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Policy Report

Tax Shift Plans Chart Wrong Path to Reform

Shifting from Income to Sales Taxes Threatens Harm to Georgia

By Wesley Tharpe, Senior Policy Analyst

State legislators are likely to consider large-scale changes to Georgia's tax system when they return to work in January 2016, and some ideas they're poised to debate threaten serious harm to Georgia families and the state's ability to maintain a strong economy and high quality of life.

One prominent proposal is to reduce Georgia's personal and corporate income taxes and replace the lost revenue with a higher sales tax rate and the return of state sales taxes on groceries. This approach is similar to tax plans enacted in Kansas and North Carolina in recent years, also known as a tax shift. The tax shift approach carries a proven track record of transferring the cost of government more onto low-wage workers and the middle class, while jeopardizing state support for education, public safety and other core services. This report details the most serious risks if Georgia embraced such a plan.

- **Swapping income taxes for higher sales taxes would likely raise taxes on many low- and middle-income families, while delivering massive tax cuts to the wealthiest households**. As a rule, wealthier taxpayers pay less with lower income taxes, while low- and moderate-income families pay more with higher sales taxes and fees. Shifting the balance in favor of sales taxes inherently falls more on working families since they spend most of their annual income on basic necessities.

- **Eliminating the state sales tax exemption for groceries could add another layer of harm**. Lawmakers would compound the damage of raising sales tax rates if they also remove Georgia's current exemption for groceries, a change that tax shift supporters often propose. Adding the state sales tax back to groceries is included in House Bill 445, one prominent proposal currently on the table for example. Only Alabama and Mississippi fully apply their state and local sales taxes to groceries.

- **Slashing income tax rates could harm key state services like schools, public safety and health care.** Recent cuts to income tax rates in Kansas and North Carolina led to massive budget shortfalls, even in cases when lawmakers tried to replace the revenue through other means. Similar efforts in Georgia would probably lead to similar cuts. State experts estimate that if lawmakers had enacted HB 445 in its original form in 2015, it would have cost an average of about $800 million a year over the first five years.[1]

Georgia lawmakers are right to identify comprehensive tax reform as a priority but shifting from income to sales taxes is the wrong approach. Legislators can do better than adopt the tax shift strategy as a template for reforming Georgia's revenue system, and instead pursue more reasonable pathways to reform. One option to consider is detailed in the Georgia Budget and Policy Institute's upcoming report, "**A Tax Blueprint to Strengthen Georgia**."

Background: Georgia Lawmakers Consider Tax Shift Proposals

The Georgia General Assembly appears poised to take up the issue of comprehensive tax reform in the 2016 legislative session that starts in January. Key legislative leaders support the idea of a major tax overhaul, and a bill passed in 2015 established a special committee designed to put tax legislation on the fast-track to passage.[2]

Potential tax change proposals in 2016 could vary widely, but the tax shift approach to reform dominates the debate thus far. Proponents plan to slash Georgia's personal income tax rate and replace the lost revenue with higher sales taxes and fees. Some plans slash corporate rates as well. Here is a sampling of recent proposals:

- **2015 –** Legislators introduced House Bill 445, which proposes to cut Georgia's personal and corporate income taxes by a third, raise the state sales tax to 5 percent from its current 4 percent and eliminate the state exemption on groceries, among other changes.[3]

- **2014 -** Georgia enacted a constitutional amendment that permanently caps the state's top personal income tax rate at 6 percent. The move was widely seen as a first step toward a more aggressive campaign against the state's income tax.

- **2013 –** The Georgia State Senate created the so-called Fair Tax Study Committee, to hold a series of summer hearings across the state to examine ways Georgia can transition from income to sales taxes. The committee's final report recommends cutting the personal income tax by at least a third.[4]

Georgia lawmakers seem ready to consider some version of this tax shift concept in the upcoming session. The following sections outline the potential repercussions of that approach.

