taxpayers



Source: Institute on Taxation and Economic Policy, 2009

According to the National Conference of State Legislatures:

A high-quality state revenue system

1. Comprises elements that are complementary, including the finances of both state and local governments.
2. Produces revenue in a reliable manner. Reliability involves stability, certainty, and sufficiency.
3. Relies on a balanced variety of revenue sources.
4. Treats individuals equitably. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.
5. Facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.
6. Promotes fair, efficient, and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.
7. Is responsive to interstate and international economic competition.
8. Minimizes its involvement in spending decisions and makes any such involvement explicit.
9. Is accountable to taxpayers. [10]

$701 million
Estimated additional revenue from including select personal services in the sales tax

— Improves fairness, adequacy, economic neutrality

$344 million
Estimated revenue loss from ¼ percent sales tax rate cut on new base

— Improves fairness

$838 million
Georgia state & local revenue if collected on remote sellers

— Improves fairness, adequacy, economic neutrality

The following discussion lays out tax options commonly used by states that, when combined, enhance adequacy and fairness. These options focus on the taxes that comprise more than 80 percent of state revenues: sales and use tax, personal and corporate income tax, and excise taxes.

SALES AND USE TAXES

Broaden the Base to Cover More Personal Services

Georgians are buying more and more services, but our outdated sales tax remains focused on goods. Services comprised 45 percent of household purchases in 2007 in the United States, up from 31 percent in 1970, while goods were a declining share of purchases over that time.[11] Yet as of 2004, after the economy had already shifted towards services, Georgia taxed only 36 out of 168 possible services (see Figure 4).[12]

Georgia could prevent further erosion of the tax base and strengthen long-term adequacy by expanding the tax base to include more services. Broadening the base of the sales tax, as well as the income tax, also allows for the lowest possible tax rates and fairer treatment among taxpayers.

For example, a family buying a mousetrap pays sales taxes, but a family hiring pest control services in Georgia does not. Including these personal services in the sales tax base would improve horizontal equity by removing the current tax bias against those taxpayers who purchase more goods than services, as well as increase stability and economic neutrality.

Economists warn against taxing business-to-business services since the end product will also be taxed, but there are numerous personal services that other states are already taxing and could be incorporated into the Georgia tax base (see list on page 9). These do not include professional services, such as lawyers and doctors, but include household purchases such as pet grooming, i-Tunes downloads, and dry cleaning.

Although broadening the sales tax base meets several principles of tax reform, it increases taxes on low- and middle-income taxpayers, which conflicts with the fairness principle (vertical equity). Tax reform could include other changes to offset those impacts, such as lowering the sales tax rate and creating refundable income tax credits. (Read more about how refundable income tax credits can offset regressive sales taxes on page 12.)

Lower the Rate

Combining a sales tax base expansion with a cut in the sales tax rate eases the vertical inequity to low- and middle-income Georgians. A related consideration is the ballot question for a regional sales tax for transportation, which will be decided by voters in 2012. Lowering the state sales tax rate now could create a better environment for voter approval of such a regional tax, thus increasing the state's overall ability to meet its residents' needs.

Our 1950s sales tax didn't anticipate i-Tunes.

Encourage Collection From Remote Sellers
Support the Main Street Fairness Act

Along with buying more services, Georgians are purchasing more online. Federal law to date restricts states from requiring remote sellers (e.g. Internet and catalogue retailers) to collect sales tax, which raises concerns over fairness between local brick-and-mortar retailers and online retailers. This also cuts into Georgia's ability to ensure it has adequate revenues; Georgia state and local governments are expected to lose $838 million in 2012 due to uncollected taxes from remote sellers.[13]

