Policy Report

A Tax Blueprint to Strengthen Georgia

Fixing Georgia's Tax System Can Help Working Families and Protect the State's Investments

By Wesley Tharpe, Senior Policy Analyst

Reforming Georgia's rickety tax code is once again a hot topic among members of the General Assembly, and the question lawmakers must answer is how best to do it. The most prominent pending reform option would slash Georgia's top personal income tax rate and try to make up the lost revenue with increased sales taxes, an approach commonly known as a tax shift. Tax shift plans have a proven track record of raising total taxes for low- and middle-income families, delivering a windfall for wealthy families at the top and jeopardizing state support for education and other key services. The risks of that approach are described in the Georgia Budget and Policy Institute's companion to this report "**Tax Shift Plans Chart Wrong Path to Reform**." Better options exist.

The alternative blueprint outlined in this report provides a targeted tax cut to Georgians climbing the ladder toward the middle class, while protecting the state's most critical investments. The plan consists of three core tenets: **cut income taxes from the bottom up; modernize the sales tax to fit today's online commerce** and **make special tax deductions less generous**. The proposal would improve the lives of Georgians in several ways:

- **Provide a targeted tax cut to Georgia families**. Most of the bottom 60 percent of Georgia households, those with incomes less than $56,000 a year, would receive a sizable average tax cut under this plan. The proposal keeps taxes about the same for the next 20 percent of Georgians, or households with incomes from $56,000 to $94,000 a year. The wealthiest 20 percent of Georgians would contribute a bit more, on average, though the change would be modest for most households that make less than about $200,000 a year.

- **Help more Georgians reach the middle class for the long haul.** Many Georgians still struggle to get ahead in the wake of the recession that ended in 2009, and this tax plan gives them a hand up. A single mother with one child working full-time at the minimum wage to earn $14,500 a year would get a tax cut of about $500. A married family of three making around $38,000 a year could receive an estimated tax cut of nearly $700.

- **Protect state services from harmful funding cuts**. The most prominent reform ideas proposed in Georgia today would slash Georgia's top income tax rate and try to recover lost revenues through higher sales taxes. That is a recipe for large-scale shortfalls in Georgia's budget. House Bill 445, filed in early 2015, could cost an average of about $800 million a year if passed in its original form.[1] GBPI's plan detailed here is revenue-neutral in the short term and strengthens the foundation of Georgia's revenue system in the long term.

State lawmakers are on the right track to identify comprehensive tax reform as a priority that could help Georgia thrive long-term, but not all reform options are good choices. This report recommends a path designed to boost working Georgia families, broaden economic prosperity and put the state on firm financial footing for the future.

Snapshot of Georgia's Tax System Today

Updating Georgia's tax code requires a basic understanding of the starting point. Below are some key conceptual points and the following page provides some technical details that describe how the system works.

Georgia has among the lowest taxes in the country by any measure. Families and businesses in Georgia are not overly taxed relative to other states. Out of 50 states plus the District of Columbia, Georgia ranks 47th in state and local revenue per capita and 43rd in state and local revenue as a share of personal income. Georgia also ranks 44th in state and local business taxes as a share of the economy.[2]

Georgia's Tax Rates Similar to Southern Neighbors

	Personal Income Tax (Top Rate)	Sales Tax Rate (State and Local Average)
Alabama	5.0%	8.9%
Arkansas	6.9%	9.3%
Florida	None	6.7%
Georgia	**6.0%**	**7.0%**
Louisiana	6.0%	8.9%
Mississippi	5.0%	7.0%
North Carolina	5.75%	6.9%
South Carolina	7.0%	7.1%
Tennessee	None	9.5%
Texas	None	8.1%

Sources: Federation of Tax Administrators, Tax Foundation

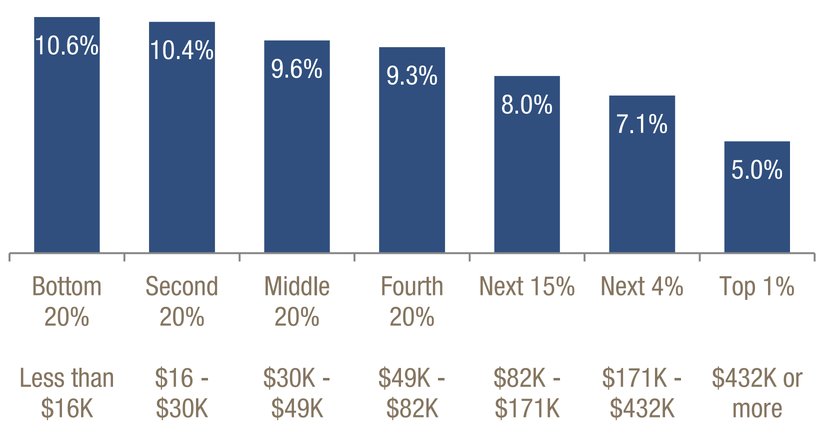
Georgia's tax rates are regionally competitive. Some lawmakers worry that Georgia's top personal income tax rate of 6 percent harms its economic prospects relative to other southern states. But Georgia's tax rates are similar to its regional counterparts in both income and sales taxes, as the table shows.

Everyone has skin in the game.[3] It's true that not all Georgians pay state or federal *income* taxes every year, because many seniors, students and low-wage workers are exempt. But everyone pays sales taxes. Anyone who drives a car pays gas taxes. Most adults pay local property taxes, including renters since most landlords pass along their tax expenses to tenants in the form of higher rents. New arrivals to Georgia make these contributions as well, contrary to popular belief. Undocumented immigrants paid Georgia an estimated $352 million in state and local taxes in 2012, the most recent year of data available.[4]

Georgia taxes fall most sharply on low- and middle-income families. As in most states, low- and middle-income Georgians pay a greater share of their income in state and local taxes than do the wealthy. This is known as a regressive tax structure. The poorest fifth of Georgia taxpayers pay an average estimated 10.6 percent of their annual income in state and local taxes and the middle fifth pays 9.6 percent. The wealthiest 1 percent pays only 5 percent of their income on average.[5]

Taxes Fall More Sharply on Working Families

Georgia state and local taxes as a share of family income, non-elderly taxpayers, 2015 income levels



Source: Institute on Taxation and Economic Policy. Figures provided upon request and incorporate 2015 legislative changes, specifically the increased motor fuel taxes. For context, Georgia's median household income in 2014 was $49,321.

