

## Tax Reform

*“Explicit manipulation of the tax system to control personal choices violates the long-standing principle that taxes should be general. Discrimination through taxation is as destructive to democracy and liberty as discrimination in any other form.” – Nobel Economics laureate James M. Buchanan*

### Principles:

- **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.
- **Focus taxation on consumption rather than work, savings and investment.** Shifting taxation away from income and toward consumption is more efficient and encourages entrepreneurship, job growth, capital formation, investment and overall economic growth.
- **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.
- **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.
- **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 micromanage economic decisions in a complex economy.

### Agenda:

- Broaden the tax base by eliminating exemptions
- Shift taxes to consumption rather than income
- Reduce taxes on small businesses
- Eliminate the sales tax on energy used in manufacturing
- Require a supermajority to increase tax rates
- Call a tax a tax
- Cap the growth in property taxes
- Avoid harmful taxes
- Reduce spending

### Facts:

#### *Tax Burden*

Tax burden measures *how much* you tax. There are many ways to measure tax burden. It is important to adjust for cost of living differences by comparing taxes as a percentage of personal income as opposed to per capita comparisons. States also differ on their state/local spending mix decisions. For example, some states may fund K-12 education almost completely at the state level, like Michigan, or they may shift more funding to the local level. In order to adjust for these differences, it is important to look at combined state and local taxes.

**Georgia State and Local Tax Revenues – 2008 (latest data as of July 2010)**

	Percent of Personal Income	Rank	Per Capita	Rank
State and local taxes	<b>9.95%</b>	<b>37</b>	\$3,468	38
Local taxes	4.60%	11	\$1,605	24
State taxes	5.35%	42	\$1,863	44

Source: Census Bureau

Tax Freedom Day, the day when Americans finally have earned enough money to pay off their total tax bill for the year, is a measure of tax burden. In 2010, Georgia taxpayers had to work until April 8 to pay their total tax bill, ranking them 24th nationally. That's one day earlier than national Tax Freedom Day (April 9). The Tax Freedom Days of neighboring states are: Tennessee, April 1 (ranked 44th nationally); Alabama, April 2 (ranked 42nd nationally); Florida, April 5 (ranked 31st nationally); South Carolina, April 3 (ranked 40th nationally); and North Carolina, April 7 (ranked 26th nationally).<sup>1</sup>

*Tax Structure*

Tax structure measures *how* you tax. The Tax Foundation's State Business Tax Climate Index measures tax structure as it relates to business. Georgia ranks 29th in the latest index published for 2010, behind all but one neighboring state. 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 (22nd), Alabama (19th), Florida (5th), South Carolina (26th) and North Carolina (39th).<sup>2</sup>

The Small Business & Entrepreneurship Council's Business Tax Index, another measure of tax structure, ranks the 50 states and District of Columbia according to the costs of their tax systems for entrepreneurship and small business. Georgia ranks 21st, lower than all of its neighboring states.<sup>3</sup>

**Georgia vs. Neighboring States (higher rank is better)**

	<u>AL</u>	<u>FL</u>	<u>GA</u>	<u>NC</u>	<u>SC</u>	<u>TN</u>
2010 State Business Tax Climate Index	19	5	29	39	26	22
2010 Small Business Tax Index	7	6	21	37	12	13
Top Personal Income Tax Rate	12	1	26	43	38	1
Inventory Tax	Yes	No	Yes	No	No	No
Sales Tax on Energy Used in Manufacturing	Exempt	Exempt	Taxed at full rate	Taxed at reduced rate	Exempt	Exempt

Georgia also taxes inventory and the energy used in manufacturing. Only 15 states levy an inventory tax. Energy is a business input and therefore should not be subject to a sales tax. Georgia is one of only 14 states that do not provide a sales tax exemption for energy used in manufacturing.

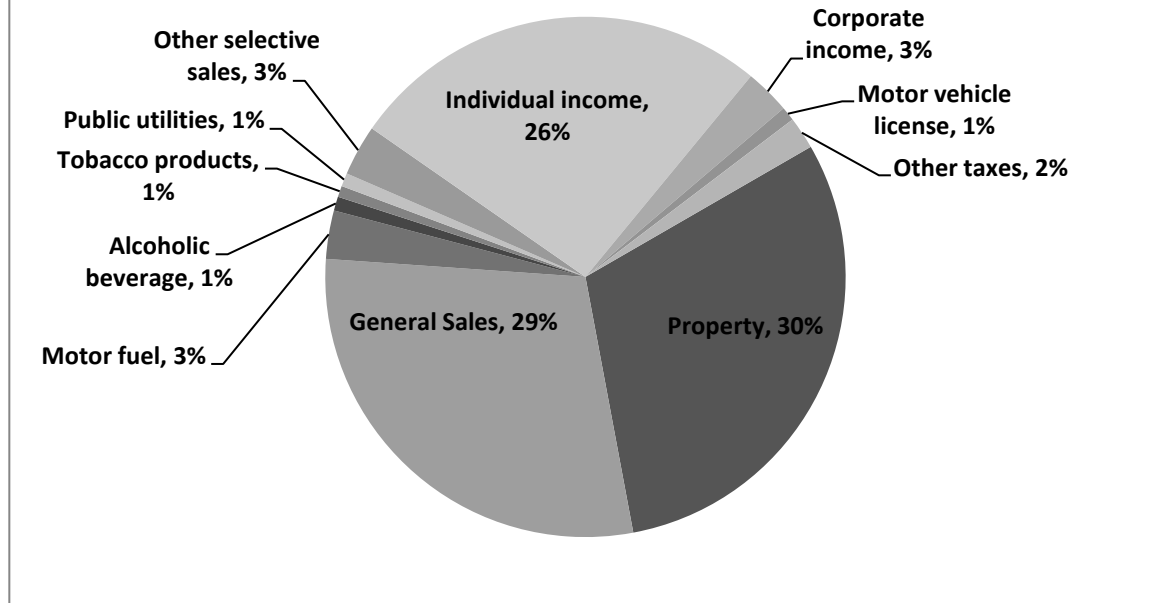
<sup>1</sup> <http://taxfoundation.org/taxfreedomday/>

<sup>2</sup> <http://www.taxfoundation.org/research/show/22658.html>

<sup>3</sup> <http://www.sbecouncil.org/businessstaxindex2010/>

## 2008 State and Local Taxes

Source: Census Bureau



### 2008 State and Local Tax Revenues<sup>4</sup>

<u>Tax</u>	<u>State and Local</u>	<u>State</u>	<u>Local</u>
Property	\$10,219,678	\$ 81,928	\$10,137,750
General Sales	9,770,932	5,796,653	3,974,279
Motor fuel	1,011,202	1,011,202	-
Alcoholic beverage	293,441	165,640	127,801
Tobacco products	233,158	233,158	-
Public utilities	279,964	-	279,964
Other selective sales	1,063,018	482,192	580,826
Individual income	8,845,476	8,845,476	-
Corporate income	943,042	943,042	-
Motor vehicle license	296,648	296,648	-
Other taxes	<u>675,942</u>	<u>214,093</u>	<u>461,849</u>
All Taxes	\$33,632,501	\$18,070,032	\$15,562,469

According to the latest IRS figures for 2008, a record 52 million filers – 36 percent of the 143 million who filed a tax return – had no federal tax liability because their credits and deductions reduced their liability to zero. Georgia ranks second in the nation, behind Mississippi, for the number of tax filers without liability. **Of 4,255,054 Georgia filers, 41 percent had no tax liability:** 2,598,415 paid taxes and 1,753,675 had no tax liability. Tax credits such as the child tax credit and earned income tax credit have become so generous that a family of four earning up to about \$52,000 can expect to have their income tax liability erased entirely.<sup>5</sup>

According to the latest figures released by the Georgia Department of Revenue, **the top 10 percent of Georgians filing tax returns in 2007 had incomes over \$100,000 and paid 57 percent of all income**

<sup>4</sup> <http://www.census.gov/govs/estimate/>

<sup>5</sup> <http://www.taxfoundation.org/publications/show/26336.html>

**taxes, up from 40 percent in 1997. Those in the bottom 53 percent (incomes less than \$25,000) paid 9 percent of the total in 2007, down from 10 percent in 1997.** (The number for the bottom 53 percent would be lower, but out-of-state and partial year returns are consolidated and also reported in this category.)<sup>6</sup>

Georgia does not have an inheritance tax or a gift tax, but it does have an estate tax. The Georgia estate tax is the amount allowable by the IRS as a credit for state estate taxes. In effect, the estate taxes paid to Georgia may be used to reduce the estate taxes due the IRS."<sup>7</sup> Hence, Georgia's estate tax doesn't add to anyone's overall estate tax bill, it simply keeps more of the money at the state, rather than federal, level.

Georgia could add almost 42,000 new jobs at no cost to taxpayers if the federal estate tax were repealed, according to an analysis released by the Georgia Public Policy Foundation.<sup>8</sup> The analysis, conducted for the Washington-based nonprofit American Family Business Foundation, is based on research by Douglas Holtz-Eakin, the former director of the nonpartisan Congressional Budget Office.