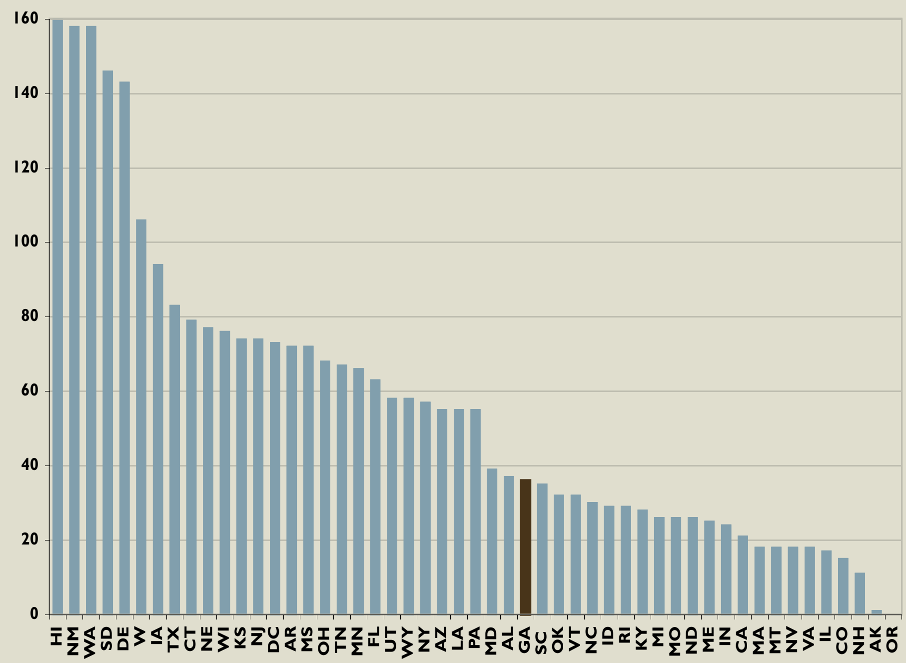
Note: Unless otherwise noted, revenue estimates used in this section are provided by the Institute on Taxation and Economic Policy.


Courtesy of Georgia Archives, Vanishing Georgia collection, roc070

Many states, including Georgia, have joined together in the Streamlined Sales Tax Agreement (SSTA) to ease compliance, enter into voluntary agreements with online and catalogue retailers, and encourage the U.S. Congress to change federal law. Tax reform should explore ways Georgia can improve collections through reform of state law, but also determine how best to encourage changes to federal law. One important opportunity is the federal Main Street Fairness Act (U.S. House Bill 5660), a legislative proposal that would allow SSTA states to collect sales taxes from online retailers.

Figure 4

The Number of Services Georgia Taxes is Below Average



Source: Federation of Tax Administrators

Note: The Federation performed an updated survey of states in 2007; however, Georgia and four other states did not respond, therefore data used for these states is from 2004. Several states have expanded their bases since 2007; for example, North Carolina expanded its base to include digital downloads. Georgia has not expanded its base.

SERVICES TAXED IN AT LEAST 15 STATES, BUT NOT IN GEORGIA

Labor charges on repairs to motor vehicles

Automotive washing and waxing

Automotive road service and towing services

Auto service, except repairs, including painting & lube

Parking lots and garages

Automotive rustproofing and undercoating

Software – Downloaded

Books – Downloaded

Music – Downloaded

Movies/Digital Video – Downloaded

Carpet and upholstery cleaning (in-home)

Altering and repairing garments

Health clubs, tanning parlors, reducing salons

Shoe repair

Swimming pool cleaning and maintenance

Membership fees in private clubs

Repair labor, general

Labor on radio/TV repairs; other electronic equip.

Labor charges – repairs, other tangible property

Service contracts sold at the time of sale of tangible personal property

Installation charges by persons selling property

Installation charges – other than seller of goods

Custom processing (on customer's property)

Taxidermy

Welding labor (fabrication & repair)

Janitorial services

Pest control

Landscaping services (includes lawn care)

Automotive storage

Marina service/docking

Overnight RV park

Source: Federation of Tax Administrators, 2007

$446 million
Additional revenue from repealing state income tax deduction

— Improves fairness, adequacy

$132 million
Additional revenue from scaling back retirement exclusion

— Improves fairness, adequacy

PERSONAL INCOME TAX

Broaden the Base by Scaling Back Preferences

As demonstrated with the sales tax, Georgia can improve its personal income tax by broadening the tax base. Just as the sales tax can be broadened by adding new services to the base, the income tax can be broadened by allowing fewer deductions, exemptions, and credits.