Key Technical Aspects of Georgia's Tax System

<table>
<tr><th colspan="4">PERSONAL INCOME TAX</th></tr>
<tr><td>Rates and Brackets</td><td colspan="3">Taxable income above $7,000 for individuals and $10,000 for married couples filing jointly is taxed at the top rate of 6%. Taxable income below that level is taxed through a graduated bracket structure where different increments of income are taxed at rates ranging from 1-5 percent. A married couple’s first $1,000 of taxable income is taxed at 1 percent, the next $2,000 is taxed at 2 percent and so on until they reach the top rate of 6 percent at $10,000 of earnings.</td></tr>
<tr><td rowspan="5">"Tax Shield"</td><td colspan="3">Georgia's income tax shields a certain level of earnings from the tax, as do other states and the federal government. For about two-thirds of Georgia taxpayers, this "tax shield" consists of the personal exemption, standard deduction and the dependent exemption for families with children - values shown below. The other third of Georgia taxpayers, typically more affluent, substitute the standard deduction for a series of special deductions.</td></tr>
<tr><td>Type of Deduction</td><td>Single or Head of Household</td><td>Married Filing Jointly</td></tr>
<tr><td>Standard Deduction</td><td>$2,300</td><td>$3,000</td></tr>
<tr><td>Personal Exemption</td><td>$2,700</td><td>$7,400</td></tr>
<tr><td>Dependent Exemption</td><td>$3,000 per dependent child</td><td>$3,000 per dependent child</td></tr>
<tr><td>Special Deductions</td><td colspan="3">For about a third of Georgia taxpayers, the "tax shield" includes itemized deductions rather than the standard deduction. These special deductions are granted for expenses like mortgage interest and charitable contributions. Their total value per taxpayer is nearly limitless. In 2010, the average Georgia itemizer claimed a deduction of $23,739.</td></tr>
<tr><th colspan="4">SALES TAX</th></tr>
<tr><td>Rates</td><td colspan="3">4% sales tax rate levied by Georgia's state government
Up to 3% or 4% in select cases levied by local governments
7% average state and local tax rate statewide</td></tr>
<tr><td>Tax Base</td><td colspan="3">Georgia's sales tax applies to most physical goods, although there are about 80 exemptions for specific purchases. Major exemptions for individuals include groceries, prescription drugs and lottery tickets. Groceries are exempt from the state portion of the tax but still subject to local sales taxes. Major business exemptions include supplies and energy used in manufacturing and agriculture. Some physical goods purchased online are taxed but others are not, due to quirks in federal law.

Sales taxes are not collected on digital goods such as software, e-books, apps and mp3s. Basic internet access isn't taxed due to federal restrictions. Streaming services like Netflix and Spotify aren't taxed.

Most business and personal services are exempt from the tax; for example, auto repair, accounting, haircuts, landscaping services, club memberships, legal advice and others.</td></tr>
<tr><td colspan="4">Sources: Georgia Code Section 48, Federation of Tax Administrators, Tax Foundation. Notes: *Exemptions for married filing separately are half those for married jointly in each case.</td></tr>
</table>

GBPI's Blueprint Consists of Three Core Reforms

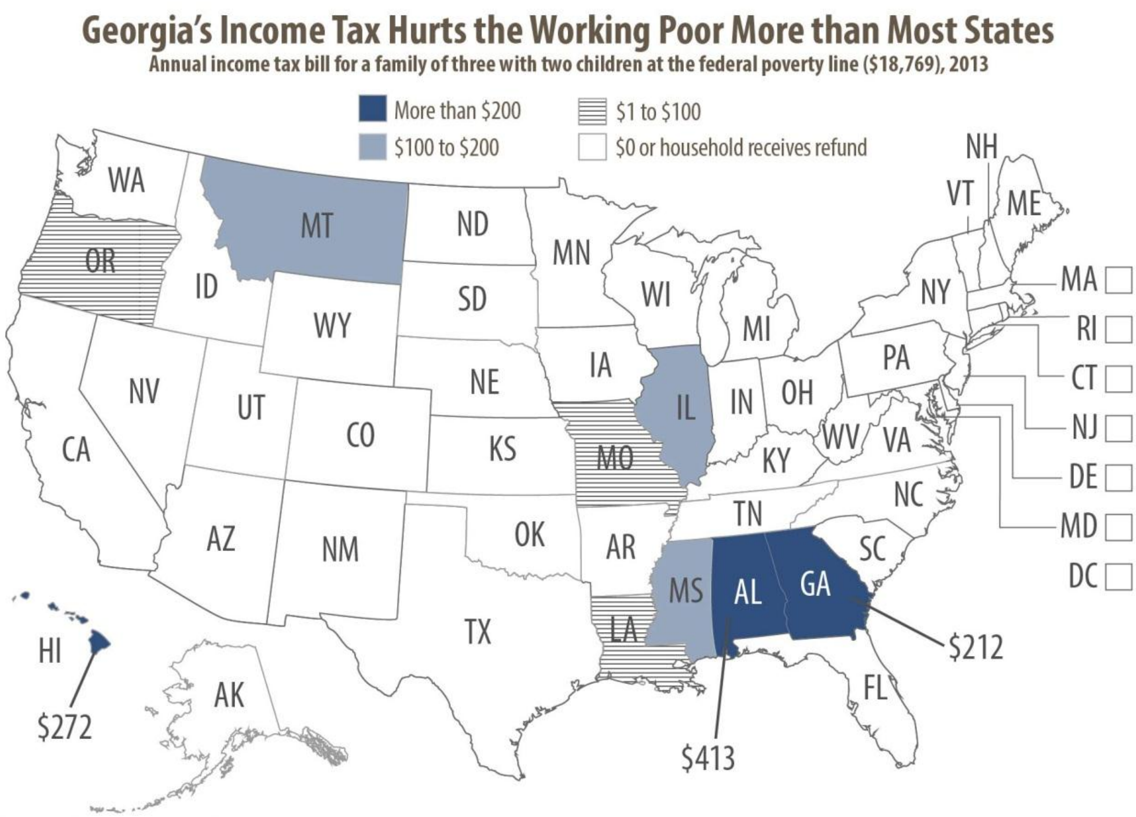
The approach outlined in this report would cut the yearly tax bill for average Georgia families and put the state's tax code on firmer footing for the 21st century. It achieves that goal through three main strategies: **Cut income taxes from the bottom up rather than the top down; modernize the sales tax to fit today's online commerce** and **make special tax breaks and deductions less generous**.

Step 1: Cut Income Taxes from the Bottom Up

The heart of the plan is a bottom-up income tax cut aimed at low- and middle-income working families. The bottom-up approach stands in stark contrast to the more common tactic of cutting income tax *rates*, a top-down strategy that disproportionately benefits wealthier households.[6]

Focusing an income tax cut on average families responds to the fact that the state's income tax contains a design flaw that causes it to fall too sharply on workers with small paychecks. One of the core benefits of the income tax is to offset less equitable levies like sales taxes and fees, which take a larger share of income from low-wage workers and the middle class than affluent ones. Properly designed income taxes provide a counterweight to sales and excise taxes by asking more from top earners.

The problem is Georgia's income tax is mostly unchanged from the 1930s, when $10,000 a year was considered a high-wage salary. As a result, the state's income tax starts applying to families at unusually low levels of income. Looking specifically at families in poverty, single Georgia parents with two children faced the **third highest** income tax in the country in 2013. For poor families of four with two children, Georgia ranked **sixth highest**.[7]



