

## Tax Reform

### Principles:

- **Minimize the impact of taxes on economic growth.** It makes a difference how large a share of income is taken by government in taxes. The private sector is the source of all wealth, and is what drives increases in the standard of living in a market-based economy. Taxes should consume as small a portion of income as possible, should not interfere with economic growth and investment and should not place the state at a competitive disadvantage.
- **Uphold the principle of limited government by minimizing the tax burden.** Taxes are necessary to fund core government services, but mission creep and inefficiency can quickly bloat government beyond what is necessary or appropriate. Government needs to be reminded that an additional dollar of taxes is a discretionary dollar taken away from a family. A decision to raise taxes is an explicit decision that a government program has a higher priority than these individual decisions.
- **Avoid picking winners and losers.** Tax policy should not single out individuals, businesses or particular groups for preferential treatment. Taxes should be designed to raise revenue to fund necessary government programs, not to micromanage economic decisions in a complex economy.
- **Limit exemptions to encourage a broad tax base and low rates.** Exemptions shift the tax burden onto others and high tax rates distort economic decision-making. Everyone who is financially able should pay some tax to support the necessary services they receive from government. Voting to grow government spending is easy if you don't have to pay for it.
- **Ensure fairness.** Although everyone who utilizes government services should pay some tax, there should be consideration of excessive tax burdens on those at the lower end of the income scale. In addition, individuals in similar situations should be taxed similarly.
- **Ensure taxes are visible and only paid once.** Taxes should not be hidden in business transactions.
- **Focus taxation on consumption rather than savings and investment.**
- **Encourage simplicity and stability.** Complex tax codes increase compliance and enforcement costs and encourage tax avoidance schemes. Tax changes should be permanent and not temporary or retroactive.

### Agenda:

- Cut spending!
- Require a supermajority to increase tax rates
- Lower tax rates by broadening the tax base

### Facts:

State and Local Tax Revenues - 2006

	Per Capita	Rank
State and local taxes	\$3,313	35
Local taxes	\$1,494	21
State taxes	\$1,819	43
State and local property taxes	\$955	33
State and local personal income taxes	\$859	24
State and local corporate income taxes	\$95	42
State and local general sales taxes	\$1,014	16

Source: Census Bureau

Per Capita Taxes vs. Benchmarks (1998 – 2006)

Taxes levied by:	Change
State and local government	3.8%
State	2.5%
Cities / Counties	4.2%
School Boards	7.5%

Inflation	3.0%
Per Capita Personal Income	3.1%

Source: Census Bureau

**Property Taxes Levied – 2007**

*By Type of Property*

	<u>Total</u>	
Residential	\$5,686,625,892	55%
Commercial	2,692,974,382	26%
Motor Vehicle	695,694,149	7%
Industrial	593,288,995	6%
Utility	352,104,651	3%
Agricultural	232,545,497	2%
Conservation Use	58,605,813	1%
Mobile Homes	35,309,183	0%
Timber	15,275,720	0%
Preferential	12,325,115	0%
Historic	5,973,018	0%
Heavy Duty Equipment	2,764,904	0%
Residential - Transitional	107,254	0%
Environmentally Sensitive	10,910	0%
Brownfield	<u>22,549</u>	0%
State Total:	\$10,383,628,032	

*By Type of Tax*

School M&O	\$5,849,280,045	56%
Unincorporated County M&O	1,671,592,560	16%
Incorporated County M&O	1,221,914,514	12%
City	733,918,108	7%
Other	557,996,585	5%
School Bond	178,167,253	2%
County Bond	87,585,313	1%
State	<u>83,173,654</u>	1%
Total	\$10,383,628,032	

Source: <http://www.etax.dor.ga.gov/PTD/cds/revenue/index.aspx> ("M&O" stands for "Maintenance and Operations")

Personal Income Tax Filers and Liability by Income Level  
(dollars, except income level, are in thousands)

1996				
Income Level	Number of Filers	Percentage of Total	Personal Income Tax Liability	Percentage of Total
\$1,000 and under *	208,493	6.58%	140,907	3.23%
\$1,001 to \$5,000	314,881	9.94%	665	0.02%
\$5,001 to \$10,000	358,071	11.31%	16,935	0.39%
\$10,001 to \$15,000	335,376	10.59%	62,976	1.45%
\$15,001 to \$20,000	307,101	9.70%	120,985	2.78%
\$20,001 to \$25,000	256,905	8.11%	161,533	3.71%
\$25,001 to \$30,000	201,225	6.36%	177,257	4.07%
\$30,001 to \$50,000	535,993	16.93%	744,344	17.08%
\$50,001 to \$100,000	489,159	15.45%	1,312,908	30.13%
\$100,001 to \$500,000	150,348	4.75%	1,101,498	25.28%
\$500,001 to \$1,000,000	5,908	0.19%	197,653	4.54%
\$1,000,001 and higher	2,817	0.09%	320,198	7.35%
	3,166,277	100.00%	4,357,859	100.00%

