ALMOST THERE…

Tax Council's Recommendations Improve Finances, but Shift Taxes onto Vulnerable and Working Georgians

By Sarah Beth Gehl, Deputy Director

Summary

The Special Council on Tax Reform and Fairness for Georgians provided recommendations that make improvements to structural issues plaguing Georgia's tax system. The Tax Council took strong action to broaden tax bases—a tenet of good tax policy. In the sales tax, the Tax Council recommended expanding the tax base to services, which would allow the tax system to better reflect current spending habits of Georgians and better track the economy in the future. They also recommended expanding the income tax base by reducing exemptions, credits, and deductions.

Although the Tax Council's recommendations would improve Georgia's ability to meet current and future needs, they would do so by shifting taxes away from wealthy Georgians and onto middle- and low-income Georgians. The best-off one percent of Georgians, those earning more than $389,000 in 2010, would receive an almost $7,800 average tax *decrease*. In contrast, middle- and low-income Georgians would see an average *increase* of $394 and $83, respectively, according to preliminary estimates by the Institute on Taxation and Economic Policy.

Legislators could make one of the following three adjustments to the Tax Council's recommendations to lessen that tax shift, while maintaining the Tax Council's improvements to long-term finances.

- ***Option 1* – Maintain the grocery exemption and reduce the income tax rate to 4.5 percent rather than 4 percent.**
- ***Option 2* – Lower the state sales tax rate to 3.5 percent and reduce the income tax rate to 4.5 percent rather than 4 percent.**
- ***Option 3* – Re-craft the proposed personal income tax credit into a refundable low income tax credit and targeted standard deduction.**

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Overview of Tax Council's Recommendations

Personal Income Tax

- Broaden the tax base by eliminating personal exemptions, standard and itemized deductions, retirement income exclusion, and most tax credits.
- Lower income tax rates to at least a flat 5 percent in 2012, at least 4.5 percent in 2013, and 4 percent in 2014.
- Create a personal credit to replace personal exemptions, deductions, and credits.

Corporate Income Tax

- Lower corporate income tax rate to at least 5 percent in 2012, at least 4.5 percent in 2013, and 4 percent in 2014.
- Consolidate economic development tax credits to focus on jobs and investment credits, provide discretion to the Department of Economic Development on the provision of credits, and allow the legislature to place annual caps on credits. Sunset all other corporate tax credits in 2014.

Sales and Use Tax

- Broaden the tax base to
  - Select household services
  - Casual sales of cars, aircraft, and boats
- Eliminate exemptions on
  - Groceries on June 30, 2011
  - Film production equipment
  - Sales tax holidays
- Sunset exemptions for
  - Government authorities (2011)
  - Health care (2012)
  - Education (2013)
  - Nonprofits and Miscellaneous (2014)
    (**Note**: The Tax Council recommends these exemptions are sunsetted and debated, not necessarily eliminated.)
- Expand/Renew exemptions for
  - Sales tax on energy used in manufacturing, mining, and agriculture
  - Sales tax on jet fuel (The exemption is set to expire in 2011. The Tax Council recommends renewing the exemption until 2014.)
- Maintain/Refine exemptions for
  - Government, business inputs, agricultural inputs, and manufacturing inputs

What Happens to Newly Expired Exemptions?

Several sales tax exemptions, such as the exemption for sales to food banks, were up for renewal in 2010. They were not renewed due to the fiscal crisis. The Tax Council notes these expired or expiring exemptions, but only pointedly recommends that the sales tax holiday not be renewed. It is unclear whether the Tax Council is recommending the Legislature revisit these newly expired exemptions.

Excise and Other Taxes

- Increase the cigarette excise tax to 68 cents and index the tax rate to inflation.
- Transform the 3 percent sales tax on motor fuels to a revenue neutral cents per gallon rate, and index the rate (combined with the existing 7.5 cents per gallon) to inflation for highway construction annually.
- Replace existing communications taxes and franchise fees with a 7 percent excise tax and incorporate all communications platforms.
- Lower Insurance premium tax rates to 1.75 percent.

