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## Reforming the Georgia Tax Structure

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# Full Text: 'Reforming The Georgia Tax Structure'

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## ===== SUMMARY =====

[The Policy Research Center at Georgia State University in Atlanta prepared the technical papers that underlie this Final Report of the Joint Study Commission on Revenue Structure. Roy Bahl served as Director. The senior research staff included Martin Grace and Jorge Martinez, Corporate Income Tax; Richard Hawkins, Sales Tax; Keith Ihlanfeldt, Tax Incentives; David Sjoquist, Property Income Tax; and Sally Wallace, Individual Income Tax.

For news coverage of the report, see State Tax Notes, Feb. 13, 1995, p. 630.]

## ===== FULL TEXT =====

### Introduction

The Georgia tax system is not in bad shape. It is balanced in its use of income, sales, and property taxes, the level of taxes is not high relative to other states, our credit rating has remained strong, and jobs are migrating to Georgia at a rate that is the envy of much of the rest of the country. Our most serious revenue problems have come in times of economic contraction when all states face problems. If the story ended here, we would simply follow an old adage that tells us not to fix things that are not broken.

But underneath this generally favorable picture is a tax structure that has some important flaws: it weighs more heavily on some sectors of the economy and population than on others, and its built-in revenue growth shows signs of slipping because we do not adequately tax some of the faster growing sectors of our economy, and the automatic growth in revenue may not be adequate to meet long-run expenditure requirements. /1/

The problems with the Georgia tax structure are not so much in the present as in the future, and sooner or later we will need to face up to the fundamental problem that the economy has outgrown the tax system. The present tax system was formed more than two decades ago when it seemed appropriate to tax a base of "traditional" wage and salary earnings, the consumption of goods rather than services, the activities of corporations, and real estate wealth. Today's Georgia economy produces, consumes and holds wealth differently; does business in more complicated ways; and earns income to a much greater extent from capital sources and from transfer payments. The population that must be reached with this tax system is getting older and has a heavy concentration of the poor; and income and wealth have become increasingly concentrated in the Atlanta region.

We should respond to this mismatch by taking a broader look at what our tax system should accomplish, and by changing the system to reflect the new realities of the Georgia economy. The Joint Study Commission on Revenue Structure was created to take the long view, to consider

comprehensive reform of the tax structure, and to find a better match between the state's tax structure and its economy. This report begins where our commission began its work: with a description of the changing Georgia economy and what this means for our fiscal system. We then review the Georgia tax structure, and in the third section of this report lay out what we think to be the strengths and weaknesses of the current system, and the reform issues that are raised. Fourth, we present the recommendations of the commission, both the proposals for change to be considered in this legislative session and a discussion of other reforms that should be considered in the longer run. The final section of the report lays out some principles for future tax policy changes that the commission would urge the legislature to consider.

## The Georgia Economy and Population /2/

In 1970, Georgia accounted for 1.8 percent of national income and 2.3 percent of the national population. By 1993, the shares had increased to 2.5 and 2.7 percent, respectively. The growth in Georgia relative to the rest of the United States has been dramatic. This is pictured in Table 1, where the graph tracks the relative increase in income, per capita income, and population (see p. 1530). A horizontal line would mean that Georgia's position relative to other states did not change since 1969. Few states could boast such strong growth as is described in Table 1. If these trends continue, or are bent towards an even stronger economic performance in Georgia, our national shares of income and population will be even greater in the future.

This said, it is important to note that Georgia remains a poor state, i.e., we have not completely caught up. The average Georgian has an income of \$19,204, while the average American has an income of \$20,781, nearly 8 percent higher. The gap has been narrowing (see Table 2 see p. 530). In 1969, Georgia's income was 17 percent below the national average. Since 1986, however, our average income has not gained on that in the rest of the country. By contrast, the average personal income in Atlanta is almost equivalent to the national average for all metropolitan areas.

[TABLE 1 OMITTED]

[TABLE 2 OMITTED]

### Population Growth

Between the 1970 and 1990 censuses, Georgia's population increased from 4.6 million to 6.5 million. Only 12 states exceeded this 41-percent growth. Within the South, only Florida showed a more rapid growth in the 1980s.

Three features of this population growth should be noted in terms of the important implications they hold for future tax policy. The first is the heavy in-migration. Between 1980 and 1992 there was a net in-migration of 500,000 people. These new residents brought with them a capacity to pay taxes but they also brought a demand for state and local government services. As the Georgia economy continues to grow, new families will continue to be attracted to Georgia, and it will become increasingly important to match the increased expenditures they require with the taxes they contribute.

The second feature is the changing age distribution of the population. In 1970, 8 percent of Georgia's population was 65 years of age or older. By 1993, this share had grown to 10.1 percent and in the next decade, it is projected to rise to 11.6 percent. In fact, the U.S. Bureau of Economic Analysis (BEA) projects that within a decade, more than one-fourth of Georgia's population growth will be people over 65 years of age. Though not as pronounced a trend as in the rest of the country, this holds important implications for finances in our state. The elderly require a different set of public services, and there is a propensity to relieve their tax burdens by exemption of pension income and property tax reductions. The legislature must think about the tax treatment of the elderly in a different way than in the past, if for no other reason than the sheer number of people involved and the proportion of total state income and consumption that they will generate. A reasonable approach for the legislature to consider is means testing any further relief program for the elderly, so as to target tax relief on the elderly poor.