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<sup>6</sup> [https://etax.dor.ga.gov/oic/2009stats/TLP\\_WebStatReportFY2009.pdf](https://etax.dor.ga.gov/oic/2009stats/TLP_WebStatReportFY2009.pdf)

<sup>7</sup> Georgia Department of Revenue 2008 Tax Guide for Georgia Citizens, [https://etax.dor.ga.gov/taxguide/TSD\\_Tax\\_Guide\\_for\\_Georgia\\_Citizens\\_2008.pdf](https://etax.dor.ga.gov/taxguide/TSD_Tax_Guide_for_Georgia_Citizens_2008.pdf)

<sup>8</sup> <http://www.gppf.org/default.asp?pt=newsdescr&RI=1499>

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

<b>1997</b>				
<u>Income Level</u>	<u>Number</u> <u>of Filers</u>	<u>Percentage</u> <u>of Total</u>	<u>Personal</u> <u>Income Tax</u> <u>Liability</u>	<u>Percentage</u> <u>of Total</u>
\$1,000 and under *	179,455	5.70%	\$ 121,565	2.60%
\$1,001 to \$5,000	288,223	9.20%	627	0.00%
\$5,001 to \$10,000	351,564	11.20%	16,707	0.40%
\$10,001 to \$15,000	323,424	10.30%	60,912	1.30%
\$15,001 to \$20,000	299,250	9.60%	118,260	2.50%
\$20,001 to \$25,000	255,570	8.20%	161,813	3.50%
\$25,001 to \$30,000	201,478	6.40%	178,976	3.80%
\$30,001 to \$50,000	537,975	17.20%	752,675	16.10%
\$50,001 to \$100,000	514,530	16.40%	1,391,187	29.80%
\$100,001 to \$500,000	167,751	5.40%	1,230,690	26.40%
\$500,001 to \$1,000,000	6,744	0.20%	223,397	4.80%
\$1,000,001 and higher	<u>3,618</u>	<u>0.10%</u>	<u>408,920</u>	<u>8.80%</u>
	3,129,582	100.00%	\$4,665,720	100.00%

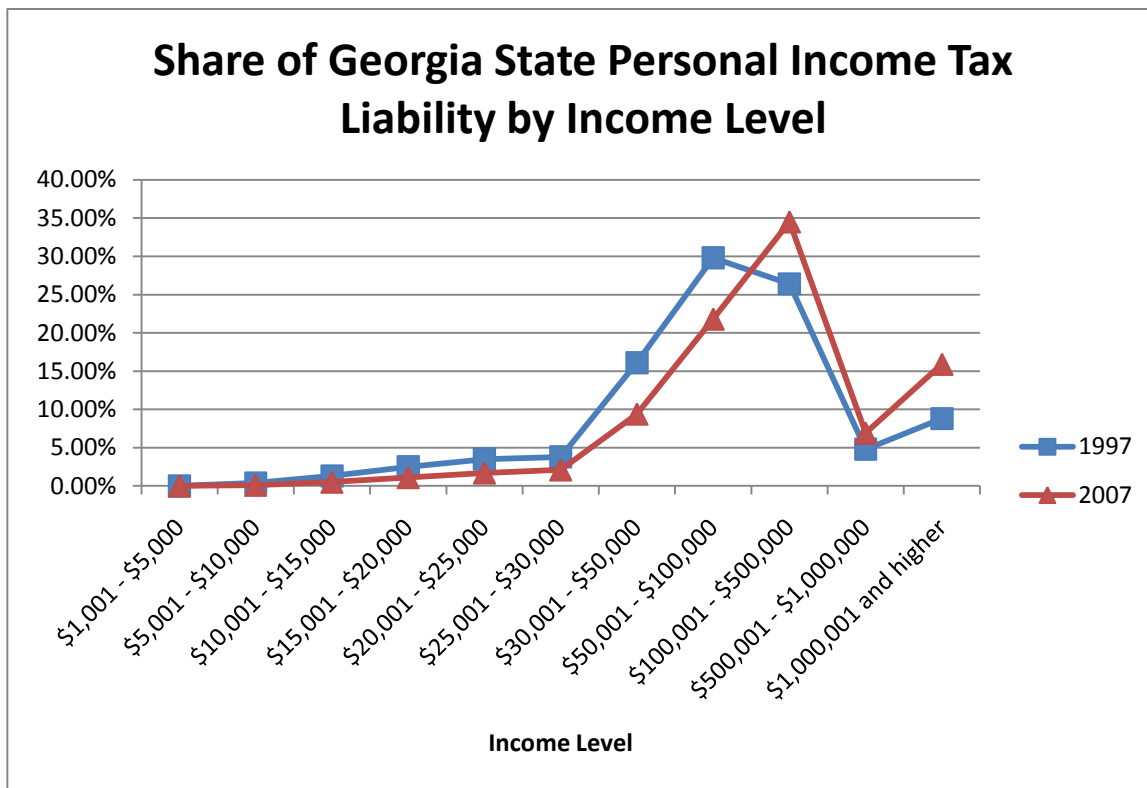
<b>2007</b>				
<u>Income Level</u>	<u>Number</u> <u>of Filers</u>	<u>Percentage</u> <u>of Total</u>	<u>Personal</u> <u>Income Tax</u> <u>Liability</u>	<u>Percentage</u> <u>of Total</u>
\$1,000 and under *	715,800	16.80%	\$ 505,330	6.00%
\$1,001 to \$5,000	274,100	6.40%	20	0.00%
\$5,001 to \$10,000	355,200	8.30%	9,100	0.10%
\$10,001 to \$15,000	334,500	7.80%	40,876	0.50%
\$15,001 to \$20,000	306,000	7.20%	90,780	1.10%
\$20,001 to \$25,000	276,500	6.50%	139,990	1.70%
\$25,001 to \$30,000	243,900	5.70%	175,088	2.10%
\$30,001 to \$50,000	649,100	15.20%	790,663	9.40%
\$50,001 to \$100,000	700,000	16.40%	1,827,148	21.80%
\$100,001 to \$500,000	392,300	9.20%	2,886,601	34.50%
\$500,001 to \$1,000,000	16,800	0.40%	577,675	6.90%
\$1,000,001 and higher	<u>9,000</u>	<u>0.20%</u>	<u>1,330,000</u>	<u>15.90%</u>
	4,273,200	100.00%	\$8,373,271	100.00%

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

Source: 2008 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)

The chart below shows how the distribution of Georgia income taxes has changed over the last ten years. The trend is similar to what has occurred on the federal level, with the share of taxes paid by lower income Georgians decreasing and the share of taxes paid by upper income Georgians increasing.



- There are currently seven states that do not collect any state income taxes at all – Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.
- There are two states that only collect income taxes on dividends and interest income – New Hampshire and Tennessee.
- Hawaii and Oregon have the highest incremental state tax rate – 11.0%.
- Six states have only one income tax bracket, charging its residents one rate on all income, which is called a flat rate – Colorado (4.63%), Illinois (3.0%), Indiana (3.4%), Massachusetts (4.35%), Michigan (3.9%), Pennsylvania (3.07%), and Utah (5.0%).

**Data Sources:**

- Georgia Department of Revenue
  - [Publications](#) including millage rate manuals and the annual Statistical Report, which contains detailed statistical data<sup>9</sup>
  - [Sales tax data](#), including current and historical sales tax rates by county<sup>10</sup>
  - [Property tax data](#), including millage rates and ad valorem taxes levied<sup>11</sup>
- [Census Bureau](#)<sup>12</sup>
- Tax Foundation: [Georgia Tax Overview](#)<sup>13</sup>
- Rankings vs. other states:

<sup>9</sup> <https://etax.dor.ga.gov/gaforms/publica.aspx>  
<sup>10</sup> [https://etax.dor.ga.gov/lndTax\\_SalesTax.aspx](https://etax.dor.ga.gov/lndTax_SalesTax.aspx)  
<sup>11</sup> [https://etax.dor.ga.gov/lndTax\\_PropTax.aspx](https://etax.dor.ga.gov/lndTax_PropTax.aspx)  
<sup>12</sup> <http://www.census.gov/govs/>  
<sup>13</sup> <http://taxfoundation.org/research/topic/22.html>

- [The Public Policy Institute of New York State](#)<sup>14</sup>
- [The Taxpayers Network](#)<sup>15</sup>

Total State and Local Business Taxes:

- [Ernst and Young's 50-State Estimates for Fiscal Year 2009](#)<sup>16</sup>

## Overview

On June 1, 2010, Governor Perdue signed HB 1405, creating the Special Council on Tax Reform and Fairness, which is charged with modernizing Georgia's tax code. Georgia's tax structure fares poorly in comparisons to other states, particularly neighboring competitors. These problems stifle Georgia's standard of living and economic growth. Georgia's per capita personal income lags the national average and its growth is nearly the lowest in the nation (49th) over the last 10 years. Growth in GDP during this same period was not much better as Georgia also underperformed the national average and neighboring states.

Although tax policy is not the only factor in economic performance, it plays a large role. The good news is that structural reform can be accomplished during a difficult economic period because the impact can be revenue-neutral. In fact, good tax policy can spur increased economic activity. This is recognized in "dynamic" tax analysis. A good example is the impact of reductions in income and capital gains taxes. A recent study published by the National Bureau of Economic Research concludes, "In the long run, about 17 percent of a cut in labor taxes is recouped through higher economic growth. The comparable figure for a cut in capital taxes is about 50 percent. This means that the true revenue cost of a cut in capital taxes is only half of the cost estimated with static scoring."<sup>17</sup> This underscores the importance of looking at tax policy in terms of how it impacts changes in human behavior as well as both the short-term and long-term effects.