Key Aspects of Georgia's Tax System

Personal Income **(45% of state revenue)**	Top rate = 6% 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 structure with rates ranging from 1%-5%.
Corporate Income **(4% of state revenue)**	6% flat rate on all taxable income Wide variety of credits and exemptions for certain activities and industries
Sales Tax **(25% of state revenue)**	4% state sales tax Local governments may levy up to an additional 3% or 4% in select cases Groceries are exempt from the state-portion of the tax but are still taxed at the local level

Source: Georgia Code, House Bill 445 9LC 34 4571S)

Tax Shift Policies Usually Cut Taxes for Top Earners, Raise Them for Everyone Else

People often think of tax changes as merely the difference between something that is a tax cut or a tax hike. But reality is more nuanced. Tax changes affect people differently, depending income, age, work status and other factors. Shifting the balance between personal income and consumption taxes changes who pays, and how much they pay. As a result, large-scale tax revisions usually cut taxes for some people and hike them for others.

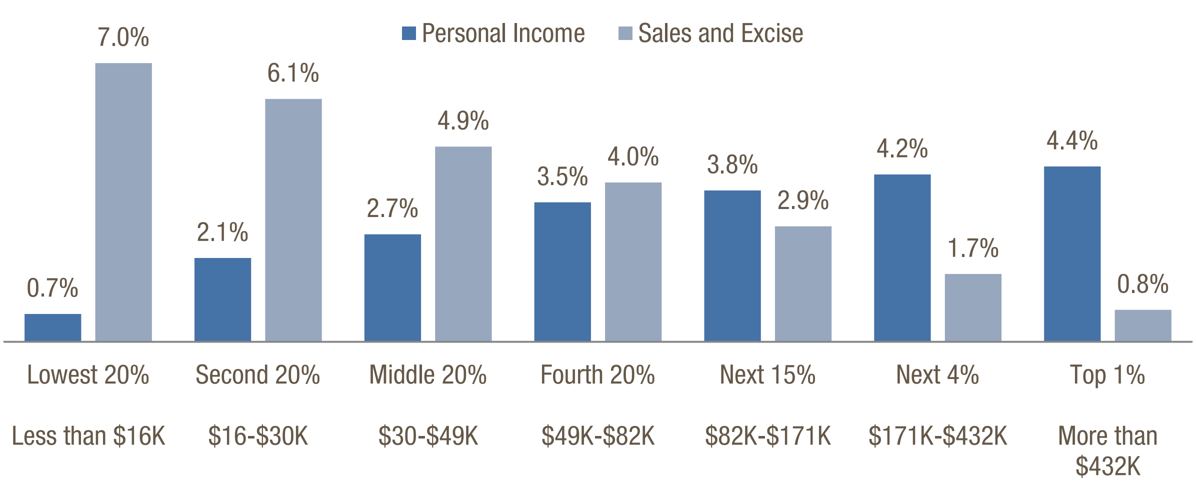
The tax shift plans under discussion in Georgia cut personal income taxes, while raising sales taxes and other levies to try and replace the lost revenue. Some plans also cut corporate income tax rates. These proposals threaten to destabilize a balanced system in a way that increases taxes for low- and moderate-income people, while cutting them for wealthy households and larger corporations. The shift is due to a fundamental contrast in the way these taxes work.

- **Sales and excise taxes take a bigger bite from people who earn less**. State and local sales taxes and excise fees take a larger share of income from low-wage workers and the middle class than the affluent. Working families typically spend most or all their earnings on basic necessities, while wealthier taxpayers can save or invest money left over after covering the basics. Georgia taxpayers with annual incomes under $16,000 pay an average 7 percent of their earnings in sales and excise taxes each year, compared to less than 1 percent for people who make more than $432,000.

- **Personal income taxes collect more from the well-off than the average working family.** Income taxes provide a counterweight to sales and excise taxes by asking more from top earners. Georgians who make less than $16,000 per year and fall in the bottom fifth pay an average of 0.7 percent of annual earnings in personal income taxes. The middle fifth of Georgians pay 2.7 percent and the top 1 percent who make more than $432,000 a year pay 4.4 percent.

