A FLAT RATE INCOME TAX IN GEORGIA

With the introduction of HR 900, there has been discussion regarding a flat rate income tax in Georgia. The original version of HR 900 presented a flat rate income tax at 5.75 percent of Georgia taxable income while current discussions suggest a 4 percent rate may also be considered over the next year. This policy brief provides an overview of the revenue and distributional implications of a flat rate income tax in Georgia. This brief is one in a series of policy briefs that relate to tax policy options for Georgia.

Background

Georgia’s individual income tax (IIT) is the single most important revenue source for the state. In FY2006, the IIT accounted for 49.2 percent of all state government tax revenue. The general sales tax accounts for 35 percent of state government tax revenue and the corporate income tax 5 percent. Local governments in Georgia do not impose an individual income tax, although there are provisions in the state constitution that allow local governments in Georgia to impose a local income tax.

The IIT in Georgia is levied on a tax base that is derived from the federal definition of adjusted gross income (FAGI). FAGI is the sum of all forms of income such as wages, capital income, income from business, and some pensions and social security, minus certain allowances like health insurance payments for the self-employed and some pension contributions. From FAGI, Georgians are allowed to take various deductions to calculate Georgia taxable income (GATI). The most important of these deductions include: deduction for dependents, standard deduction or itemized deductions, social security income that is taxable under the federal income tax, and the retiree income exemption. Once Georgia taxable income is calculated, a tax rate is levied, with tax rates ranging from 1 percent to 6 percent. Since the tax brackets—or thresholds for each tax rate are relatively low, most Georgians face the top tax rate of 6 percent.

Figure 1 demonstrates the distribution of the IIT burdens in Georgia. The taller bars are Georgia tax liability/Georgia taxable income and the shorter bars are Georgia tax liability/Federal AGI. Figure 1 shows that the tax as a percentage of Georgia taxable income reaches 5 percent at about $18,000 of Georgia taxable income and then approaches 6 percent. Thus, while fairly progressive at very low income levels, the structure of the current Georgia IIT is very flat over a large range of Georgia taxable income. The shorter bars shown in Figure 1 indicate for the various levels...
of income, the Georgia tax liability as a percent of the Federal Adjusted Gross Income (FAGI) and represent an effective tax rate in Georgia. Because the Georgia income tax base is smaller than the Federal income base due to the presence of various deductions and tax credits available at the state level, the effective tax rate for a given level of taxable income is smaller than the statutory rate. The area in Figure 1 above the short lines and to the top of the taller lines represent the decrease in the tax burden borne by the taxpayer because of the deductions and credits from the more inclusive tax base represented by the Federal IIT base. As shown in Figure 1, the state tax structure when viewed according to effective tax rates is not as flat as that viewed according to the statutory rates.

A Flat Rate Income Tax in Georgia

“Flat taxes” have been a familiar part of the tax policy debate for many years. At the federal level, a dozen or more flat tax proposals have been offered in just the last 4 years. There is an important distinction to make among these types of proposals—including the flat rate income tax proposal for Georgia. A flat tax of the consumption tax variety uses a flat tax rate but also exempts savings from taxation and integrates the individual and corporate income tax systems. It also eliminates many of the exemptions and deductions available under the current tax structure. Flat taxes of the consumption variety are not currently used in the U.S. and very few countries have actually attempted them. Flat rate income taxes are just that—income tax systems with one tax rate. The base of these types of taxes can be very broad or narrow. These tax systems are not specifically integrated with the corporate income tax nor do they exempt savings.

They do, however, often eliminate or greatly reduce the number of exemptions and deductions, which simplifies the system and may reduce the cost of administering and complying with the tax system.

In the U.S., 41 states plus the District of Columbia impose broad-based individual income taxes. Of these states, six use flat income tax rates: Colorado, Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania. Of these states, all but Pennsylvania and Colorado use FAGI as the starting point for tax calculation. Rhode Island imposes a flat 25.0 percent rate on federal tax liability—basically buying into the progressive tax rates of the federal government.

HR 900 outlined a flat rate income tax for Georgia at a rate of 5.75 percent. This tax would eliminate all deductions and exemptions except for a deduction for rental housing, mortgage interest expense, and charitable contributions. More recently a 4 percent flat rate income tax has been proposed, which we assume also applies to the HR 900 tax base. We analyzed the revenue and tax burden effects of a 5.75 and 4 percent flat rate income tax for Georgia using the Fiscal Research Center Georgia Tax Model, which is currently based on 2002 individual income tax information. The 2002 data were adjusted to account for the changes in dependent deductions and retiree income deductions through 2006.

To analyze the impact of a flat rate income tax with a deduction for rent paid, we needed to eliminate the exemptions and deductions from the adjusted 2002 tax information (except for charitable contributions and mortgage interest expense) and impute the value of a deduction for rent. The first part is relatively easy—we simply use FAGI as the base and subtract a portion of reported itemized deductions to capture the proposed law deduction for mortgage interest expense and charitable contributions. We use IRS data on itemized deductions to estimate, by income group, the amount of deduction allowed under the proposal. We use data from the
Bureau of Labor Statistics, Consumer Expenditure Survey (CES) on charitable contributions by income group to impute deductible contributions for non-itemizers. To do this, we calculate the percent of families who make contributions (and the average contribution) by income group. We compare that percentage by income group to the percent of itemizers who report charitable contributions by income group. If the former percentage is larger than the latter, we subtract the percent of itemizers who report charitable contributions from the percent of families who report making contributions. That resulting number is our estimate of the percent of families who make charitable contributions but do not currently itemize their tax returns. We randomly select that percent of returns from the Georgia Tax File and attribute to those returns the average level of contributions. If the percent of itemizers with contributions is greater than the CES estimate of the percent of itemizers, we make no additional imputation for charitable contributions in that income group.

