Policy Memorandum

FISCAL RESEARCH CENTER

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FISCAL RESEARCH PROGRAM
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SUBJECT: Eliminating the State Income Tax

Analysis Prepared by the Fiscal Research Program

The following are issues that should be considered in evaluating a proposal to replace the Georgia individual income tax with an increase in the state retail sales tax. The estimates are preliminary, back of the envelope calculations.

1. Georgia would not be alone in not having a broad-based individual income tax; for example, Texas, Tennessee, and Florida do not have income taxes.

2. To replace the current revenue from the income tax would require an increase in the state sales tax rate of about 4.3%, i.e., an increase from 4% to 8.3%. This would mean a maximum rate of about 11.3% rate for the combined state and local sales taxes, and an average rate of about 10.5%.

   By way of comparison, the state sales tax rate are 6% in Florida, 5% in South Carolina, 6% in Tennessee, and 4% in Alabama. Including local sales taxes, the top rates are 7% in Florida, 8.5% in Tennessee, 6% in South Carolina, 9% in Alabama.

   8.3% is a pretty hefty rate, and could be big enough to cause people to begin to look for other places or ways to shop, including other states, mail order houses, the internet, and the underground economy.

3. If we eliminate the individual income tax, the federal government will receive a windfall since the state income tax is deductable for Federal income tax purposes, but the sales tax is not. About 30% of Georgia's filers are itemizers. Given $4.3 billion in income tax (FY96), we estimate that the elimination of the state income tax will result in an increase of over $800 in federal income taxes paid by Georgia taxpayers because of the loss of the deduction. Thus, the net income tax reduction for Georgians is $3.5 billion. The revenue neutral increase in sales tax burdens in Georgia will be $4.3 billion; thus, Georgians will experience a net increase in taxes. Itemizers are generally higher income households itemize, so it is this group that would experience the increase in Federal income taxes.

4. The sales tax is probably more cyclical than the income tax, so that would be a problem. This is especially true given that food has been removed from the sales tax base.

5. The substitution will shift tax burdens away from higher income household to low income households (but no calculations have been made.) About 15% of Georgia families pay no state income tax, but would pay the increase sales tax.

6. If the individual income tax is eliminated but corporate taxes were left in place, you would introduce a real incentive for people to do business in ways that would avoid the corporate tax. This could introduce some real disparities in treatment and could cause companies to do business in different ways just because of the tax system.

   This may mean eliminating the corporate income taxes as well as the individual income tax. To do this would require that the state sales tax rate be increased to about 9%.

7. The entire income tax administration in Georgia could be eliminated and the business of tax preparer services would be reduced. The result is a direct saving to both the state and to taxpayers.

8. The income elasticity of the state income tax is greater than for the state sales tax. Thus, tax revenue will grow more slowly if the switch is made.

9. The scheme could increase economic development. Imagine the effect from being able to tell the world that Georgia had dropped its income tax. On the one hand, this might invite investors and high income households. High income households would realize a drop of about 6% in their tax liability on the marginal dollar earned, and working people would see a tax reduction.

   The other side of this story is that if workers receive a reduction in the income tax, this might simply be capitalized (eventually) into lower wages as additional workers migrate to the state, so the only winners in the long run might be high income households. And, remember, neither neighboring Florida nor Tennessee has a broad based income tax.

10. The switch would put more pressure on the local property tax since the increase in the state sales tax rate would effectively eliminate the local option sales tax or local income taxes as escape valves.

11. In order to make the scheme more palatable (i.e., have a lower sales tax rate), the base of the sales tax could be expanded to include services.

12. The sales tax includes a lot of business-to-business transactions. An increase in the sales tax rate would heighten the distortions caused by this practice.

13. Eliminating the income tax means that the state will not have to worry about such things as how to treat retirement income and how to react to undesirable changes in federal tax code that effect Georgia AGI and therefore tax liability.