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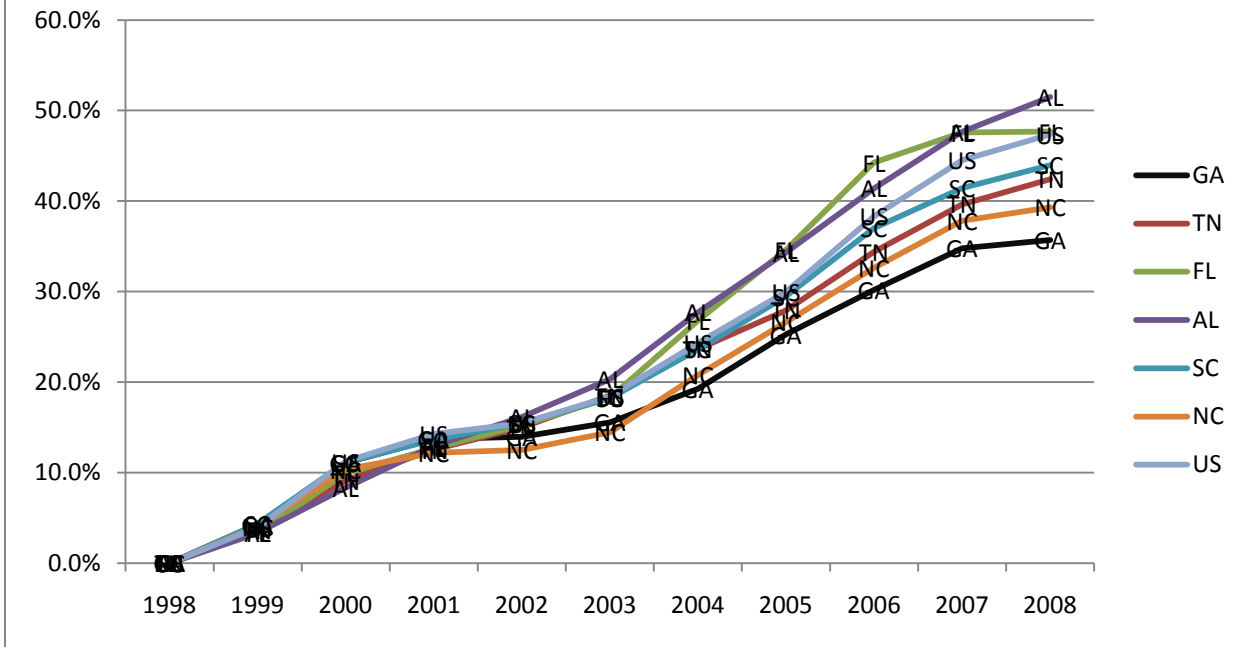
<sup>14</sup> [www.ppinys.org/reports/JustTheFacts.html](http://www.ppinys.org/reports/JustTheFacts.html)

<sup>15</sup> [www.taxpayersnetwork.org/DesktopDefault.aspx?tabindex=6&tabid=3402](http://www.taxpayersnetwork.org/DesktopDefault.aspx?tabindex=6&tabid=3402)

<sup>16</sup> [http://www.ey.com/Publication/vwLUAssets/Total-state-and-local-business-taxes-March-2010/\\$FILE/Total-state-and-local-business-taxes-March-2010.pdf](http://www.ey.com/Publication/vwLUAssets/Total-state-and-local-business-taxes-March-2010/$FILE/Total-state-and-local-business-taxes-March-2010.pdf)

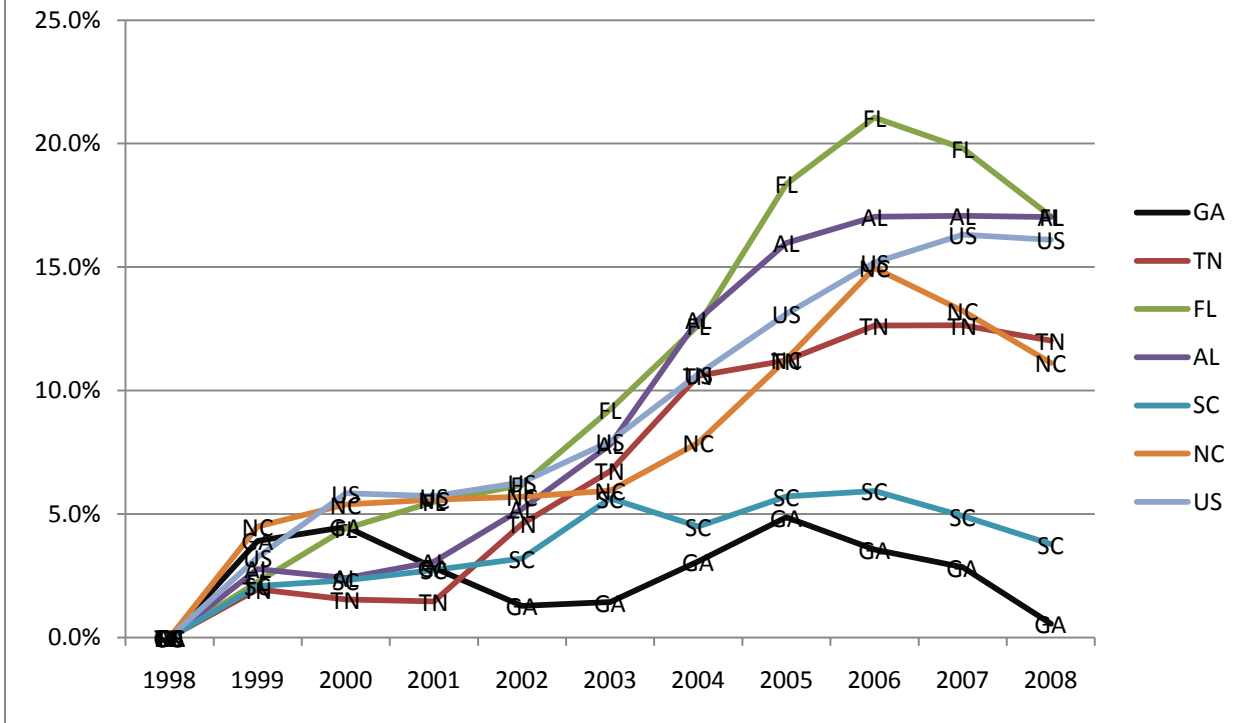
<sup>17</sup> "Dynamic Scoring: A-Back-of-the-Envelope Guide," NBER Working Paper No. 11000, N. Gregory Mankiw and Matthew Weinzierl, 2006, <http://www.nber.org/digest/jul05/w11000.html>

## Personal Income Per Capita (% Change from 1998)



Source: Bureau of Economic Analysis

## State GDP Per Capita (% change from 1998, chained 2000 dollars)



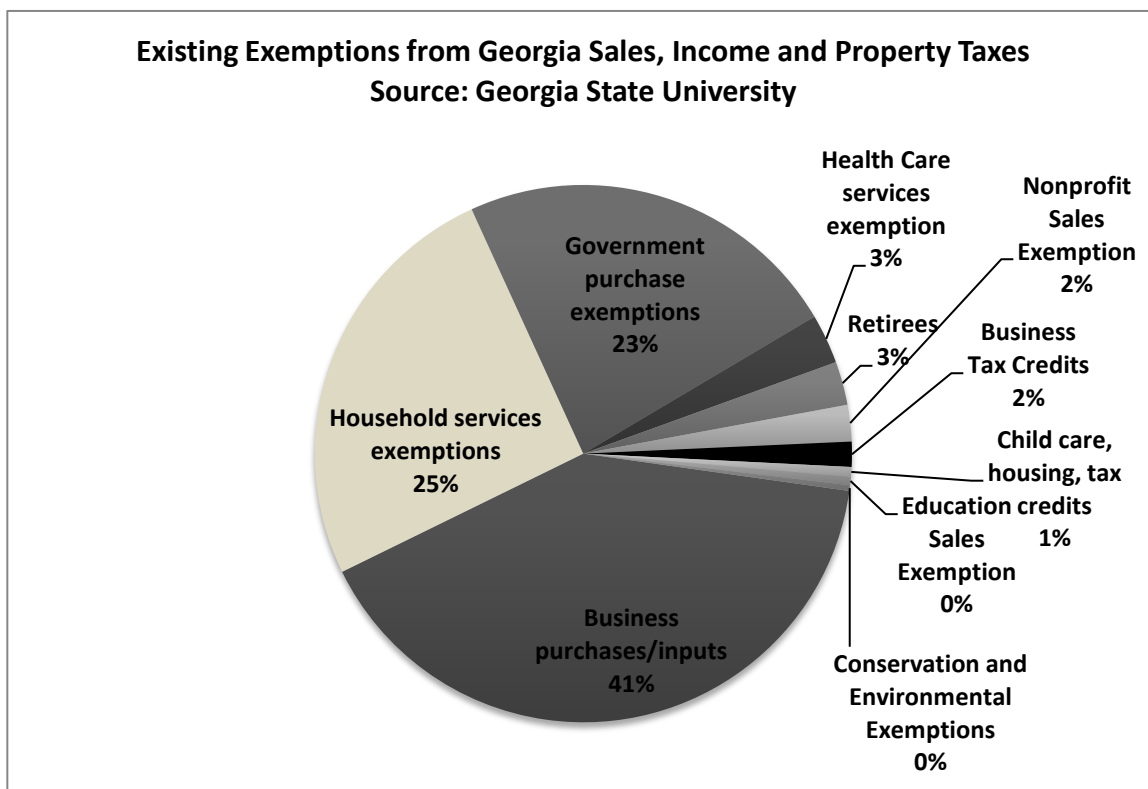
Source: Bureau of Economic Analysis

**Agenda:**

**Broaden the tax base by eliminating exemptions**

One of the few principles most economists and tax experts agree on is that **broadening the tax base is good tax policy**. Georgia has a promising opportunity to broaden its tax base in several areas, which would allow the state to reduce tax rates.

Georgia State University estimates the total value of tax exemptions and tax credits in the Georgia tax code is just over \$10 billion.<sup>18</sup> The largest three account for 90 percent of the total: business inputs (\$4.2 billion), government purchases (\$2.4 billion) and household purchases, including education (\$2.7 billion). Health care and exemptions for nonprofits and retirees account for \$805 million. Another \$96 million of exemptions are provided to incentivize environmental actions, conservation and low-income housing. Other business exemptions and tax credits – mainly economic development incentives – account for \$156 million.



**Broadening the Sales Tax**

Most economists agree that **the sales tax base should include all goods and services purchased by the final consumer. Exempting any goods or services narrows the tax base, drives up the sales tax rate and introduces unnecessary distortions into the market.**<sup>19</sup> There is also broad agreement that business purchases should be exempt (see “Sales Taxes on Business Purchases” below).

