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Georgia Should Respond to Recession with Tax Reform, Not Tax Gimmicks

By Justin Higginbottom

Introduction

Georgia recently has come off a large drop in tax revenue that required Governor Purdue to cut some public spending. While tax revenue is expected to stabilize soon, federal stimulus money will run out in 2012, so champions of higher taxes and state spending are pointing with alarm at the long-range projected budget gap of over $2 billion.

Tax hike proposals are proliferating, with the intention of either preventing more spending cuts or making possible new spending increases. Two of the most frequently mentioned so far are a cigarette tax hike (from $.37 to $1.37) and a hospital tax.[1] But targeted tax hikes and increasing the size of Georgia's troubled Medicaid system is not the path to sound tax policy and stable revenue.

Recessions can stimulate needed tax changes. Georgia should take this opportunity to get smarter with its tax policy, doing everything possible to soften a future recession's blow and increase reliable revenue now. This report summarizes Georgia's tax climate and proposes reform for this end.

Overview of Georgia's Tax Climate

The Tax Foundation's 2010 State Business Tax Climate Index, a measure of how conducive a state's tax system is to non-distorted economic growth, ranked Georgia 29 out of 50, where 1 is the best tax system (see Table 1). This places Georgia's tax system close to the middle nationally, though Georgia has a lower ranking than four of its five neighboring states.[2]

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[1] Higginbottom, Justin, *Tax Foundation Fiscal Fact,* No. 203 "State Hospital and Medical Provider Taxes: Not What the Doctor Should Order.".
[2] Alabama: 19; Florida: 5; North Carolina: 39; South Carolina: 26; Tennessee: 22. Padgitt, Kail, *Tax Foundation Background Paper,* No. 59, "2010 State Business Tax Climate Index."

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While Georgia ranks 29th in the *way* its tax system is structured, the ranking of its tax burden is a little more alarming. Georgia's citizens pay the16th highest state-local tax burden in the country, 9.9% of all income earned in state. That's higher than all of Georgia's neighbors.[3]

Georgia's top income tax rate of 6% is about average nationally (though two of Georgia's neighbors, Florida and Tennessee, have almost no income tax[4]), and while Georgia does have separate six brackets, the brackets are so narrow (only $1,000 each) and at such low income levels that they do little economic damage. Effectively, the state has a 6% flat tax.

Georgia's corporate income tax rate of 6% is also about average nationally and regionally. But taken together with the United States corporate income tax rate of 35%, corporations pay a higher tax rate in Georgia than in almost any country in the world. (Georgia has a single-sales factor corporate rate, explained below).[5] Besides a corporate income tax, Georgia is one out of 22 states that also have a tax on the net worth of a business, called a net worth or capital stock tax, which ranges from $10 for a net worth less than $10,001 to $5,000 for a net worth in excess of $22 million. It raised about $31 million in FY 2009.[6]

Table1
Various Measures of Georgia's Tax System Compared to Neighboring States

State	2008 State-Local Tax Burden: Percentage of State Income and Rank (1 is highest)	Rank in 2010 State Business Tax Climate Index (1 is best)	Top Income Tax Rate	Top Corp. Income Tax Rate	Property Taxes on Owner-Occupied Housing as Percentage of Median Home Value and Rank (2008)	General Sales Tax Rate
Alabama	(8.6%) 38	19	5%	6.5%	(.32%) 48	4%
Florida	(7.4%) 47	5	None	5.5%	(.85%) 24	6%
Georgia	(9.9%) 16	29	6%	6.0%	(.77%) 28	4%
North Carolina	(9.8%) 20	39	7.75 %	6.9%	(.75%) 30	5.75%
South Carolina	(8.8%) 37	26	7%	5.0%	(.49%) 44	6%
Tennessee	(8.3%) 44	22	6%**	6.5%	(.67%) 34	7%

*Highest bracket rate
**Applies to interest and dividend income only

Georgia's average sales tax, counting state and local rates, is 7.02%. That rate ranks 17th highest nationally but is on par with neighbors. Tennessee's is considerably higher, over 9%, which is perhaps understandable in a state that does not tax wages, but Florida has kept its average sales tax rate to 7.01% despite the lack of an income tax.[7]

Georgia has fairly low local and state property taxes. Property taxes on owner-occupied housing as a percentage of median home value were 0.77% in 2008, 28th highest in the country. Counting commercial real estate and other property, as well as owner-occupied homes, state and local property tax collections in 2007 were $1,009 per capita, giving Georgia a low rank of 32.