2005				
Income Level	Number of Filers	Percentage of Total	Personal Income Tax Liability	Percentage of Total
\$1,000 and under *	510,000	13.29%	458,963	6.46%
\$1,001 to \$5,000	263,000	6.85%	10	0.00%
\$5,001 to \$10,000	343,000	8.94%	8,374	0.12%
\$10,001 to \$15,000	329,000	8.57%	39,438	0.56%
\$15,001 to \$20,000	296,000	7.71%	88,772	1.25%
\$20,001 to \$25,000	268,000	6.98%	136,413	1.92%
\$25,001 to \$30,000	234,000	6.10%	169,462	2.39%
\$30,001 to \$50,000	618,000	16.10%	762,204	10.73%
\$50,001 to \$100,000	647,000	16.86%	1,710,975	24.10%
\$100,001 to \$500,000	312,000	8.13%	2,289,828	32.25%
\$500,001 to \$1,000,000	11,000	0.29%	374,754	5.28%
\$1,000,001 and higher	7,000	0.18%	1,061,631	14.95%
	3,838,000	100.00%	7,100,824	100.00%

\* Category also includes payment from out-of-state residents and partial-year payers

Source: 2007 State of Georgia Comprehensive Annual Financial Report,  
[https://www.audits.state.ga.us/sgd/cafr\\_main.html](https://www.audits.state.ga.us/sgd/cafr_main.html)

Georgia ranks 27th in the Tax Foundation's State Business Tax Climate Index. The Index compares the states in five areas of taxation that impact business: corporate taxes; individual income taxes; sales taxes; unemployment insurance taxes; and taxes on property, including residential and commercial property. Neighboring states ranked as follows: Tennessee (17th), Alabama (21st), Florida (5th), South Carolina (25th) and North Carolina (39th). Source: [2009 State Business Tax Climate Index](#) (full study)

Contrary to common perception, Georgia does not impose an estate tax in addition to the federal estate tax. Georgia simply takes advantage of a provision in the law that allows the state to keep a portion of the federal tax. Changing this practice would not reduce the estate taxes paid by Georgians.

Delaware, Texas, Colorado and Georgia are the most economically free states in the United States, while West Virginia has the dubious distinction of being the least economically free, according to the Fraser Institute's new study, "Economic Freedom of North America: 2008 Report." The report reinforces the notion that economic freedom leads to greater prosperity: Colorado, Georgia, Delaware, North Carolina, New Hampshire, Tennessee and Texas – states with consistently strong records of economic freedom – had a GDP per capita that was more than \$4,300 above the American average in 2005, and their growth rate from 1981 to 2005 is nearly 20 percentage points higher. States with high levels of economic freedom are those that tend to have lower taxes, smaller government and flexible labor markets. These conditions create jobs and opportunities leading to economic growth, says Fred McMahon, co-author of the report. Source: Fraser Institute, <http://www.fraserinstitute.org/researchandpublications/publications/5741.aspx>

#### **Data Sources:**

Georgia Department of Revenue

- [2007 Statistical Report](#) - These reports offer detailed data on all Georgia taxes.
- [Sales Tax Data](#)
- Property Taxes:
  - [Millage Rates](#)
  - [Ad Valorem Taxes Levied](#)

Georgia State Auditor:

- [State Comprehensive Annual Financial Report \(CAFR\)](#) - This annual audited financial report provides historical data on tax revenues.

Census Bureau:

- [Georgia Revenue and Expenditures per capita from the Census Bureau](#)
- [State and Local Government Finance](#)

Tax Foundation:

- [Georgia Tax Overview](#)

Rankings vs. other states:

- [www.ppiny.org/reports/JustTheFacts.html](http://www.ppiny.org/reports/JustTheFacts.html)
- [www.taxpayersnetwork.org/DesktopDefault.aspx?tabindex=6&tabid=3402](http://www.taxpayersnetwork.org/DesktopDefault.aspx?tabindex=6&tabid=3402)

Ernst and Young:

- [Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007](#)

## Overview

### *Property Tax Reform*

Property taxes have dominated the tax reform debate over the last few years, not just in Georgia, but across the nation. In Georgia, rapidly increasing property values led to large increases in property taxes for many Georgians. Overall, the biggest driver was education spending. Compared to the growth of all other state and local taxes, local education taxes have skyrocketed, growing more than three times faster than the rate of inflation between 1995 and 2005. On the national scale, Georgia's education spending per student grew faster than all but one other state from 1986 to 2006.<sup>1</sup>

To properly understand the property tax issue, it is necessary to understand how property taxes differ from the other major sources of revenue – income and sales taxes. The Washington Policy Center describes the difference: "Most people are familiar with rate-based tax systems, like the state sales tax or the federal income tax. Under a rate-based system elected officials first set a percentage rate which determines the fraction of each dollar of a given tax base that must be paid to the government. The revenue the government will receive from such a tax cannot be known in advance; it can only be estimated. A budget-based system like the property tax begins at the other end. Elected officials *first* decide how much money they feel is needed for their government budget, then divide this among the tax base to determine what rate is needed to raise that amount of revenue. The rate is expressed as so many dollars per \$1,000 of assessed value. Under this system, the amount of revenue the government will collect is known from the beginning. It is the tax *rate* that is unknown until the assessor calculates it."<sup>2</sup>

There are several options for property tax reform. The most effective way to reduce the property tax burden is the reduce spending on items funded by property taxes. Any other reform simply shifts the burden somewhere else. According to a 2006 survey by the National Tax Journal, Georgia is one of only five of the 48 states in the continental U.S. that have no explicit limits on property taxation. In the property tax reform debate of 2008, both assessment caps and rate caps were proposed. Below is a discussion of these and other options.

