Council on Tax Reform and Fairness for Georgians

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PRESENTATION BY:

Christine P. Ries
Professor of Economics
Georgia Institute of Technology
Atlanta, GA 30332

The First Law of Economics

"The first law of economics is scarcity,

and the first law of politics is to disregard

the first law of economics."

Thomas Sowell

Tax Reform

Former Senator Russell Long of Louisiana had a succinct definition of tax reform:

"Tax reform means

'don't tax you,

don't tax me,

tax that fellow behind the tree"

Taxes Ripple Through the Whole Economy and Have 'Unintended' Consequences

In reality,

you will pay someone else's tax increase.

An increase in taxes on a business causes them to increase their prices. Business who purchase these inputs see their costs go up and they raise prices. And so on, until the consumer ends up pay the higher costs of all – driven by a tax increase on the first business.

Moral: You can tax the fellow behind the tree, but you'll end up paying the bill. The economy is a system and a tax paid directly by one is paid indirectly by many.

What Does Tax 'Reform' Mean?

- Many, if not all, states are doing what we are doing – beginning the process of 'tax reform.' The rest either have done 'reform' quite recently or are planning to begin. But, read carefully. 'Reform' means different things to different states.
- For some it means finding a justification to raise taxes rather than take the alternative path – cut state expenditures.
- For others, reform means a deep restructuring of the system of taxation, particularly the proportion of tax revenue that is drawn of each of the major categories of tax: income tax, sales tax, capital gains taxes, etc.

Basic Structure of Tax System

Tax on savings, Investment, capital formation and investment returns	Tax on Business Inputs	Graduated Income Taxes	Flat Income Taxes	Sales tax on Goods	Sales and Use Taxes (goods and services)	Excise Taxes	User Fees

Rules for Rebalancing Tax Categories

- Deep, structural tax reform makes sense when you realize how strongly changes in taxes in one area ripple through the entire state economic system. Structural reform shifts taxes away from the categories that cause the greatest distortion and loss of productivity, jobs, production, income, and even tax revenue. When we eliminate those distortions we allow our producers, investors and households to make the absolute best use of their own resources and, by extension, the state's resources.
- In the best cases, tax reform means taking a good hard look at the basic structure of taxation and rebalancing among the various types/categories to release the potential hidden in the economy.

An Overview of Structural Reform and the Council's Work

- An effective way of summarizing the work of the Council is that we recommend an appropriate or optimal balance among the various tax categories.
- The Governor's and Assembly's task of determining the effective tax structure tax burden to generate a budget involves adjusting the 'rates' in the various categories and finding the combination that produces the necessary revenue.
- In summary, reform means we will recommend getting rid of some kinds of taxes and replacing them with others. With agreement on the best structure or direction we want to move, we can fill in the rates for each category.

A Tax Structure that Minimizes Market Distortions and Releases Potential Value

- What is a distortion? How can elimination of a distortion actually create jobs?
  - JUST changing the tax balance WILL allow us to get the most bang for the buck. With the right balance, we can release the most productivity, employment, and economic growth available from Georgia's resources.
  - We will also attract additional resources…especially productive talented people and companies…from those states that are slow on the uptake or moving the wrong way.
  - Economic efficiency …better use of what we already have…
  - Best, most effective use of our resources, happens when we tax as little as possible and in a way that distorts the economy as little as possible.

A Tax Structure that Minimizes Market Distortions and Releases Potential Value

- Best, most effective use of our resources, happens when we tax as little as we need to and in a way that distorts the economy as little as possible.
- Why haven't I 'seen' the loss in jobs and production that distortion has caused?
  - Economists call it a *deadweight loss.*
  - *Distortions destroy potential.*
  - *The idea is new to many people because you can't see the 'loss.'*
- *The Loss is the production, jobs, tax revenues that*

WOULD HAVE BEEN if there had been fewer distortions.

Another Law of Economics: What could have been…

From the basics principles taught in all those economics classes that you took and loved…

You get less of whatever you tax.

The ‘less’ is the potential you’ve given up.

When you impose a tax on something, it’s price will rise and a smaller amount is made and sold.

Seen as a system…the whole community pays more and has less of the thing that is taxed.

Don’t Tax the Things you Need

"If you want income producing activities, don't tax income. If you want people to save, don't tax savings. If you want people to build capital, don't tax the building of capital and the return on capital... to the extent you tax, you're going to get less of those things."

This Law of Economics: In Reverse

Reduce taxes and distortions and release potential.

THE GOAL:

Every decision maker, every buyer and seller, every borrower, saver and investor, weighing the realities of the marketplace rather than adjusting choices to minimize tax consequences.

When they change choices to minimize taxes, they (and we) lose the production that could have been.