Georgia Income Taxes Fall More on Well-off, Sales Taxes Take More from Working Families

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



Source: Institute on Taxation and Economic Policy (ITEP), "Who Pays?" Updated figures provided to GBPI upon request, September 2015.

Georgia Taxes Now Fall More Sharply on Working Families

A plan that shifts the cost of government from the affluent to the poor and middle class worsens a tax system already disproportionately reliant on working families. Low- and middle-income Georgians today pay a greater share of their income in state and local taxes than do the wealthy. This upside-down approach, also common in other states, is known as a regressive tax structure.

The poorest fifth of Georgia taxpayers pay an estimated average of 10.6 percent of annual income in state and local taxes and the middle fifth pays 9.6 percent. The wealthiest 1 percent pays an average of only 5 percent of their income.[5] If the state increases its reliance on sales taxes, Georgia's tax burden shifts more toward low- and moderate-income people.

Georgia's Upside-Down Tax System

2015 income levels, non-elderly taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $16K	$16K-$30K	$30K-$49K	$49-$82K	$82K-$171K	$171K-$432K	$432K or more
Average Income in Group	$10,000	$22,000	$39,000	$64,000	$113,000	$251,000	$1,179,000
State and Local Taxes as a Share of Income	10.6%	10.4%	9.6%	9.3%	8.0%	7.1%	5.0%

Source: Institute on Taxation and Economic Policy. Figures provided upon request and incorporate 2015 legislative changes, including increased motor fuel taxes.

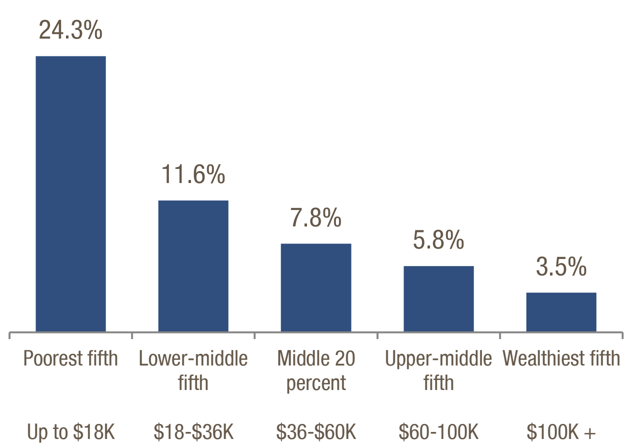
Return of State Grocery Taxes Pose Risk

Tax shift advocates often argue for Georgia to eliminate its state sales tax exemption on groceries, which adds another dose of pain to any potential plan. Georgia shoppers today are exempt from the state sales tax of 4 percent on food for home consumption. They are still subject to local sales taxes, which average 3 percent statewide.[6] The average American family of four spent an estimated $5,765 on groceries in 2014.[7] Two vulnerable groups are first in line to lose if this exemption is eliminated.

- **Poor families** – Grocery taxes fall most sharply on low-income Georgians, since they spend an outsized share of their money on food and life's other necessities. The poorest fifth of Americans spend about a quarter of earnings on groceries, compared to less than 4 percent for the wealthiest fifth of families.

Working Families More Exposed to Grocery Tax

Share of pre-tax income spent on "food for home consumption," 2014, by income quintile



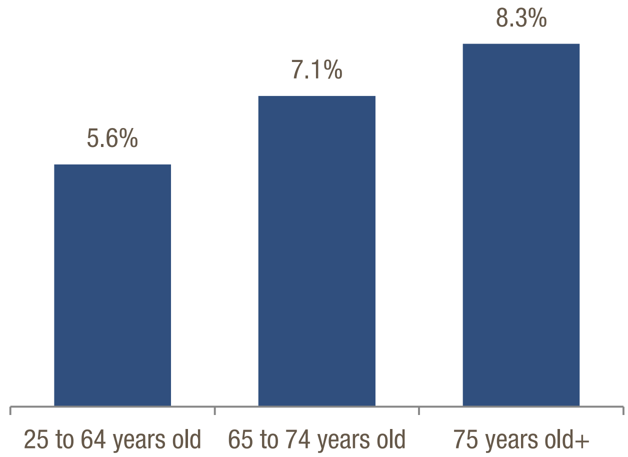
Source: GBPI analysis of Consumer Expenditure Survey