Council Recommendations Would Improve Long-term Sustainability

Adequacy is a key principle of tax policy, as it covers the most fundamental reason we have taxes—to pay for public services. 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 19 percent in two years. They are not expected to return to 2007 levels until after 2015; however, demand for services has not fallen by 19 percent. Instead, the recession and Georgia's continued population growth are causing demand to rise. In the foreseeable future the state can expect to fall short of meeting its needs by hundreds of millions of dollars a year.

In the face of a structural deficit, reforming Georgia taxes would address ways to meet the state's current and future needs, including a state-of-the-art transportation network, a smooth-functioning court system, a trained workforce, a quality K-12 and college education, and many other tax-funded initiatives and services crucial to helping Georgia's economy thrive.

The Tax Council's recommendations make improvements to structural issues that have been damaging the adequacy of revenues in recent years and decades. The Tax Council took strong action to broaden tax bases—a tenet of good tax policy. In the sales tax, the Tax Council recommended expanding the tax base to services, which would allow the system to better reflect the current spending habits of Georgians and better track the economy in the future. They also recommended expanding the income tax base by reducing exemptions, exclusions, credits, and deductions. It is unclear what the long-term yield of these changes would be, but it is clear that these changes would make the tax system more sustainable over the long haul by ensuring that the fastest growing elements of consumer spending and personal income are taxed.

Revenue Neutrality – What Does It Mean?

The Tax Council has stated that its recommendations are revenue neutral when fully implemented. The question becomes whether that means a continuation of the downward spiral Georgia's tax system is currently on, or a move to a modern, well-functioning tax system. The Tax Council recommendations shore up the tax system by broadening tax bases and modernizing the system to today's economy. These improvements appear to make the tax system revenue neutral to the path Georgia's tax system should normally be on—not its current path, which includes the worst recession since the Great Depression. The recommendations provide an immediate boost in revenues to regain the ground lost in the recession and then stabilize revenues going forward.

Recommendations Would Cause a Decline in Fairness

A fair or equitable tax system treats taxpayers in similar circumstances similarly and considers taxpayers' ability to pay. According to the National Conference of State Legislatures, "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."[1]

Among the goals of the Tax Council, according to its final report, were "enhancing the perception of fairness for all" and shifting from income to consumption taxes. Although many perceive consumption taxes as fairer than income taxes, in truth, consumption taxes fail in fairness. The farther down the income scale a household is, the greater share of its earnings goes to pay sales taxes. In short, sales taxes are regressive.

A Special Note on Seniors

Currently, seniors receive special treatment in the income tax system, with $35,000 exclusions for retirement income ($70,000 for a couple), as well as more generous standard deductions and low income tax credits. The Tax Council recommends phasing out the retirement exclusions and replacing the standard deduction and low income tax credit with a personal credit that treats seniors the same as non-seniors. Thus, seniors will be disproportionately affected by the Tax Council's recommendations.

The Tax Council might have achieved the enhanced *perception* of fairness given the common myth surrounding the sales tax, but they did not achieve actual gains in fairness. If implemented in full, the Tax Council's recommendations will shift taxes onto middle- and low-income Georgians. One important basic question legislators should ask of any tax reform package is whether it will impose taxes on Georgians living below the poverty line.