Source: National Center for Children in Poverty

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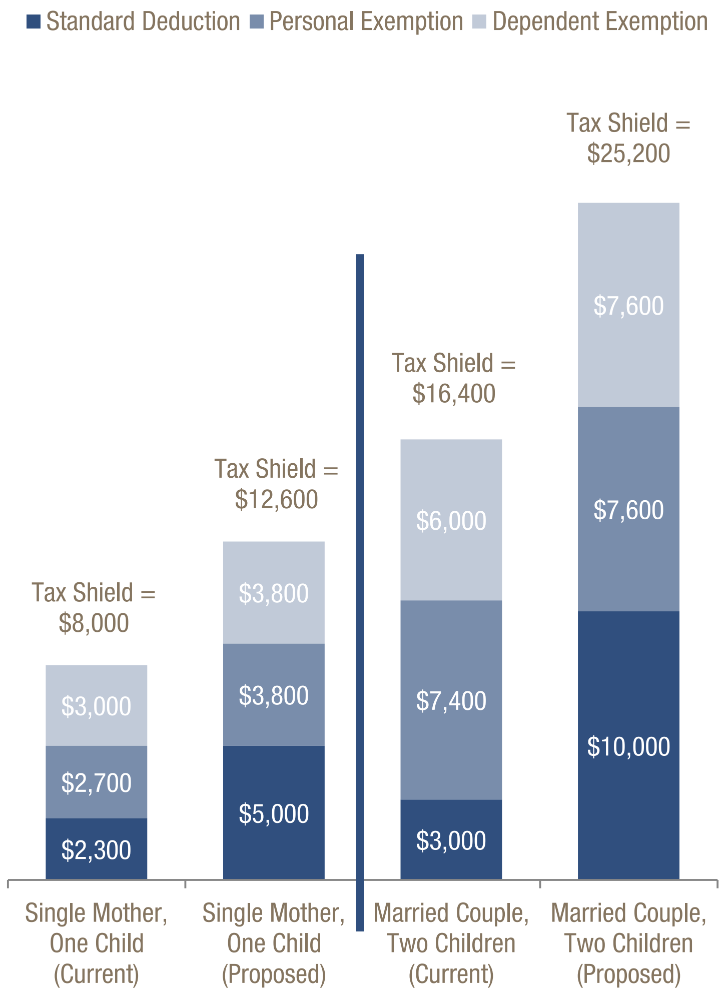
Lawmakers can fix this design flaw by reducing the annual income tax bill for low- and middle-income families. GBPI's blueprint achieves that bottom-up income tax cut through three specific policy changes: **raise Georgia's tax shield**, or the amount of annual income that's protected from the state income tax; **fix the marriage penalty** found in Georgia's current income tax brackets and **create a state Earned Income Tax Credit (EITC).**

Raise Georgia's Tax Shield – State taxpayers are able to shield a certain amount of their annual income through broadly available exemptions. This shield includes the standard deduction for typical Georgia taxpayers, a personal exemption and, for taxpayers with children, a dependent exemption. Georgia lawmakers can strengthen this shield by adopting the following changes:

- Raise the **standard deduction** to $5,000 from $2,300 for single taxpayers and to $10,000 from $3,000 for married couples filing jointly
- Raise the **personal exemption** to $3,800 from $2,700 for single taxpayers and to $7,600 from $7,400 for married couples filing jointly
- Raise the **dependent exemption** for taxpayers with children to $3,800 from $3,000

Proposal Raises Georgia's Tax Shield

Amount of taxable income in Georgia protected from the personal income tax by broadly available deductions



Note: Amounts for married couples filing *separately* are same as those for single taxpayers in all cases.

For a single parent with one child, these changes raise Georgia's tax shield to $12,600 from $8,000. That makes an additional $4,600 of their annual earnings tax-free. For a married couple with two children, the shield rises to $25,200 from $16,400, making an extra $8,800 of income tax-free. The specific size of the tax shield and the resulting benefit would vary among taxpayers based on number of dependent children.

Fix the marriage penalty – The plan also eliminates the marriage penalty in Georgia's personal income tax. The penalty is partly removed with the tax shield discussed earlier, which is twice as large for married taxpayers than for singles. The rest of the penalty is eliminated through a tweak to Georgia's tax brackets.

Georgia's income tax includes a graduated structure where different increments of income are taxed at different rates. A married couple's first $1,000 of taxable income is taxed at 1 percent, the next $2,000 is taxed at 2 percent and so on. Once a couple's taxable income reaches $10,000, they pay the 6 percent top rate on the remainder of their earnings. In a well-designed income tax, the brackets that apply to married couples are exactly twice as large as those that apply to single people. If a single person's taxable income above $7,000 is taxed at 6 percent, then a married couple shouldn't pay the 6 percent rate until their taxable income reaches $14,000. But Georgia's state income tax falls short of this goal, as the table below shows.

Proposed Tax Plan Resolves Marriage Penalty in Georgia's Income Tax

Tax Rate	Single (Current and Proposed)		Married Filing Jointly (Current Law)		Married Filing Jointly (Proposed)	
	Start of Bracket	*Top of Bracket*	*Start of Bracket*	*Top of Bracket*	*Start of Bracket*	*Top of Bracket*
1%	$0	$750	$0	$1,000	$0	$1,500
2%	$750	$2,250	$1,000	$3,000	$1,500	$4,500
3%	$2,250	$3,750	$3,000	$5,000	$4,500	$7,500
4%	$3,750	$5,250	$5,000	$7,000	$7,500	$10,500
5%	$5,250	$7,000	$7,000	$10,000	$10,500	$14,000
6%	**$7,000**	Rest of Income	**$10,000**	Rest of Income	**$14,000**	Rest of Income

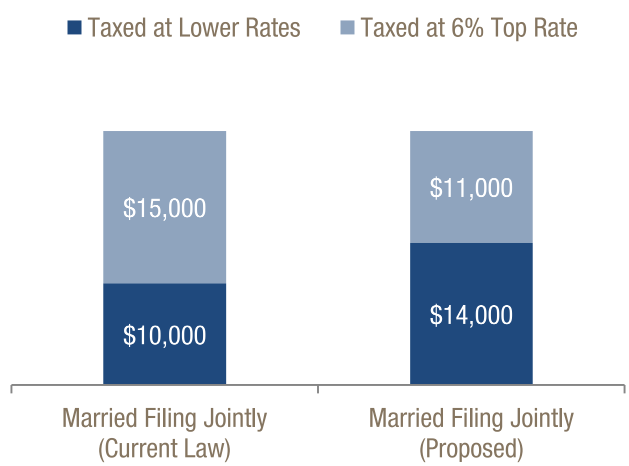
Source: Georgia Code Section 48

The highlighted squares above illustrate the dynamic. Married taxpayers today start paying Georgia's top rate of 6 percent at $10,000 of taxable income, compared to $7,000 for single taxpayers. The GBPI tax blueprint resolves this flaw by raising the income threshold for that top rate to $14,000 for married taxpayers and adjusting the lower brackets as well to make them twice the size as those for singles.

The chart on the right shows an example of this reform in practice. A married couple today with $25,000 of taxable income has $15,000 of those earnings taxed at Georgia's top rate of 6 percent. The revised brackets drop the amount subject to the top rate to $11,000. The result of this specific change for the couple in this example is an annual tax cut of $120.