The third feature is that the school-aged population has declined significantly as a share of the total population as well as in actual number, and this decline is projected to continue. The pressures to accommodate more children in our public schools will be less than in the past. This does not necessarily mean that the state will see significant opportunities to reduce spending for education. Quality improvements, renewal of the education infrastructure, and catching up with the rest of the nation are all high on the state's economic and social development agenda, and will require significant outlays.

### The Sources of Income Growth

The structure of Georgia's income has been changing. In 1970, 64 percent of all income came from wages and salaries, arguably the source of income that is most fully reached by the state tax system. By 1992, the wage and salary share had fallen to 55 percent. The exempt or "harder to tax" sources of personal income (capital income, self-employment income, transfer payments, and fringe benefits) now account for 45 cents of every dollar of income earned. It is projected that within a decade transfer payments will begin to grow faster than labor income.

This change in the source distribution of income has important public finance implications for the state. Transfer payments to individuals are largely outside the tax system. As may be seen from Table 3, three-fourths of the total amount received is for retirement and medical assistance, and another 6 percent is from Aid to Families With Dependent Children (AFDC) and food stamp payments. If the share of income that is conventionally taxable continues to decline, future tax policy may take one of two directions. It may directly tax a greater share of transfer payments, possibly by exempting less income from retirees, or it may shift reliance away from the income tax. However, it is also important to note that the Georgia sales tax exempts the consumption of most medical care expenditures, and food stamp consumption is exempt by federal law. Tax planning by the state to accommodate the changing distribution of income will be an important challenge of the next decade.

### Employment Patterns

Employment growth in the state during the last two decades has been strong relative to that in the United States and the Southeast region, and has remained so in the first half of the 1990s. Georgia's

employment increase between 1990 and 1994 was 8.3 percent, more than twice the national rate. The growth in employment since 1980 has been concentrated in the services, retail trade and transportation, communications and utilities sectors (over 70 percent of all new jobs). Like the rest of the country, we have reduced our reliance on the more cyclical manufacturing sector, and on government.

### Regional Balance

Much has been written about two Georgias: one a wealthy Atlanta and the other a poorer and more rural region. Though this dichotomy oversimplifies, it is roughly accurate. Atlantans have an average income that is 15 percent higher than in the rest of the state, and the Atlanta population is growing at a more rapid rate. As may be seen in Table 4, metropolitan Atlanta holds 46 percent of the state's population, as opposed to 36 percent in 1970, generates 55 percent of the state's income, and accounts for half of employment. The disparity between Atlanta and the rest of the state is widening. It would not be unreasonable to argue that 55 percent or more of the state's revenue yield comes from metropolitan Atlanta.

The simple dichotomy of two Georgias breaks down when one examines the disparities within metropolitan Atlanta. The population of the city of Atlanta is only 16 percent of that in the total metropolitan region. The poverty rate in metropolitan Atlanta is less than that in the rest of Georgia but again there are wide disparities. Gwinnett County's poverty rate was only 4 percent in 1989, while Butts and Spalding counties are more typical of Georgia with poverty rates close to 16 percent. Fulton County's poverty rate is about 18 percent, but the poverty rate within the city of Atlanta is 5 times greater than that in Fulton County outside of Atlanta. The per capita income was 11 percent lower in the city of Atlanta than in the surrounding suburbs.

This growing concentration of economic strength in metropolitan Atlanta holds important public financing implications. The choices the state makes about its tax structure will determine the relative tax burdens of Atlantans versus other Georgians. More progressive income taxes would weigh more heavily on higher income residents who appear to be concentrated in metropolitan Atlanta, whereas income tax relief to the lower wage workers would appear to be of more benefit to those in the rest of the state; the heavier taxation of the production and consumption of services could burden Atlanta more, and the relief of taxes on manufacturing firms could provide more benefit to the rest of the state. The relative effects of property tax relief are unclear. The lesson here is that future tax planning will have to take into account the wide disparity in economic structure as well as taxpaying capacity between Atlanta and the rest of the state.

Table 4  
Selected Characteristics of Atlanta and  
Georgia Outside Atlanta

	Georgia outside Atlanta <sup>1</sup>	Atlanta as a percent of Georgia
Population		
Income		
Employment		
Revenue		

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Population (thousands)			
1970	1,773	2,832	35.5
1980	2,248	3,239	41.0
1990	2,979	3,525	45.8
Per Capita			
Income			
1980	\$10,130	\$7,114	70.2 /2/
1990	\$20,437	\$11,870	58.0 /2/
Employment			
1980	1,271	1,465	46.5
1990	1,897	1,778	51.6
Poverty Rate			
1980	16.3	19.3	1.18 /2/
1990	10.0	18.3	1.83 /2/
Assessed Value			
1980	14,679,763	18,926,696	128.9
1990	55,745,601	45,954,886	54.8

FOOTNOTES TO TABLE

/1/ The 18-county Atlanta MSA is used in this component.

/2/ Rates of Georgia-outside-Atlanta to Atlanta.