Two base-broadening options that adhere to the principles of effective tax reform, particularly their ability to promote adequacy and fairness, are scaling back both itemized deductions and the retirement income exclusion.

Itemized deductions:

- Georgia allows filers who itemize to deduct state income taxes. Many states allow taxpayers to claim the same itemized deductions at the state level as they do at the federal level; however, most states sensibly disallow the federal deduction for state income taxes in order to prevent the bizarre outcome of state taxpayers using their own state income tax bills to reduce their state income taxes.

  Georgia is one of only seven states that allow the deduction for state income taxes. Repealing it would raise an estimated $446 million a year (at current tax rates).[14] Repealing the deduction increases fairness among taxpayers by preventing the current inequitable decrease in the effective tax rate for Georgia taxpayers who itemize compared to those taxpayers who do not.

- Georgia could take a broader approach than removing a single deduction, as discussed in the example above, thus allowing greater flexibility in modernizing rates and increasing standard deductions. It could completely eliminate itemized deductions as Rhode Island recently did. Rhode Island significantly broadened its income tax base by eliminating itemized deductions and almost all tax credits, while simultaneously increasing the standard deduction and lowering tax rates.

Retirement income exclusion:

- A growing share of the population will not pay state income taxes when the retirement income exclusion grows to a full exclusion in 2016. Senior citizens in Georgia currently have several tax preferences, including full exclusion of Social Security income and a $35,000 retirement income exclusion ($70,000 for couples).

MAINTAIN THE CURRENT CAPITAL GAINS TAX

Lawmakers attempted to cut the income tax on capital gains in half during the last two legislative sessions, for a loss of about $350 million a year. Both times, Governor Perdue vetoed the legislation, thereby avoiding more severe budget gaps and a more regressive tax system.

- ***Not the economic gain touted by proponents.*** Claims that capital gains tax breaks help to promote economic growth are without merit. A policy statement by the state's economist last year notes: "Because of how states tax capital gains, the effect of a cut in Georgia's tax on capital gains will likely provide little incentive to increase investment in Georgia." [19]
- ***Against the national norm.*** Only nine states had significant tax preferences for capital gains in 2008, and three states have since eliminated or reduced those capital gains preferences in the face of mounting revenue losses.
- ***Tax shift to low- and middle-income Georgians.*** Not surprisingly — given the concentration of capital gains income among the very wealthiest taxpayers — the benefits of capital gains tax preferences are similarly focused on the well-to-do. If Georgia excluded half of net long-term capital gains from taxation in 2008 as the General Assembly wanted, virtually all — 99 percent — of the tax reductions would have been realized by the richest 20 percent of taxpayers in the state. [20]

Although many seniors are in need of tax assistance due to their fixed, low-incomes, many persons over the age of 65 do not have a constrained ability-to-pay. In addition, the effectiveness of these tax preferences at attracting wealthy retirees, as proponents contend, is highly questionable and has not been measured against other tax options. [15]

This across-the-board tax preference will grow more costly to the state as the population ages and therefore pays less taxes, and it will diminish fairness to taxpayers by shifting the obligation to pay for state services to younger workers and to senior citizens who must continue to work.

Tax reform must account for shifting demographics, as well as employment patterns. It must consider whether it is smart tax policy to narrow the base so significantly to employment income, rather than including both employment and retirement income to ensure adequate revenues. Scaling back the retirement income exclusion to $17,500 (half of the current exclusion) would increase state tax revenues by an estimated $132 million a year. [16]

Modernize Brackets, Rates, and Standard Deductions to Reflect Current Income Levels

Broadening the base provides Georgia the opportunity to enact reforms that reduce revenues — such as expanding brackets, lowering rates, and increasing standard deductions — without reducing overall adequacy or fairness.

Georgia's tax brackets are essentially flat since the top tax rate begins at $7,000 of taxable income for single filers and $10,000 for married filing jointly — upper incomes in the 1930s when the state began taxing income, but below poverty levels now. In addition, the $2,300 standard deduction has not been raised since 1981; it would be valued at more than $5,000 today if it had kept pace with inflation.