Raising Brackets Means Less Income Taxed at Top Rate

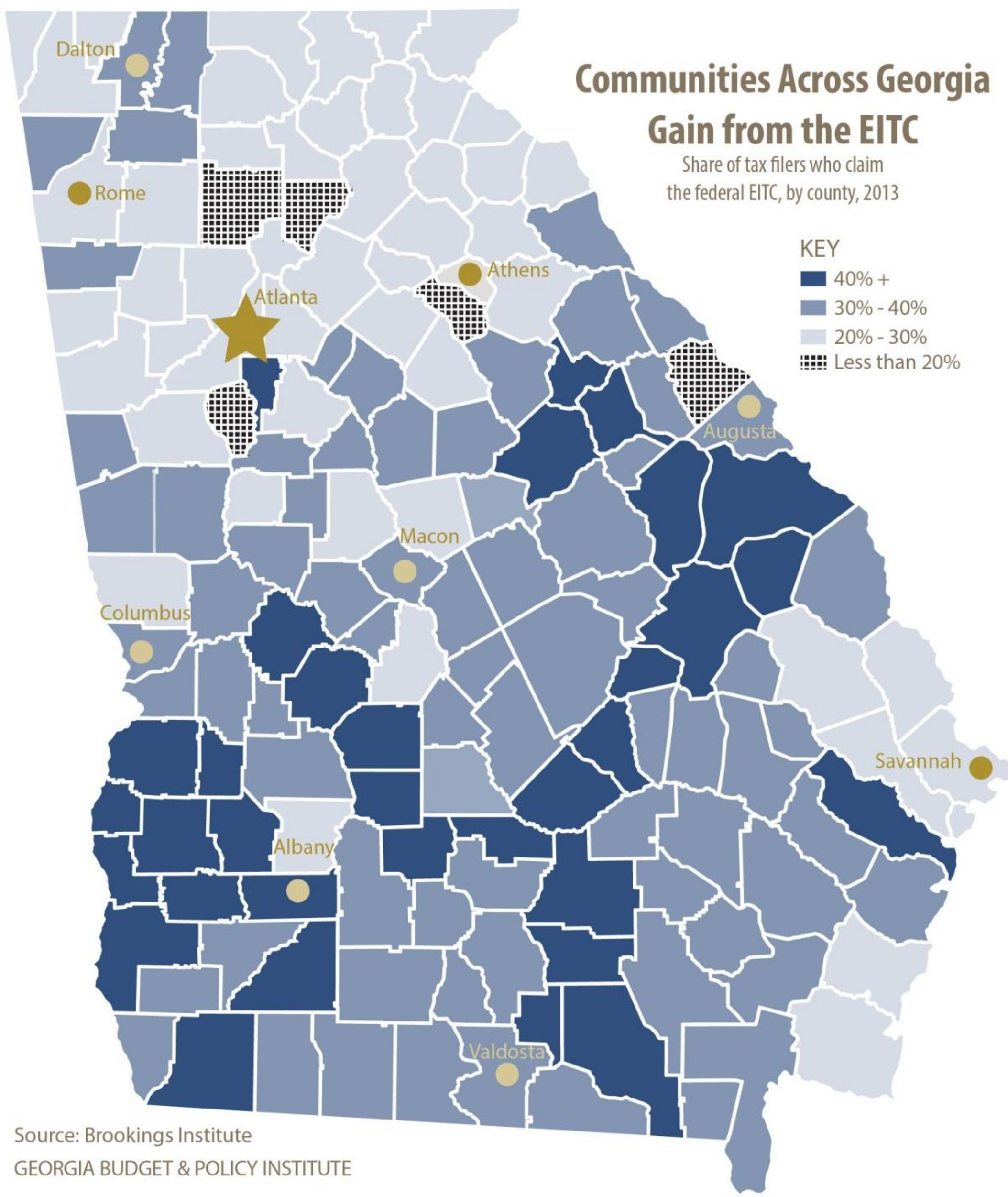
Amount of Georgia income subject to top vs. lower rates for married couple with $25,000 of taxable income



Source: GBPI calculations

Create a state Earned Income Tax Credit (EITC) – Twenty six states and the District of Columbia offer a state income tax credit that boosts the incomes of low-wage workers and helps families reach the middle class. The credit is a state level version of the federal EITC, which cuts taxes for workers with small paychecks like cashiers, construction workers, teaching assistants and home health aides. Nearly 1.1 million Georgia households received the federal EITC in 2013, at an average value of $2,700. The case for creating a Georgia EITC is more fully detailed in the 2015 Georgia Budget & Policy Institute report "**A Bottom-Up Tax Cut to Build Georgia's Middle Class**."

GBPI's plan creates a refundable[8] state EITC valued at 10 percent of the federal credit. For example, a Georgia taxpayer who is eligible for a $2,000 federal EITC would also receive a $200 state credit. A refundable Georgia EITC set at 10 percent of the federal credit would put an estimated $270 million annually into the pockets of working families spread across Georgia, as illustrated in the map below.



Step 2: Modernize the Sales Tax to Fit Today's Online Commerce

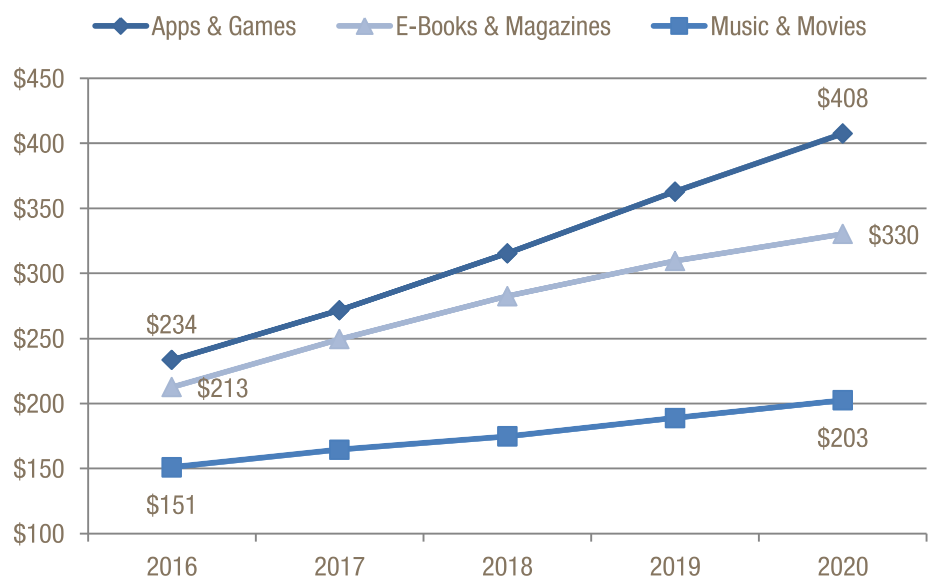
The second broad reform in GBPI's blueprint is to update Georgia's sales tax for the 21st century by extending it to the purchase of digital downloads, including software, music files, movie files, apps, games and e-books. This approach to reform is also included in House Bill 445, a major tax proposal unveiled by legislative leaders in 2015.

Downloaded merchandise is now untaxed in Georgia, unlike physical counterparts bought in brick-and-mortar stores. Georgians pay sales taxes on DVDs but not on movies they download from the Internet, for example, even though value to the buyer is the same. This anachronistic exemption is due to state tax laws that lag behind the rapid growth of the online economy, a mismatch that threatens Georgia's long-term finances. As more consumers purchase digital goods instead of physical ones, state and local governments lose out on more revenue.

Georgians are expected to spend nearly $2.2 billion on digital merchandise over the course of the 2016 budget year, growing to more than $2.7 billion in 2020. The accompanying chart shows the rising market share of some popular categories of digital merchandise, including apps and e-books.[9]

Digital Purchases Expected to Keep Growing

Estimated digital purchases in Georgia by fiscal year, in millions



Source: Official fiscal note for HB 445 as presented by the Department of Audits and Accounts

Georgia is forgoing an estimated $47 million to $57 million in state revenue in the 2016 budget year by not taxing digital goods. Local governments in Georgia will lose $35 million to $43 million.[10] These losses are forecast to grow considerably in the future as consumers shift more toward online purchases. The long-term growth of the digital industry is a key reason states need to modernize sales tax systems soon, so revenue systems keep pace with rapidly changing economic realities.