END OF FOOTNOTES

Source: U.S. Bureau of Census,, 1980 and 1990 Census of Population,, General Social and Economic Characteristics: Georgia,, 1983 and 1993. U.S. Bureau of Economic Analysis,, Regional Economic Information System,, 1994 and Georgia Department of Revenue,, 1980 and 1993 Statistical Report,, 1981 and 1994.

Poverty

Approximately 14.7 percent of Georgians lived below the poverty income line in 1990. This is above the national average. The concentration of the poor in Georgia has decreased since 1980, when 16.6 percent of families were below the poverty level income. However, the poverty rate outside Atlanta has fallen very little over the decade. The implications of this heavy concentration of the poor for public sector policy decisions are important. On the one hand, essential services must be supplied to this population, and the budget resources required may be substantial. In an era of federal offloading, the state may have to assume a greater share of the responsibility for the social safety

net. On the other hand, this segment of the population is outside the tax base in several respects: they do not pay individual income tax, part of their consumption is excluded via food stamps, and their purchasing power to consume housing and taxable goods is low. This means that the remaining 85 percent of the population will have to carry much of the tax load for these families.

## The Tax Structure

The structure of Georgia taxes is described in Table 5 (see page 1534). Georgia state and local governments receive about 20 percent of revenues from the federal government, 25 percent from user charges of various kinds, and most of the remainder is split about evenly between sales, income, and property taxes. Compared to the rest of the United States, we rely more heavily on sales taxes, but less heavily on everything else.

Do we have the right tax structure for Georgia in the 1990s? On the one hand, the Georgia tax structure is well balanced among income, sales, and property taxes. As a result of this balance, the tax rates are not high by comparison to other states. For example, our sales tax rate of 5 percent is lower than that in some of the surrounding states (Alabama and Tennessee), our top marginal individual income tax rate of 6 percent is not high compared to the rest of the nation, and our motor fuel tax is 49th lowest among the states. On the other hand, a major issue is the unpopularity of the property tax. Voters everywhere, not just in Georgia, are unhappy with property taxation because of the judgmental assessment, because it is a tax on accumulated wealth and may not reflect ability to pay, and because it is so "visible." Other critics see it as a tax that does not automatically grow, especially in times of slow growth in real property values. But the property tax is a major revenue producer (27 percent of state and local government taxes in 1991), and to replace it would take a very significant increase in the sales or income tax rate. The commission took up the issue of whether our tax structure should change in the direction of more or less reliance on sales, income, or property taxation.

There are other ways in which our fiscal structure differs from that in the rest of the United States. In per capita terms, our expenditures are comparatively low (we rank 35th), but about in line when compared to the rest of our region (Table 6, see page 1534). We employ 11 percent more state and local government workers per capita than does the average state, and we pay these workers a compensation that is 22 percent below the national average. Our reliance on federal aid is about 10 percent below the national average.

## Problems and Issues With the Georgia Tax System

The commission considered the goals for a good tax system, and considered how these goals ought to be prioritized for Georgia. Each tax, and the entire tax structure was evaluated in terms of these objectives. This led the commission to ask the following set of questions:

- o Are taxes too high?
  
- o Are tax revenues growing too fast or too slow?

- o Do tax burdens fall on families in an equitable way?
- o Is there fairness in this tax system?
- o Is our tax system conducive to economic development?

The answers to these questions have led the commission to make some proposals for short-term change, and to suggest some other options that ought to be considered in the longer term.

#### Are Georgia Taxes High?

Taxes in Georgia are equivalent to 9.8 percent of personal income, slightly higher than in the rest of the South, but a full percent lower than the national average. By this measure, our tax effort would be 10 percent below the national average. The U.S. Advisory Commission on Intergovernmental Relations (ACIR) has made more refined estimates of tax effort that take account of the peculiarities of each state, and estimate that Georgia's tax effort is only 5 percent below the national average (Table 6). Though these data are for 1992 and 1991, respectively, they indicate that we are a low-taxing state. It would be difficult to come to the conclusion that our present level of taxes is out of line with the rest of the country.

This commission was never given the mandate to study the question of the "right" size of the Georgia budget, and ultimately it is the answer to this question that determines how high taxes should be. In fact, the original intent of the commission was to take a position of revenue neutrality, i.e., to recommend neither an increase nor a reduction in taxes.

#### Will Revenues Grow By an Adequate Amount in the Future?

The obvious way to answer the adequacy question is to ask whether the growth in revenue will be sufficient to cover the long-term expenditure needs of the state. If we assume that state and local government expenditures in Georgia follow the same future path as they have in the past five years, a real growth rate of 3.3 percent per year, we can conclude that the tax system will need to generate \$17.1 billion (in real 1994 dollars) by the year 2000 in order to maintain this growth in expenditures (tables 7 and 8, see p. 1535). Our projections are that the present tax system will fall short of this target by \$1.2 billion, an amount equivalent to 7.6 percent of current revenues. That is, by the year 2000, we will face the choice of either cutting "desired" expenditures by 7 percent, raising taxes, or doing some combination of the two.

This leads us to the conclusion that we could have a revenue adequacy problem, i.e., under present conditions we might not have the resources to cover desired expenditures by the year 2000. But this is a tentative conclusion, really an illustration, and there are at least three ways in which a long-term financing gap may be avoided.