- **Seniors** – The average senior spends a higher share of income on groceries than younger adults. That is especially true once they reach 75 years old, as shown in the accompanying chart. Older Georgians also get a good deal through the state's income tax code, since Georgia exempts both Social Security benefits and most retirement income.[8] So most seniors won't benefit much from a state income tax cut but they will pay higher taxes on food.

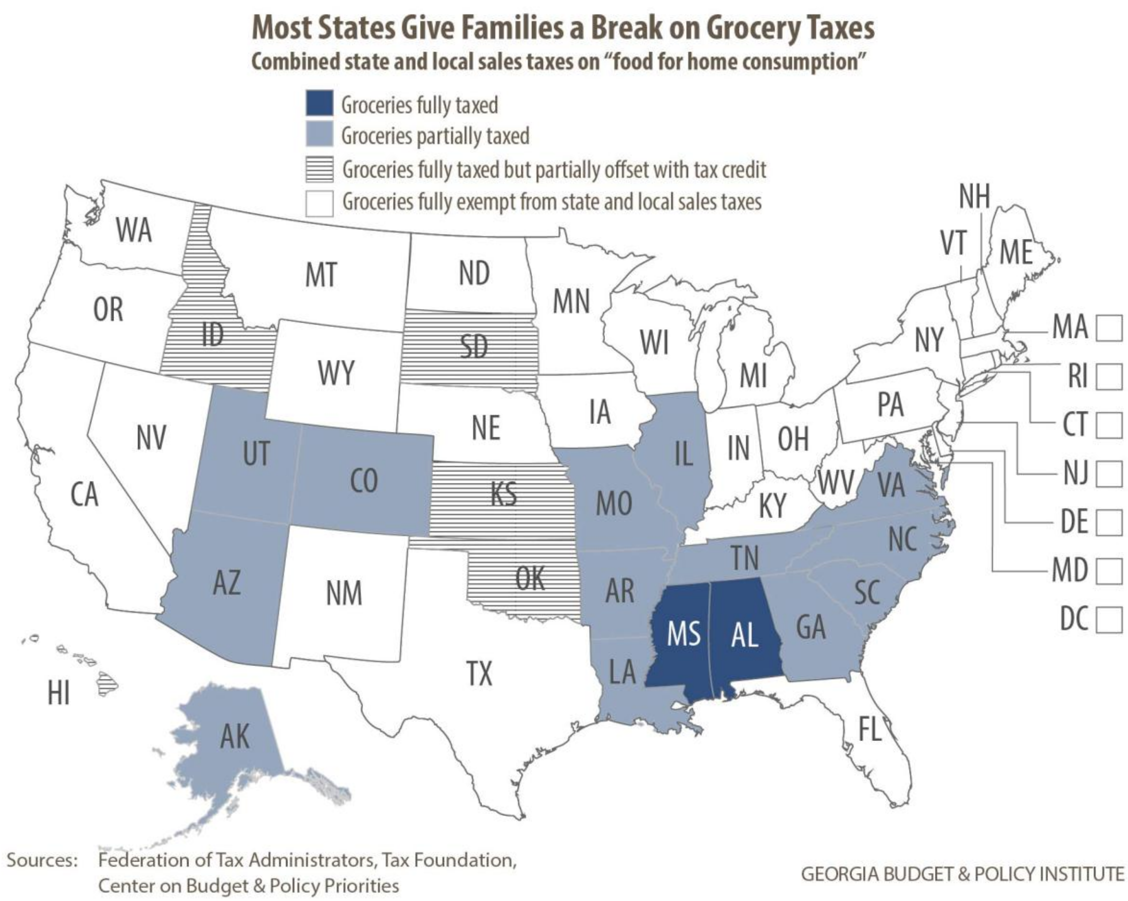
Georgia becomes a national outlier if it taxes groceries at the full state and local sales tax rate, as illustrated in the map below. Georgia is now one of 48 states and the District of Columbia that exempts groceries completely, partially exempts them or uses a tax credit to offset some of the expense. Only Alabama and Mississippi tax groceries at the full state and local tax rate.