#### *Assessment Caps*

Assessment caps are one way to limit property taxes by limiting the increase in the property assessment. Some caps freeze the value of the property at the purchase price until the property is sold. Other caps limit the annual increase to a certain percentage. On the positive side, assessment caps increase the predictability of property taxes. However, with growth of the tax base limited, tax rates will increase faster than they ordinarily would without assessment caps. In addition, the tax burden is shifted from those with property that is increasing in value faster than the assessment cap to other property owners.

In Michigan, property owners have complained that the assessment cap is hurting the housing market. "The claim is that people who have lived in their house for a long time are discouraged from purchasing a new house because the property taxes on the new home will be much higher because the cap comes off when ownership changes. "Senior citizens claim that when it is time to downsize, they have to significantly lower the "fair" price so the prospective buyer can afford the higher property taxes."<sup>3</sup>

In Florida, similar problems have surfaced. "A special problem in Florida is property tax inequity. Some homeowners are grandfathered in to large homestead exemptions, so they pay far less tax than new

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<sup>1</sup> "2007 Report Card on American Education," American Legislative Exchange Council, <http://www.alec.org/am/pdf/states/georgia2007.pdf>

<sup>2</sup> "Property Tax Limitation in Washington State," August 2003, [http://www.washingtonpolicy.org/Centers/government/policybrief/03\\_guppy\\_propertytax.html](http://www.washingtonpolicy.org/Centers/government/policybrief/03_guppy_propertytax.html)

<sup>3</sup> "Michigan's Experience with Property Tax and Assessment Limitations," presented by Jay Wortley, Senior Economist, Michigan Senate Fiscal Agency, "Towards a Better Understanding of Property Taxes and Proposed Policies Conference," Andrew Young School of Policy Studies, Georgia State University, September 11, 2008, <http://aysps.gsu.edu/frc/files/Wortley.pdf>

homeowners with a similar house across the street. This creates an inefficient lock-in effect in which some families can't get a good price for their home because any new owners could instantly face a tripling or more of the property tax bill. Young people face a rapid property tax escalator in part because of the tax exemptions of long-time owners."<sup>4</sup>

California also provides a useful example. "In 1978, California led the property tax revolution by passing Proposition 13, a measure that froze property tax rates statewide at one percent and rolled back assessments to 1975 levels. Reassessment was permitted only upon sale of property, except for a maximum 2 percent annual increase.

"Proposition 13 reduced property taxes significantly in California and to this date, property taxes are still among the lowest in the country. However, the inflexibility of the program, coupled with the inability to vote on the budget has created pressures from the education and municipal delivery system."<sup>5</sup>

### *Rate Caps*

Rate caps are another way to limit property taxes. They can be a maximum tax rate, such as the 20 mill maximum imposed on most school districts in Georgia, or they can be a maximum annual percentage increase. In most cases, the rate cap can be overridden by a supermajority vote of the governing body or by referendum.

### *Levy Caps*

The simplest and most effective property tax limitation is a levy cap, which limits the increase in property tax revenues. As with a rate cap, levy caps can usually be overridden by a supermajority vote of the governing body or by referendum.

New York Gov. David Paterson recently submitted a proposal that "would limit the increase in school tax levies (the total amount of taxes to be collected by a school district) to the lesser of 4% or 120% of the Consumer Price Index each year."<sup>6</sup> This proposal was based on the work of the New York State Commission on Property Tax Relief. One of the models recommended by the Commission was Massachusetts:<sup>7</sup>

"Proposition 2½ was enacted in 1980 in response to the level of property taxation in Massachusetts, among the highest in the nation. Proposition 2½ is both a levy cap and a rate cap. The property tax levy cannot increase by more than 2½ percent annually, plus additions to the tax roll from new construction. Amounts less than the levy limit may be reserved and used in a subsequent year. ...

"Public involvement is an important aspect of Proposition 2½, which allows a community to increase its levy limit through the public override vote, and to reduce the levy by way of a voter override. Over the course of 22 years, Massachusetts cities and towns have placed 3,583 override referenda before voters. Approximately 39 percent of the override attempts were successful, based on a simple majority vote. There have been only a few dozen override votes, with over half approved.

"Proposition 2½ has been successful in lowering the property tax burden in Massachusetts. In the first 20 years following the passage of Proposition 2½, the per capita residential property tax levy dropped 1.6 percent, after adjusting for inflation. Since the enactment of Proposition 2½, Massachusetts dropped from 3rd nationally in 1977 to 33rd in 2005 on the measure of state and local tax burden."<sup>8</sup>

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<sup>4</sup> "Florida Tax Revolt," Wall Street Journal editorial, June 30, 2007

<sup>5</sup> "A Model for Property Tax Reform in 2006 Reducing Property Tax Growth through Local Spending Limits," Americans for Tax Reform, January 25, 2006, [http://www.atr.org/content/pdf/2006/jan/012606ot-property\\_study.pdf](http://www.atr.org/content/pdf/2006/jan/012606ot-property_study.pdf).