Change the elasticity. One way to eliminate the revenue shortfall is to increase the elasticity of the tax system, i.e., the automatic responsiveness of revenues raised to income growth, not including the revenue effects of any changes in the tax code. In fiscal 1992, the elasticity of the tax system was

0.54, i.e., revenues grew by about one-half the rate of growth in personal income. But this was the end of a recession and the growth in revenues was sluggish. Over the past decade, the average income elasticity of the tax system appears to be about 1.1 (Table 9, see p. 1536). If income grows by 10 percent, we can expect, on average, about an 11-percent increase in revenues. There are several ways to make Georgia revenues grow faster in response to an income increase, e.g., by increasing the frequency of real property assessments, adding a new marginal rate on the individual income tax, or expanding the sales tax

[TABLE 5 OMITTED]

[TABLE 6 OMITTED]

[TABLE 7 OMITTED]

[TABLE 8 OMITTED]

base to cover some of the faster growing services. A higher elasticity would eliminate the financing gap. However, it also would mean an increase in the average level of taxes.

Reduce expenditure growth. Another way to eliminate the financing gap is to cut the rate of growth in state and local government expenditures. Since the current expenditure budget of the state is heavily weighted toward education (24.3 percent) and health and welfare (30 percent), the cuts will likely have to be in these areas. If the real rate of expenditure growth is reduced from its present path of 3.3 percent per year, to 2.3 percent per year, the present tax system will produce an adequate flow of revenues.

Rely on faster economic growth. A third option is to rely on a faster rate of economic growth to stimulate the growth in revenues, i.e., assume that Georgia will get on a faster economic growth path during the next five years. If the Georgia economy grows by 3.6 percent over the next five years, instead of the 2.1 percent projected here, the financing gap will disappear.

## Tax Burdens

Who pays Georgia taxes? Every state has some notion of social justice that shows up in its tax system, i.e., how the tax burden should be distributed among high-, low- and middle-income families. In Georgia, we balance the individual income tax and the sales tax to achieve some vertical equity in our system. The individual income tax threshold excludes those individuals with incomes below \$4,500. The brackets are mildly progressive up to a range of \$75,000, and then the tax is roughly proportional, i.e., families pay about the same proportion of their income in taxes no matter how high their income (Table 10). The latter result follows from the fact that Georgia's top tax rate kicks in at a fairly low level of income.

Table 9

Income Elasticities of Specific Georgia Taxes

1990 through 1993

Year	General Sales <sup>1</sup>	Personal Income	Corporate Income	Property
1990-91	0.18	0.37	(1.71)	1.24
1991-92	0.13	0.98	(2.04)	0.74
1992-93	1.16	0.91	1.99	0.45
Long-Run Estimates	0.9	1.19	0.67	0.94

Note: These elasticities are calculated as the ratio of the percent change in revenues divided by the percent change in income. The sales and income tax elasticities are related to the natural growth in revenues in that the effects of discretionary changes are removed. Changes in property revaluation are included,, hence it overstates the automatic growth.

FOOTNOTE TO TABLE

<sup>1</sup>/ Sales tax elasticities are calculated in from fiscal year personal income -- the other elasticities use the previous calendar year income.

END OF FOOTNOTE

Source: Georgia Department of Revenue,, Statistical Report (various years).

The sales tax appears to show a pattern of sharp regressivity over the low ranges of income and mild regressivity over the middle- and upper-income ranges. The "abnormal" circumstances of some low-income residents leads to high expenditures relative to income (students, upwardly mobile younger workers, elderly with substantial income from assets), making the sales tax appear more regressive than it actually is. When adjustments are made for these abnormal spending groups, the sales tax is found to be only mildly regressive.

When the sales and income tax liabilities are combined, the total tax burden distribution is roughly proportional. Most Georgians pay about the same proportion of their income in the major state taxes. This result is consistent with that found in independent studies of tax burden distributions among the states. The Citizens for Tax Justice study found Georgia's tax burdens to be about in the middle range of states in terms of the vertical equity of their tax systems.

Where does this leave us? We are not a state with an extremely regressive distribution of tax burdens. We do tax consumption, including food, and this weighs heavily on the budgets of low-

income families, and we do have a low threshold for entry into the individual income taxpaying population. In the name of vertical equity, there would be room to either lift the income tax floor for lower-wage workers, or to provide some kind of credit for low-income families. An alternative approach to vertical equity is to concentrate on the expenditure side, where the relief can be directly targeted on those who are most needy.

## Fairness

Another problem with our tax system is that of fairness -- people and businesses in the same circumstances are not always treated equally. Sometimes this unfairness is introduced as a matter of state policy, and justified on grounds that it serves a worthy objective. Democrat Gov. Zell Miller's program for tax incentives to attract business to Georgia -- which places some businesses in an advantageous position relative to others -- is an example of such a policy. Other times a tax structure is inequitable for administrative reasons. Those who hold wealth in the form of real property are taxed differently from those who hold wealth in the form of intangibles, but the latter are much more difficult to reach with the state and local tax system.

Other times, however, the unfairness arises not from design, but from a failure to correct a flaw in the system. Arguably the major horizontal inequity in the Georgia tax system arises from the failure to tax services to the same extent as other consumption goods are taxed. This burdens some consumers more heavily than others because of their consumption choice, and all Georgians face a higher sales tax rate because the exclusion of services narrows the sales tax base. According to the Federation of Tax Administrators, Georgia covers fewer services than most Southern states.

