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HB 387: Recommended Adjustments to Tax Reform Bill

By Sarah Beth Gehl, Deputy Director

The Special Joint Committee on Revenue Structure met on Monday and provided an alternate proposal to the Tax Council's recommendations. The committee substitute to House Bill 387 includes the following:

- 4.5 percent income tax rate, elimination of standard deduction and personal exemptions, a limit on itemized deductions, $2,000 dependent exemption, additional dependent tax credit for those earning less than $70,000, and a tax credit for those earning less than $50,000;
- New sales tax on casual sales of cars, boats, and aircraft, as well as on automotive repair services;
- Sales tax exemption on energy used in manufacturing, mining, and agriculture;
- Revised sales tax exemptions on equipment and machinery used in manufacturing, mining, and agriculture;
- Communications services tax of 7 percent to replace existing franchise fees and other related taxes; and,
- Sales tax exemption for equipment for telecommunications service providers, capped at $90 million.

The substitute does *not* include putting the state sales tax back on groceries. It also leaves the corporate income tax rate at 6 percent, leaves most services untaxed, leaves the tobacco and motor fuel tax rates untouched, and leaves exemptions and credits as is.

Some Good Policy…
Several Missed Opportunities

Positive steps:

- Bringing the retirement income exclusion back down to $35,000,
- Taxing some services,
- Saving the grocery exemption,
- Limiting itemized deductions.

Missed opportunities:

- Bringing more services into the sales tax base,
- Raising the tobacco tax rate,
- Lowering the retirement income exclusion below $35,000,
- Creating a refundable low-income credit to protect against a tax shift onto low-income Georgians,
- Improving the income tax to benefit all Georgians rather than just the top earners,
- Evaluating and revising tax breaks, and
- Providing an immediate boost in revenues to assist with the current budget challenges.

Recommended adjustments

HB 387 will not be amended once it leaves committee; thus, it is vitally important to make adjustments to the bill in the next several days. Below are several changes lawmakers should consider:

1. **Restore the tobacco tax increase.** Raising the cigarette tax by 31 cents, as recommended by the Tax Council, would generate $114 million in revenues, while a $1 per pack increase would generate $350 million. Georgia has the 4th lowest cigarette tax rate in the nation. Raising the rate now would assist with the immediate budget challenges, and provide long-term benefits due to decreased smoking-related illnesses and lowered rates of teen smoking.

2. **Lower the retirement income exclusion**. The $35,000 retirement exclusion could be lowered without affecting the senior population since the remainder of their income will be taxed at 4.5 percent rather than 6 percent. For example, a $26,500 exclusion would hold a person with $60,000 harmless given the rate reduction from 6 percent to 4.5 percent, while a senior with retirement income below $60,000 would actually receive a tax cut with a $26,500 exclusion at 4.5 percent.

	Current System	**New System**	**Current System**	**New System**
Retirement Income	$ 60,000	$ 60,000	$ 100,000	$ 100,000
Exclusion	**$ 35,000**	**$ 26,500**	**$ 35,000**	**$ 13,500**
Income after Exclusion	$ 25,000	$ 33,500	$ 65,000	$ 86,500
Tax rate	6.0%	4.5%	6.0%	4.5%
Tax	$ 1,500	$ 1,508	$ 3,900	$ 3,893

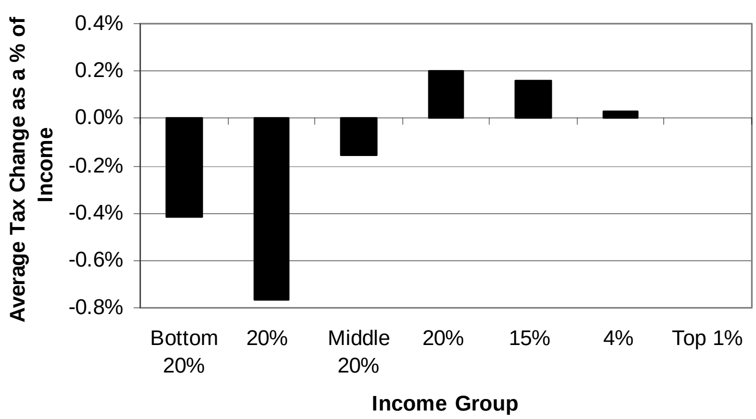
(*Note: The figures above are for illustrative purposes only, as they do not include other deductions and credits.)*

3. **Include Household Appliance Repair services in the sales tax base.** HB 387 includes auto repair services in the sales tax base, with the rationale that auto repair business already collect sales tax on parts and thus can administratively handle the collection of tax on labor services. Like auto repair, household appliance repair businesses collect sales taxes on parts. Including household appliance repair labor in the sales tax base broadening would raise approximately $44 million.

4. **Replace the itemized deductions limit and "hold-harmless" credit with a standard deduction**. GBPI has recommended limiting itemized deductions or eliminating them completely in favor of a better standard deduction. This would provide equal treatment between taxpayers at similar income levels. However, the proposed cap on itemized deductions and "hold-harmless" credit system is overly complex and should be revised to improve administration ease and simplicity.