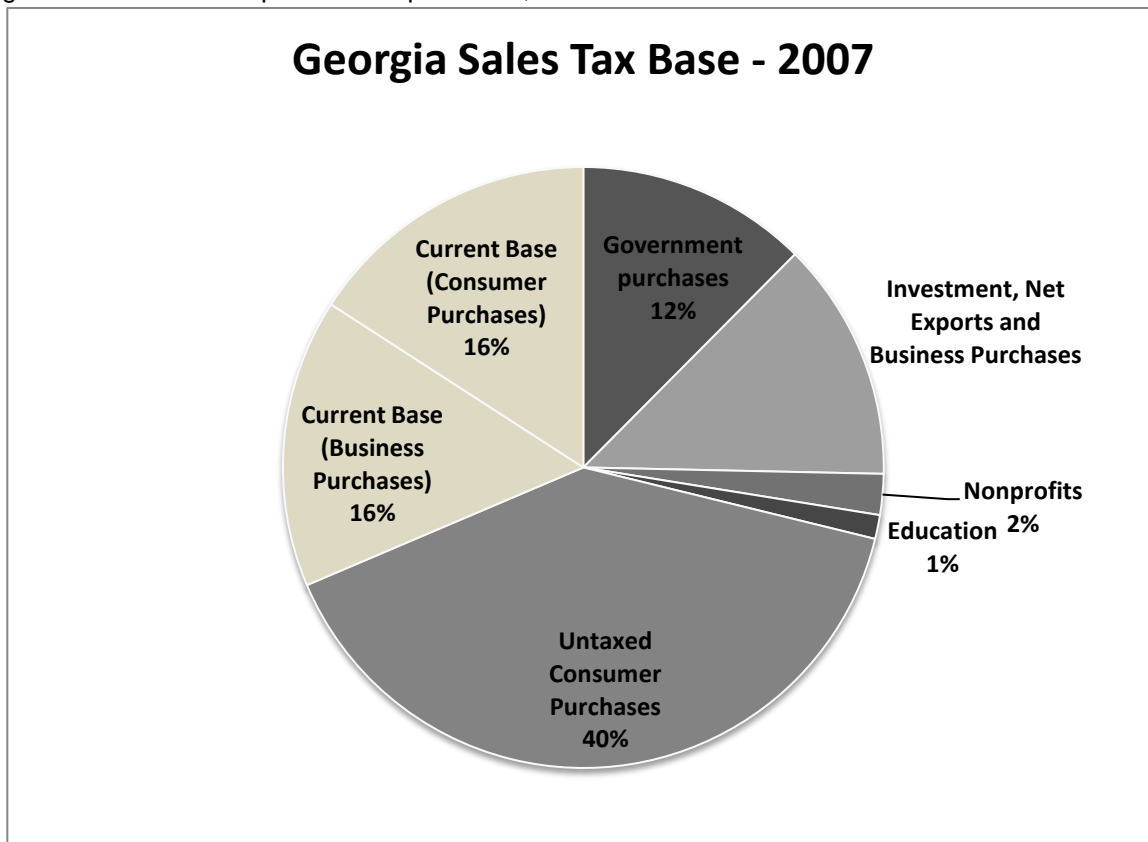
<sup>18</sup> <http://www.gppf.org/pub/TaxExpenditureSummary.pdf>

<sup>19</sup> “2010 State Business Tax Climate Index,” Tax Foundation, September 2009, <http://www.taxfoundation.org/research/show/22658.html>

In 2007, estimated personal consumption spending in Georgia was \$278 billion.<sup>20</sup> To calculate the maximum size of the sales tax base it is necessary to subtract several items: contributions to nonprofits and religious organizations (which are unlikely to be taxed), Internet access charges (which cannot be taxed due to federal law) and education spending (a form of investment that should not be taxed). Adding business purchases that are currently taxed (estimated at \$73 billion<sup>21</sup>) leaves a possible sales tax base of \$334 billion, more than double the current sales tax base of \$148 billion. In other words, expanding the sales tax base to \$334 billion could raise the same revenue with a rate of 1.8 percent rather than the current rate of 4 percent. If the rate were kept at 4 percent the additional revenue would be \$7.4 billion.

**The majority of untaxed consumer purchases are services.** Although applying a sales tax on consumer services does not violate good tax policy, there are fairness, administrative, political and economic competitiveness considerations that must be addressed. A set of principles should be established to guide these decisions, such as focusing first on services that are taxed in a number of other states and where businesses are already collecting sales tax on the sale of other products.

It is important to remember that **broadening the sales tax base will result in a windfall for local governments with local sales taxes.** (This is true of any broadening other than groceries, which are already taxed at the local level.) In other states that have broadened their sales tax base, local governments were required to adopt a lower, revenue-neutral sales tax rate.



<sup>20</sup> Personal consumption expenditures are commonly estimated as 70 percent of Gross State Product (GSP). GSP data is from <http://www.bea.gov/regional/spi/default.cfm?selTable=summary>. Georgia's 2007 GSP was \$398 billion.

<sup>21</sup> According to the 2007 Personal Consumption Expenditure (PCE) data for the US, consumer spending on goods less spending on food for home consumption was 26.7% of PCE. This would indicate a Georgia sales tax base of only \$73,158, when the actual tax base was \$147,888. At 4%, this would yield \$2.9 billion. Therefore, the remaining \$3 billion may represent sales taxes paid by businesses. The FY2007 State and Local Business Tax Study by the Council on State Taxation<sup>21</sup> indicates that Georgia businesses paid \$4.3 billion in state and local sales taxes. State sales taxes were 60% of the total in 2007, which indicates \$2.6 billion in state sales taxes paid by businesses. Using either estimate, it is clear that businesses are paying close to half of the sales tax in Georgia.



*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>22</sup>

Both conservative, moderate and liberal tax organizations agree on this issue.<sup>23</sup> Despite this uniform opinion that sales taxes on business purchases are not good tax policy, most states, including Georgia, include a substantial amount of business purchases in their sales tax base. Rather than making the problem worse by removing these exemptions, Georgia should analyze business purchase exemptions on a case-by-case basis.

### **Broadening the sales tax base: Groceries**

Food bought for home consumption – groceries – are currently exempt from state sales tax. The Tax Foundation discusses this exclusion in a recent tax study: “Like Georgia, most states exempt groceries, and they maintain long, ever-changing lists of grocery items that supposedly deserve the exemption and others that do not. Opponents of taxing groceries are correct that the tax is regressive-it taxes a good on which the poor spend a larger percentage of their income. But when examined more closely, this is a weak argument for exempting groceries. By this definition of regressive, sales taxes on all goods are regressive. Any product bought by a person with little income means that person has spent a larger portion of their income on the product than a person with more income would have. If this were a barrier to taxation, then there could be no sales taxes. Besides, every state has a food stamp program that provides not just tax-free groceries but completely free groceries, so the poorest are not greatly affected. The grocery exemption forces the rate on other items up substantially, typically a full percentage point, and it makes sales tax revenue much more volatile.”<sup>24</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>25</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 at least \$600 million.** Although the sales tax is usually termed a regressive tax, groceries are an exception for those under the poverty level. Food purchased with food stamps or through programs such as the Women, Infants and Children program (WIC) is not subject to sales tax, therefore, these families would pay no additional sales tax. (A family of four with annual income up to \$26,856 is eligible for food stamps and WIC eligibility goes up to 185 percent of the federal poverty level.)<sup>26</sup> **For other families, the increased tax on groceries can be offset by a lower overall sales tax rate or by targeted tax credits.**

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<sup>22</sup> “An Old Admission of Gambling,” State Tax Notes, Jan. 30, 2005, p. 332-339.

<sup>23</sup> See “Pennsylvania Governor Proposes Spending Boost, Broader Sales Tax, Heavier Business Taxes,” Tax Foundation, February 25, 2010, [http://www.taxfoundation.org/research/show/25905.html#\\_ftn4](http://www.taxfoundation.org/research/show/25905.html#_ftn4), “Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services,” Council on State Taxation and Ernst and Young, January 25, 2005, <https://custom.cvent.com/4FD9AEB0B66149A089E5F2DBB2DBFE9F/files/017e40544c2d4dac8aaf2e082a5aeede.pdf>, and “Expanding Sales Taxation of Services: Options and Issues,” Center on Budget and Policy Priorities, August 10, 2009, <http://www.cbpp.org/cms/index.cfm?fa=view&id=2888>