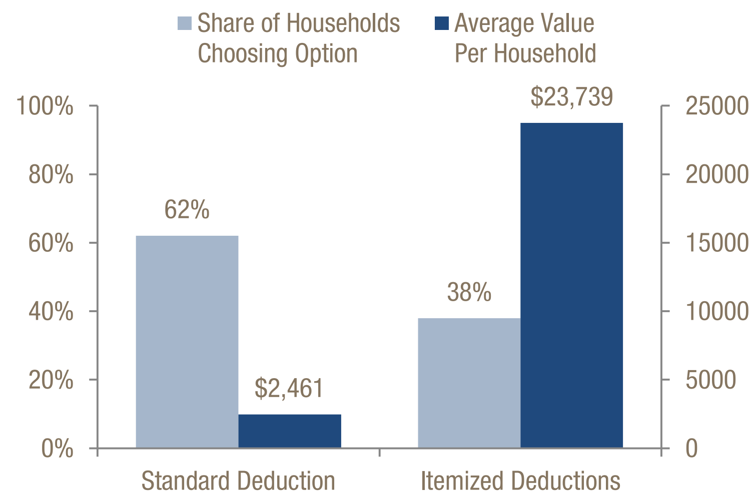
Step 3: Make Special Deductions Less Generous

The third aspect of the GBPI blueprint is to reign in the outsized benefit that a series of special income tax deductions provide to a select group of Georgia taxpayers. When Georgians file state income returns, they take *either* the standard deduction or a series of special deductions commonly known as itemized deductions. Modeled off of federal tax rules, these deductions include mortgage interest payments, charitable contributions, large medical expenses and state and local taxes.

About a third of Georgia taxpayers itemized deductions in 2010, the most recent year of available data.[11] The average deduction for those taxpayers was $23,739. That dwarfs the average $2,461 deduction for the two-thirds of Georgians who took the standard deduction that year, as shown in the chart on the right. Put another way, Georgians who itemize get to shield nearly 10-times as much of their income through deductions than typical taxpayers.

Special Deductions Provide Huge Benefit to Small Share of Taxpayers

Georgia-specific data for calendar year 2010



Source: GBPI calculations based on Department of Revenue 2012 Statistical Report, the most recent report containing the requisite data.

Although middle class Georgians choose to itemize, the largest benefit flows to the state's wealthiest families. Affluent taxpayers typically have larger mortgages, higher local property taxes and other large expenditures that allow them to shield more of their income through these deductions.[12] Itemized deductions cost Georgia more than $1.8 billion a year in lost tax revenue, due in large part to their outsized value to the most affluent taxpayers.[13]

The GBPI blueprint scales back these deductions in two ways to offset the bottom-up tax cuts described earlier in the report and keep the plan revenue-neutral.

- **Limit special deductions to three of the most important**. This approach to tax reform reduces itemized deductions available to Georgians to three of the most broadly claimed: *mortgage interest*, *charitable contributions* and *extraordinary medical expenses*. Reducing the number of deductions simplifies Georgia's tax code[14] and reigns in runaway costs, while also accommodating deductions that may serve valid policy goals and help protect families in unique circumstances. This proposed reform is similar to new restrictions North Carolina passed in 2013 and Maine adopted in 2014.[15]

- **Cap the total available value**. The GBPI blueprint establishes a new cap so remaining Georgia taxpayers who still itemize can only claim a maximum deduction of $10,000 for individuals, $15,000 for single head-of-household taxpayers and $20,000 for couples filing jointly. This differs from Georgia's current system, where the potential savings are almost unlimited. Georgia would join 13 states that either cap the value of itemized deductions or disallow them completely if it limited the size of deductions.[16]

Proposal Benefits Regular Georgians and Protects the State Budget

GBPI's three core reforms of cutting income taxes from the bottom up, modernizing the sales tax to fit today's online economy and reigning in special deductions combine to cut taxes for Georgians who need relief most, while also avoiding cuts to key state services like education. Many low- and middle-income Georgians could enjoy a sizable reduction in their annual tax bill, while the wealthiest Georgians – especially the top 1 percent –contribute a bit more.

Brief Notes on Methodology

The estimates below are provided by the nonpartisan, nonprofit Institute on Taxation and Economic Policy (ITEP) based in Washington, D.C. This report is only possible through its technical support. ITEP houses one of the most advanced tax simulators in the country and enjoys a respected reputation for modeling state and federal tax reforms. Developed in 1996, the ITEP Microsimulation Tax Model relies on one of the largest databases of tax returns in existence, encompassing close to three quarters of a million records. For more details on the ITEP model, visit http://www.itep.org/about/itep_tax_model_simple.php

Proposed reforms cut average taxes for the bottom 60 percent of Georgians and maintain the status quo for the next 20 percent. It impossible to know how complex tax reforms will affect every taxpayer in the state, since different tax bills result from distinct circumstances. But GBPI's tax plan would cut taxes *on average* for three in five Georgia taxpayers, specifically households with up to $56,000 in annual income. The plan keeps average taxes the same for the next 20 percent of residents, specifically households with annual incomes from $56,000 to $94,000; some people in this group would pay less and some would pay a bit more as circumstances vary. The wealthiest 20 percent of Georgians, on average, would receive a tax hike under the plan, though increases would be modest for most families below about $200,000 of annual income.

The following table provides the details on how Georgians' average tax bills would change. Take special note of the bottom two rows. The "average tax change" row shows the estimated **dollar amount** that each group's average tax bill would change. The "tax change as a percent of income" row shows how the plan changes the **share of household income** that taxpayers devote to state and local taxes; for example, Georgians with less than $18,000 in annual earnings would find their share of income that goes to state and local taxes drop 1.5 percentage points.

Plan Targets Benefits to Working Georgians

All state residents, 2015 income levels

Income Group	**Lowest 20%**	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Next 15%**	**Next 4%**	**Top 1%**
Income Range	Less than $18K	$18K - $33K	$33K - $56K	$56 - $94K	$94 - $196K	$196 - $481K	$481K or More
Average Income in Group	$12,000	$25,000	$44,000	$73,000	$128,000	$283,000	$1,299,000
Tax Change as % of Income	-1.5%	-1.1%	-0.4%	0.0%	0.3%	0.4%	0.4%
Average Tax Change	-$172	-$288	-$206	-$20	$279	$1,078	$5,274

Source: Institute on Taxation and Economic Policy (ITEP)

The plan balances out Georgia's upside-down tax structure. Cutting the annual tax bill for average Georgians spreads the cost of state and local government more fairly across Georgians of different means. Low- and middle-income Georgians now spend a greater share of income on state and local taxes than the wealthy. This imbalance is called a regressive tax structure. The poorest fifth of Georgians spend 10.6 percent of their income on state and local taxes, for example, and the middle fifth pays 9.6 percent of their income. That compares to the top 1 percent of Georgians, who pay only 5 percent.