Table 1

Broadening the Income Tax Base Provides the Funds to Expand Brackets and Lower Rates:

Sample Bracket and Rate Modernization for Taxable Income

Rate	Single	Married Filing Jointly
1.0%	Less than $800	Less than $1,600
2.0%	$800-$4,000	$1,600-$8,000
4.0%	$4,000-$8,000	$8,000-$16,000
5.5%	$8,000 and above	$16,000 and above

Source: Institute on Taxation and Economic Policy

The state has failed to regularly update the tax structure, therefore exemptions, deductions, and brackets have not grown with incomes. Currently, the state income tax even applies to families living in poverty. [17]

Georgia can modernize its brackets and rates, as demonstrated by the suggestions for taxable income used in Table 1. When combined with an enhanced standard deduction and a refundable earned income tax credit, these taxable income brackets better reflect current income levels. If combined with an increase in the standard deduction to $4,000 for single filers and $8,000 for married filing jointly, this new structure would mean a loss of revenue. However, if the state combines these changes with eliminating itemized deductions, so that all taxpayers claim just the enhanced standard deduction, it would increase revenues by $208 million a year.

$208 million
Revenue gain from eliminating itemized deductions and modernizing brackets, rates, and the standard deduction

— Improves fairness, adequacy, simplicity

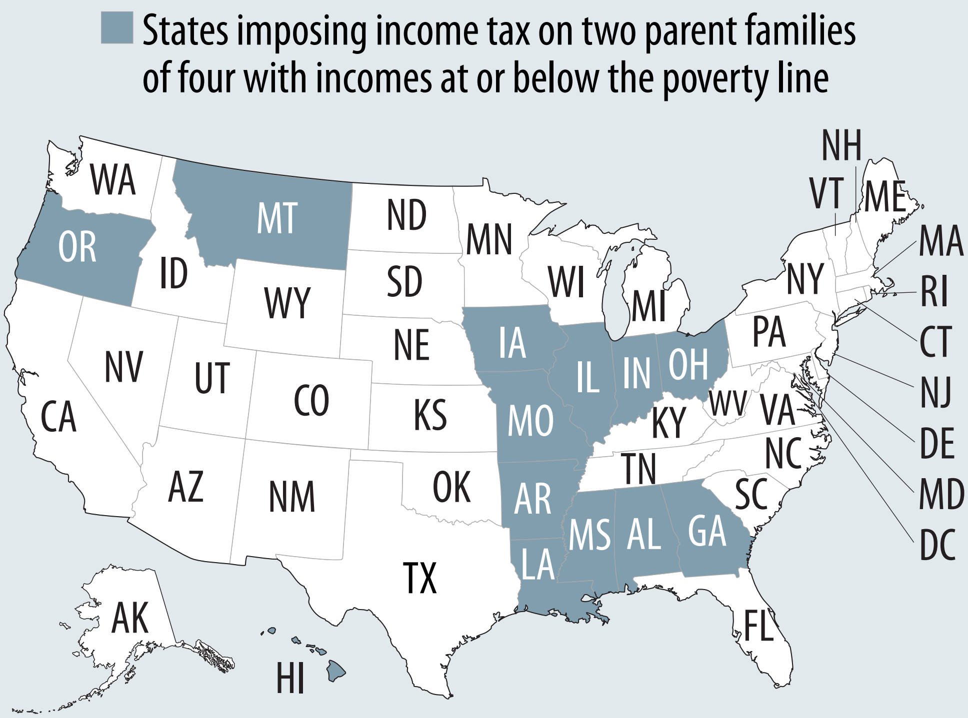
$251 million
Revenue loss from a 10% refundable state EITC

— Improves fairness

WHY ARE WE TAXING POOR FAMILIES FURTHER INTO POVERTY?

Figure 5

Georgia is One of 13 States That Places the Income Tax on Families of Four Living in Poverty



Source: Center on Budget and Policy Priorities

Create Refundable Credits to Offset Regressive Sales Taxes

Modernizing income tax brackets and rates lowers taxes for families, but many states have taken an additional step to leverage the income tax as a tool for targeting tax relief to low-income working families. Since 1986, twenty-three states and the District of Columbia have created state-level earned income tax credits (EITC) to offset highly regressive state and local sales taxes.