<sup>6</sup> "Capping the growth of property taxes," New York State Commission on Property Tax Relief, [http://www.cptr.state.ny.us/propertyTaxCap/pamphlet\\_QnA.html](http://www.cptr.state.ny.us/propertyTaxCap/pamphlet_QnA.html)

<sup>7</sup> New York State Commission on Property Tax Relief, Preliminary Report, June 2008, [http://www.cptr.state.ny.us/reports/CPTRPreliminaryReport\\_20080603.pdf](http://www.cptr.state.ny.us/reports/CPTRPreliminaryReport_20080603.pdf)

<sup>8</sup> "A Model for Property Tax Reform in 2006 Reducing Property Tax Growth through Local Spending Limits," Americans for Tax Reform, January 25, 2006, [http://www.atr.org/content/pdf/2006/jan/012606ot-property\\_study.pdf](http://www.atr.org/content/pdf/2006/jan/012606ot-property_study.pdf).

Americans for Tax Reform also recommends the Massachusetts approach: "By including voters in municipal spending decisions, the property tax burden is also shifted from the state to the local level. When the responsibility lies at the local level, where it belongs, local officials are held accountable and are guided towards policies preferred by their constituents. In the long run, residents also have the ability to sort themselves among municipalities that meet their optimal level of taxing and spending.

"Under most property tax systems, when property values increase with no corresponding rate reductions, local governments are able to increase spending and thus create a 'need' for future rate increases. However, with this model, capping the tax levy means that an increase in home values may reduce tax rates to equalize the amount that a municipality is able to raise and spend. Since the Massachusetts program caps the levy (for spending purposes) and not property values, when the real estate boom of the 1980's and 90's took off, local revenue was able to increase slightly above inflation, but tax rates actually declined when values increased."<sup>9</sup>

#### *Replacement*

Another popular approach is to replace property taxes with other taxes. The most common proposal in Georgia and other states has been to replace the property tax funding of schools with higher sales taxes. In most cases, neither spending nor overall taxes are reduced, but shifted to another source of revenue. In most situations this is complicated by the fact that property taxes are primarily local taxes while the sales tax revenues to replace those local property taxes typically come from the state. One solution to this problem is to allow local governments, including school systems, to assess local sales taxes to offset property taxes. Currently, most local sales taxes are restricted to funding of capital projects, so this would require legislative action.

#### *Ability to Pay*

One challenge with the property tax is when property owners, typically those on a fixed income, face dramatically higher taxes on greatly appreciated property. Homestead exemptions are very broad and provide very little relief in these situations. Of course, the owner is now wealthier (on paper) due to the higher value of his or her home, but that value can only be realized by selling the home. There are several options. Homeowners can tap this new equity with a home equity line, and those who are at least 62 years of age are eligible for a reverse mortgage. In addition, in Georgia homeowners who are at least 62 years of age and have incomes of \$15,000 or less can defer their property taxes. Interest is due when the taxes are finally paid. Other states have enacted "circuit breakers," which cap property taxes once they reach a certain percentage of the homeowner's income.

#### *Income tax cuts, personal motor vehicle tax cuts and senior citizen tax cuts*

Last year we asked the Tax Foundation to review the various tax reform proposals being debated. Here is the analysis:

*Arguments have been put forth in favor of cutting income taxes, the personal property tax on cars, and even cutting income taxes for senior citizens only. Each side argues that its tax cut would be best for Georgia's economy going forward. ...*

*Although America's rapidly aging population justifies paying an increasing amount of attention to the economic status of the elderly, it should be noted that cutting taxes exclusively for senior citizens has very little justification from the perspective of sound tax policy. Therefore, we do not address this issue.*

*The two major proposals are those in both houses of the legislature. The Senate wants a cut in the state's income tax by 10 percent in five annual 2-percent increments, so that five years from now, the current 6.0 percent rate would fall to 5.4 percent, and all the lower rates would fall commensurately. Meanwhile, the House wants to cut the state's car tax over that same period. Which is better tax policy?*

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<sup>9</sup> "A Model for Property Tax Reform in 2006 Reducing Property Tax Growth through Local Spending Limits," Americans for Tax Reform, January 25, 2006, [http://www.atr.org/content/pdf/2006/jan/012606ot-property\\_study.pdf](http://www.atr.org/content/pdf/2006/jan/012606ot-property_study.pdf)

*First, any extra tax on an arbitrarily selected product like automobiles needs to be justified. Typically, proponents of an extra tax will argue that the product imposes costs on society, a bad side effect that economists call a negative externality, and that government needs money to correct it. However, a specific tax on a product can also function as a sort of user fee that is linked to some government service. With automobiles, the link is transportation spending, and it's true that taxing cars and trucks and gasoline is a reasonable way to fund road building and maintenance. This is the so-called "benefit principle" of taxation. The people who get the benefit of good roads pay for them through the taxation of gasoline and vehicles.*