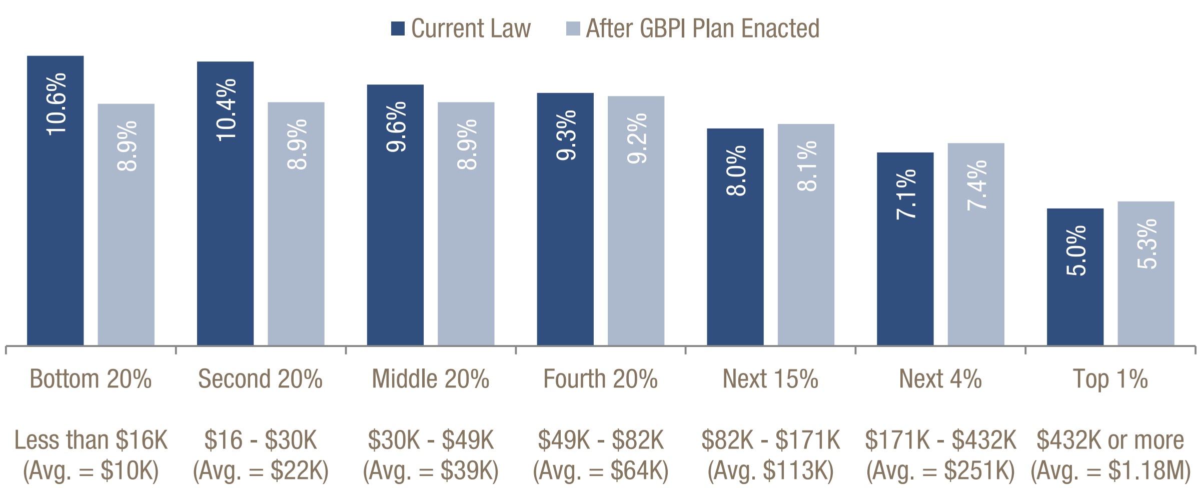
"There are moral and practical reasons to be concerned about [regressive taxes]. Unfair tax systems not only exacerbate widening income inequality in the short term, but they also will leave states struggling to raise enough revenue to meet their basic needs in the long term."

-Institute on Taxation and Economic Policy "Who Pays? 2015 Edition"

The GBPI blueprint balances out Georgia's revenue system by lightening the load for low- and middle-income Georgians, while asking slightly more from those at the top. The chart below details these changes. For example, the share of income going to Georgia taxes drops to 8.9 percent from 9.6 percent for the middle fifth of Georgia taxpayers, or those who make $30,000 to $49,000 a year.

Plan Gives Georgia Better Balance

State and local taxes as a share of personal income, non-elderly taxpayers, 2015 income levels



Source: Institute on Taxation and Economic Policy; Note: These percentages differ slightly from those on the prior page because (a) these are limited to non-elderly taxpayers as opposed to all Georgia residents and (b) they include the federal offset from their state income taxes.

GBPI's tax blueprint protects state services in the short-term and strengthens the tax system's foundation in the long-term. Some pending tax proposals threaten Georgia's ability to fund education, health care and other key services that help support a strong economy and high quality of life. House Bill 445, unveiled by legislative leaders in 2015, could remove an average of about $800 million a year from the state treasury if enacted in its original form.[17] GBPI's plan is revenue-neutral in the short term.[18] In the long-run, it ensures Georgia's revenue system can meet growing future needs. That is because modernizing state sales taxes and making special deductions less generous are proven ways for state tax systems to keep pace with economic changes and collect sufficient revenues from taxpayers enjoying the strongest income growth.[19]

Wide Range of Families Benefit Under Proposed Reforms

The next two pages describe a few hypothetical examples of how GBPI's tax blueprint affects Georgia families. Details on relevant assumptions and methodology are found in this endnote.[20]

Single Mom, One Child, Full-Time Minimum Wage Worker

A single mother of one who works full-time at a minimum wage job earns about $14,500 a year before taxes. In 2015, she pays Georgia an estimated $189 in income taxes and $1,015 in sales and excise taxes, a category that includes both retail sales taxes and other levies like gas taxes and fees. She benefits from the higher tax shield and new EITC in the GBPI plan. Her income tax bill falls by $510 and results in a new refund at the end of the year. Once small sales tax changes are factored in, she receives a total tax cut of $507.

- $507

Assumptions: Takes standard deduction; eligible for new state EITC of $336; $3 in sales taxes on digital downloads

Working Senior, Single, no Dependent Children, Side Job to Supplement Social Security

Consider an elder Georgian who continues to work so she can supplement the income she gets from Social Security. If she earned $22,000 in annual wages on top of her Social Security check, she now owes Georgia an estimated $487 in state income taxes. This worker already receives some age-specific benefits through Georgia's income tax, which remain in place under GBPI's plan.[21] But she also gains from the higher tax shield in the GBPI blueprint, especially the higher standard deduction and personal exemption. Once the small sales tax hike is added, her overall estimated tax change is a cut of $222.

- $222

Assumptions: Takes standard deduction; claims existing $1,300 extra senior deduction; exempts first $4,000 of income under Georgia's rules for taxpayers over 65; ineligible for federal or state EITC; $6 in sales taxes on digital downloads

Young Married Couple, One Child, Work Variety of Low-Wage Jobs

A pair of young Georgia workers, married with one child, might earn around $38,000 in a year through jobs in retail, food service or construction. They would pay Georgia about $1,216 in income taxes at that income level and $1,862 in sales and excise taxes. This couple benefits substantially from GBPI's blueprint due to the higher tax shield, the elimination of the state's marriage penalty and the new state EITC. Their income tax bill drops considerably under the plan, to $510 from $1,216. Once factoring in a small sales tax hike, the couple receives an overall tax cut of $698.

- $698

Assumptions: Takes standard deduction; eligible for new state EITC of $106; $8 in sales taxes on digital downloads

Married Couple, Two Children, Two Middle-Class Jobs
A married Georgia couple with two children working in mid-wage professions like education, health care or manufacturing might bring in around $75,000 a year. That family now owes Georgia an estimated $3,256 in income taxes and $3,000 in sales and excise taxes. They benefit from GBPI's tax blueprint through a combination of a higher tax shield and elimination of Georgia's marriage penalty and pay only a few extra dollars a year in new sales taxes. They receive an estimated tax cut of $637 under the plan.

- $637

Assumptions: Takes standard deduction; ineligible for federal or state EITC; $11 in sales taxes for digital purchases

Single father of one, Successful Businessman
This example assumes a single father with one child. He brings home $100,000 before taxes, which places him just over the threshold for Georgia's most affluent 20 percent. Since he owns a business as well as his home, he itemizes his deductions. Assuming he claims $18,000 in special deductions today, he would become subject to GBPI's proposed value-cap for taxpayers who choose to itemize. But he would also still see some benefit from the plan's higher personal and dependent exemptions. The final impact on his annual tax bill is essentially a wash; he owes Georgia an estimated $66 more in income taxes and $14 more in sales taxes than he pays today.

+ $80

Assumptions: Available itemized deductions drop to $15,000 from $18,000 due to new cap; $14 in sales taxes for digital purchases

Married couple, three children, High-Income Professionals
A married couple with three children making a combined $196,000 a year lands in the top 5 percent of Georgia's income scale. They pay Georgia an estimated $8,836 in state income taxes, assuming $28,000 in itemized deductions for mortgage interest, charitable contributions and other things. They reach the new $20,000 cap on special deductions but see some benefit from other parts of the plan, like higher deductions for dependent children. The total effect of the plan on this family is an estimated tax increase of $223.