Putting the Laws of Economics to Work

- Returning to our tax structure, we now have an objective to guide our rebalancing of the tax categories.
  - Tax as little as possible via the types of taxes that ripple through the economy and create the greatest distortion and loss of economic power.
  - In the next slide, the categories are arranged with the most distorting categories on the left and the least distorting on right.
  - Exemptions, tax brackets and special arrangements always increase distortions, so the when added to any category, the distortion created by the 'adjusted' tax increased. The more exemptions, the more brackets, the greater the distorting impact.
- A growth-creating structure that releases Georgia's economic potential uses taxes from categories to the top right corner as heavily as possible .

Basic Structure of Tax System- Variations

Tax on savings, Investment, capital formation and investment returns	Tax on Business Inputs	Graduated Income Taxes	Flat Income Taxes	Sales tax on Goods	Sales and Use Taxes (goods and services)	Excise Taxes
		Brackets				
Exemptions	Exemptions	Exemptions	Exemptions	Exemptions	Exemptions	Exemptions
Special Cases	Special Cases	Special Cases	Special Cases	Special Cases	Special Cases	Special Cases

We've Looked at the Common Sense: Now for the Proof

- Examples abound
  - of this proposition that communities with lower and less-distorting tax schemes are more prosperous and growing faster
- We have extraordinarily strong evidence from countries, states, communities all over the world and through many points in time. I'll select a few good examples and put these examples into one of two basic State Tax Strategy types and talk about the differences in principles:
  - Strategy I: Tax systems that distort (tax structure relies increasingly on the bottom left of our chart
  - Strategy II: Tax systems with low distortion damage (taxes drawn primarily from the upper right hand side of the chart)