Low-income families pay substantial sales taxes since they consume a greater portion of their income than higher income residents do (see Figure 3 on page 7). Since a state cannot target relief specifically to low-income taxpayers through the sales tax, almost half of the states rely on refundable EITCs in the income tax system. The refund ensures taxpayers get the full value of the offset to sales taxes, even if their income tax liability is low.

Georgia currently has a low-income tax credit for those at the very bottom of incomes, but it has become less effective over the years since it is not indexed to inflation. In addition, Georgia lawmakers eliminated the refundability of the Low Income Tax Credit in 2010, decreasing its already declining value by two-thirds and eliminating its ability to offset sales taxes effectively.

A refundable Georgia EITC would improve upon the current Low Income Tax Credit by keeping pace with inflation, easing compliance, covering more Georgia families, and offsetting sales taxes, including new sales taxes on services as discussed on page 8. An EITC lowers taxes and enhances fairness rather than promotes adequacy, thus, the state can ensure adequacy if it enacts the EITC in coordination with broadening the income tax base. A refundable EITC set at 10 percent of the federal EITC would cost an estimated $251 million.[18]

CORPORATE / BUSINESS TAXES

Close Corporate Loopholes

Georgia has low corporate income taxes per capita compared to other states, ranking 41st in 2008.[21] Choosing to be a low business-tax state is one thing, but losing tax revenues to unintended corporate loopholes reduces fairness: Corporate loopholes are unfair because they shift the tax burden from those businesses which avoid their tax obligation by using a loophole onto other businesses that pay their fair share.

Georgia lawmakers closed some corporate tax loopholes in recent years by restricting the use of Delaware-holding companies and captive real estate investment trusts as tax avoidance mechanisms, but other loopholes still exist. Georgia could limit other income transferring mechanisms by instituting combined reporting, which requires affiliated companies to file a combined report on their profits. As of 2009, 23 other states used combined reporting.[22]

Evaluate and Revise Exemptions and Credits

Lawmakers have been enacting new corporate exemptions and credits each year, however, once in the tax code, they remain there without evaluation or scrutiny. These tax preferences shrink the tax base and reduce fairness by shifting the tax obligation onto other businesses and individuals who do not receive the exemption, or alternatively, cause lawmakers to reduce state services (see Figure 1). Although some of these tax preferences serve valid policy purposes, others likely are not producing the intended results.

The Council's recommendations would increase fairness and protect adequacy by specifying that before adding more tax breaks on top of the many existing tax breaks, the state should evaluate which exemptions and credits serve agreed upon public policies and which among the current tax preferences do not. In addition, the Council could improve tax credit management by recommending that lawmakers agree on how much Georgia is willing to spend on economic development through tax exemptions and credits in comparison with direct appropriations for such programs as QuickStart, technical colleges and universities, K-12 education, and the Department of Economic Development.

The Council could also ensure the state has more adequate and reliable funding, both principles of effective tax reform, if any new worthwhile exemptions are measured against current exemptions and the adequacy of state revenues, with discussion of whether less worthwhile tax preferences should be eliminated or replaced as a new exemption is added.

For example, one proposed exemption that has been a particular focus of the corporate community is the sales tax exemption for energy used in manufacturing, estimated to cost the state $80 million if enacted.[23] This is likely a worthwhile exemption due to the fact that raw materials are typically exempt from sales tax. However, because it is prudent to refrain from adding a new tax break in a vacuum and causing a loss in revenue without a corresponding gain, this new exemption could be offset by eliminating existing tax breaks.

TAXES AND ECONOMIC DEVELOPMENT

"One of the main economic goals of most state policy makers is, quite sensibly, to attract businesses to their state — but all too often, these policy makers have been encouraged to think that tax cuts make the best bait. A growing body of literature reminds us that taxes themselves create public infrastructure that spurs investment and improves the quality of life for businesses and workers alike. Unaffordable tax cuts shift the cost of funding public services onto every business that isn't lucky enough to receive these tax breaks — and makes it harder to fund the public investments on which all businesses rely."[26]

—Institute on Taxation and Economic Policy

Potentially millions of dollars

Revenue gain from:

- *Closing loopholes*
- *Revising and eliminating tax breaks*
- *Modernizing the corporate net worth rates*

— Improves adequacy, fairness, economic neutrality, simplicity

1931

Year the state set the $10 minimum corporate net worth tax rate.