*If the current car tax is excessive in this sense, then one could argue that economic welfare and/or individual liberty would be enhanced by the tax cut, possibly even if it were financed by a separate tax increase somewhere else. However, a study of transportation spending and funding necessary to determine whether Georgia's transportation spending is adequately and exclusively funded by transportation-related levies, and therefore is in perfect compliance with the benefit principle, is beyond the scope of this memo.*

*Regardless, then, of whether a car tax cut is justified in the larger picture of Georgia's budget, we can comment briefly on its likely economic impact. In the short run, cutting the car tax would put more money in the hands of people, and this is usually an economic plus. However, lower government spending and/or higher taxes elsewhere must be the result. If higher taxes are levied elsewhere, the net effect could be positive or negative. If the government spending were cut from programs that have been particularly wasteful, then the economic boost of the tax cut would be preserved. The nature of government budget restraint makes this sort of accurately targeted spending cut rare, so in the short run Georgia's economy would probably not get much of a boost from a cut in the car tax.*

*The obvious short-term effect of five annual 2-percent cuts in income tax rates is likely to be quite small, although it's difficult to gauge the confidence of business leaders and citizens that a five-year phase-in will be permitted to continue on schedule. Many state-level enactments of that nature in other states have been short-circuited by subsequent legislatures.*

*In the long run, though, cutting the income tax rate in Georgia would increase the state's economic productivity, partly at the expense of other states. Once again, it matters if and how spending is cut in response. If comparatively wasteful spending can be cut – possibly sports stadium funding, to choose a provocative example – then Georgia will have made an economically ideal fiscal exchange.<sup>10</sup>*

## General Tax Reform

### *Resisting Class Warfare*

The author of the following story is unknown, but it conveys an important lesson on tax policy. This example discusses the fairness of allocating tax cuts, but it could just as easily have discussed the fairness of allocating tax increases. As we enter a budget downturn, it is something to keep in mind.

*Let's put tax cuts in terms everyone can understand. Suppose that every day, ten men go out for dinner and the bill for all ten comes to \$100. If they paid their bill the way we pay our taxes, it would go something like this:*

*The first four men (the poorest) would pay nothing. The fifth would pay \$1. The sixth would pay \$3. The seventh would pay \$7. The eighth would pay \$12. The ninth would pay \$18. The tenth man (the richest) would pay \$59. So, that's what they decided to do.*

*The ten men ate dinner in the restaurant every day and seemed quite happy with the arrangement, until one day, the owner threw them a curve. Since you are all such good customers," he said, "I'm going to reduce the cost of your daily meal by \$20." Dinner for the ten now cost just \$80.*

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<sup>10</sup> "An Economic Analysis of Georgia's Tax Cut Proposals," The Tax Foundation, March 28, 2008, <http://www.taxfoundation.org/research/show/23055.html>

*The group still wanted to pay their bill the way we pay our taxes so the first four men were unaffected. They would still eat for free. But what about the other six men - the paying customers? How could they divide the \$20 windfall so that everyone would get his 'fair share?'*

*They realized that \$20 divided by six is \$3.33. But if they subtracted that from everybody's share, then the fifth man and the sixth man would each end up being paid to eat their meal. So, the restaurant owner suggested that it would be fair to reduce each man's bill by roughly the same amount, and he proceeded to work out the amounts each should pay.*

*And so: The fifth man, like the first four, now paid nothing (100% savings). The sixth now paid \$2 instead of \$3 (33% savings). The seventh now pay \$5 instead of \$7 (28% savings). The eighth now paid \$9 instead of \$12 (25% savings). The ninth now paid \$14 instead of \$18 (22% savings). The tenth now paid \$49 instead of \$59 (16% savings). Each of the six was better off than before. And the first four continued to eat for free. But once outside the restaurant, the men began to compare their savings.*

*"I only got a dollar out of the \$20," declared the sixth man. He pointed to the tenth man, "but he got \$10!" "Yeah, that's right," exclaimed the fifth man. "I only saved a dollar, too. It's unfair that he got ten times more than me!" "That's true!!" shouted the seventh man. "Why should he get \$10 back when I got only two? The wealthy get all the breaks!" "Wait a minute," yelled the first four men in unison. "We didn't get anything at all. The system exploits the poor!"*

*The nine men surrounded the tenth and beat him up.*

*The next night the tenth man didn't show up for dinner, so the nine sat down and ate without him. But when it came time to pay the bill, they discovered something important. They didn't have enough money between all of them for even half of the bill!*

*And that, boys and girls, journalists and college professors, is how our tax system works. The people who pay the highest taxes get the most benefit from a tax reduction. Tax them too much, attack them for being wealthy, and they just may not show up anymore. In fact, they might start eating overseas where the atmosphere is somewhat friendlier.*

#### *Call a tax a tax*

A fee sounds much more innocuous than a tax. In addition, in many states legislators have attempted to call a tax a fee to avoid supermajority requirements for tax increases. For these reasons, it is important that a state clearly defines taxes and fees so that any assessment that raises money in excess of what is needed to defray costs must be called a tax.