Table 1: **Combined Tax Changes Shift Taxes onto Middle- and Low-income Georgians**

Tax Reform Recommendations	**Average Tax Change as a Percentage of Income and by Dollar Amount (by income group)**						
	Lowest 20%: Less than $15,000	***Second 20%:*** $15,000 to $28,000	***Third 20%:*** $28,000 to $45,000	***Fourth 20%:*** $45,000 to $75,000	***Next 15%:*** $75,000 to $157,000	***Next 4%:*** $157,000 to $389,000	***Top 1%:*** $389,000 or more
Personal incomes tax changes	–0.1%	0.1%	0.5%	0.5%	0.1%	–0.4%	–0.8%
	-$10	$24	$196	$296	$100	-$853	-$8,267
Cigarette tax increase	0.2%	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%
	$23	$29	$34	$36	$35	$44	$45
Sales tax changes	0.7%	0.6%	0.5%	0.4%	0.3%	0.2%	0.1%
	$70	$120	$165	$218	$275	$352	$687
Corporate income tax cut	–0.0%	–0.0%	–0.0%	–0.0%	–0.0%	–0.0%	–0.0%
	$0	$0	-$1	-$1	-$4	-$18	-$257
COMBINED CHANGES	**0.9%**	**0.8%**	**1.1%**	**0.9%**	**0.4%**	**–0.2%**	**–0.7%**
	$83	**$172**	**$394**	**$549**	**$405**	**-$475**	**-$7,793**

Source: Preliminary estimates by the Institute on Taxation and Economic Policy, January 2011

Three Adjustments for the Legislature to Consider

The Legislature could lessen the tax shift in the Tax Council's report by selecting one of the following three alternatives, which make adjustments to the Council's proposal. Each of these alternatives would lessen the tax shift somewhat, while protecting the Tax Council's numerous improvements to long-term finances (see Chart 1 on following page).

- ***Option 1 – Maintain the grocery exemption and reduce the income tax rate to 4.5 percent rather than 4 percent.*** The sales tax exemption on groceries makes the sales tax slightly fairer towards low-income Georgians. Thus, removing that exemption is one of the main tax shifts in the Tax Council's recommendations. Legislators could enact all of the Tax Council's recommendations with those two changes—keeping the grocery exemption and lowering the income tax rate to 4.5 percent rather than 4 percent—to improve fairness in the tax package. This adjustment would not negatively impact the adequacy of the recommendations, since the grocery exemption costs an estimated $472 million and the income tax rate cut from 4.5 percent to 4 percent costs an estimated $723 million.[2]

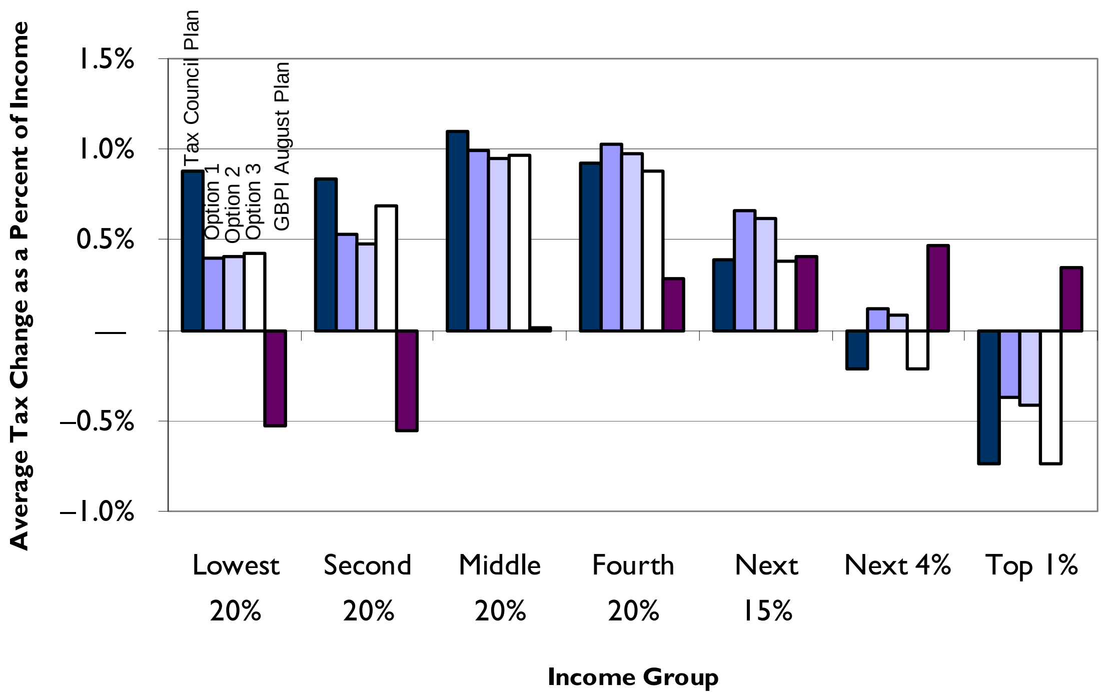
- ***Option 2 – Use the broadened sales tax base to lower the sales tax rate.*** The Tax Council broadened bases in both the sales and income tax, but only lowered rates in the income tax. If legislators insist on eliminating the sales tax exemption on groceries, they should consider lowering the sales tax rate to help offset a portion of the shift onto low-income taxpayers. For example, an alternative proposal could include the base broadening changes the Tax Council recommends, while also:
    - Lowering the state sales tax rate to 3.5 percent, and
    - Lowering the income tax rate to 4.5 percent, rather than the full 4 percent recommended by the Tax Council.