## Economic Development /3/

Our state must hold its own in an increasingly competitive environment. Education, infrastructure, quality of life, and the tax system are all policy instruments that can make us more competitive. Georgia's tax system meets many of the requirements for being "friendly to economic development": Taxes are low relative to the rest of the country; the tax burden on capital income (the corporate income tax and the business property tax) is not out of line; and the top marginal personal income tax is not high.

[TABLE 10 OMITTED]

There are, however, three areas of concern. First, businesses like certainty in taxation, and dislike an unstable fiscal situation. The slow growth in Georgia revenues led to ad hoc tax rate increases in some recent years, and to budget cuts, creating a climate of uncertainty. Second, economic development requires adequate public expenditures to support infrastructure and education investment, and the present tax system may not be giving up adequate revenue growth to support these needs. Third, there are some problems with the Georgia corporate profits tax, as currently structured, that cause us to ask whether it enhances our competitive position.

## A Program for Reform

The commission came to the conclusion that four major avenues of tax structure reform would be consistent with good tax practice and with Georgia's long-run social and economic development objectives. These changes would not move us out of line with competing states.

1. Reduce the income tax burden, especially on the working poor, and decrease administrative costs by raising the threshold for payment.
2. Adjust the corporate income tax to make it more investor-friendly, and to close off some avenues for tax avoidance.
3. Reduce the property tax burden, either by a general rollback or by introducing a relief program for the low income.
4. Expand the sales tax base to include more services.

The commission recommends that the Legislature enact the income tax reforms this year, and that it hold the property and sales tax reforms for future consideration.

#### Individual Income Tax Reforms /4/

The commission recommends three changes in the individual income tax structure:

1. Increase the personal exemption from \$1,500 to \$2,500 per dependent, taxpayer, and spouse. 1994 legislation began this reform by increasing the exemption for dependents to \$2,500. This reform would extend this increase to all dependents, including the taxpayer and spouse.
2. Increase the standard deduction amount to the federal level, as shown below:

Georgia	
Current Law	Proposed
-----	

Joint Filers	\$3,000	\$6,500
Singles	\$2,300	\$3,900
Head of Household	\$2,300	\$5,750
Married Separate	\$1,500	\$3,275

3. Adopt a \$50 income tax credit for elderly care, i.e., an additional relief for those families with elderly

dependents.

This set of changes will significantly raise the threshold for income tax payment and make the distribution of individual income tax burdens more progressive. At present, a family of four incurs income tax liability when income reaches \$11,000. Under this proposal, the floor is raised to \$16,550. Our estimate is that by increasing both the personal exemption and the standard deduction, approximately 250,000 filers will be taken off of the tax rolls.

This program will provide some relief to all 2.7 million Georgians who pay the individual income tax, though it will benefit lower-income families most. The following examples illustrate the impact for a hypothetical family of four at different income levels:

Income Level	Tax Liability		Tax Liability	
	Under the Present System	Under the Proposed System	Reduction	Percent Reduction
\$16,500	\$130.00	\$0.00	\$130.00	100.0
25,000	580.00	262.50	317.50	54.7
50,000 (standard deduction)	2,080.00	1,747.00	333.00	16.0
50,000 (itemized deduction)	1,840.00	1,720.00	120.00	6.5
100,000 (itemized deduction)	4,420.00	4,300.00	120.00	2.7

This reform is consistent with the objectives of the Revenue Commission for improving the tax system. It does not harm the elasticity or stability of the income tax, it improves the vertical equity of the system by relieving the burden on low-income workers, and it lessens the administrative and compliance cost by removing 250,000 filers from the system.

There is a revenue cost to this proposal. We estimate that individual income tax revenues would have been \$225 million (6.1 percent) less in 1995 had this reform been in effect. The same percent loss in 1996 would imply a revenue cost of \$235 million.

The elderly care credit is designed to provide relief to those taxpayers caring for elderly relatives. A \$50 refundable credit would be allowed for such families caring for relatives. We estimate that approximately 70,000 taxpayers would claim the credit. The revenue cost of such a credit is approximately \$3.5 million in 1995, or about 0.1 percent of total income tax revenue.

The commission considered, and rejected, other possibilities for changing our income tax. The possibility of increasing the top marginal tax rate above 6 percent was evaluated. This would have increased the elasticity of the tax system and it would have significantly increased the revenue yield.

However, this proposal has a serious drawback. The feeling of the commission is that the imposition of higher marginal tax rates on those who influence investment decisions is not a desirable strategy in a time when there is aggressive interstate competition to attract new investment.

The possibility of stretching out the tax brackets so that the higher rates become applicable at higher income levels was also considered. This too would have increased the elasticity of the system and it would have moved us away from a flat-rate tax, but it would have imposed a heavy revenue cost. The commission felt that some overall income tax relief to wage earners was a higher priority.