To impute a rental payment deduction, we used data from the U.S. Census. The Census reports rent expense. We tabulated households by income (using a definition similar to FAGI) and calculated the percent of households that pay rent by income group. For renters, we computed the average rent payment per month. We used this information to randomly select the same percentage of tax filers in the 2002 Georgia tax file by income group, and assigned them the average annualized rent payment per year. We use this as an estimate of the actual rent deduction. In the analysis, we assume that no refunds would be paid (if rent payments exceeded state taxable income), so if tax liability before or after the tax change were negative, we set it to zero.

There are three major changes associated with the flat rate income tax proposal from the IIT in Georgia. Taken separately, they give us some indication of the change in tax burden and revenue—but these changes must ultimately be examined together. First, the elimination of many deductions and exemptions should increase the tax liability for all individuals, thereby increasing total revenue for the state. The inclusion of a deduction for rent payment and charitable contributions (for non-itemizers) will reduce the tax liability for renters and for lower income individuals who make charitable contributions. Since renters are more highly concentrated in lower income groups, those taxpayers would see more of a reduction in tax liability than higher income taxpayers. Finally, the change in the tax rate structure from a high of 6 percent to 5.75 or 4 percent will reduce the tax liability for higher income earners more than lower income earners. For some low-income individuals, the change in the tax rate will increase their tax liability. On net it is difficult to determine what happens to the tax burden across income groups without using data on individual tax filers. The FRC Georgia Income Tax Model utilizes such data and simulates the impact of alternative tax systems.

The revenue impact of a 5.75 percent flat rate tax is an increase in IIT revenues of more than 50 percent. A flat rate of 4 percent would yield approximately 7 percent higher income tax revenue from residents. The distribution of the tax among Georgia residents would be affected by the income tax change. The data in Table 1 and Figure 2 include Georgia income tax liability divided by federal adjusted gross income for residents (FAGI). FAGI is a relatively broad definition of income, so the ratio gives an indication of the tax burden associated with the current and proposed law. As seen in the table and figure, the current law is progressive—the tax burden increases as income increases. Both of the proposed taxes are also progressive—but they are, by design, flatter than the current system. The combination of a loss of personal exemptions and standard deduction with a flat tax rate will affect lower income individuals more than higher income individuals.

Conclusions

Georgia’s present IIT is a relatively simple income tax with a tax rate structure that is in effect close to a flat rate. Deductions and exemptions in the system reduce the revenue yield, increase the complexity of the system, impact behavior of individuals (to take advantage of deductions and exemptions), and also impact the distribution of the tax among Georgia taxpayers. A flat rate income tax system that eliminates deductions and exemptions could reduce the potential for tax avoidance and reduce the cost of administering the tax system. Using the available data on tax returns, we find that a 5.75 percent flat rate income tax as described above will increase income tax revenues by more than 50 percent. A flat income tax rate of 4 percent would yield a smaller increase in revenue—roughly 7 percent for residents. The distributional implications of the change are such that low income people would see an increase in their tax liability relative to high income individuals. This analysis does not include a deduction for mortgage interest for those who currently do not itemize. Additional mortgage interest deductions will lower the tax burden at the lower income end to some extent but are not likely to fully offset the loss of personal exemptions and standard deductions.

Notes

1. It is not clear at this time if FAGI is the base that was implicitly suggested in HR 900.
2. We do not, however, impute mortgage interest for individuals who currently do not itemize their deductions. The number of non-itemizers who have mortgage interest to deduct is likely to be small.
TABLE 1. DISTRIBUTION OF GEORGIA INCOME TAX BURDEN FOR RESIDENTS, CURRENT LAW AND PROPOSED LAW (% OF FEDERAL ADJUSTED GROSS INCOME)

<table>
<thead>
<tr>
<th>Federal Adjusted Gross Income 2002 ($)</th>
<th>Current Law</th>
<th>Proposed Law 5.75%</th>
<th>Proposed Law 4%</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-10,000</td>
<td>0.80</td>
<td>3.93</td>
<td>2.73</td>
</tr>
<tr>
<td>10,000-25,000</td>
<td>1.57</td>
<td>4.60</td>
<td>3.20</td>
</tr>
<tr>
<td>25,000-40,000</td>
<td>2.72</td>
<td>4.85</td>
<td>3.35</td>
</tr>
<tr>
<td>40,000-60,000</td>
<td>3.14</td>
<td>4.94</td>
<td>3.44</td>
</tr>
<tr>
<td>60,000-75,000</td>
<td>3.39</td>
<td>5.02</td>
<td>3.49</td>
</tr>
<tr>
<td>75,000-100,000</td>
<td>3.65</td>
<td>5.07</td>
<td>3.53</td>
</tr>
<tr>
<td>100,000-150,000</td>
<td>3.99</td>
<td>5.12</td>
<td>3.56</td>
</tr>
<tr>
<td>150,000-200,000</td>
<td>4.31</td>
<td>5.16</td>
<td>3.59</td>
</tr>
<tr>
<td>&gt; 200,000</td>
<td>4.97</td>
<td>5.32</td>
<td>3.69</td>
</tr>
<tr>
<td>Total</td>
<td>3.59</td>
<td>5.10</td>
<td>3.53</td>
</tr>
</tbody>
</table>

Source: FRC, Georgia Income Tax Model.

FIGURE 2. DISTRIBUTION OF TAX BURDEN: CURRENT AND PROPOSED LAW

![Distribution of Tax Burden: Current and Proposed Law](image)
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