Elder Georgians Spend More of Their Income on Groceries

Share of pre-tax income spent on "food for home consumption," by age range, 2014



Source: GBPI analysis of Consumer Expenditure Survey



Income Tax Cuts Threaten Schools and Other Key State Investments

A tax shift threatens a range of state services vital to Georgia families and businesses. Personal and corporate income taxes generate nearly half of Georgia's annual tax revenue, more than $10 billion out of about $21.8 billion in the 2016 fiscal year. To put that in perspective, the income tax alone could cover all state spending for public education in Georgia including K-12, universities and technical colleges. Income tax cuts drain the state treasury of necessary funds and jeopardize these critical services, for two reasons.

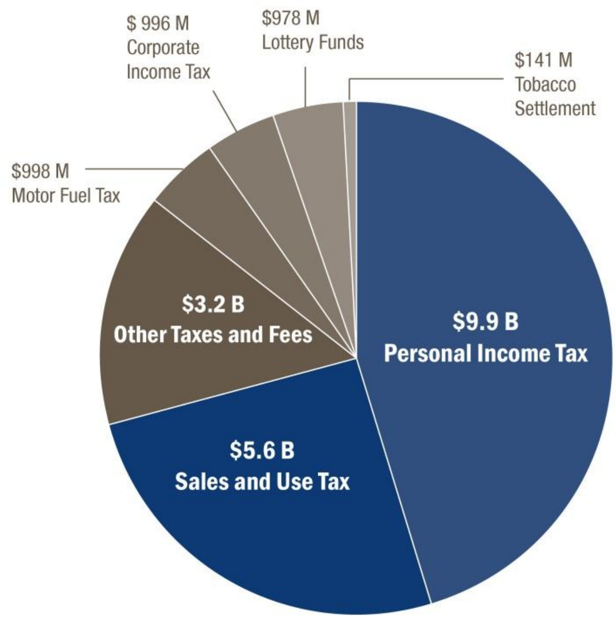
First, sales tax revenues do not grow with economic growth as well as income taxes and thus struggle to keep pace with the growing needs of state populations. That is partly because as the economy increasingly shifts toward difficult-to-tax things like personal services and digital goods, the sales tax captures a shrinking share of consumer purchases.[9] The result is that, over time, stagnant revenue growth can force state lawmakers to cut services or repeatedly raise other taxes to keep up.

Second, raising sales taxes and fees is far more politically difficult than cutting income tax rates, which makes paying for tax shift plans easier in theory than in practice. These and other reasons are why tax shift plans are rarely "revenue neutral" once implemented.

- **Kansas** in early 2012 adopted one of the largest state level tax cuts ever. It slashed its top personal income tax rate by 25 percent, eliminated tax credits for groceries and child care and opened a gaping tax loophole for business income. Lawmakers tried to offset some of the costs by scaling back a previously scheduled sales tax cut. The package hammered key public services, reducing the Kansas general fund 13 percent after the tax change, or roughly an $800 million cut from state services each year.[10] Kansas's attempt at tax reform led to deep cuts in K-12 education and other public investments at a time when most states started to increase funding post-recession.[11] Credit rating agencies also downgraded Kansas as a direct result of the destabilizing changes, increasing the cost of the state's borrowing.

