Policy Memorandum

FISCAL RESEARCH CENTER

GEORGIA STATE UNIVERSITY
FISCAL RESEARCH CENTER
ANDREW YOUNG SCHOOL OF POLICY STUDIES
NOVEMBER 8, 2013

SUBJECT: Inquiry from Chairman Hill, Senate Fair Tax Study Committee, regarding taxable consumption of households at different income levels and other matters.

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In follow-up to the analysis of alternative consumption tax structures for Georgia, presented to the committee on September 20, Sen. Hill asked for additional information to address certain related questions, which are restated/summarized as follows:

1. How do household consumption expenditures that are taxable under each of the following tax base scenarios vary across the income distribution?
   a. Current law sales and use tax base.
   b. Current law plus currently exempt groceries.
   c. Broad household consumption base modeled on South Carolina Fair Tax Act.

2. What would be the implications of taxing state and local government purchases as is done under the proposed South Carolina law? Secondarily, how are Medicaid expenditures treated in that model, where federal government expenditures cannot be taxed.

3. What is the feasibility of combining income tax reductions to, say, a 3 percent or 4.5 percent flat rate, and elimination of all itemized deductions except for a) charitable contributions, and b) a maximum of $20,000 annually of mortgage interest?

TAXABLE CONSUMPTION BY INCOME GROUP—THREE TAX BASE SCENARIOS

Using data from the U.S. Census Bureau's Consumer Expenditure Survey (CES), it is possible to estimate taxable consumption patterns by income level, but because of sample size limitations, it is necessary to base the analysis on no smaller than a regional sample, rather than Georgia alone. Nevertheless, if the sample is limited to only southeast U.S. states where, for example, regional differences in energy consumption for heating and cooling would not come into play, it is believed that the sample would be representative of consumption patterns in Georgia households of similar incomes.

The sample used for the tables below includes the CES samples for Georgia and 15 other states, plus the District of Columbia, in the South census region.[1] The total sample size is 12,045 households, which is divided into income deciles based on estimated federal adjusted gross income. The broad base alternative is based on taxing all household consumption expenditures for new goods and services except for education expenses, as in the proposed South Carolina Fair Tax Act, and motor vehicles, which are taxed under the new title fee implemented this year. In addition, spending on motor fuels is excluded from these figures because only the 1 percent sales tax portion of the second motor fuels tax goes to the general fund and, rather than assuming any change to motor fuels taxes, motor fuels were excluded from the broad base alternative in the September 20 presentation estimates.

Estimates of the mean taxable consumption by income group, under the three tax base scenarios, are presented in Figure 1 and Table 1 below, with the latter also showing taxable consumption as a percent of total consumption expenditures and of income.[2]

FIGURE 1. TAXABLE CONSUMPTION—THREE ALTERNATIVES, BY INCOME GROUP (2012)

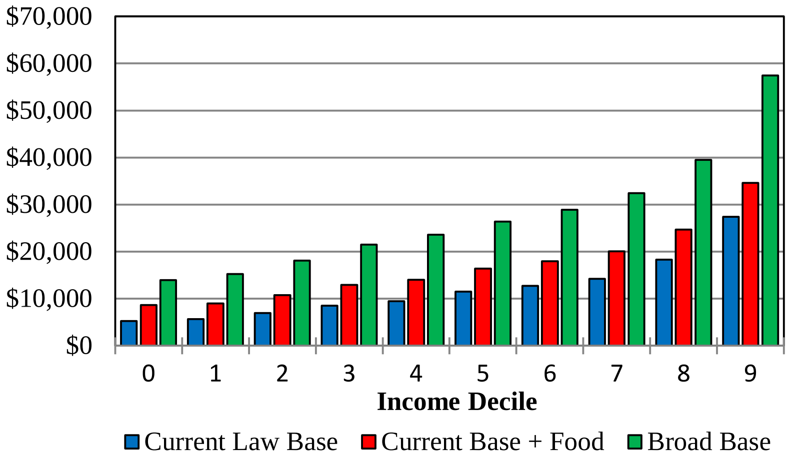

TABLE 1. TAXABLE CONSUMPTION—THREE ALTERNATIVES, BY INCOME GROUP (2012)