+ $223

Assumptions: Available itemized deductions drop to $20,000 from $28,000 due to new cap; $19 in sales taxes for digital purchases

Two Additional Reforms Needed Long-Term

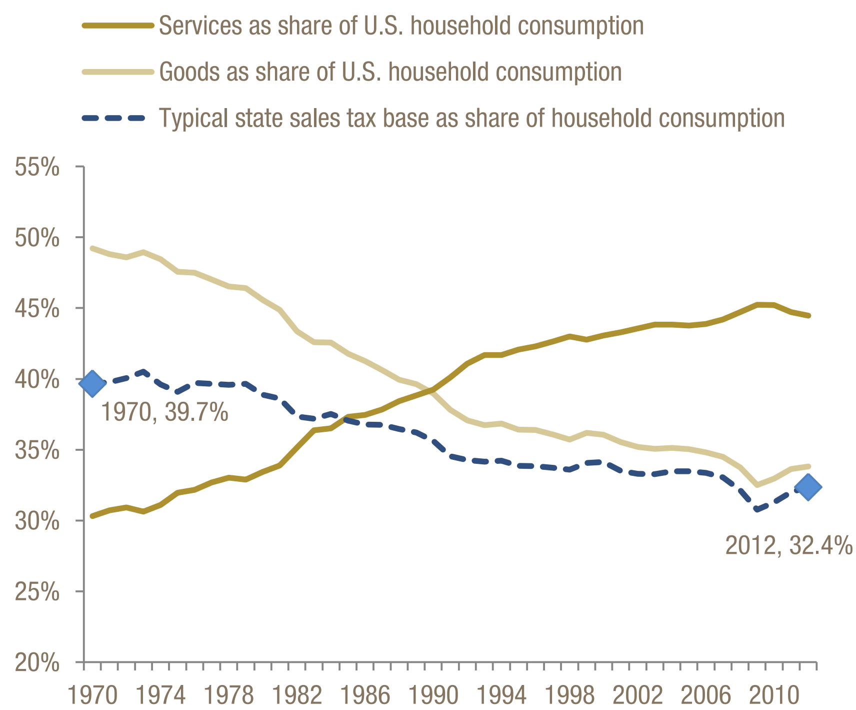
GBPI's blueprint does not include each and every reform needed to update Georgia's rickety tax system. Rebuilding an entire state tax system from scratch has proven politically unrealistic in the past, both in Georgia and most other states. So lawmakers should also take note of two additional tax reforms that while not included in GBPI's blueprint, warrant strong consideration sometime soon.

Raise the cigarette tax. At 37 cents per pack, Georgia charges the third lowest cigarette tax in the nation and the lowest rate among its neighbor states.[22] Florida, Louisiana, North Carolina, South Carolina, Arkansas, Mississippi and Kentucky all raised tobacco tax rates in recent years. If Georgia follows the lead of its neighbors, it could raise substantial revenue while also pursuing a vital public health goal to reduce smoking-related illness. Raising the tax by $1 per pack could generate as much as $467 million annually[23] and rank Georgia in the middle of what other states charge.[24] Raising tobacco fees could help achieve a key public health goal by giving smokers an incentive to quit, discouraging young people from starting and generating money to expand investments in public health or close the state's health insurance coverage gap.

Extend the sales tax to cover some personal services. Georgia's state sales tax policies are mostly unchanged from the 1950s and lag behind changing consumer choices. The sales tax applies to most physical goods people purchase, but few household services. A Georgia family that buys a new lawnmower to use themselves pays sales taxes, while a family that pays a private company to mow their yard does not.

Because Americans buy more services and fewer goods than in the past,[25] exempting services shrinks the sales tax base over time. The typical state sales tax applied to only 32 percent of consumption in 2012, compared to nearly 40 percent in 1970. Georgia could adapt to changing times with a sales tax extended to cover a variety of household services now taxed in at least 15 states[26], and use the resulting revenue for a combination of new investments and perhaps a new credit to offset some of the hike. Georgia taxes only 36 of 168 possible services compared to the national average of 56, based on the most recent available evidence.[27]

Growth of Service Economy Erodes Sales Tax Base Over Time



Source: Bureau of Economic Analysis. Provided to GBPI along with some calculations by the Center on Budget and Policy Priorities (CBPP)

Conclusion: Retool Georgia for the Future

The plan outlined in this report is a blueprint to reform Georgia's tax code in a way that benefits regular families trying to reach the middle class and stay there, without undermining the state's ability to raise enough revenue to meet it needs. The package enhances the fairness of Georgia's regressive tax system by reducing taxes from the bottom up, rather than the top down. And it pays for that targeted tax cut through an overdue reform to the sales tax and a scaling back of special deductions that deliver outsized benefit to a small share of taxpayers. It's a measured, realistic alternative to the problematic tax shift proposals that dominate today's public debate.

Appendix A: Timeline of Georgia's Ongoing Tax Reform Debate

Georgia lawmakers repeatedly explored options to update the state's tax code in recent years. Here is a brief timeline of Georgia's recent history with tax reform.

- **2010** - Georgia convenes a special committee of academics and business leaders to study comprehensive tax reform and suggest specific legislative remedies. Formally known as the Special Council on Tax Reform and Fairness for Georgians, the committee offered a sweeping set of recommendations touching nearly every aspect of Georgia's revenue system.[28] Many of the ideas had merit, though others such as extending sales taxes to groceries raised concerns. A few of the council's proposals made it into law through legislative proposals enacted in later years.

- **2011** - The General Assembly considers several pieces of legislation aimed at passing the bulk of the Special Council's proposal. The proposals failed after intense legislative and public debate.

- **2012** - Lawmakers take a narrower approach to tax reform than the prior year by enacting a grab-bag package of changes through House Bill 386. The bill reworked Georgia's taxes on automobiles, provided an income tax cut for married couples and created large-scale sales tax exemptions for manufacturers and farmers. It was judged to be revenue neutral at the time, but recent evidence suggests the package may have hurt *local* government revenues.[29]

- **2013** - The Georgia State Senate convenes the "Fair Tax Study Committee," which held a series of summer hearings across the state to determine ways Georgia could shift from partial reliance on income taxes more to sales taxes. The committee's final report recommends cutting personal income tax rates by at least a third.[30] GBPI advised the committee against that strategy at the time.[31]

- **2014** - Georgia voters approve a constitutional amendment that permanently caps the state's top personal income tax rate at 6 percent. National financial agencies subsequently suggested the move could undermine Georgia's stellar AAA bond rating.[32]

- **2015** - Legislators introduce House Bill 445, which proposes to cut Georgia's personal and corporate income tax rates by a third, raise the state sales tax to 5 percent from 4 percent, eliminate sales tax exemptions for groceries and digital downloads, boost the cigarette tax and rework how Georgia taxes cable television and other communication services. The bill remains a possible reform option lawmakers could consider in 2016.

ENDNOTES

[1] Official fiscal note for House Bill 445 (LC 34 4535) as presented by the Department of Audits and Accounts. 3/27/2015.

[2] First two rankings come from the Federation of Tax Administrators, "Summary of Tax Burden Measurement Methods," and are based on the 2013 Census of State and Local Government Finance. Accessed 10/19/15. The rank for business taxes as a share of the economy comes from "Total state and local business taxes," Council on State Taxation. August 2014.

[3] For more details, see the Georgia Budget & Policy Institute fact sheet "Tax Facts: All Georgians Have Skin in the Game."

[4] "Undocumented Immigrants' State and Local Tax Contributions," Institute on Taxation and Economic Policy (ITEP). 2015.

[5] Source: Institute on Taxation and Economic Policy. "Who Pays? 2015 Edition." Updated Figures provided upon request and incorporate Georgia's 2015 legislative changes, specifically the increased motor fuel taxes.