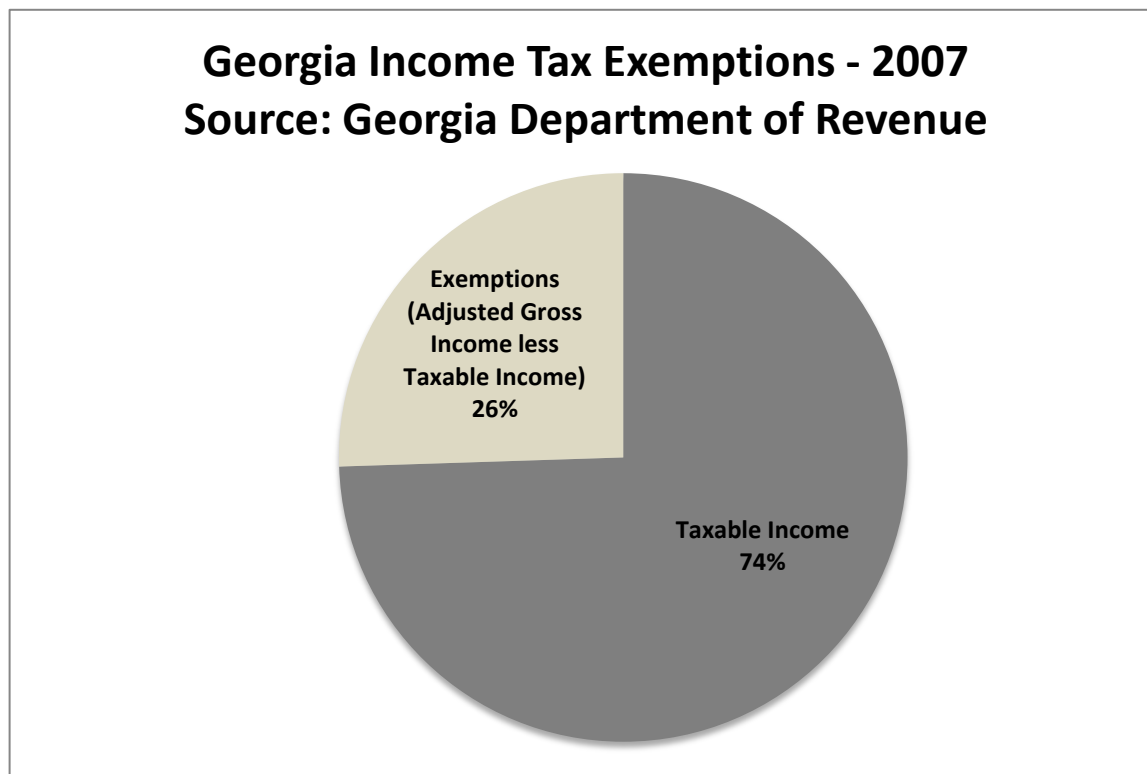
<sup>24</sup> “Georgia Should Respond to Recession with Tax Reform, Not Tax Gimmicks,” Tax Foundation, February 19, 2010, <http://www.taxfoundation.org/research/show/25871.html>

<sup>25</sup> 2008 State Business Tax Climate Index,” Tax Foundation, October 2007, <http://www.taxfoundation.org/files/bp57.pdf>

<sup>26</sup> WIC program, <http://www.fns.usda.gov/wic/WIC-Fact-Sheet.pdf>, Food Stamp program, [http://www.fns.usda.gov/snap/applicant\\_recipients/eligibility.htm#income](http://www.fns.usda.gov/snap/applicant_recipients/eligibility.htm#income)

## ***Broadening the Income Tax Base***

Exemptions in the personal income tax amount to approximately \$3 billion.<sup>27</sup> To remain revenue neutral, the top income tax rate could be reduced to approximately 4.4 percent if these exemptions were removed.<sup>28</sup>



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 percent (2002) to 4.9 percent (2008).<sup>29</sup>

Despite dire predictions that the state would lose revenue, during the years of this tax reduction revenues increased and New Mexico experienced a period of substantial economic growth. The simple explanation could be that the increases in New Mexico's tax revenue reflect the economic boom of the mid-2000s. Yet, when compared with Georgia's economic growth over the same time period, New Mexico shows far superior growth.

Georgia's top income tax remained constant at 6 percent from 2003 to 2008 while New Mexico's top income tax dropped 3.3 percentage points. Personal income per capita in New Mexico grew 33 percent, from \$25,049 in 2002 to \$33,385 in 2008. Georgia's personal income increased just 19 percent, from

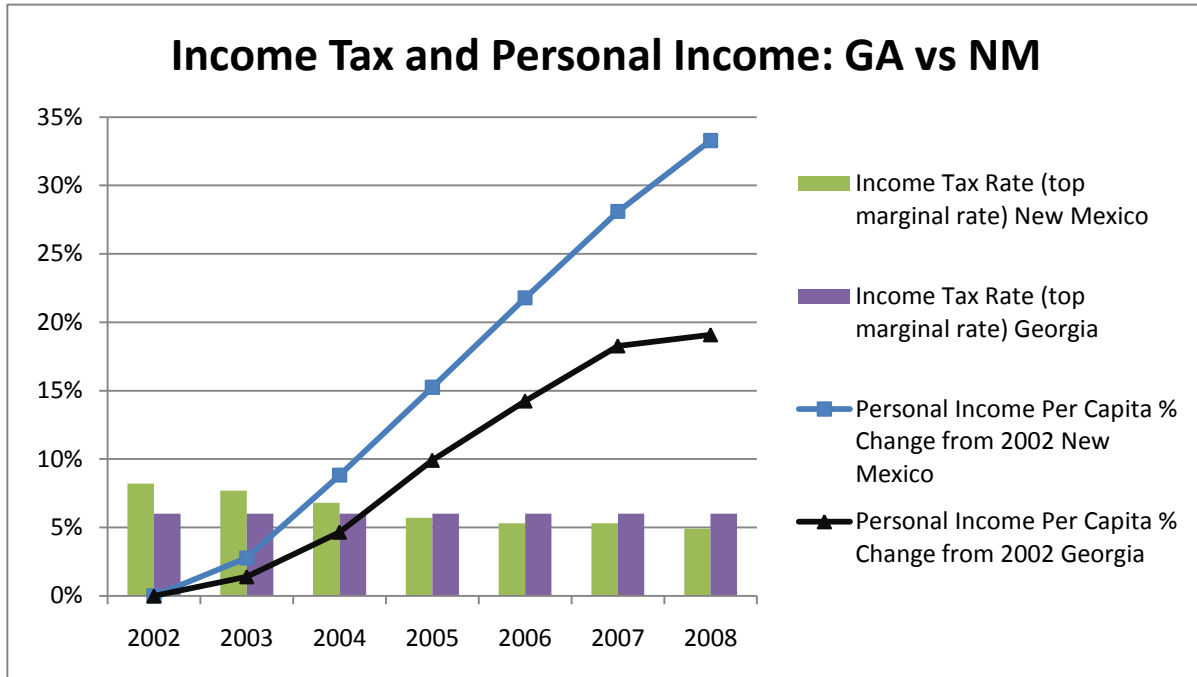
<sup>27</sup> Using 2007 tax data ([https://etax.dor.ga.gov/oic/2009stats/TLP\\_WebStatReportFY2009.pdf](https://etax.dor.ga.gov/oic/2009stats/TLP_WebStatReportFY2009.pdf) - pages 41 and 42), adjusted gross income of \$202,747 less net taxable income \$151,026 is \$51,721. Dividing 2007 personal income tax revenues of \$8.8 billion by net taxable income of \$151 billion equals an average tax rate of 5.8%. Applying this average tax rate to the total deductions of \$51.7 billion equals \$3 billion in addition tax revenue if these deductions were removed.

<sup>28</sup> This calculation does not factor in a law passed in 2010 that will eventually exempt all retirement income for senior citizens.

<sup>29</sup> "Stimulating New Mexico's Economy by Phasing out its Personal Income Tax," Rio Grande Foundation, April 1, 2008, [http://riograndefoundation.org/downloads/rgf\\_eliminating\\_the\\_income\\_tax.pdf](http://riograndefoundation.org/downloads/rgf_eliminating_the_income_tax.pdf)

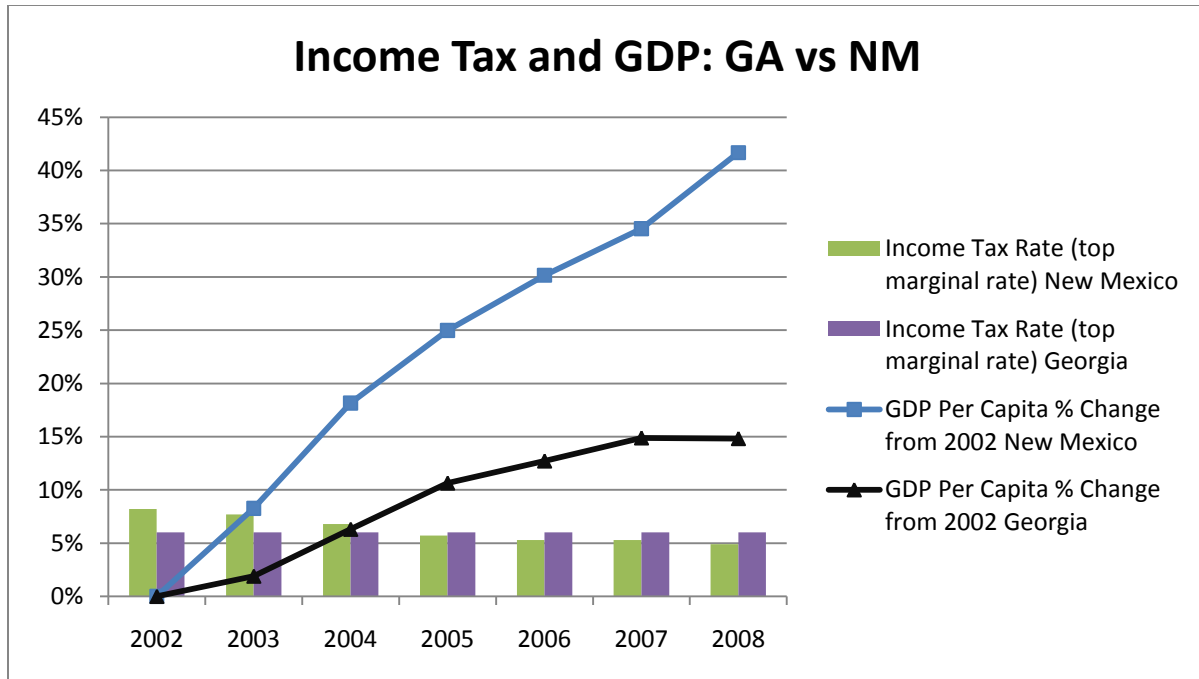
\$29,264 to \$34,849. GDP expansion shows an even more dramatic difference: From 2002 to 2008, GDP per capita grew a whopping 42 percent in New Mexico compared with just 15 percent in Georgia. New Mexico had a lower starting point with both metrics, but has nearly surpassed Georgia with no sign of slowing down.<sup>30</sup>

