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TESTIMONY OF MATTHEW GARDNER
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before the Georgia Special Council on Tax Reform
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Thank you for the opportunity to appear before you this afternoon. I'm Matthew Gardner, Executive Director of the Institute on Taxation and Economic Policy (ITEP). Founded in 1980, ITEP is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy issues with an emphasis on tax fairness and adequacy.

The Special Council has been charged with developing a comprehensive plan for reform Georgia's state tax system. While the short-term budget deficits that have plagued the state in recent years add urgency to this task, the longer-term structural budget deficit facing the state has been a developing threat for decades. Any tax reforms put forward by the Council should be designed to resolve both these short-term and long-term challenges—and should do so without sacrificing other important goals such as economic development and fairness.

My testimony today surveys recent state legislative activity on tax reform issues that has been designed to achieve these goals. Wherever possible, my remarks will focus especially on tax changes enacted by regional competitor states. This survey, while not exhaustive, will also include tax changes enacted by states in other regions of the country--and tax reforms that have been discussed or proposed but not enacted--in cases where I believe there are productive lessons to be learned in constructing an agenda for Georgia tax reform. I'll first give a brief overview of the structural challenges facing the major taxes (income, sales, corporate and excise taxes) that states rely on most heavily, and will then discuss salient reform proposals in each of these areas.

Structural Challenges Facing State Tax Systems

Each of the major tax types levied by state governments face threats that have reduced the yield and fairness of these taxes—and threaten to make them unsustainable as funding sources in the 21st century. While some of these threats stem from unforeseen long-term shifts in economic patterns, others are self-inflicted: tax changes enacted by lawmakers nationwide are digging the hole deeper for those seeking a sustainable tax system. In particular:

- State sales taxes are being threatened by an inexorable shrinkage of their tax base (that is, the set of activities that are subject to tax). In the sixty-plus years since states first enacted this taxes, states have enacted a host of tax exemptions for different types of tangible goods, ranging from "necessities" like food, rent and clothing to targeted exemptions for college textbooks.
- Even as lawmakers are actively reducing the number of goods subject to the sales tax, they are, in generally, not acting to expand the base to include the intangible services that are the fastest-growing area of consumption. From car repair to movie tickets,

spending areas that simply didn't exist when most sales taxes were enacted remain untaxed because lawmakers won't make the hard choices needed to expand the base.

- Even the transactions that are supposed to be taxed under sales tax laws are, increasingly, not having tax collected because they're being purchased over the Internet tax-free. Federal law mandates that companies like Amazon that sell into a state over the Internet are not require to collect sales tax on retail sales unless they have a "physical presence" in a given state. This loophole is, by all appearances, growing about as fast as the Internet itself.
- Personal income taxes are being eroded by a host of tax exemptions enacted by lawmakers, ranging from capital gains to retiree income to itemized deductions. Collectively, these (usually well-intentioned) tax breaks reduce the yield of the income tax and force lawmakers to increase tax rates, usually on the very best-off taxpayers.
- The growth of "millionaire's taxes" has also spawned concerns—at least in some quarters—about excessive volatility in the personal income tax, and possible impacts on the migration patterns of upper-income families.[1]
- Corporate income taxes are being decimated by the proliferation of targeted tax incentives, usually in the name of economic development—and clever tax planning by multi-state corporations is further eroding the tax base.
- Excise taxes on gasoline, cigarettes and beer are themselves a structural problem insofar as states are relying on them to fund important public investments. Because these taxes typically grow only when the tax rate is changed, there is a guaranteed long-term mismatch between these taxes and the services they are meant to fund.

The recurring theme in these diagnoses is the erosion of state tax bases due to loopholes, some of which are the product of intentional choices by lawmakers and others of which are the product of clever tax avoidance techniques. It should come as no surprise, then, that the sustainable tax reform strategies discussed in what follows focus on broadening the tax base by eliminating these loopholes.

Restoring the Sales Tax Base

Since Florida and Massachusetts aborted their especially-aggressive efforts at expanding their general sales tax base to include more services more than two decades ago, state policymakers have been leery of efforts to make similar changes, even in the face of growing budget deficits. A botched effort to target politically-vulnerable services three years ago in Maryland only added to these fears, to the point where lawmakers have recently been far more willing to hike the sales tax rate on everyone's purchases than to eliminate unwarranted exemptions.