#### Corporate Income Tax Reform /5/

Georgia's corporate income tax is not a major revenue producer, and the reforms proposed here are less aimed at revenue objectives than at increasing the overall fairness of the corporate tax system and increasing the competitiveness of Georgia firms. The commission recommends the following:

1. Adopt a double-weighted sales apportionment factor for computing Georgia taxable income. The purpose of double-weighting the sales apportionment factor is two-fold:

(1) It provides a "level playing field" to companies that have relatively heavy investment in facilities and employees in Georgia, vis--vis competitors in other states that have moved to adopt double-weighted sales factors; and (2) it encourages companies to invest in new or expanded facilities and jobs in Georgia, by providing companies with relatively heavier property and payroll factors a benefit vis--vis other companies that actively market to Georgia consumers but have relatively low investments in facilities on employees in Georgia. At present, 16 states double-weight sales in their formula.

2. Subject companies providing services to the same apportionment formula as other companies. The commission feels firms should be treated equally and any unfairness associated with a differential tax treatment should be removed.

3. Adopt combined income reporting with a water's edge limit. Combined income reporting eliminates the use of accounting and strategic allocations of revenues and expenses across state lines to avoid payment of Georgia taxes. Since unitary businesses have a variety of options for reducing state tax liability, the present approach is ineffective. The proposal would reduce the ability of companies to "tax plan" to avoid paying

Georgia income tax. There is, however, a condition on this recommendation. Although combined reporting has some attractive aspects when properly applied, it represents a very fundamental change in the way Georgia approaches corporate income taxation. Such a change should be made very deliberately, after careful preparation for its implementation and administration. The move to combination is quite complicated and implementation should be held off until the Department of Revenue is adequately prepared. The revenue gain from this change is unknown.

It is difficult to estimate the overall impact of these changes, but their adoption would likely reduce revenues to the state in the short run. To the extent they lead to a stimulation of investment and job formation in Georgia, their long-run effects would be revenue- positive. If companies do not react to this change in any way, there would be a revenue loss associated with double-weighting sales, and, given efficient administration, a revenue gain from the adoption of combined income reporting.

Double-weighted sales in the apportionment formula would make Georgia a more attractive place to do business because it would lower the tax on companies that produce in Georgia, and it moves in the same direction as the governor's investment incentive program of 1994. Combined income reporting has the opposite effect, because it closes off a loophole companies can use to avoid tax payment. The view of the Commission is that the revenue uncertainty is justified. The commission considers the corporate tax in Georgia to be fair. In its present form, the tax does not impose an onerous burden. With this reform, it would be especially favorable to those who invest in Georgia. The continued use of a mechanism for tax avoidance only on the part of businesses that are able to take advantage of it both violates the idea of a tax system that applies equally to all and gives an unfair competitive advantage to certain firms.

The commission also considered but rejected the adoption of a throwback rule, i.e., to close off the possibility for companies to allocate part of their taxable income to states without a corporate income tax. The view of the commission was that the adoption of a "throwback" rule tends to undermine and even be counterproductive to the incentive to invest in Georgia, especially in conjunction with double-weighting of the sales factor. Although it is true that the absence of a "throwback" rule permits companies to have some income that may not be taxed in any state, that is not because Georgia is not getting its "fair share" of tax, but rather because other states are not getting the tax attributable to the companies' business in those states. Georgia is getting its fair share of tax revenue based on the companies' business and sales here. Not having a throwback rule, especially in conjunction with double-weighting the sales factor, is a positive economic development feature because it makes Georgia a very attractive state in which to locate manufacturing or distribution facilities. Putting in a throwback provision, on the other hand, would reduce this attractiveness and the economic development benefits of double-weighting the sales factor.

Property Tax Reform /6/

The commission feels strongly that property taxes are too high and that some Georgia families feel an especially heavy burden. It also feels that the claims of education on public funds are likely to drive up property tax rates in the future. However, it is not possible to recommend a reduction in property taxes in this report, for two reasons:

1. Property tax relief and school finance cannot be separated. The commission did not have the mandate to thoroughly study school finance, and was not able to find a property tax reform that would leave the financial integrity of local school districts untouched.
2. The commission felt that the reduction in the individual income tax was a more important priority than property tax relief, and that the state budget could not afford both in the same year. The alternative of raising the sales tax to pay for property tax reductions seemed untenable at the time the commission was completing its work.

However, the commission strongly feels that the property tax issue should be revisited, perhaps as soon as next year, but in a context of a complete review of the school finance issue. The three options for property tax reform that were considered by the commission should be reconsidered at that time. These options are briefly summarized below. /7/

**Property Tax Rollback.** The commission evaluated the option of rolling back the property tax rate by an amount equivalent to between one-third and two-thirds of total school property taxes. It was proposed to pay for this with some combination of an increase in the sales tax rate, and an expansion of the sales tax base to include certain services. While this reform would have produced significant property tax relief, it was not clear how the relief would be allocated across school districts. The commission simply did not have the time to work out the details of such a program and to devise an alternative funding source that would have alleviated the concerns of the local school districts.

The commission still feels, however, that the present system of funding schools heavily from the property tax is untenable in the long run and that some alternative or supplemental revenue source will have to be found. It also feels that taxpayers will not readily accept the increases in property taxes that will almost certainly be asked of them in the future.

**Targeted Property Tax Relief.** The commission considered a more targeted property tax relief program. Among the many options considered was a plan under which eligibility would be restricted to households with incomes of less than \$50,000. Property taxpayers would be given an income tax credit equivalent to the amount by which property taxes exceeded 3 percent of income. Renters would be included with a property tax credit equivalent to 8 percent of rental payments (less 3 percent of their income). This would have been a generous program compared to other states. Of

those eligible to participate, the average homeowner would have received relief of \$356 and the average renter relief of \$150.