The First Circuit Court of Appeals in the *San Juan Cellular* case provides a helpful tax vs. fee test. Then-Chief Judge Breyer wrote: "The classic 'tax' is imposed by a legislature upon many, or all, citizens. It raises money, contributed to a general fund, and spent for the benefits of the entire community. The classic 'regulatory fee' is imposed by an agency upon those subject to its regulation. It may serve regulatory purposes directly by, for example, deliberately discouraging particular conduct by making it more expensive. Or, it may serve such purposes indirectly by, for example, raising money placed in a special fund to help defray the agency's regulation-related expenses."

#### *Dedicated taxes*

Another close relative of the fee is the "dedicated tax." In fact, Georgia is in the midst of a debate on whether we should levy a dedicated tax to fund the state trauma care network. Lawmakers should exercise great caution here. It is the job of our elected officials to prioritize the needs of government in order to provide core government services. When all core government functions are placed together, legislators must prioritize them against each other with the realization that government's appetite for funding is insatiable, but tax revenues are not.

Dedicated taxes have several problems. Providing a dedicated source of revenue effectively removes a program from the annual process of prioritizing the state's needs. In addition, a dedicated tax is more difficult to adjust up or down than an appropriation. From the perspective of those interested in this service, a dedicated tax certainly provides more certainty, but wouldn't every state program like to have this certainty? Another problem is determining a direct relationship between the government program and what is taxed. In terms of trauma care, taxes on cell phones and motor vehicles have been proposed. Motor vehicles certainly have a closer relationship to trauma care than wireless phones, but the relationship is still tenuous. Trauma care is a public good that benefits the entire population of the state and should be funded as broadly as possible through general tax revenues.

#### Harmful taxes

##### *Sales taxes on business purchases*

Sales taxes levied on business-to-business transactions are very detrimental to a state's business climate. Consider the comments of David Brunori, contributing editor of *State Tax Notes*:

*A graduate student wrote me recently and asked what I thought was the most egregious flaw embedded in the state tax system. I told her that I thought there were about 100 flaws that could vie for the top spot. Here is one: the sales tax on business purchases.*

*Everyone who has ever studied the issue will tell you that the sales tax should not be imposed on business purchases. That is, when a business purchases a product or service, it should not pay tax on the purchase. There is near unanimity among public finance scholars on the issue. The sales tax is supposed to be imposed on the final consumer. Taxing business purchases causes the tax to be passed on to consumers without their knowledge.*

*There is nothing efficient or fair about that. But business purchases are taxed widely in every state with a sales tax. Some studies have estimated that business taxes make up nearly 50 percent of total sales tax revenue. Why? Two reasons. First, because business sales taxes raise so much money that the states cannot repeal them. The states would have to either raise other taxes or cut services. Second, many politicians think it is only fair that "businesses" pay taxes because individuals pay them. That ridiculous belief is unfortunately shared by many state legislators; it's usually espoused by liberals who don't understand that businesses aren't the ones who pay taxes. People do. Every time a business pays sales tax on a purchase, people are burdened. They just don't know it.<sup>11</sup>*

According to the most recent estimates available, Georgia businesses paid \$4.3 billion in sales taxes in 2007, representing over 30 percent of the total taxes paid by businesses.<sup>12</sup> Although it would be fiscally irresponsible to eliminate all of this revenue at one time, Georgia should prioritize how these harmful taxes can be phased out.

Last year, Georgia chose a good place to start by passing a temporary cap on the amount of state sales tax levied on energy used in manufacturing. Georgia is one of the few states in the Southeast that tax the energy used in manufacturing, placing Georgia manufacturers at a competitive disadvantage. A full exemption should be a tax reform priority.

##### *Inventory Tax*

Levied on the value of a company's inventory, the inventory tax is especially harmful to large retail stores and other businesses that store large amounts of merchandise. Inventory taxes are highly distortionary because they force companies to make decisions about production that are not entirely based on economic principles, but rather on how to pay the least amount of tax on goods produced. Inventory taxes

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<sup>11</sup> "An Old Admission of Gambling," *State Tax Notes*, Jan. 30, 2005, p. 332-339.

<sup>12</sup> "[Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2007](#)", Ernst and Young, 2007

also create strong incentives for companies to locate inventory in states where they can avoid these harmful taxes. Georgia is one of only 15 states to levy inventory taxes.<sup>13</sup>

#### *Tobacco Taxes*

Taxes on tobacco products are often viewed as a politically expedient way to raise revenue during an economic downturn. However, this tax also obeys the fundamental principal that “if you tax something you get less of it.” According to the Tax Foundation, “Numerous studies have shown cigarette taxes to be highly regressive, with the poor bearing a disproportionate share of the tax burden. Evasion and compliance costs undermine many of the asserted benefits of such tax increases.”