Impact of Reform

Other countries

The Impact of Policy U-Turn in Ireland

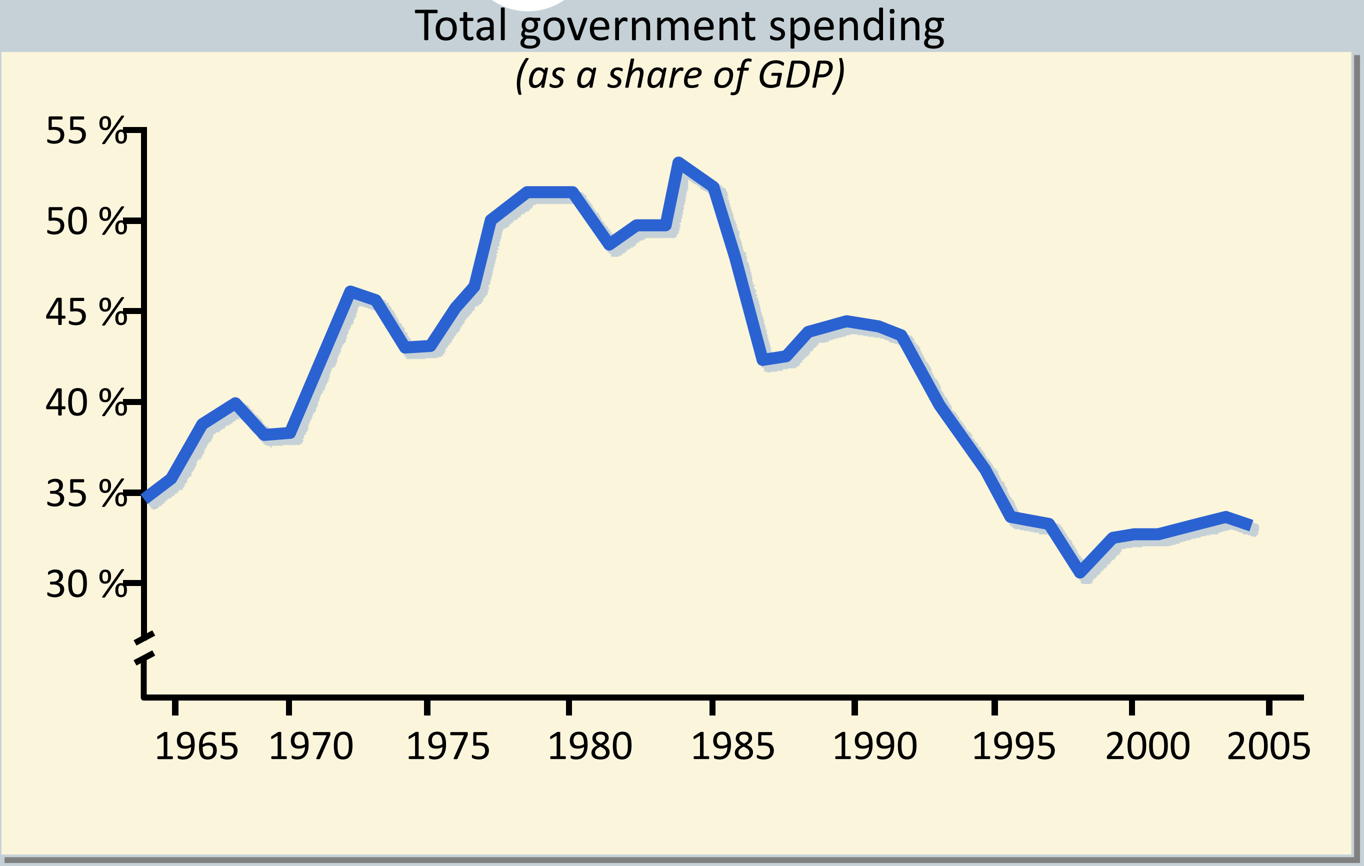
Other states

Ireland: Big U turn in Policy in mid – 1980s

- Watch the reduction in taxes on production (corporate income tax) and income production (personal income tax)
  - Perhaps a bad choice since the Irish subsequently used the income and wealth to 'buy' many new government programs. Rather than cut these programs, they reversed tax policy. Irish bonds downgraded today

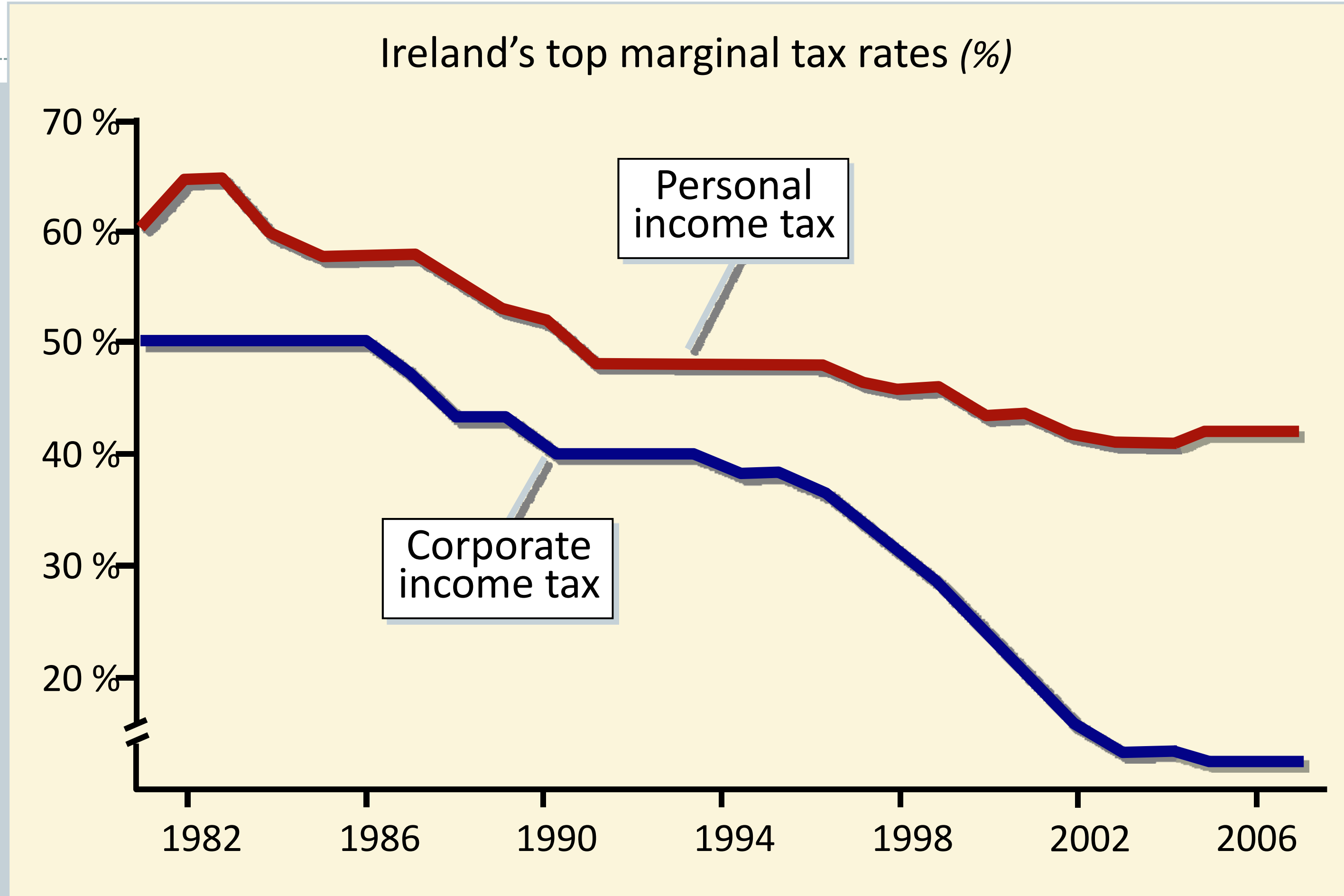
Source of following charts: Gwartney, James, et. al. Economics: Private and Public Choice, 12th ed. Cengage Learning, 2010.