Georgia's highest income tax bracket is higher than states such as Massachusetts, Virginia, Michigan, Illinois, Ohio, Colorado, Alabama and Pennsylvania, not to mention two of Georgia's neighboring states with no tax at all on wages: Tennessee and Florida.<sup>31</sup>



<sup>30</sup> "New Mexico Provides Model for Georgia Tax Reform," Georgia Public Policy Foundation, July 16, 2010, <http://gppf.org/article.asp?RT=&p=pub/Taxes/NewMexico100716.htm>

<sup>31</sup> "Georgia Should Respond to Recession with Tax Reform, Not Tax Gimmicks," Tax Foundation, February 19, 2010, <http://www.taxfoundation.org/research/show/25871.html>



### Fairness

Removing exemptions can have the unintended consequence of harming low-income families. There are several options to offset this effect. Pennsylvania, which has a low income tax rate of 3.07 percent and no dependent exemptions or standard deduction, uses a tax credit called “tax forgiveness” to reduce the tax burden for low-income families.<sup>32</sup> Other states have used a state-level Earned Income Tax Credit (EITC) that is calculated as a percentage of the federal EITC.<sup>33</sup>

In 2004, (the latest numbers available) Georgia families failed to claim \$2.7 billion in federal EITC dollars. A state-level EITC could be used to encourage citizens to claim their federal tax credit, adding up to \$2.7 billion to the Georgia economy as it helps low-income Georgians get back on their feet. According to the Heartland Institute, “Because the EITC targets low-income persons and is larger if the filer has one or two dependents, it provides a powerful work incentive for single mothers. Researchers have consistently found expansion of EITC to be a major factor in declining welfare participation rates and rising workforce participation rates for single mothers.”<sup>34</sup>

### Shift taxes to consumption rather than income

As Georgia considers major tax reform, this is a perfect opportunity to shift toward a more pro-growth tax code by reducing or eliminating the state income tax. Many studies argue that this would encourage economic growth, capital formation and job creation:

- In examining the impact of average tax rates and marginal tax rates on income growth over the period of 1961-1992, the Federal Reserve Bank of Atlanta concluded “relative marginal tax rates have a statistically significant negative relationship with relative state growth.” It further found that state and local tax rates “have temporary growth effects that are stronger over shorter intervals

<sup>32</sup> [http://www.portal.state.pa.us/portal/server.pt/community/tax\\_forgiveness/13789/eligibility/580754](http://www.portal.state.pa.us/portal/server.pt/community/tax_forgiveness/13789/eligibility/580754)

<sup>33</sup> <http://www.irs.gov/individuals/article/0,,id=150513,00.html>

<sup>34</sup> “Welfare Reform After Ten Years,” The Heartland Institute, 2008, [http://www.heartland.org/policybot/results/23498/No\\_119\\_Welfare\\_Reform\\_after\\_Ten\\_Years\\_A\\_StatebyState\\_Analysis\\_summary.html](http://www.heartland.org/policybot/results/23498/No_119_Welfare_Reform_after_Ten_Years_A_StatebyState_Analysis_summary.html)

and a permanent growth effect that does not die out over time.” The study states, **“If growth is a policy objective, one should, at the very least, assess whether tax policies are out of line with other states. If long-term growth rates seem too low relative to other states, lowering aggregate state and local marginal tax rates is likely to have a positive effect on long-term growth rates.** This likelihood is greater if the reduction in marginal tax rates is sustained rather than temporary.”<sup>35</sup>

- For total GSP growth, the states with no personal income tax rate (PIT) have on average outperformed those states with the highest PIT rates by 26.5 percentage points over the past decade; they have outperformed the U.S. average by 20 percentage points. ... The evidence is clear: States without an income tax outperform in every conceivable fashion than their higher-taxed brethren and have more tax revenues. ... **By relying on sales taxes rather than on income taxes, government revenue fluctuations, over bad and good times alike, are lower.**<sup>36</sup>
- Why Not an Income Tax?
  - Lowers net pay of workers
  - Reduces productivity
  - Can reduce company profits
  - More easily avoided than sales taxes
  - Too many tax credits provide loopholes<sup>37</sup>
- An income tax won't push salaried workers and full-time employees paid hourly into working fewer hours per week, but it will discourage part-time workers from adding hours. And it will act as a brake on overtime hours, cutting productivity. ... Removing the income tax would eliminate the favoritism mechanism behind many of the state's tax credit programs.<sup>38</sup>
- Why a sales tax?
  - Doesn't slow investment
  - Stable revenue source
  - Individuals can control it<sup>39</sup>
- Relying on sales or consumption taxes more broadly imposes fewer economic costs on society and allows for a more prosperous state. ... The sensitivity of behavior in response to investment-oriented taxes appears to be much greater than with other taxes. ... **Consumption taxes, of which sales taxes are one category, are actually among the most efficient (least costly) ways of raising revenue in terms of minimizing economic distortions.** ... Higher taxes – especially on income and capital – stifle entrepreneurship and lead to lower investment and slower economic growth.<sup>40</sup>
- Income taxes effectively double tax the money used for saving and investment (but tax only once the money used for consumption), thereby producing a tax bias against saving and investment, which generates a disincentive to dedicate money toward future production.<sup>41</sup>

<sup>35</sup> “Do State and Local Taxes Affect Relative State Growth?” Zsolt Becsi, Federal Reserve Bank of Atlanta, *Economic Review*, March/April 1996, <http://www.frbatlanta.org/filelegacydocs/ACFD5.pdf>

<sup>36</sup> “Rich States, Poor States,” American Legislative Exchange Council, April 7, 2010, [http://www.alec.org/AM/Template.cfm?Section=Rich\\_States\\_Poor\\_States](http://www.alec.org/AM/Template.cfm?Section=Rich_States_Poor_States)

<sup>37</sup> “Why a Sales Tax Is Better For Missouri Than An Income Tax,” Show-Me Institute, December 18, 2009, [http://www.showmeinstitute.org/publication/id.226/pub\\_detail.asp](http://www.showmeinstitute.org/publication/id.226/pub_detail.asp)

<sup>38</sup> Ibid.

<sup>39</sup> Ibid.

<sup>40</sup> Taxifornia: California's tax system, comparisons with other states, and the path to reform in the Golden State,” April 15, 2010, <http://www.pacificresearch.org/publications/taxifornia>

<sup>41</sup> A Comprehensive Retail Sales Tax as a Single Tax for the State of Kansas,” University of Kansas, December, 2009, [http://www.business.ku.edu/FileLibrary/PageFile/1537/TB%2009-1218--Comprehensive%20Sales%20Tax%20\(Hall\)UPDATED.pdf](http://www.business.ku.edu/FileLibrary/PageFile/1537/TB%2009-1218--Comprehensive%20Sales%20Tax%20(Hall)UPDATED.pdf)

- A permanent reduction in the personal income tax rate will expand private entrepreneurial activity, increase employment, and raise wages. ... Entrepreneur-friendly areas request more patents, spend more on research, start more hi-tech companies, and are more likely to attract the Next Big Thing.<sup>42</sup>
- Texas depends on a consumption tax which has several virtues.
  - Simplicity – generally low compliance costs
  - Does not favor big business over small business by putting a premium on the skill of CPAs and tax attorneys
  - Transparency – people know the true cost of government
  - Horizontal equity – those similarly situated pay the same (partly due to simplicity)
  - Does not directly discourage work effort, job creation or investment
  - Is less likely to “pyramid” (build on itself and distort economic decisions)
  - Does not depend on the structure of the economy or major industries to fund government<sup>43</sup>
- Real personal income growth was more than twice as high in the states raising their income taxes the least (or not at all), compared with the states with the biggest increase in tax burden (1957-1997). ... During the 1990s, some 2,849,310 people moved from states with income taxes into states without income taxes.<sup>44</sup>
- High income taxes in particular discourage work and capital formation, thereby reducing output. ... Income taxes and property taxes penalize productive activity. They tax enterprise and creativity and in so doing, they discourage such activity. Consumption taxes, on the other hand, while they do discourage some consumption, through the absence of production taxes may encourage individuals to just work harder to overcome the consumption burden.<sup>45</sup>
- “The problem isn’t that taxes are too low in California. It’s that spending growth outstripped revenue growth. A big cause of California’s budget crisis was spending commitments derived from overreliance on volatile revenue sources, particularly taxes on high-income earners, corporate profits and capital gains revenue. These revenue sources soared during the boom, and legislators made spending commitments as if that soaring would never end.”<sup>46</sup>

### Reduce Taxes on Small Business

Few people realize that small businesses are not directly impacted by corporate tax reductions at the state or federal level. This is because 93 percent of small businesses are organized as “pass through” or “flow through” entities – sole proprietorships, partnerships, Limited Liability Corporations (LLCs) or Sub-Chapter S corporations. These entities are not subject to state or federal corporate income taxes; their net income is passed along to the owners who pay personal income tax on that income. These businesses produce over half of the business net income in the nation.<sup>47</sup>

<sup>42</sup> “Stimulating New Mexico’s Economy by Phasing out its Personal Income Tax,” Rio Grande Foundation, April 20, 2008, <http://www.riograndefoundation.org/content/stimulating-new-mexico's-economy-phasing-out-its-personal-income-tax>

<sup>43</sup> “Virtues of a Consumption Tax,” Texas Public Policy Foundation, March 2006, <http://www.texaspolicy.com/pdf/2006-03-testimony-bs.pdf>