Inc Decile	**Min Income**	**Mean Income**	**Current Law Base**	*% Ttl Expend*	*% of Income*	**Current + Food**	*% Ttl Expend*	*% of Income*	**Broad Base**	*% Ttl Expend*	*% of Income*
0	<$0	<$0	$5,209	26.0%	nmf	$8,661	43.2%	nmf	$13,926	69.4%	nmf
1	$0	$3,057	$5,637	25.1%	184.4%	$8,968	40.0%	293.4%	$15,252	68.0%	499.0%
2	$7,553	$12,108	$6,960	28.3%	57.5%	$10,760	43.7%	88.9%	$18,090	73.5%	149.4%
3	$17,355	$22,143	$8,519	29.2%	38.5%	$12,893	44.2%	58.2%	$21,513	73.7%	97.2%
4	$26,402	$31,839	$9,435	26.8%	29.6%	$14,018	39.8%	44.0%	$23,560	66.9%	74.0%
5	$36,821	$43,102	$11,524	27.7%	26.7%	$16,411	39.5%	38.1%	$26,400	63.5%	61.2%
6	$49,921	$57,263	$12,702	25.4%	22.2%	$17,920	35.8%	31.3%	$28,892	57.7%	50.5%
7	$65,400	$75,420	$14,231	25.3%	18.9%	$20,028	35.7%	26.6%	$32,400	57.7%	43.0%
8	$87,000	$102,777	$18,313	25.6%	17.8%	$24,709	34.6%	24.0%	$39,521	55.3%	38.5%
9	$122,440	$204,646	$27,384	24.9%	13.4%	$34,620	31.5%	16.9%	$57,472	52.3%	28.1%
All		$55,093	$11,987	26.0%	21.8%	$16,894	36.7%	30.7%	$27,694	60.2%	50.3%

TAXING STATE AND LOCAL GOVERNMENT PURCHASES

Both the proposed national Fair Tax and the proposed South Carolina Fair Tax provide for taxing government purchases of goods and services, including labor, unless the purchases are made by a government enterprise that provides goods or services for payment and that collects the tax on its sales. The South Carolina act would not tax federal government purchases in the state due to constitutional issues, but it would tax state and local governments.

The rationale for taxing government spending, even though the state government would be paying itself, is to "level the playing field" between the public and the private sector in terms of costs of providing services and thus limit market distortions.

On the surface, it might seem that government costs would rise by the amount of the taxes paid on goods, services, and labor purchased by governments, but this is not clearly so. Government workers, contractors, and vendors would no longer be subject to individual or corporate state income taxes, nor would contractors and vendors be subject to sales taxes on their business purchases under existing Fair Tax proposals. As a result, these currently existing taxes would no longer be embedded in the wages or prices paid by government purchasers and pretax prices should decline. In fact, this effect should apply regardless of whether the purchaser is in the private or the public sector. On this basis, the estimated breakeven tax rate for the broad base alternative in the September 20 presentation assumed that the price effect of eliminating embedded taxes from government purchases would be to roughly offset the gross consumption taxes paid on those purchases.

However, it is not clear that such pretax wages and prices would necessarily fall immediately or even quickly, so for that reason, an additional breakeven broad consumption tax rate has been estimated that assumes no reduction in pretax prices of goods and services, or labor. That is, it is assumed for this estimate that pretax prices are unchanged, so government spending would increase by exactly the amount of tax paid on government purchases. Adjusting for this is mathematically equivalent to removing government spending from the tax base and results in a breakeven consumption tax rate of 7.61 percent compared to 6.42 percent under the original assumption. Further study of this question is needed and though the original assumption should hold in the long term, it may be prudent in drafting any potential proposal for Georgia to consider an initial tax rate between these two rates with provisions for reducing the rate over time.

LIMITING ITEMIZED DEDUCTIONS TO LOWER INCOME TAX RATES

To estimate the effect of limiting itemized deductions to only charitable contributions and mortgage interest, with the latter capped at $20,000 per year, it is necessary to rely on IRS Statistics of Income program summary data rather than microsimulations using actual return data. Though simulations with return data would be preferable, Georgia income tax data made available by the Department of Revenue do not include a breakdown of the components of itemized deductions, providing instead only the totals for each return.

However, comparing 2011 IRS figures for total itemized deductions by income group for Georgia residents to the Georgia returns data, the numbers of returns itemizing and the total deductions by income group and overall are similar, so the effect of this hypothetical tax change can be approximated roughly. The IRS figures for total itemized deductions, and the mortgage interest and charitable contribution claims for tax year 2011, by income group, are provided in Table 2 below.

TABLE 2. SELECT ITEMIZED DEDUCTION DATA FOR GEORGIA (2011)

		--Total Fed. Itemized Deductions--			----------Mortgage Interest----------			------Charitable Contributions-------		
SOI Group	**FAGI**	**#Returns**	**Sum (,000)**	**Mean**	**#Returns**	**Sum (,000)**	**Mean**	**#Returns**	**Sum (,000)**	**Mean**
1	<$1	-	-	-	-	-	-	-	-	-
2	<$25,000	214,673	$2,396,454	$11,163	97,373	$689,401	$7,080	123,350	$253,380	$2,054
3	<$50,000	353,029	$5,434,437	$15,394	245,381	$1,665,572	$6,788	275,031	$826,755	$3,006
4	<$75,000	313,761	$5,666,292	$18,059	255,767	$1,935,931	$7,569	264,109	$923,971	$3,498
5	<$100,000	236,340	$5,672,152	$24,000	204,556	$1,745,418	$8,533	207,072	$819,312	$3,957
6	<$200,000	351,233	$9,402,788	$26,771	307,394	$3,252,264	$10,580	321,610	$1,651,630	$5,136
7	<$500,000	96,512	$4,584,649	$47,503	80,910	$1,323,761	$16,361	91,209	$864,661	$9,480
8	<$1,000,000	14,711	$1,468,106	$99,796	11,440	$273,070	$23,870	14,159	$367,073	$25,925
9	>=$1,000,000	6,318	$2,199,597	$348,148	4,193	$112,924	$26,932	6,123	$868,880	$141,904
All		1,586,577	$36,824,475	$23,210	1,207,014	$10,998,342	$9,112	1,302,663	$6,575,664	$5,048
Source: IRS Statistics of Income TaxStats.										