[3] Alabama: 8.6%, 38; Florida: 7.4%, 47; North Carolina: 9.8%, 20; South Carolina: 8.8%, 37; Tennessee: 8.3%, 44. *Tax Foundation Special Report,* No. 163, "State-Local Tax Burdens Dip as Income Growth Outpaces Tax Growth."
[4] Tennessee only taxes interest and dividend income while Florida taxes no personal income.
[5] *Tax Foundation Fiscal Fact,* No. 184, "U.S. Lags while Competitors Accelerate Corporate Income Tax Reform."
[6] Georgia Department of Revenue Statistical Report FY 2009
[7] *Tax Foundation Fiscal Fact,* No. 196, "Updated State and Local Option Sales Tax."

However, Georgia is one of only 10 states that have a tax on businesses' inventory, bringing in approximately $250 million a year to localities.[8]

Even if no tax in Georgia is outrageously high – no one will mistake this tax code for New Jersey's – the state still has room for improvement.[9] And unlike some high-tax, high-spending states, Georgia's political climate may be more conducive to tax reform. Moving from 5 to 10 on the scale of sound tax policy is certainly easier than moving from 1 to 10.

Which Tax Cuts (and Tax Hikes) to Enact, and Which to Avoid

Tax Incentives Versus Tax Reform

The best advice is the old mantra of tax reform: a broad tax base and a low rate. Especially in its corporate income tax and in its sales tax, Georgia has a lot of room to expand its tax base--that is, to eliminate unwarranted loopholes and use the extra revenue to lower rates.

Those loopholes, called "tax incentives" by their lobbyists, are the enemy of tax reform. Some politicians, lobbyists and pundits will cry "Tax hike!" at the loss of their special tax breaks. And eliminating them does raise revenue, but the all-important distinction is that these base-broadening measures do not raise the statutory tax rate. In fact, they pave the way for a lower statutory tax rate, decreasing distortion in the economy and improving the stability of government's revenue flow. By repealing targeted tax breaks and incentives, Georgia can create a more attractive climate for all business, but to do so requires resisting the temptation to control which types of business should prosper.

If Georgia cannot muster the political support to repeal targeted tax incentives, and of course it is not easy, then the state's lawmakers must at least hold the line and avoid enacting new ones. Advocates of new, targeted tax incentives promise great benefit to the economy, but do they deliver? In short, no. Tax incentives to "create jobs" in general or to stimulate certain industries often show no evidence of "paying for themselves" (if any evidence is provided at all). From 2004 to 2006 Georgia gave up $265 million for incentives programs, even though the Georgia Department of Audits and Accounts has gone on the record, saying they have no way to know if that money helped Georgia's economy.[10]

As a prime example of tempting but unjustified tax incentives, take movie production incentives. There's the allure of Hollywood stars visiting Georgia, and the thrill of seeing in-state sights on the big screen or on TV series. Most states have fallen for this con, and Georgia is no exception. The 2008 Georgia Entertainment Industry Investment Act dipped into both the corporate tax base and the sales tax base, offering tax credits up to 20 percent and sales and use tax exemptions.[11] While luring movie companies into Georgia might be politically popular, there is no evidence it does anything long-term for the state's economy other than depriving it of revenue and giving the legislature and the Department of Revenue a chance to pick favorites.[12] Georgia should get out of the business of pleasing certain industries with bribes paid out of the taxpayers' pockets.