  Lowering the state sales tax rate would have the added benefit of preparing Georgians for a possible regional sales tax for transportation in 2012.

- ***Option 3 – Re-craft the proposed personal income tax credit into a refundable low income tax credit and a targeted standard deduction.*** The personal credit in the Tax Council's report replaces current personal exemptions and deductions for taxpayers earning less than $50,000. In addition, a $50 credit per family provides a small offset to the new sales tax on groceries. Although the credit is supposed to hold low-income families harmless, it only does so for the income tax. It must be more generous and refundable to offset the additional sales taxes placed on low-income families and seniors.

  The Tax Council's language leaves the door open to adjustments to the personal credit, by stating that the credit should provide "at least tax neutrality for low-income taxpayers."[3] Re-crafting the personal credit into a more robust, refundable low income tax credit and a standard deduction would provide a better offset to the new sales taxes on moderate- and low-income taxpayers. For example, legislators could institute a $5,000 standard deduction that phases out at $20,000 for singles ($10,000 deduction phasing out at $40,000 for married couples filing jointly). The refundable credit could be an expanded version of the existing low income tax credit, with $50 per person maximum and double credits for seniors. These changes would improve the fairness of tax changes, as well as ease the administrative burden created by the Tax Council's personal credit.

Chart 1: **Adjustment Options Could Improve Fairness in the Tax Reform Proposal**



Source: Preliminary estimates by the Institute on Taxation and Economic Policy, January 2011

TAX PLANS

Tax Council Plan
- **Proposed changes in income, sales, and cigarette tax**

Option1:
- **Tax Council Plan**
- **Keep grocery exemption**
- **Lower income rates to 4.5%**

Option 2:
- **Tax Council Plan**
- **Lower income tax rates to 4.5%**
- **Lower sales tax rate to 3.5%**

Option 3:
- **Tax Council Plan**
- **Refundable low-income credit and targeted standard deduction**

GBPI August 2010 Plan

(Download *Advancing Georgia's 1930s Tax System* at GBPI.org to view full plan.*)*

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Endnotes

[1] National Conference of State Legislatures, "Principles of a High-Quality State Revenue System," updated June 2007, http://www.ncsl.org/default.aspx?tabid=12673.
[2] Special Council on Tax Reform and Fairness for Georgians, "Recommendations," January 7, 2011, http://fiscalresearch.gsu.edu/taxcouncil/downloads/FINAL_REPORT_Jan_7_2011.pdf. (Note: Estimate of income tax change from initial revenue estimates by the Georgia State University Fiscal Research Center.)
[3] Special Council (2011)