A simpler and fairer method would be to have a robust standard deduction that taxpayers take rather than itemized deductions or this hold-harmless tax credit, with a phase-out of the exemption or deduction at a certain income level. For example, a standard deduction of $9,500 for singles phasing out above $20,000 AGI ($19,000 for married filing jointly phasing out at $40,000) would be far simpler and cost the same as the itemized deduction and credit scheme under the new rate. The poorest 60 percent of taxpayers would experience a tax decrease from this change on average, while the top 40 percent would see a slight tax increase. (Note: The chart below displays the effects for only one change – replacing itemized deductions and the hold-harmless credit with a standard deduction. It does not incorporate the effects of other changes such as the 4.5 percent rate reduction which would provide a tax cut to the top earners.)

Chart 1: **Impact of Simplifying HB 387 Income Tax Proposal in Revenue Neutral Way**



Source: Institute on Taxation and Economic Policy, March 2011

5. **Along with the income changes in item 4, maintain and improve the existing low income credit.** As a robust standard deduction replaces itemized deductions and hold-harmless credit, the existing low-income credit should be maintained, increased and **refundable** so that individuals with low income tax liability can receive the full benefit of the credit. If refundable credits are not an option for individuals, then lawmakers should eliminate refundability for corporate income tax credits.

6. Move the sales tax exemption for telecommunications providers to a separate bill. Credits and exemptions are typically intended for projects that are mobile–meaning, “but for” this exemption the project would move elsewhere. Lawmakers should have a thorough debate outside of the time-constraints on HB 387 as to whether this new exemption fits the “but for” requirement, as infrastructure upgrades for telecommunications are constrained to where customers live.

7. **Evaluate tax breaks**. The Council was tasked with producing an evaluation method for tax credits and exemptions. Rather than providing a methodology, the Council offered sunsets for sales tax exemptions and left the evaluation criteria to the legislature. Georgia lawmakers should consider two bills moving through legislatures in Texas and Maryland (SB 1051 and HB 620, respectively) which construct a process for tax break evaluation. Each bill sets up a commission to study tax breaks regularly and provides the components of what that evaluation will include.

8. **Eliminate other corporate credits and exemptions to fund the new sales tax exemption on energy used in manufacturing**. If the sales tax exemption for manufacturers is the new priority, then it should be funded through the reduction or elimination of lower priority corporate tax breaks. Scaling back or eliminating certain corporate credits and exemptions could assist in paying for the new corporate tax break, rather than residents picking up the cost.

Revenue Neutrality

The bill is revenue neutral, according to comments by committee members. In contrast, the Tax Council's proposal (perhaps unwittingly) would have raised $500 million to $970 million, depending on the state and local split of certain revenues.

Georgia is in a fiscal hole. The state faces a serious structural deficit even after the economy fully recovers due to its outdated tax system. In hitting a "revenue neutral" target, legislators should consider whether they would like this proposal to be revenue neutral to the hole in which we currently find ourselves, or revenue neutral to a trend line that doesn't include the worst recession since the Great Depression.

Prior to releasing the bill from committee, lawmakers should take a hard look at whether other items such as additional services or cigarette taxes should be included. These additional provisions could ensure Georgia is revenue neutral to a good year, rather than a year that will see us continue to cut school days, increase class sizes, and put off needed business-attracting investments in the state's infrastructure. The tax changes could be revenue neutral to 2008 and have $1.7 billion in additional revenue over FY 2012. Or, the tax changes **could be revenue neutral to 2006 ($16.5 billion in overall tax revenues) and have $500 million in breathing room from our current fiscal situation.** We should not hold ourselves in the short-term to revenue neutrality to 2012 alone – it is not a magical year. We could be revenue neutral to 2006 and gain $500 million by raising the tobacco tax and covering a few additional services.

Although the reform package could be better in stabilizing Georgia's short-term fiscal problems, it does strengthen long-term finances by bringing some items back into the tax code and by very modestly broadening tax bases.

Tax reform in the future – Are we going to tax services?

The Tax Council recommended taxing several categories of services, while the current proposal in HB 387 extends the sales tax only to the category of auto repair services. This is a good first step, but other services will need to be brought into the tax base in the future to stop the deterioration of the sales tax.

Frank Shafroth, director of the Center for State and Local Leadership at George Mason University, just this week captured the necessity of this move to taxing services in his column in *State Tax Notes*:

> "The state tax world risks becoming a kiwi bird, moving toward extinction, if it persists in increasingly raising tax rates on the shrinking world of tangible goods on which there is nexus. That's not to ignore either the political challenges of expanding the sales tax base, or the more complex issue of pyramiding.
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> The federal government is zealously concentrating nearly all of its fearless deficit reduction on that small 12 percent of the federal budget that most directly affects states and local governments -- especially in education and infrastructure, the two keys to a state's economic vitality. One would think state leaders would make sustained efforts to create tax systems that are not just consistent with today's economy but, perhaps more importantly, are in line with what they would like their future state economies to be. Eroding state tax bases will leave U.S. states increasingly unable to invest in order to challenge Bangalore and Hyderabad, now filling with America's leading companies. Creatively restructuring state tax systems to be consistent with the emerging economy will be critical to avoid overly burdening the property taxpayers and to ensure that there is sufficient revenue to compete against rising foreign economies."

Contact: Sarah Beth Gehl, sbgehl@gbpi.org, 404.420.1324 ext. 102