Georgia Services Rely on Income Taxes

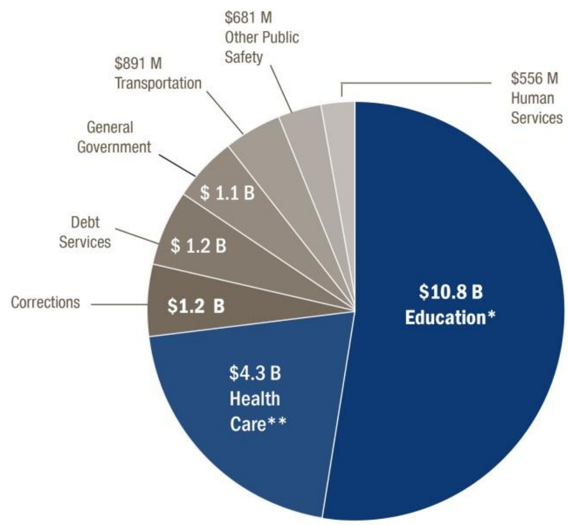
State general fund revenue by category, FY 2016



Source: GBPI analysis of Georgia FY 2016 budget

More than Half of State Revenue Goes to Schools, Universities

State general fund revenue by category, FY 2016



Source: GBPI analysis of Georgia FY 2016 budget

- **North Carolina** passed deep income tax cuts in 2013. The cost already exceeds original projections and could lead to a funding shortfall of as much as $1.1 billion per year once fully phased in.[12] North Carolina cut state support for higher education by nearly a quarter from 2008 to 2015, due in part to tax cuts.[13] It's also cut back on support for K-12 schools by more than all but six other states over that span.[14]

Georgia's official cost estimate for House Bill 445, a still-pending tax proposal introduced in 2015, reveals the potential threat to shared investments like education. State experts estimate that had lawmakers enacted HB 445 in its original form in 2015, it would have cost an estimated average of about $800 million a year over the first five years for a total of $4 billion.[15] Specific year to year cost estimates are shown in the chart.

Lost revenue from provisions in the bill comes out of Georgia's general fund, which is the state's main bank account to fund education, health care, public safety and other core services. Here are some examples of how far $800 million in state revenues goes. It is:

- More than double Georgia's annual investment in **technical colleges**.

- About $250 million more than Georgia spends annually on all **human services** combined, including child welfare, elder abuse prevention and temporary aid to poor families.

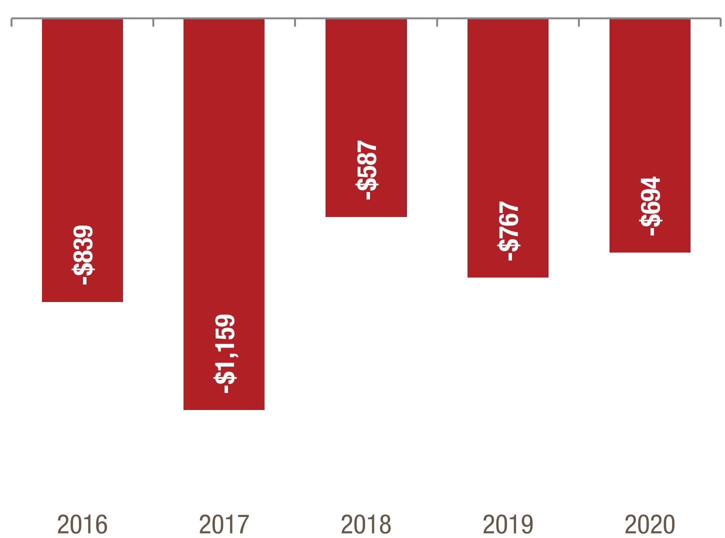
- A bit less than the amount of state funds Georgia lawmakers spent on **roads and bridges** in the 2016 budget year.

"The tax cuts [in North Carolina] are creating unnecessary headaches for state agencies and preventing investments in education, infrastructure and services for the needy. It's one thing to be frugal about government budgets. It's another to give money away in tax cuts when the state is falling short of meeting its needs."

-Editorial Board
Raleigh News & Observer

Tax Shift Package Could Lead to Deep Shortfalls

Estimated annual loss in state revenue from House Bill 445, LC 34 4535, in millions



Source: Official fiscal note for House Bill 445 (LC 34 4535) as presented by the Department of Audits and Accounts.