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[8] Some exemptions are part of a well constructed sales tax system, such as "goods in the process of being manufactured or produced including raw materials and partly finished goods" (see Freeport Exemption).
[9] See a summary of New Jersey's not-to-be-emulated tax climate at http://www.taxfoundation.org/research/topic/44.html
[10] http://www.gpb.org/news/2010/01/06/are-business-tax-breaks-working-in-georgia
[11] http://www.georgia.org/SiteCollectionDocuments/Industries/Entertainment/HighlightTaxCredit2008.pdf
[12] See Tax Foundation Special Report No. 173 "Movie Production Incentives:

Business Taxes: What to Enact and What to Avoid

If tax incentives such as the film tax credit and others like it can be repealed, it will be feasible to lower the state's corporate income tax rate. That is usually a good way to grow the private sector. Depending on the details of each state's tax structure, different types of firms will benefit. Georgia has what's called a single sales factor gross receipts apportionment formula—meaning that a company's sales to Georgia customers are the only thing that matters in determining its corporate tax liability, not in-state property and not in-state personnel as in some other states. For example, in an extreme hypothetical case, a corporation that has property and employees in Georgia but no sales in state has no corporate tax liability. Conversely, an out-of-state company whose customers are all in Georgia will have a large tax liability to Georgia.

Therefore, lowering the statutory corporate income tax rate will certainly help local businesses selling locally, but it will not provide much help to large Georgia companies that sell most of their products out of state. Another idea for in-state tax improvement would be for Georgia to repeal its inventory and net worth tax. This would lower costs for locating a business in Georgia.

The Sales Tax: What to Enact and What to Avoid

The general sales tax ought to be applied to as many end-user products and services as practicable so that prices are not the product of politics. Politicians are apt to enact exemptions or punitive taxes on products, and that leads to a smaller and inconsistent tax base. If Georgia can expand its general sales tax base to currently untaxed end-user products and services, it will be possible to lower the general sales tax rate and refrain from raising product-specific taxes, all without losing revenue.

For example, Georgia could expand the sales tax to groceries. 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 either items up substantially, typically a full percentage point, and it makes sales tax revenue much more volatile. The best solution is to lower the tax rate on all products, and that is only possible by expanding the sales tax base. Exempting groceries from taxation interferes with the price system and shields a subset of the population from the cost of government, eroding checks on government power by that group.

The other major area of exemption from Georgia's sales tax is, as in many states, the service sector. Services as well as goods should also be uniformly taxed at the point of sale. Can anyone really keep a straight face while justifying a tax exemption for legal services, tattoos, haircuts, car repair, health club memberships and other common services? Political influence on prices, even when saving some group money, is not sound tax policy. Instead, Georgia should save money for all by lowering rates after extending the tax base.

Blockbuster Support for Lackluster Policy."

One way extra tax revenue should not be raised is by taxing unpopular products like tobacco through “sin taxes.” That burdens an unpopular, mostly low-income minority with the state’s finances. Many smokers are the same low-income people paying Georgia’s beer tax, which is the third highest in the country at $1.01 per gallon. If the recently proposed dollar increase in the cigarette tax became law, Georgia would have cigarette taxes higher than two thirds of the other states. The state’s beer drinkers and smokers are already paying more than their fair share.

The Personal Income Tax: What to Enact and What to Avoid

Georgia’s progressive income tax structure, while not extreme, should be flattened to a single low rate. If Georgia wants to attract residents, and ease the burden on current residents, having a low income tax rate will help. Georgia’s highest bracket of 6% is higher than in many states such as Massachusetts, Virginia, Michigan, Illinois, Ohio, Colorado, Alabama and Pennsylvania, not to mention that two of Georgia’s neighboring states have no tax at all on wages: Tennessee and Florida.

At the least, Georgia should refrain from enacting a “millionaire’s tax” as California, Connecticut, New Jersey, Oregon and several other states have done. While it might provide a short burst of tax revenue, it would leave Georgia dependent on the volatile income of the wealthy, the disastrous budget effects of which are painfully plain in California and many other states.

Conclusion

Cutting useless incentives, broadening bases, and lowering rates will make Georgia more competitive, less distortionary, and save the state money. Georgia should focus on emerging from this recession with a better tax system.

Georgia’s tax incentive programs are the best place to start. Investigations into their alleged benefits should be the first step. In the future, eliminations or reductions in tax incentive programs would provide needed revenue, enabling the state to lower tax rates and lessen distortions in the state’s economy.