An important qualification to using these data is that, because the IRS provides only the numbers of returns claiming mortgage interest deductions and the total of those deductions, it is not possible to determine precisely how much of such deductions would be disallowed due to the hypothetical $20,000 cap. However, based on the mean mortgage interest deductions, we can see that the top two income groups exceed the cap, on average, by $3,870 and $6,932. These amounts, multiplied by the number of filers claiming this deduction in those income groups, provide a minimum estimate of the amount of disallowed mortgage interest—about $73.3 million for tax year 2011.

TABLE 3. ESTIMATE DISALLOWED DEDUCTIONS AND TAX CHANGE

SOI Group	FAGI	Disallowed Deductions*	Filers Affected	AETR	Tax Change* @AETR	Tax Change @ ---Lower of AETR or:--- 4.50%	3.00%
1	<$1	-	-	-	-	-	-
2	<$25,000	$1,453,673	214,673	0.956%	$13,897	$13,897	$13,897
3	<$50,000	$2,942,110	353,029	3.521%	$103,592	$132,395	$88,263
4	<$75,000	$2,806,390	313,761	4.550%	$127,691	$126,288	$84.192
5	<$100,000	$3,107,422	236,340	4.992%	$155,123	$139,834	$93.223
6	<$200,000	$4,498,894	351,233	5.391%	$242,535	$202,450	$134,967
7	<$500,000	$2,396,227	96,512	5.593%	$134,021	$107,830	$71,887
8	<$1,000,000	$872,233	14,711	5.335%	$46,534	$39,250	$26,167
9	>=$1,000,000	$1,246,857	6,318	4.843%	$60,385	$56,109	$37,406
ALL		$19,323,803	1,586,577		$883,777	$818,053	$550,001

*Dollar amounts in thousands.

Assuming the remainder of mortgage interest would qualify for deduction under this hypothetical, along with all of the charitable contributions claimed, then the total disallowed itemized deductions would be about $19 billion, distributed across the income groups as shown in Table 3. Applying the average effective tax rates for all itemizers in each group, estimated from the actual returns data and shown in the table as well, we can estimate the additional revenue generated by the hypothetical change, before any reduction in tax rates, at about $884 million. The tax change is also calculated at lower, hypothetical top tax rates of 4.5 percent and 3.0 percent (or the groups AETR, if lower) for comparison.[3]

The estimated tax liability effects of limited itemized deductions can then be compared to simulated effects of reductions in top tax rates to the same levels, 4.5 and 3.0 percent, with no other changes, to get a rough estimate of the overall net tax change. For a reduction in the two top marginal rates to 4.5 percent (from 6 percent and 5 percent), leaving other brackets unchanged, the total change in tax liability for all filers would be a reduction of more than $1.7 billion.[4] Similarly, a reduction in the three top rates to 3 percent with the lower three brackets unchanged would reduce overall tax liabilities by more than $3.5 billion. A similar analysis with a top marginal rate of 5% would result in about a $300 million gap between the revenue loss from the rate cut and the gain from the itemized deduction limits. Clearly, the hypothetical limitations on itemized deductions would not come close to offsetting the revenue loss from rate cuts of these magnitudes. Though these are rough estimates because of data limitations, it is likely that the largest rate cut that could be offset by these hypothetical itemized deduction limitations would be about ¾ percent off of the top rate, bringing it to 5.25 percent.

NOTES:

1. The Census Bureau’s South region includes Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, and West Virginia.

2. Note that these estimates are based on household expenditure types that are not necessarily readily classifiable into taxable or non-taxable categories, particularly under the broad base scenario.

3. One note of caution about itemized deduction limitations of these sorts is that some taxpayers may find it more advantageous to take the standard deduction instead, causing the revenue gains to be smaller. However, it is assumed that the choice to itemize is dominated by federal tax considerations and that few taxpayers, if any, would gain enough savings on their Georgia taxes from a switch to the standard deduction to offset the cost of such a switch on their federal return.

4. Simulation using all filer records produces a reduction of $1.7 billion, but because we cannot confirm that all 2011 returns are included in the file, the actual reduction could be somewhat larger.

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