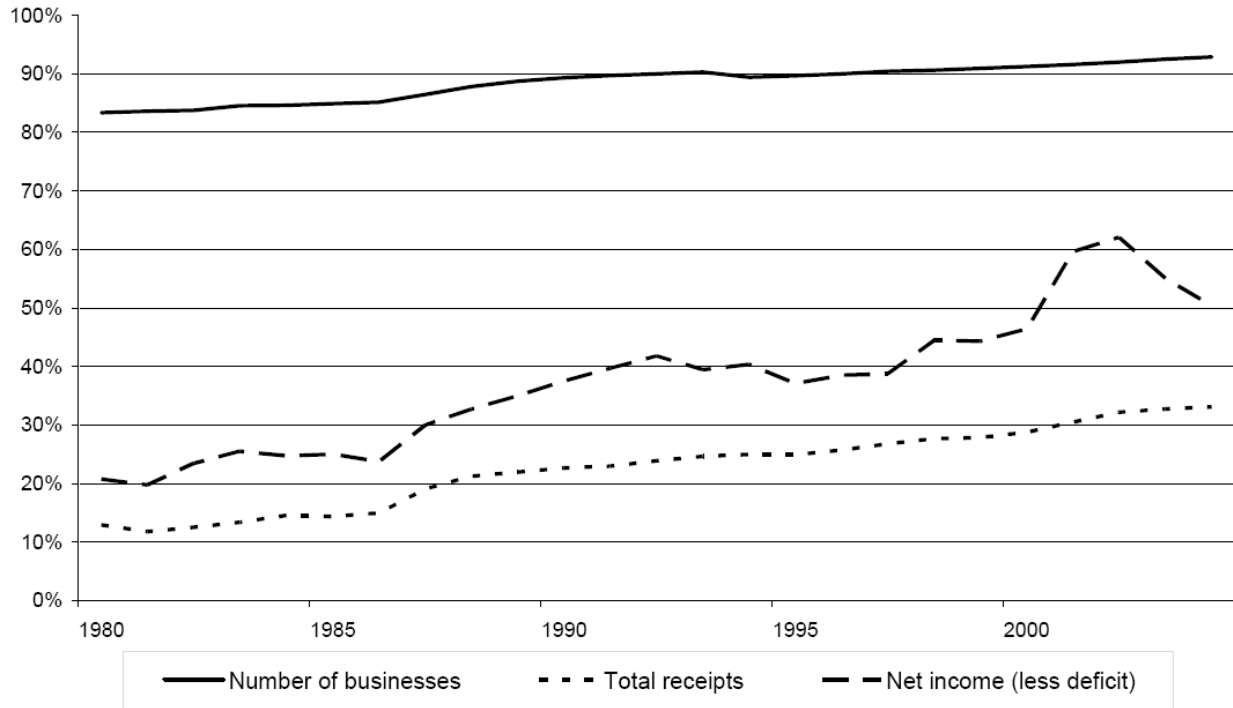
<sup>44</sup> “The Worst Tax for Texas,” Texas Public Policy Foundation, February 28, 2002, <http://www.texaspolicy.com/pdf/2002-02-28-tax-taxingtexans1.pdf>

<sup>45</sup> “A Fair Tax for Texas?” Texas Public Policy Foundation, January 24, 2005, <http://www.texaspolicy.com/pdf/2005-01-fair.pdf>

<sup>46</sup> “Pew Report on State Budget Troubles: Good Research But Misses Causes,” Tax Foundation, November 12, 2009, <http://www.taxfoundation.org/blog/show/25506.html>

<sup>47</sup> <http://www.ustreas.gov/press/releases/reports/07230%20r.pdf>, page 16, Chart 3.1

## Flow-through Shares of All Business Returns, Receipts, and Net Income, 1980-2004



Source: Internal Revenue Service, Statistics of Income, [www.irs.gov/taxstats](http://www.irs.gov/taxstats).

This means that a reduction in the personal income tax rate would be a tax cut for entrepreneurs and the majority of small businesses in Georgia. In fact, many of the taxpayers who appear “rich” are in fact small business owners recognizing a one-time windfall of revenue from selling their business. This is often the nest egg that will provide for their retirement. Because of Georgia’s 6 percent income tax rate, there are many anecdotes of small businesses moved to Florida just before their sale.

One way to help small businesses would be to reduce Georgia’s tax rate on capital gains. **At 6 percent, Georgia’s capital gains tax rate equals the state’s top income tax rate and is second highest in the Southeast. Nationally, it is 20th highest.**

The capital gains tax has several disadvantages. First, capital gains are not adjusted for inflation when they are taxed. Therefore, the seller is paying tax above the real purchasing power gains on the asset, an argument for capital gains taxes to be lower than income tax rates.

Second, the tax ignores investment losses above a certain level. This distorts the market for investment; those on the fence are steered away from taking a risk. The economy is built on risk-takers trying to fill the voids of supply in response to consumer demand. A high capital gains tax rate acts as a suppressant on the economic engine.

Further, capital gains taxes produce an unstable revenue stream that fluctuates enormously with the health of the economy. Looking at the last 10 years, the capital gains tax base in Georgia has fluctuated by more than 15 percent either way in eight of those years, compared to zero years for the income and sales tax base. In 2001 and 2008, the capital gains tax base decreased by 40 percent and 53 percent respectively; in 2004 it increased by 51 percent and in 2005 it increased 42 percent.

Such fluctuations produce huge headaches for the state's financial projections. States that rely highly on capital gains taxes, such as California, spend these excess funds in the good years, overinflating their budgets, and face major budget crises in the down years. Reducing reliance on the capital gains tax to fund the state will result in a steadier, more predictable revenue stream. In Georgia, net capital gains range from 6 to 12 percent of taxable income in a given year depending on the economy.

Researchers have found that cuts in capital gains taxes do not cost as much to government revenues as other tax cuts. The National Bureau of Economic Research found that evaluating tax cuts using dynamic scoring (factors in resultant economic growth) shows 50 percent of a cut in capital gains is recovered by higher economic growth in the long run. For labor taxes, the figure is just 17 percent.

Essentially, each dollar of capital gains allowed to remain in the investor's hands costs the government only 50 cents in revenue. This is a small price to pay for economic growth, increased investment and job creation.

In the short run, capital gains tax cuts have shown to actually increase revenues as investors become much more active. The cuts at the federal level in 1980, 1997 and 2003 all increased revenue in the years following.

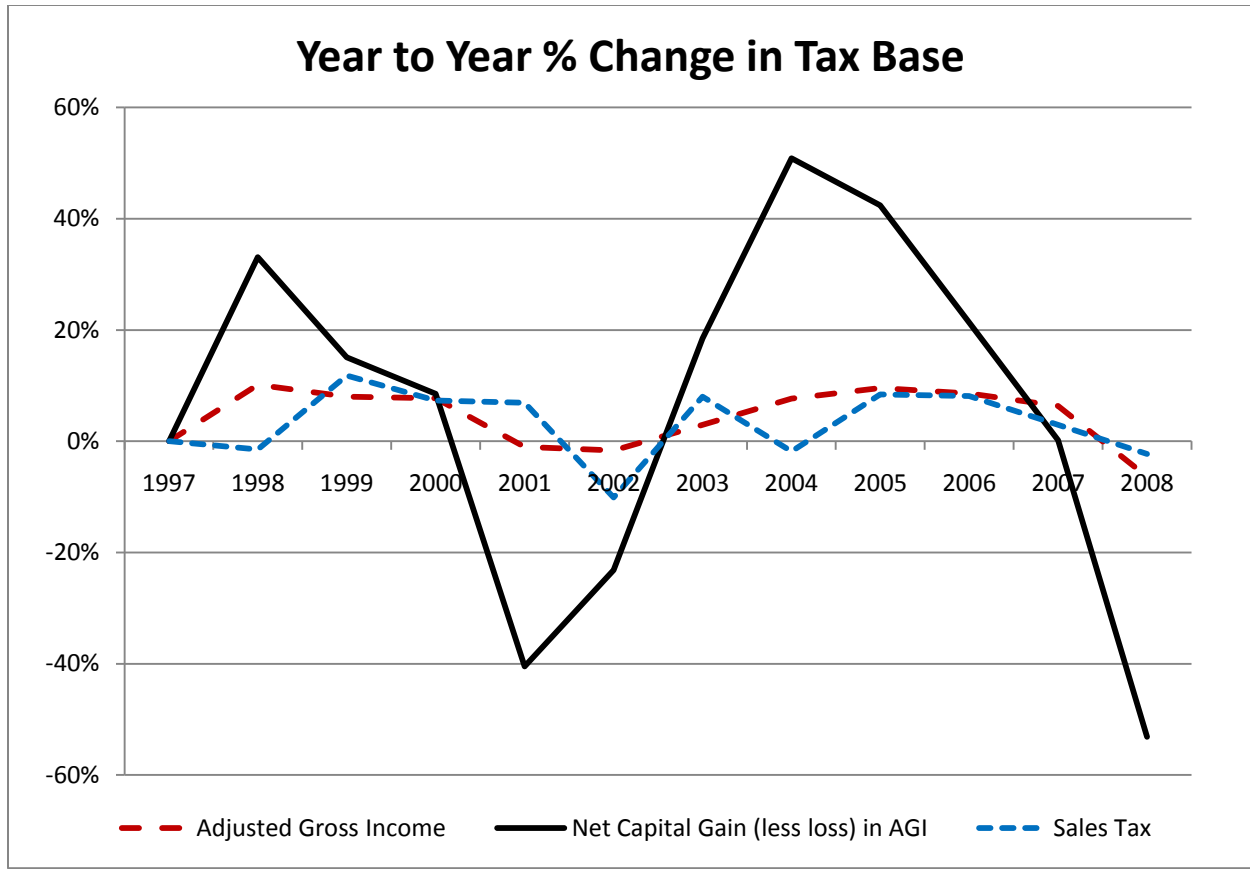
Seniors ages 65 and over earn 30 percent of capital gains income, according to the Tax Foundation. This is highly disproportionate to their share of the population. Given that Georgia has made the commitment to eliminate the tax burden on this age group, the net cost of reducing the capital gains tax is even lower.

One potential benefit of lowering the capital gains tax rate is to incentivize investment in higher-risk startup companies, typically in high-tech industries with large potential payoffs. Coupled with state pension reform that allows for venture capital fund investment, a cut in capital gains tax rates could help keep companies formed at Georgia's world-renowned research institutions and attract greater outside investment to further the state's prowess as an incubator for ground-breaking businesses.