[6] Reducing the personal income tax rate delivers disproportionate benefit to taxpayers with more income, because they have more income subject to the top rate. For example, a married couple with two children earning $30,000 a year pays an estimated $556 annually in Georgia state income taxes under current law. Cutting Georgia's top rate to 4 percent from 6 percent would deliver this family an estimated tax cut of $102. Conversely, a married couple with two children earning $300,000 a year pays Georgia about $15,436, assuming $25,000 worth of itemized deductions. Cutting the top rate to 4 percent delivers this family an estimated cut of $5,062. More details on the general concept of why cutting income tax rates doesn't benefit working families can be found in "Shifting from Income to Sales Taxes Would Raise Taxes for Many," Georgia Budget & Policy Institute. December 2014.

[7] The top three states for families of three with two children in 2013 were Alabama ($413), Hawaii ($272) and Georgia ($212). The top six states for families of four with two children were Alabama ($588), Hawaii ($317), Montana ($240), Illinois ($240), Oregon ($230) and Georgia ($202). For the full list of states, see "Taxing the Poor: State Income Tax Policies Make a Big Difference to Working Families," National Center for Children in Poverty. November 2014.

[8] When a tax credit is refundable, families receive the full value of the credit even if it exceeds their state income taxes. This is important because lower earning households spend a greater share of their income paying other taxes, like sales taxes and fees, than do affluent households. A refundable state EITC helps correct that imbalance and lets working people keep more of what they earn.

[9] For readability, the chart excludes downloaded software, which is the largest category of digital goods potentially subject to the sales tax. Purchases of online software in Georgia are expected to reach $1.8 billion in 2020.

[10] Official fiscal note for House Bill 445 (LC 34 4535) as presented by the Department of Audits and Accounts. 3/27/2015.

[11] GBPI calculations using data from Georgia Department of Revenue Statistical Report FY 2012. Page 29. Subsequent DOR reports for FYs 2013 and 2014 do not contain the relevant data. More recent figures were also unavailable upon request.

[12] "Writing Off Tax Giveaways, How States Can Help Balance their Budgets by Reforming or Repealing Itemized Deductions," Institute on Taxation and Economic Policy. August 2010.

[13] Institute on Taxation and Economic Policy (ITEP). Estimate provided by email, 6/29/15

[14] Georgia's special tax reform council noted in its 2010 final report that itemized deductions introduce unneeded complexity into the tax code, writing "Itemized deductions narrow the tax base, create non-conformity adjustments, complicate filing and create distortions in fairness and efficiency." 2010 Special Council on Tax Reform and Fairness for Georgians: Recommendations. 1/7/2011. Page 15.

[15] North Carolina passed a large-scale tax bill in 2013 that eliminates all itemized deductions except mortgage interest, charitable contributions and local property taxes.

[16] Institute on Taxation and Economic Policy, provided by email 8/27/2015.

[17] Official fiscal note for House Bill 445 (LC 34 4535) as presented by the Department of Audits and Accounts. 3/27/2015.

[18] Revenue estimate provided upon request by the Institute on Taxation and Economic Policy. The precise estimate is a revenue increase of $12 million but, given the complexity of the plan, that minor amount is the same as revenue-neutral in all practical terms. Any real-world legislative package would need to be accompanied by an official fiscal note prepared by Georgia's Department of Audits and Accounts.

[19] For more details, see "Why States' Increasing Reliance on Sales Taxes is Risky," Governing Magazine. 9/22/2015.

[20] The six example taxpayers were chosen to represent typical taxpayers at different levels of Georgia's income tax ladder; for example, the mother on minimum wage is typical of someone in Georgia's bottom 20 percent, while the married couple with two kids making $75,000 is typical of someone in Georgia's "fourth 20 percent," meaning the 61st to 80th income percentiles.

Whether or not taxpayers chose to itemize their deductions, and the subsequent size of those deductions, were subjective judgments made in good faith by the author.

To generate the estimates for these "representative taxpayers," GBPI constructed a simple tax model that contrasts current Georgia law to the new structure that would exist if GBPI's reform plan was enacted in full. The key differences between current and potential income tax law include increases to the standard deduction, personal exemption and dependent exemption; a new state EITC set at 10 percent of the federal credit; an increase in the income tax brackets for married couples filing jointly; and a new cap on itemized deductions of $10,000 for singles, $15,000 for head of households and $20,000 for married couples filing jointly. The only sales tax change is the expansion of the tax to include digital downloads. Those changes are explained in detail throughout the report.

Estimates for how much Georgians currently pay in income taxes were generated through model described above. Estimates for how much they pay in sales and excise taxes were calculated by comparing each taxpayer's income to the share of household income that different groups devote to those levies, which are figures provided by ITEP. GBPI accounted for the slightly higher sales taxes due to digital downloads by including estimates shown in the following table.

Estimated Change in Annual Taxes Due to Proposed Sales Tax on Digital Downloads

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Tax Change as % of Income	+0.0%	+0.1%	+0.1%	+0.1%	+0.0%	+0.0%	+0.0%
Average Tax Change	+3	+6	+8	+11	+14	+19	+43

Source: Institute on Taxation and Economic Policy (ITEP)

[21] These include an additional $1,300 on top of the standard deduction; complete exemption of Social Security income; and up to $65,000 in annual income ($130,000 for married couples) exempted from retirement accounts like 401Ks and IRAs.

[22] "State Cigarette Excise Tax Rates," The Henry J. Kaiser Family Foundation. Accessed 9/28/2015.

[23] Or, hiking it by $1.23 per pack as legislation proposed in 2015 could raise about $530 million annually over the next five years. Source for estimates is GBPI analysis of official fiscal note for non-numbered Senate Bill (LC 34 4402).

[24] The current median state – where half of states have higher tobacco taxes and half have lower ones – is Iowa, where cigarettes are taxed at $1.36 per pack.

[25] Services increased from 30 percent to 45 percent of purchases by U.S. households from 1970 and 2012, while the share of purchases for tangible goods fell from 49 percent to 34 percent. Michael Leachman and Michael Mazerov. "Four Steps to Moving State Sales Taxes into the 21st Century," Center on Budget and Policy Priorities (CBPP). 7/9/2013.

[26] For more details on which personal services Georgia could tax, see page 13 of "Menu of Revenue Options to Pave Way for Georgia's Rebound: 2014 Update," Georgia Budget and Policy Institute. June 2014.

[27] "Sales Taxation of Services." Federation of Tax Administrators. The Federation performed an updated survey of states in 2007; however, Georgia and four other states did not respond. Therefore, data for these states is from 2004.

[28] Final report of the Special Council on Tax Reform and Fairness for Georgians can be found at http://www.terry.uga.edu/media/documents/selig/georgia-tax-reform.pdf.

[29] For details on original 2012 tax reform package, see "Bill Analysis: House Bill 386 (LC 34 3484S)," Georgia Budget and Policy Institute. March 2012. For a commentary on the possible impact of one aspect of that reform – new sales tax exemptions on agriculture – see "Georgia Sales Tax Exemptions: GMA Report on the Impact to Georgia's Counties and Cities," Georgia Municipal Association. October 2014. For perspective on another aspect of that reform, the new Title Ad Valorem (TAVT) tax on cars, see "Low income areas take hit under new car tax," The Valdosta Daily Times. 8/30/2015.

[30] Report can be found at http://www.senate.ga.gov/sro/Documents/StudyCommRpts/13FairTaxStudyCommitteeReport.pdf.

[31] "Senate Fair Tax Study Committee. Presentation: Wesley Tharpe, Policy Analyst, Georgia Budget & Policy Institute. 9/20/2013.

[32] "Wall Street reviews Georgia's new limit on individual income tax rate," Saporta Report. 11/7/2014