But a number of states have enacted legislative changes in recent years that provide a guidepost for Georgia policymakers—and even more are set to consider such changes in the near future. For example:

- In 2007, New Jersey lawmakers helped to balance their budget by expanding the base to include landscaping services, limousine rentals, tattoo parlors and more.
- In 2004, taxing personal services such as dry cleaning, pest control, self-storage and pet grooming was a vital part of Arkansas's effort to adequately fund schools.

[1] As I am happy to discuss at length, neither of these claims is especially convincing.

- Perhaps more important, tax reform commissions in North Carolina, California and, most recently, South Carolina have recommended taxing personal services (as opposed to services consumed by businesses in the process of manufacturing their products, which from a tax policy perspective should remain exempt from tax) as generally as is practical.

These moves are all welcome steps towards reform in that they more make it more likely that a consumer's sales tax bill will depend on how much they spend, not on which items they buy. These reforms also reduce the pressure on lawmakers to continually ratchet the sales tax rate upwards. Nothing demonstrates this tension between the tax base and the tax rates more clearly than well-intentioned tax changes that narrow the base in a number of states:

- In the late 1990s, North Carolina lawmakers exempted groceries from the state sales tax and subsequently increased the statewide sales tax rate on all other items to help pay for this tax cut.
- In 2002, New Mexico lawmakers enacted the same set of tax changes—narrowing the base by excluding groceries and increasing the tax rate—in one legislative session.
- In 2006, South Carolina lawmakers made this same swap as part of a single tax bill.

When it's unaffordable to do so, exempting groceries and other "necessities" from the sales tax is a progressive move that offers meaningful tax relief to low-income families—but any move to narrow the tax base increases the long-term pressure on lawmakers to hike the tax rates on every other item in the base. This inexorable logic applies to each of the taxes being discussed today.

In addition to modifying the tax treatment of specific goods and services, states have also taken welcome steps toward ensuring that otherwise-taxable retail transactions won't end up exempt from tax simply because they were made over the Internet. While federal law prevents states from requiring sales tax collection by firms such as Amazon that sell goods into a state when those firms have no "physical presence" in the state—a fact that Congress is capable of reversing, but has unfortunately chosen not to—several states have enacted laws that either encourage (in the case of Colorado) or require (in the cases of North Carolina, New York and Rhode island) companies like Amazon to collect the tax. Until Congress acts to close the barn door and allow states to generally tax Internet-based transactions, enacting an "Amazon" law is a workable second-best solution for Georgia and other states.

Eliminating Personal Income Tax Loopholes (and other options)

In theory, the personal income tax is the fairest major revenue source available to states. No other tax is as clearly tied to a taxpayer's ability to pay it. But state personal income taxes frequently don't live up to this promise, due to lavish tax giveaways for capital gains, itemized deductions and retirement income that offer large tax cuts to the best off and pennies to low-income working families. Fortunately, there has been a remarkable recent trend toward paring back these giveaways in state houses across the nation.

- Three states—Rhode Island, Utah and Maine—have recently enacted income tax overhauls that either eliminate itemized deductions or transform them into better-targeted tax credits, usually in combination with changes in tax rates. (Maine's action was subsequently overturned by a vote of the people in June of 2010.)

- Several other states have enacted tax reforms that either cap the overall value of itemized deductions (Hawaii, in a measure that was vetoed by the Governor), or the value of specific itemized deductions (Vermont, New Jersey and New York).
- One state (New Mexico) entirely repealed a specific itemized deduction, the state income tax deduction for state income taxes, which had served mostly to make non-tax-practitioners dizzy and to enrich better-off taxpayers. Georgia is, in fact, one of a small number of states that still allow this odd deduction.
- Four states (Vermont, Wisconsin, Rhode Island and Colorado) have repealed or pared back generous capital gains tax breaks in recent years, recognizing that these expensive and regressive tax giveaways were not living up to their billing as an economic development tool.[2]
- Virginia and Utah have each restructured generous income tax breaks for retirement income in a way that reduces their cost and makes them more targeted to middle- and low-income seniors.