Modernize the Corporate Net Worth Tax

The corporate net worth tax has come under fire in recent legislative sessions, as multiple legislative proposals have sought to phase it out entirely. The tax acts as a sort of minimum corporate tax, ranging from $10 to $5,000 depending on a corporation's level of assets. It raises approximately $30 million annually. Some profitable corporations escape state corporate income taxes altogether through tax avoidance; therefore, rather than phasing it out, maintaining and modernizing the corporate net worth tax would help both level the playing field among corporations and improve the state's revenue streams.

Proponents of eliminating the corporate net worth tax have stated that it is an onerous tax, due to the filing requirements for such a small amount ($10 for 52 percent of corporations).[24] The state could modernize it to ease compliance, such as moving to single sales factor apportionment. If the state modernized the tax rate, since the $10 minimum tax from 1931 would equal $140 today, it would be another way to ensure adequacy and fairness. If the rates had kept pace with inflation, the corporate net worth tax would have raised more than $250 million in 2005 rather than the $30 million it brought in.[25] In addition, the Council could recommend the net worth tax becomes an offset to corporate income taxes, so that it truly acts as a minimum tax.

EVALUATING AND MANAGING TAX CREDITS

- North Carolina's Joint Select Committee on Economic Development Incentives explored the effectiveness of corporate tax credits, measuring the credits against both other incentives and lower overall corporate tax rates. It found that tax credits were the least effective mechanism for attracting businesses, and that elimination of credits allowed for a lower overall tax rate, a trade-off preferred by businesses surveyed. Their methodology and findings are available at http://www.ncleg.net/gascripts/DocumentSites/browseDocSite.asp?nID=29.
- Iowa legislators enacted a Legislative Tax Expenditure Committee to evaluate tax credits regularly (Senate File 2380).
- Missouri lawmakers proposed better oversight of economic development spending through the tax system by subjecting tax credits to the budget appropriations process (Senate Bills 728 and 954).

OTHER TAXES

Update Excise Tax Rates

Excise taxes are levied on a per unit basis rather than as a percent of the sales price. For example, the cigarette excise tax is 37 cents per pack, no matter the cost of a pack of cigarettes. Likewise, the motor fuel excise tax rate is 7.5 cents per gallon. While other tax revenues rise with the cost of goods or level of incomes, excise taxes remain a fixed rate no matter how the price of the product changes, thus they can become outdated easily.

Although Georgia raised its cigarette excise tax in 2004, it remains fourth lowest in the nation, slipping in the ranking over the past several years as states across the nation increased their rates. Florida, North Carolina, South Carolina, Arkansas, Mississippi, and Kentucky, along with numerous other states, raised their excise taxes on tobacco in 2009 and 2010. If Georgia increases its cigarette tax by $1 per pack, along with increases to rates on other tobacco products as proposed in recent legislation, it would raise an estimated $350 to $400 million annually.[27]

Georgia's motor fuel excise tax rate is even more outdated, remaining at 7.5 cents per gallon since 1971. Even after accounting for the four percent sales tax on gasoline, Georgia's tax rate per gallon of gasoline is among the lowest in the nation.[28] Increasing the motor fuel excise tax provides additional funds for transportation projects, rather than contributing to Georgia's general fund, and thus is not included in this report's cost estimates.

Support the Revival of the State Credit for Estate Taxes

The federal estate tax has been in flux in recent years, dropping to zero and then scheduled to return to previous levels. These changes have reduced Georgia's estate tax revenue since the state tax is a credit for taxpayers against federal estate taxes. The state credit does not raise an individual's overall estate tax obligation, but ensures a portion of the revenues remain in Georgia rather than going fully to the federal government. When the federal government phased out the allowance of a state credit during its estate tax changes in the 2000s, Georgia's $125 million estate tax revenue disappeared. Some states decoupled from the federal estate tax during that time to preserve their estate tax, but Georgia did not.