Conclusion: Georgia Can Pursue Better Options for Reform

The Georgia General Assembly is likely to take up a tax reform debate in January 2016. That presents a clear opportunity for lawmakers to improve the lives of Georgians and set the state on a more prosperous path to the future. But pending legislation that swaps income taxes for higher sales taxes is a flawed strategy. Better alternatives exist.

Tax shift strategies cause low-wage workers, poor families and many in the middle class to pay more, while wealthy households and the largest, most-profitable corporations pay far less. Georgia's schools, infrastructure and other services face financial peril due to falling revenues, similar to recent experiences in Kansas and North Carolina. That dynamic undermines the ability of Georgia families to climb the economic ladder, jeopardizes the economy and makes it harder for Georgia communities to thrive.

State legislators can still ditch the tax shift scheme in favor of more targeted reforms that deliver real benefits to Georgia families. In a soon-to-be-released alternative called **"A Tax Blueprint to Strengthen Georgia,"** GBPI will call for a revenue-neutral package that cuts Georgians' taxes from the bottom up, rather than the top down. The comprehensive plan protects the state's commitment to education and other services while scaling back outdated tax breaks and deductions that drain hundreds of millions of dollars from the state treasury each year. And it puts the state's tax system on a firmer footing to promote opportunity and broad-based growth in the years ahead.

ENDNOTES

[1] The impact of HB 445 on Georgia revenues would differ slightly from these estimates if lawmakers enacted the bill, in full, in the upcoming 2016 session. That is because two aspects of the original bill, the elimination of tax breaks for Delta Air Lines and electric car buyers, were enacted through separate legislation in 2015.

[2] House Bill 170, the so-called "transportation bill" enacted in the 2015 legislative session, creates the Special Joint Committee on Georgia Revenue Structure. Consisting of 14 members drawn from the House and Senate, the committee is designed to fast-track potential tax reform legislation in the upcoming 2016 session that starts in January. Bills recommended by the committee will receive an up-or-down vote by both the House and Senate, without amendments.

[3] HB 445 includes several additional reforms aside from its core tax shift approach from cutting income taxes and raising sales taxes. Specifically, the bill extends the sales tax to cover digital downloads like e-books and software; slightly raises Georgia's tobacco tax; eliminates a range of personal and corporate income tax credits; and proposes to streamline how Georgia taxes communication services including satellite television, cable, cellular service and streaming video. Some of these ideas show promise and merit potential inclusion in a revised reform package.

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

[5] Institute on Taxation and Economic Policy (ITEP), "Who Pays?" Updated figures provided to GBPI upon request, Sept. 2015.

[6] All Georgia counties apply their local sales taxes, which range from 2 percent to 4 percent, to food for home consumption. Georgia's average statewide local sales tax is 2.97 percent, according to the Tax Foundation.

[7] Consumer Expenditure Survey of Bureau of Labor Statistics

[8] Georgia fully exempts Social Security benefits from the state's personal income tax, as do 27 other states and the District of Columbia. Georgians 65 years old and over can exempt up to $65,000 in retirement income, including pensions and annuities, interest, dividends, net income from rental property, capital gains, royalties, pensions, annuities and the first $4,000 of earned income, such as wages. The exclusion of retirement income is $130,000 for married couples filing jointly.

[9] "Governing with Tight Budgets: Long-Term Trends in State Finances," Urban Institute. September 2015.

[10] "Kansas' Big and Damaging Tax Cut," Center on Budget and Policy Priorities. 5/22/2012

[11] "A Diminished Future: Tax-Cut States Shortchanging Education," Center on Budget and Policy Priorities. 3/12/2015.

[12] "Four Reasons 2013 Tax Plan Likely Main Driver of Revenue Shortfall," North Carolina Budget & Tax Center. 8/25/2014.

[13] "Year of Cuts Threaten to Put College Out of Reach for More Students," Center on Budget & Policy Priorities. 5/13/2015.

[14] "Most States Still Funding Schools Less than Before the Recession," Center on Budget & Policy Priorities. 10/16/2014.

[15] See endnote #1.