An Economic Analysis of Georgia's Tax Cut Proposals

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The Georgia legislature is currently facing the question of what taxes should be cut, if any. 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. Also on the table is a plan to enact a ceiling on spending growth in the Peach State. In this *Fiscal Fact*, we briefly analyze the two proposals favored by the House and Senate.

Car Tax Cuts vs. Income Tax Cuts

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?

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 Income Tax Cut

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.

Under any circumstance, when cutting government spending, those providing the least value to the state's citizens should be cut first. This question of what is wasteful in Georgia's government leads us to the next question: Should Georgia implement a constitutional rule that restrains growth in government similar to Colorado's TABOR law?

Is TABOR Necessary in Georgia?

Also involved in the tax negotiations in Georgia is a proposal to implement a constitutional restriction on government spending in the state. So would such a TABOR system be beneficial to the state's residents? The answer hinges on whether or not the government is currently taxing and spending too much. Considering the recent ferment against property taxes, and now plans with momentum to cut income taxes and car taxes, it's apparent that many citizens are convinced state and/or local government are too big.

The branch of public economics known as "public choice" has demonstrated academically what many critics of government have long suspected, that the natural, self-interested course of action pursued by government officials is often far removed from the best interest of the general public. Therefore, it is possible that limitations on government like TABOR could improve societal welfare. On the other hand, no matter how vehement and persuasive some denunciations of government growth may be, the optimal size of government is clearly greater than zero. So in theory it is also possible for a TABOR-type system to make society worse off.

Of course, a TABOR initiative is the ultimate indictment of current government officials. The initiative implicitly declares that current fiscal policies are so bad that the people need a constitutional restraint on their politicians and the bureaucracies they fund.

This amounts to a trumping of representative democracy by direct democracy. Neither is perfect. Even if the current representative democracy has failed so miserably in its fiscal policies, it's also possible for political failure to occur when it comes to voting on the proposed constitutional amendment (or any TABOR override measures).

In sum, many of Georgia's citizens seem convinced that their state government is too large, and cutting income tax rates is often mentioned in economic literature as the most economically beneficial method of reducing government's take. However, assuming the current budget is balanced, the question of what actions accompany the tax cut is all important. If other taxes are raised, the economic benefit is probably negligible. If government spending is cut, every effort should be made to cut those programs citizens value least. A TABOR initiative could keep government spending from outrunning expected revenue in the future, but also what government spending it restrains is crucial to answering the question of whether a TABOR system would make Georgia fiscal policy better for its citizens.

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