Congress' recent discussions about how to restructure the federal estate tax have not clarified whether or not the state credit will be revived. State tax reform is not independent of federal law, therefore reform efforts must take into account federal changes and explore ways Georgia leaders can encourage federal action that bolsters the adequacy and fairness of the state tax system. One such timely opportunity is for the Council's recommendations to include encouragement of our congressional delegation to restore this state credit.

$350 to $400 million
Revenue gain from increasing the cigarette tax $1 a pack
— Improves adequacy

$125 million
Revenue gain if the state estate tax credit is fully restored
— Improves adequacy, fairness

HEALTH BENEFITS FROM A TOBACCO TAX INCREASE

Raising tobacco tax rates has health and long-term financial benefits along with revenue benefits. A $1 per pack increase will cause more than 49,100 adult Georgians to quit smoking and result in 79,600 fewer future youth smokers. In the long term, a $1 increase will generate $1.8 billion in healthcare savings from reduced cigarette consumption by adults and kids.[29]

COMBINED TAX CHANGES CAN ADVANCE ADEQUACY AND FAIRNESS

A single tax change can affect multiple principles of responsible tax reform. For instance, a tax change that improves adequacy and stability could simultaneously decrease fairness among taxpayers. Effective, comprehensive tax reform balances the effects of tax changes with the system's overall adequacy, fairness, economic neutrality, and simplicity.

Table 2 provides an example of combined tax changes that improve fairness while also enhancing adequacy. In this example, the changes resolve half of Georgia's structural deficit and ensure revenues grow with the economy moving forward in order to increase long-term adequacy. This model demonstrates the ways in which the impact from reforms recommended in this report can balance each other. The estimated revenue impacts are calculated by the Institute on Taxation and Economic Policy based on the tax changes discussed in the report. (The state would raise additional funds through federal changes to estate taxes and Internet sales as previously discussed.)

Table 2

Combined Tax Changes Can Improve Fairness and Advance Adequacy

Tax Reform Option	Estimated Revenue Impact (in millions)	Average Tax Change as a Percent of Income (by income group)						
		Lowest 20% Less than $15,000	**Second 20%** $15,000 to $28,000	**Third 20%** $28,000 to $46,000	**Fourth 20%** $46,000 to $77,000	**Next 15%** $77,000 to $161,000	**Next 4%** $161,000 to $400,000	**Top 1%** $400,000 or More
Reform Income Tax System • Modernize brackets and rates • Raise standard deduction and eliminate itemized deductions • Lower retirement exclusion • Enact refundable EITC	$85	–1.4%	–1.1%	–0.4%	0.0%	0.2%	0.4%	0.3%
Reform Sales Tax System • Reduce sales tax rate to 3.75% • Broaden the tax base to select personal services	$357	0.3%	0.2%	0.2%	0.1%	0.1%	0.1%	0.1%
Increase Cigarette Tax Rate by $1, along with increases for other tobacco products	$380	0.6%	0.4%	0.2%	0.2%	0.1%	0.0%	0.0%
Reform Corporate Taxes • Close corporate loopholes • Eliminate select tax breaks • Modernize corporate net worth tax[(a)]	$100	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Estimated Tax Change	**$922**	**– 0.53%**	**– 0.55%**	**0.02%**	**0.28%**	**0.40%**	**0.47%**	**0.35%**

Source: Institute on Taxation and Economic Policy

Notes: The distributional impacts shown are average tax changes. Thus some taxpayers in each income group would have a smaller tax change, and some would have a larger change. The reform options follow the examples used in the text, such as expanded brackets and top income tax rate of 5.5%. Income tax changes include federal offsets in the distribution. Motor fuel excise tax is not included since the revenue does not go to the general fund.

(a) It is not possible to calculate how much Georgia can raise by corporate tax changes, given the variety of tax breaks that could be scaled back or eliminated. This model uses an estimate of $100 million for distributional purposes.

Numerous states have enacted short-term fixes to their revenue systems during the recession. More than 30 states passed tax increases to assist in closing budget gaps, thus preventing them from making further cuts to essential services and allowing them to maintain investments in public priorities.