#### *Sales Tax Holidays*

According to the Tax Foundation, “Tax holidays narrow the sales tax base, add compliance costs, distort consumer choice, and don’t appear to generate economic activity. ... A [study](#) by the New York State Department of Taxation and Finance, performed after that state’s first sales tax holiday in 1997, found that the holiday did not increase retail sales of the subject goods (i.e., clothing). Rather, the study found that nearly all of the increased clothing sales activity during the holiday was offset by reduced activity before and after. For the quarter in which the holiday fell, clothing sales rose just 2.9% from a year earlier, which the Department attributed to normal economic growth. This fact makes Republicans’ claim that the tax holiday would largely pay for itself through increased economic activity especially dubious.” The Tax Foundation suggests that a better idea would be to instead “calculate the tax revenue that would be foregone in the holiday and use it to cut the sales tax rate all year.”

### **Agenda**

#### **Cut spending!**

It is easy to argue that one tax is better than another or that one level of government is taxing too much or too little, but in the end a low overall state and local tax burden cannot be maintained without controlling government spending at both the state and local level. All too often, tax reform simply shifts the tax burden from one class of taxpayers to another rather than reducing the tax burden or simplifying the tax code. In the end, a low tax burden on citizens is dependent upon keeping government spending under control, focusing on core government functions and prioritizing needs vs. wants.

#### **Require a supermajority to increase tax rates**

Low marginal tax rates lead to “an expansion in the production base and improved resource allocation” while “the higher the marginal tax rate, the greater the incentive to reduce taxable income. Tax avoidance takes many forms, from workers electing to take an improvement in nontaxable fringe benefits in lieu of higher gross wages, to investment in tax shelter programs.”<sup>14</sup>

In order to keep marginal tax rates low, Georgia should establish a two-thirds supermajority requirement to raise tax rates. A supermajority requirement would ensure that tax reform efforts focus on removing exemptions rather than damaging economic competitiveness by increasing tax rates.

#### **Broaden the tax base and lower rates**

The most efficient tax system has a broad base and low, flat rates. Tax reform should focus on moving Georgia in this direction.

#### *Income Taxes*

Georgia personal income taxes provide a good example. Georgia raised \$8 billion in revenue from the personal income tax in 2006. If all deductions and exemptions were removed so that federal adjusted gross income was used as the tax base (\$216 billion in 2006), a tax rate of 3.65% would have raised the same amount of revenue as the existing 6% rate.

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<sup>13</sup> “2008 State Business Tax Climate Index,” Tax Foundation, October 2007, <http://www.taxfoundation.org/files/bp57.pdf>

<sup>14</sup> “Rich States, Poor States,” American Legislative Exchange Council, 2007, [http://www.alec.org/am/pdf/ALEC\\_Competitiveness\\_Index.pdf](http://www.alec.org/am/pdf/ALEC_Competitiveness_Index.pdf)

This would clearly make the Georgia personal income tax more simple, easier to administer and would result in less distortion of economic decisions. This, of course, would have to be balanced against fairness, particularly for those at lower income levels.

In addition, this is a static analysis and does not attempt to measure the increased economic activity (and higher tax revenues) that a lower tax rate would likely incent. New Mexico provides a possible example of what could happen in Georgia. From 2003 to 2008, New Mexico lowered its state personal income tax in steps from 8.2% (2002) to 4.9% (2008). Over the same period, revenue from personal income tax collections did not decline but in fact grew from \$923 million in 2003 to \$1.186 billion this year.<sup>15</sup>

Federal Income Tax Data – Georgia Tax Returns (2006)<sup>16</sup>

Item	Amount in thousands of dollars
<b>Adjusted gross income (AGI)</b>	<b>216,331,873</b>
Salaries and wages in AGI	154,940,197
Taxable interest	4,563,755
Ordinary dividends	4,365,168
Business or profession net income (less loss)	5,660,586
Net capital gain (less loss) in AGI	17,890,055
Taxable individual retirement arrangements distributions	3,019,607
Pensions and annuities in AGI	12,192,594
Unemployment compensation	457,412
Social Security benefits in AGI	3,365,227
Self-employment retirement plans	482,752
Total itemized deductions	37,406,505
Taxes paid	11,651,031
Mortgage Interest paid	14,349,824
Charitable contributions	6,607,960
Other deductions	4,797,690

It is important to remember that sole proprietorships, partnerships and S corporations report business income on individual tax returns rather than on corporate income tax returns. Therefore, the individual income tax is also critical to the state’s business climate.

*Sales Taxes*

Most economists agree that the sales tax base should include all goods and services purchased by the end users of those products. Exempting any goods or services narrows the tax base, drives up the sales tax rate, and introduces unnecessary distortion into the market.<sup>17</sup>

Food bought for home consumption – groceries – are currently exempt from state sales tax. The Tax Foundation discusses this exclusion in a recent tax study: “Many state officials will say that they exempt groceries in order to make the sales tax system easier on low-income people. In reality, exempting gro-

<sup>15</sup> “Stimulating New Mexico’s Economy by Phasing out its Personal Income Tax,” Rio Grande Foundation, April 1, 2008, [http://riograndefoundation.org/downloads/rqf\\_eliminating\\_the\\_income\\_tax.pdf](http://riograndefoundation.org/downloads/rqf_eliminating_the_income_tax.pdf)