Of course, base-broadening is not the only acceptable approach to revenue-raising through the income tax. Given short-term political constraints, more than half a dozen states have recently chosen to raise revenues through temporary income tax rate increases, usually applied only to upper-income taxpayers. While these so-called "millionaire's taxes" do nothing to fix the long-term structural problems facing state income taxes, they do help to close budget deficits—and the claims made in some quarters that these tax changes add an unacceptable level of volatility to state revenues while chasing millionaires out of the state are at best overblown.[3]

But Georgia's history of providing excessively generous tax breaks to even the wealthiest retirees that are unavailable to non-elderly working families at or near the poverty line, and the state's provision of a broader array of itemized deductions than most other states currently provide, mean that the state has a wealth of revenue-raising income tax reform options to choose from before tax rate changes even enter the discussion.

Corporate Income Tax Reform—Do's and Don'ts

More so than is the case with most other taxes, state policymakers appear to be headed in opposite directions in their approach to reforming state corporate income taxes. While some states have enacted sensible reforms designed to stop harmful tax avoidance dead in its tracks, others have actually discussed (or even enacted) repealing the tax entirely, and virtually all states have continued unabated in their long-term practice of offering company-specific or industry-specific tax incentives encouraging firms to either relocate, expand or simply stay put. The welcome news in this litany of "smokestack chasing" tax giveaways is that lawmakers are now learning the importance of ensuring that companies claiming these tax breaks keep their job-creation promises. In particular:

- Since 2004, seven states have enacted "combined reporting," a laudable administrative reform designed to eliminate the incentive for multi-state companies to artificially shift income from higher-tax to lower-tax jurisdictions. Georgia has not yet taken this step.

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[2] It should come as no surprise that state-specific capital gains tax breaks don't spur economic growth. After all, any investment spurred by such tax breaks is as likely to take place in Russia as in Rhode Island.

[3] See ITEP's 2010 testimony on the Maryland millionaire's tax at http://www.itepnet.org/pdf/mdtest0310.pdf .

- In 2005, Ohio lawmakers chose the strategy of "repeal, not reform," and replaced their profits tax with a broad gross receipts tax. While the verdict is not yet in on the efficacy of this tax, experience so far has shown that the tax is not immune to the cyclical changes and loopholes that lawmakers cited in repealing the income tax.
- California's legislature recently approved a bill that would require greater disclosure of the level of corporate tax giveaways, while reporting basic facts about the economic development impact of these giveaways.

Georgia has, to date, chosen not to enact the single best strategy for corporate income tax reform available to the states—combined reporting. Taking this step, and casting a critical eye on proposals to provide targeted tax incentives to specific firms or industries, will help ensure that the corporate tax is distributed fairly between the small mom-and-pop companies that don't have access to complicated tax-avoidance schemes and the large multi-state firms that pioneered these schemes. By contrast, following in the steps of Ohio lawmakers (or of the South Carolina gubernatorial candidate who recently proposed repealing that state's corporate income tax) would, in the current fiscal climate, shift the cost of funding public investments onto middle-and-low-income Georgians and endanger the state's ability to provide needed infrastructure improvements.

Making Excise Taxes More Sustainable

In general, excise taxes on gasoline, cigarettes and alcohol are based on the number of units sold, not on the price of those items—so revenues from excise taxes tend not to grow with personal income, to say nothing of the cost of funding public investments. For this reason, virtually every state has seen its gasoline excise tax revenues actually decrease as a share of personal income over the last quarter century, even as the cost of construction for transportation infrastructure has skyrocketed. In a tax-wary environment, this has meant that virtually every state—including Georgia—is dramatically underfunding its commitment to a safe highway system.

In the past year, reform commissions in Arkansas and South Dakota have recommended indexing those states' gasoline taxes to the cost of highway construction—a welcome move that could also help to make Georgia's gasoline tax better-matched with the cost of the infrastructure spending it is meant to fund.

Conclusion

The Georgia legislature's decision to create a Special Council on tax reform is both laudable and timely. The long-term structural constraints that have hobbled the state's capacity to raise needed revenues have been compounded by persistent short-term deficits—and tax changes enacted by the state legislature earlier this year will clearly make these long-term problems even worse if left in place. As my testimony has noted, many of the actions taken by other states in recent years provide a sensible road map for restoring balance to the Georgia tax system. These actions demonstrate that base-broadening reforms, which ought to be the starting point for any effort at comprehensive tax reform in Georgia, are both politically attainable and sound policy. I thank you for the opportunity to speak here today and would be happy to answer any questions.