Lowering the capital gains tax rate will spur investment and market activity in the short-term while developing the infrastructure for Georgia to lead this nation out of the recession as a hub of innovation.<sup>48</sup>

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<sup>48</sup> "Cut Capital Gains Tax Rate to Boost Georgia's Economy," Mark King, Georgia Public Policy Foundation, August 6, 2010, <http://gppf.org/article.asp?RT=&p=pub/Taxes/Capitalgains100806.htm>



#### Eliminate the sales tax on energy used in manufacturing

**There is broad agreement among economists and tax experts that business inputs should not be subject to a sales tax, but Georgia is one of only 14 states that do not provide a sales tax exemption for energy used in manufacturing.** Of these 14 states, three offer either income tax credits or lower tax rates to manufacturers to offset this tax. Georgia is the only state in the Southeast that does not offer a full or partial exemption. For some manufacturers, energy is their largest cost. In most cases, it is second only to labor costs. Therefore, in addition to being bad tax policy, this puts Georgia businesses in a competitive disadvantage.

Agriculture, mining, manufacturing and forestry are critical industries in Georgia, particularly in rural areas. They provide good paying jobs and above average impacts on local economies. In this age of intense global competition, Georgia cannot afford to let an antiquated, inefficient, unsound tax code put our industries at a disadvantage.

#### 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>49</sup>

In order to keep marginal tax rates low, Georgia should establish a two-thirds supermajority requirement to raise tax rates. Sixteen states already require a supermajority for tax increases, all but one of which are

<sup>49</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)

constitutional requirements. A supermajority requirement would ensure that tax reform efforts focus on removing exemptions rather than damaging economic competitiveness by increasing tax rates.

### **Call a tax a tax**

A fee sounds much more innocuous than a tax. The state should require that any assessment that raises money in excess of what is needed to defray costs must be called a tax. A fee that does not cover the cost of providing the tax is a subsidy and can be just as harmful. **Georgia should put in place a process to regularly update fees so that they reflect the cost of providing the service – no more and no less.**

Another close relative of the fee is the “dedicated” tax. 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.

**User fees should not be diverted to other uses.** This violates the benefit principle, a longstanding cornerstone of the theory of tax justice, which simply stated says that consumers of government services should pay in proportion to the benefit they obtain from those services.<sup>50</sup> An example of the violation of this rule is the sales tax paid on diesel fuel for locomotives in Georgia. Rather than being used to upgrade railroad infrastructure, these funds are diverted to road and bridge construction.

### **Cap the growth in property taxes**

Property taxes have dominated the tax reform debate over the last few years, not just in Georgia, but across the nation. **In Georgia, the biggest driver of property tax increases 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>51</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, and 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>52</sup>

There are several options for property tax reform. The most effective way to reduce the property tax burden is to reduce spending on items funded by property taxes. Most other reforms simply shift 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.

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<sup>50</sup> “Gasoline Taxes: User Fees or Pigouvian Levies?” Tax Foundation, November 7, 2006, <http://www.taxfoundation.org/commentary/show/2048.html>

<sup>51</sup> “2007 Report Card on American Education,” American Legislative Exchange Council, <http://www.alec.org/am/pdf/states/georgia2007.pdf>

<sup>52</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)

### *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>53</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 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>54</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>55</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>56</sup> (New York Democratic gubernatorial candidate Andrew Cuomo has also supported a levy cap, as has Republican Governor Christie of New Jersey.) This proposal was

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<sup>53</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>

<sup>54</sup> "Florida Tax Revolt," Wall Street Journal editorial, June 30, 2007

<sup>55</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.heartland.org/custom/semod\\_policybot/pdf/20113.pdf](http://www.heartland.org/custom/semod_policybot/pdf/20113.pdf)

<sup>56</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)

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>57</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>58</sup>

Americans for Tax Reform 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 1980s and ‘90s took off, local revenue was able to increase slightly above inflation, but tax rates actually declined when values increased.”<sup>59</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 or are limited to funding capital spending. One solution to this problem is to **provide local governments, including school systems, more flexibility to use local sales taxes to offset property taxes**. Since most local sales taxes are restricted to funding of capital projects, this would require legislative action to enable this flexibility.

### *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

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<sup>57</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>58</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.heartland.org/custom/semod\\_policybot/pdf/20113.pdf](http://www.heartland.org/custom/semod_policybot/pdf/20113.pdf)

<sup>59</sup> Ibid.

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.

## **Avoid harmful taxes**

### *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 distort market signals because they force companies to make production decisions that are not entirely based on economic principles, but rather on how to pay the least amount of tax on goods produced.

Inventory taxes also create a strong incentive for companies to locate their inventory in states where they can avoid the tax. This tax can be unproductive for the company when inventories are located in less profitable locations and for state governments that lose economic activity by imposing the tax. **Georgia is one of only fifteen states that levy an inventory tax.**<sup>60</sup> Although this is a local tax that the state does not control, providing local governments and school systems with the flexibility to use existing sales tax revenues for operating expenses would allow them to eliminate inventory taxes without a large revenue loss. (This could also apply to ad valorem taxes on motor vehicles, another local tax that is unpopular with citizens.)

### *Gross Receipts Tax*

An excellent report by John L. Mikesell describes the gross receipts tax, also called a "turnover tax," as "a tax on receipts of a business. The tax is levied every time a product "turns over" (or changes owners) in the chain of production and distribution from resource extraction to the eventual customer."

Mikesell shows how the **gross receipts tax violates several principles of good tax policy:**

**Economic neutrality:** A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. Most significantly, it establishes artificial incentive for vertical integration and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.

**Competitiveness:** A gross receipts tax interferes with the capacity of individuals and businesses to compete with those in other states and other parts of the world. The tax embedded in prices grows as the share of a production chain within the state increases, so there is incentive to purchase business inputs from outside the state. It discourages capital investment by adding to the cost of factories, machinery, and equipment, and the disincentive increases as more of those capital goods are produced in the taxing state. This tax structure does not promote the growth and development of the state.

**Fairness:** A gross receipts tax does not treat equally situated businesses the same. Firms with the same net income will face radically different effective tax rates on that income, depending on their profit margins. Low-margin firms will be at great disadvantage relative to higher-margin firms, regardless of their overall profitability. Many new and expanding firms have low margins (or even are initially unprofitable) and the gross receipts tax reduces the chance that these firms will survive. This also is not consistent with a climate for growth and development.

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<sup>60</sup> "2010 State Business Tax Climate Index," Tax Foundation, September 2009, page 28, <http://taxfoundation.org/files/bp59.pdf>

Transparency: A gross receipts tax is a stealth tax with its true burden hidden from taxpayers. Hiding the cost of government is inconsistent with efficient and responsive provision of government services and contrary to the fundamentals of democratic government.

Mikesell concludes, "There is no sensible case for gross receipts taxation. The old turnover taxes – typically adopted as desperation measures in fiscal crisis – were replaced with taxes that created fewer economic problems. They do not belong in any program of tax reform."<sup>61</sup>

### *Tobacco Tax*

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 principle 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."

Dr. Frank Stephenson of Berry College cites several concerns with the tobacco tax: "Revenue projections from cigarette tax increases are notoriously inaccurate. Higher taxes result in only small consumption decreases by smokers but revenue gains are still difficult to project because cigarette taxes are one of the most easily avoided forms of taxation. Smokers who purchase their cigarettes out of state, over the Internet or from smugglers all escape the tax increase. Consequently, cigarette tax revenue increases often fail to meet projections. In one recent, and admittedly rare, case, New Jersey increased its cigarette tax rate and saw cigarette tax revenues decrease."

"Although a drop in cigarette tax revenues in Georgia is unlikely, concerns about Georgians purchasing elsewhere are real. A \$1.37 tax per pack would greatly exceed Alabama's 42.5-cent per pack tax, Tennessee's 62-cent tax, and North Carolina's 45-cent tax. The gap between Georgia's increased tax and South Carolina's 7-cent per pack tax would be so large that "North of the Border" cigarette establishments would probably spring up along I-85 and I-95.

"Cross-border shopping damages more than cigarette tax revenue. People who cross borders to buy cigarettes add purchases such as gasoline, groceries or lottery tickets. Hence there is collateral economic damage from reduced gas tax revenue, sales tax revenue (especially for counties, which apply the sales tax to groceries), and lottery revenue. A complete analysis of potential gains from cigarette tax hikes must therefore include any offsetting declines in other forms of tax and lottery revenue.

"Collateral damage includes the convenience store industry. These retailers are not as glamorous to ribbon-cutting politicians as, say, auto plants sprinkled with tax credits and other largesse, but Georgia has more than 4,700 gas station/convenience stores employing more than 26,300 people and with an annual payroll exceeding \$436 million. Another 770 convenience stores that do not sell gasoline employ 2,500 Georgians with an annual payroll of \$41.5 million.

"Beyond the tax revenue and economic impacts of cigarette tax hikes, there are also equity concerns. Smoking is more prevalent among low-income people, so cigarette taxes are highly regressive. Even if smoking were equally prevalent across all income levels, a tax that cost a smoker, say, a dollar a day or \$365 per year would take a larger share of income from someone making \$20,000 than someone making \$75,000. The tax hike would be a particularly unjust approach to plugging the budget gap."<sup>62</sup>

## **Reduce spending**

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<sup>61</sup> Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," by John L. Mikesell, Indiana University, January 2007, The Tax Foundation and the Council on State Taxation, <http://www.taxfoundation.org/files/bp53.pdf>

<sup>62</sup> "Smokes and Mirrors in Resolving Budget Woes," by E. Frank Stephenson, January 29, 2010, <http://gppf.org/article.asp?RT=15&p=pub/Taxes/budget100129.htm>

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.

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.