<sup>16</sup> <http://www.irs.gov/taxstats/article/0,,id=171535,00.html>

<sup>17</sup> “2008 State Business Tax Climate Index,” Tax Foundation, October 2007, <http://www.taxfoundation.org/files/bp57.pdf>

ceries from the sales tax mostly benefits grocers, not the poor, although even grocers have occasion to complain because the maintenance of complex, ever-changing lists of exempt and non-exempt products constitutes an administrative burden for all concerned. Most importantly, though, widespread availability of public assistance for the purchase of groceries – in the form of welfare or the food-stamp program – makes the argument for such exemptions unpersuasive.”<sup>18</sup>

“Fifteen states include or partially include groceries in their sales tax base. Tennessee, Utah, West Virginia, Illinois, Missouri, Arkansas and Virginia partially include groceries, while Alabama, Hawaii, Idaho, Kansas, Mississippi, Oklahoma, South Carolina and South Dakota wholly include groceries in the sales tax base.”<sup>19</sup>

Georgia currently levies local sales tax on groceries, but not state sales tax. Including groceries in the state sales tax base is estimated to increase revenues by more than \$558 million for 2008<sup>20</sup> or about 9 percent of estimated total general sales tax revenues. This would allow the state to reduce the state sales tax rate from 4% to almost 3.6% with no loss of revenue.

Although the sales tax is usually termed a regressive tax, groceries are an exception for those under the poverty level. A family of four with annual income up to \$26,856 is eligible for food stamps.<sup>21</sup> Food purchased with food stamps is not subject to sales tax, therefore, these families would pay no additional sales tax. For other families, the increased tax on groceries would be somewhat offset by the lower sales tax rate on other purchases.

If other consumer services were taxed (as outlined above, it is not appropriate to tax business purchases), 2006 state sales tax revenues were estimated by Georgia State University to increase by the following amounts:

Estimates for Eliminating Sales Tax Exemptions for Consumer Expenditures<sup>22</sup>

Sales Tax Exemption Removed	Estimated 2006 State Revenue
Health care related services	\$594 million
Sale of food for home consumption	\$500 million
Other consumer services	<u>\$816 million</u>
Total	\$1,910 million

A 1 percent sales tax in 2006 yielded \$1,430 million, so additional revenue of \$1,910 million would have allowed the state to reduce the sales tax rate from 4% to roughly 2.7% with no loss of revenue. From a policy perspective, the wisdom of eliminating some of these exemptions is questionable. For example, raising taxes on health care related services would increase the cost of health care and increase the number of uninsured. Taxing professional services where the customer does not have to be in the same location as the service provider – such as legal and investment management services – could easily result in shifting much of this business out of state.

**Further reading:**

A Framework for Tax Reform, Institute for Policy Innovation, <http://www.ipi.org/ipi%5CIPublications.nsf/PublicationLookupFullText/28B082C7EB246EDC86256F8C005774F9>

<sup>18</sup> Ibid.

<sup>19</sup> Ibid.

<sup>20</sup> “Revenue Estimates for Eliminating Sales Tax Exemptions and Adding Services to the Sales Tax Base ,” Georgia State University, October 2007, <http://aysps.gsu.edu/frc/files/Report170.pdf>

<sup>21</sup> [http://www.fns.usda.gov/fsp/applicant\\_recipients/eligibility.htm](http://www.fns.usda.gov/fsp/applicant_recipients/eligibility.htm)

<sup>22</sup> “Revenue Estimates for Eliminating Sales Tax Exemptions and Adding Services to the Sales Tax Base ,” Georgia State University, October 2007, <http://aysps.gsu.edu/frc/files/Report170.pdf>

[Property Tax Limitations](http://aysps.gsu.edu/frc/files/Rpt_179FIN.pdf), Georgia State University (2008), [http://aysps.gsu.edu/frc/files/Rpt\\_179FIN.pdf](http://aysps.gsu.edu/frc/files/Rpt_179FIN.pdf)  
Provides a very good overview of assessment limitations, tax rate limits and levy limits in Georgia and all other states.

[Property Tax in Georgia](http://aysps.gsu.edu/frc/files/Rpt_174FIN.pdf), Georgia State University (2008), [http://aysps.gsu.edu/frc/files/Rpt\\_174FIN.pdf](http://aysps.gsu.edu/frc/files/Rpt_174FIN.pdf)  
Basic overview of the property tax.

[Georgia's Taxes: A Summary of Major State and Local Government Taxes, 14th Edition](#) A handbook on taxation that provides a quick overview of all state and local taxes in Georgia. (January 2008)

[Property Tax in Georgia](#) This report discusses the structure of the property tax in Georgia and various provisions that make up the structure of the property tax. (March 2008)

[Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance](#), The Tax Foundation (January 2007) - This report outlines why gross receipts tax are a very bad idea.

Government Killed the Internet Star: How State Sales Taxes Threaten the Online Commerce, [http://www.alec.org/AM/pdf/insidealec\\_july08.pdf](http://www.alec.org/AM/pdf/insidealec_july08.pdf)