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Services To Be Considered for Inclusion in the Sales Tax Base

Cable TV	Bank Service Charges
Sports Clubs	Laundry and Cleaning Services
Car Washes	Funeral Services
Automotive Repair and Towing	Swimming Pool Cleaning
Automotive Parking	Dating Services
Answering Services	Tanning Salons
Pest Control	Debt Counseling
Campgrounds	900/976 Phone Calls
Security Systems	Shoe Repair
Repairs (Not Automotive)	Interstate Telephone Charges
Coin Operated Games	Barber and Beauty Shops
Lottery Tickets	

This program would not have compromised school finance because the relief would be granted through the state income tax and it would have reduced taxes on those who face the heaviest burden. It would have been costly to the state, however, imposing a revenue loss of over \$100 million. The commission feels that the targeted tax relief idea should be reconsidered.

State-Funded Homestead Exemption. The commission also considered a standardized state-financed homestead exemption program, where all property taxpayers would benefit regardless of income level. The value of the exemption to the individual would depend on the tax rate in his/her local jurisdiction, hence there would be greater relief for those who are heavily taxed. This homestead exemption could replace the multitude of locally financed homestead exemptions. The problems with this proposal are that it benefits the rich as well as the poor and middle class, and it is costly. Enacting a \$15,000 homestead exemption in 1994, for example, would have cost \$500 million in state revenues.

Sales Tax Reform /8/

The commission was favorably disposed to the idea of paying for income and property tax relief with an increase in sales taxation. Some combination of an increase in the state sales tax rate, an increase in the additional tax on motor fuels, and an expansion of the sales tax base to cover more services were considered. The option of removing the sales tax on food for home consumption was also evaluated, and rejected.

Services. The consumption of services is growing significantly as a proportion of total consumption, and our tax system does not cover services to the same extent as in other states. This exclusion is of great importance for our tax policy. If we do not tax some of the fastest-growing sectors of consumption, then the sales tax will grow more slowly, and eventually the rate will have to be

increased. Moreover, it is unfair to tax one family's purchase of taxable commodities and omit another family's consumption of services. The commission feels that Georgia must expand its sales tax base to include more services, and it should begin this expansion soon.

The commission explored the feasibility of bringing more services into tax. Special attention was paid to identifying a number of areas where the tax could be easily administered, where the revenue yield would be significant, and where consumers, rather than other businesses, were often the purchaser. The list below, if brought into tax this year, would have yielded about \$250 million.

**Increase the Tax Rate.** A second option considered was to increase the state sales tax rate, by 1 percent or less, depending on revenue needs. There are two good arguments for considering this as a reform option in the future. First, the commission felt this to be preferable to higher property tax rates. The second is that it would not dramatically harm our competitive advantage. Even with a 5-percent state rate plus local option, Georgia would be below the rate levied in the larger cities in Alabama, Florida, North Carolina, South Carolina, and Tennessee.

There are problems with increasing the tax rate, however, that make this alternative less attractive than expanding the base to include more services. One is that the sales tax in Georgia is shared with local governments, and while an increase in the state rate would not benefit the local governments, a base expansion conceivably would provide resources for local governments to give property tax relief. The second problem with a tax rate increase is that it would fall partly on businesses in the form of a tax on their input purchases, and may harm their competitive position. Again, the expansion of the base to certain services seems a better route, or at least a higher priority.

**Remove the Tax on Food.** The commission considered the option of removing the sales tax on food, and studied the issue carefully. The reason to exempt food is to help lower-income households, whose food consumption weighs heavily in their budgets. The idea has appeal, and about half the states currently exempt food that is purchased for home consumption.

The commission found the arguments against exempting food to be very persuasive. The exemption of food from the sales tax would:

- o impose a revenue cost of \$450 million in 1994 (13 percent of sales tax revenues);
- o not target benefits on the poor if the lost revenues are made up with an increase in the sales tax rate, because the same people who consume more food consume more of everything else that is taxable;
- o cause the Georgia sales tax to be even more unstable over the business cycle than it already is;
- o provide a substantial relief to the middle- and upper income families who account for most of the food

consumption in Georgia;

o not provide commensurate relief for the very poorest families, because food stamps are already exempt;

o increase administration and compliance costs, as merchants would be required to determine which of their sales are not taxable; and

o create a quandary of what to do about local governments, i.e., either have separate local and state government sales tax regimes, which would create all manner of problems; or find a way to compensate local governments for their revenue loss with some form of grant, which would seem an inefficient way to restructure intergovernmental fiscal relations in Georgia.

**Additional Motor Fuel Tax.** Georgia's motor fuel tax rate is 49th lowest in the nation. In some ways this serves us well -- about 17 percent of the consumption of motor fuel in Georgia (and therefore the payment of motor fuel taxes) is made by nonresidents. In other ways it does not serve us well. The missed revenue opportunity can be measured in terms of the higher rates we must impose on other taxes to make up for the low tax on motor fuels. The commission considered an increase of 1 percent in the additional motor fuels tax, to be used as part of a plan to reduce the burden of the real property tax. This will not significantly compromise our favorable position relative to other states, since the gap between our rate and that of our neighbors' is at least three cents per gallon.