In addition, many states have formed tax reform commissions, similar to Georgia's, to undertake comprehensive tax reform. South Carolina and North Carolina offer two neighboring examples of recent commissions, both of which provide extensive information and presentations by experts on their commission websites that may be useful to the Georgia Council.

Below is a list of states that have enacted tax changes in recent years similar to the options outlined in this report.[30] Of course, several states made these tax changes prior to the past few years — for example, 23 states have an EITC, 23 states have combined reporting, and 28 states tax more services than Georgia does.

SALES AND USE TAX

- Broadened their base to cover more personal services
  - Kentucky, Maine, North Carolina, Tennessee, Vermont, Washington, Wisconsin
- Lowered the rate
  - Utah
- Encouraged collection from remote sellers
  - Support the federal Main Street Fairness Act: National Conference of State Legislatures, Streamlined Sales Tax Governing Board, Federation of Tax Administrators, Government Finance Officers Association, National Governors' Association, National Retail Federation, National League of Cities, National Association of Counties, among others[31]
  - State laws: New York, North Carolina, Rhode Island

PERSONAL INCOME TAX

- Broadened their base by scaling back preferences
  - California, Colorado, New Jersey, New Mexico, New York, Oregon, Rhode Island, Vermont, Wisconsin
- Modernized their brackets and rates
  - Connecticut, Delaware, Hawaii, Maryland, New Jersey, New York, North Carolina, Oregon, Wisconsin
- Instituted or expanded refundable credits for low-income taxpayers (enacted since 2007)
  - Louisiana, Indiana, Iowa, Kansas, Maine, Maryland, Michigan, Nebraska, New Mexico, North Carolina, Washington

CORPORATE TAXES

- Closed corporate loopholes
  - Massachusetts, Minnesota, Wisconsin
- Broadened their base by reducing credits and exemptions
  - California, Colorado, Connecticut, Indiana, Iowa, Kansas, Maine, Maryland, New York, Oklahoma, Oregon, Wisconsin, Washington[32]
- Modernized the corporate net worth (franchise) tax
  - Delaware, Oregon, Tennessee

EXCISE TAXES

- Updated cigarette and/or motor fuel excise tax rates
  - Alaska, Arkansas, Connecticut, Delaware, Florida, Hawaii, Iowa, Indiana, Kentucky, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington[33]

Men at Quaker state oil station, Courtesy of Georgia Archives, Vanishing Georgia collection, plk058-84

Tax reform is such a major undertaking that five months is not likely adequate time for the Tax Reform Council to complete its task of fully researching and addressing the many parts of the tax code that need reform, especially if it seeks to review the more than 100 unevaluated tax breaks.

Given this broad and vital charge, it might be prudent for the Council to chart out what it can readily accomplish over the next five months, as well as create an agenda for 2011. One possibility is for the Council to deliver recommendations for the 2011 legislative session that encompass some of the "low-hanging fruit" of reform, while constructing a 2011 agenda for further study. Under a renewed charge in 2011, the Council could not only complete an even more thorough analysis of complex proposals, but present recommendations to the General Assembly that could serve Georgia for another half century.

CONCLUSION

The tax reform recommendations outlined in this report contain options that stress a practical combination of raising enough money to meet Georgia's growing needs, updating the tax system to reflect today's economy, keeping rates as low as possible, and tying the system more closely to ability to pay than it is now. These reforms include:

- Lowering the state sales tax rate and simultaneously broadening the tax base to capture 21st century spending habits.
- Modernizing income tax brackets, rates, and standard deductions to reflect current income levels.
- Creating an EITC to offset highly regressive sales taxes for the state's lowest earners.
- Scaling down tax preferences, both for individuals and corporations, to avoid shifting taxes onto fewer individuals and businesses as they do now.
- Closing corporate loopholes and updating the corporate net worth tax to prevent profitable corporations from avoiding paying their fair share.
- Updating cigarette and motor fuel excise tax rates.

Georgia can make a number of changes to its tax system that, taken together, ensure the state can fairly raise adequate funds to pay for crucial public investments that expand opportunity for families and businesses.

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