## Tax Reform and the Future

Georgia's tax system is hospitable to investors and relatively fair to citizens. The adjustments proposed in the previous section will make it more investor-friendly and more fair. But there is more to be done, and much to be avoided, as we continue to change the tax system to match the economy. The commission proposes to the legislature, and to the governor, a set of principles that might be used to guide tax policy deliberations in the future.

**Principle #1:** Evaluate tax structure reforms in terms of their long-run impacts. Most structural changes are not easily reversed once they are enacted, hence policymakers must be sure about the longer-run impacts of any short-term changes. More particularly, they must be sure to protect revenues adequately to ensure the necessary financing of public programs. After all, it is public expenditure requirements that determine the amount of revenue we ought to raise. As noted above, government expenditures in Georgia will likely grow faster than revenues over the next five years and a significant financing gap could emerge by the end of the 1990s. This financing gap will not be apparent in the next two years because barring unforeseen events, the economy should continue to grow at a very strong rate. After the Olympics, however, there is some possibility of a downswing in the economy, and certainly a downswing in revenues which will have been inflated by the games. The legislature and the executive need to consider the long-run outlook in planning adjustments to

the tax system. If we undertake a reform that lowers the elasticity of our system, we should also be prepared to lower the growth in expenditures that these revenues will finance.

Principle #2: Don't let the tax structure be driven by swings in the business cycle. There is a tendency for policymakers to be influenced unduly by the emergencies of the moment, and particularly by the performance of the economy. It is easy to fall into the pattern of cutting taxes when the economy swings up and raising them when the economy swings down. This is not in itself inappropriate action for a state government. The danger, however, is that a revenue shortfall in a recession will be covered with a structural change in the tax system that may compromise the fairness and future growth of the system. If the tax base is properly structured, annual changes in revenue in response to changes in economic condition can take the form of rate increases or decreases.

Principle #3: Keep the tax base broad and the tax rate low, and always recognize the tradeoffs between these two. It is often convenient to give preferential treatment to a "needy" sector of the economy or of the population, and these often are justifiable exonerations. The legislature needs to take the broader view in providing such relief by recognizing that with every tax preference given, someone else in the economy must be asked to pay a higher tax rate. In Georgia, this means that tax preferences are covered by a higher rate of property tax, individual income tax, or sales tax. This is neither fair to those who pay the higher rate, nor good for the economy. With the changes in store for Georgia's population and economy, it is important that we keep the tax base as broad as possible and the tax rates as low as possible.


The Georgia tax code gives preferential treatment, or preferential treatment is often discussed, in the following areas:

- o Income and property tax relief for the elderly;
- o Exemption of the sales tax on food;
- o Exemption of the sales tax on services; and
- o Investment and employment tax credits for companies.

These four exempt areas have been discussed by this commission and all have some merit. Policymakers must remember, however, that Georgians have to pay for this preferential treatment, or would have to pay for this treatment, with either higher tax rates or lower levels of public service.

Principle #4: Find a meaningful resolution to the education finance issue. School finance is a key issue in the future of our state. We must settle on an equitable and adequate way to pay for education. Finding the right balance between state financing and home rule, and the proper distribution of resources among school districts is one of the most important policy issues facing the leadership in the state. As the commission discovered in its deliberations, school finance is a very complicated issue and it is inextricably linked to the subject of property tax relief. The commission

recommends a rethinking of the role of the property tax in school finance, with an eye to developing a plan to either reduce the property tax burden or limit its growth.

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#### FOOTNOTES

/1/ These weaknesses are discussed in some detail in "Staff Report to the Revenue Structure Study Commission" (Atlanta: Policy Research Center, Georgia State University, January 1994) and in various staff papers.

/2/ For more detail see Roy Bahl, The Georgia Economy: Implications for Fiscal Reform, Staff Report Number 1 of the Joint Study Commission on Revenue Structure, State of Georgia (Atlanta: Policy Research Center, Georgia State University, July 1994).

/3/ Keith Ihlanfeldt, Tax Incentives for Economic Development in the State of Georgia, Staff Report Number 2 of the Joint Study Commission on Revenue Structure, State of Georgia (Atlanta: Policy Research Center, Georgia State University, November, 1994).

/4/ Sally Wallace, The Individual Income Tax, Staff Report Number 3 of the Joint Study Commission on Revenue Structure, State of Georgia (Atlanta: Policy Research Center, Georgia State University, January 1995).

/5/ Jorge Martinez and Martin Grace, The Taxation of the Corporate Sector, Staff Report Number 4 of the Joint Study Commission on Revenue Structure, State of Georgia (Atlanta: Policy Research Center, Georgia State University, January 1995).

/6/ David Sjoquist, The Real and Personal Property Tax, Staff Report Number 5 to the Joint Study Commission on Revenue Structure, State of Georgia (Atlanta: Policy Research Center, Georgia State University, January 1995).

/7/ The intangibles tax and the severance tax were also considered but the commission felt that it was not the time to propose structure reform.

/8/ Roy Bahl and Richard Hawkins, General Sales Taxation, Staff Paper Number 6 of the Joint Study Commission on Revenue Structure, State of Georgia (Atlanta: Policy Research Center, Georgia State University, January 1995).

END OF FOOTNOTES