Irish Government Expenditures



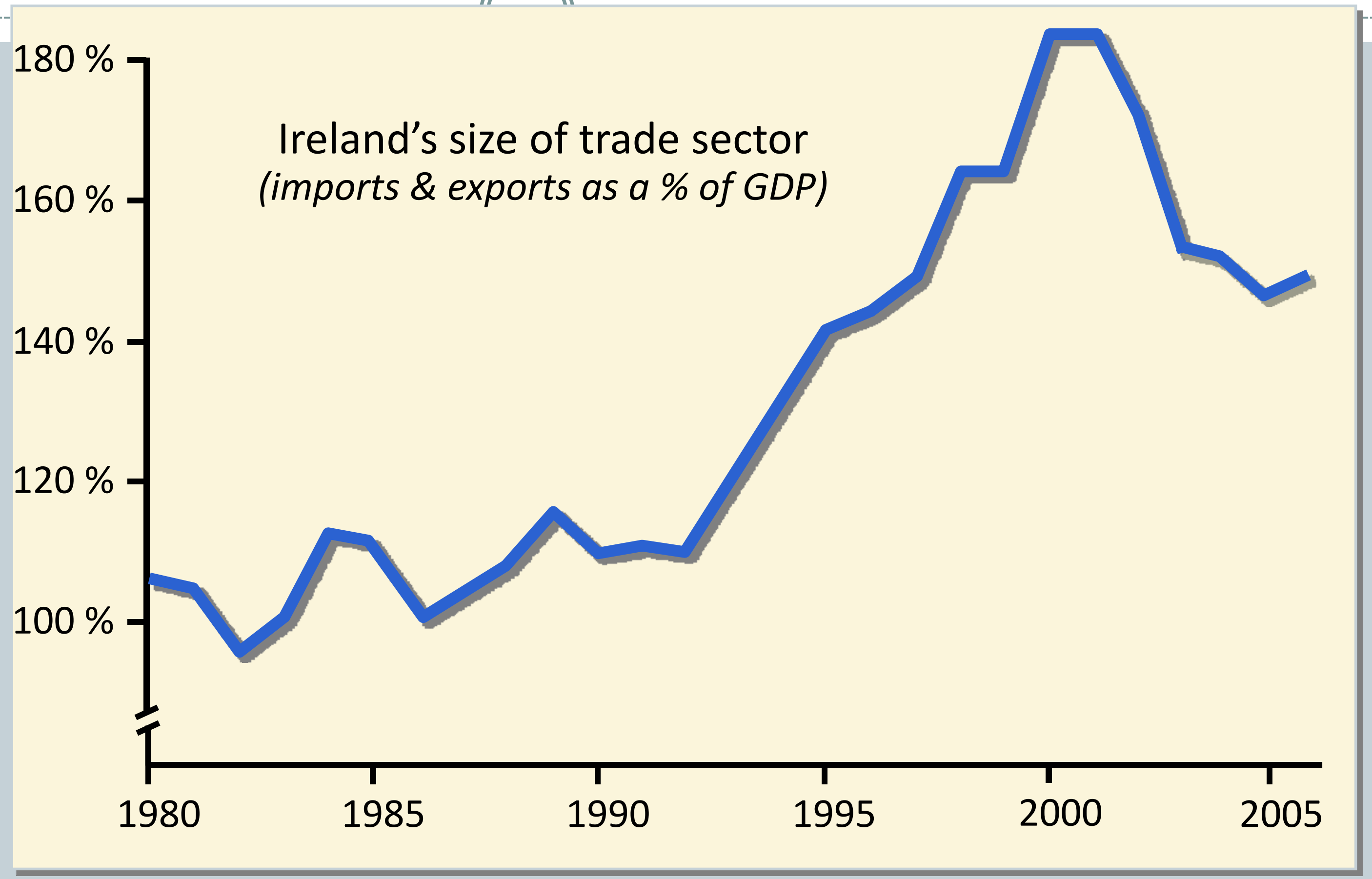
- Measured as a share of GDP, the government spending of Ireland rose throughout the 1960-1985 period, but it declined sharply in the late 1980s and again during the latter half of the 1990s.

Ireland’s Top Marginal Tax Rates



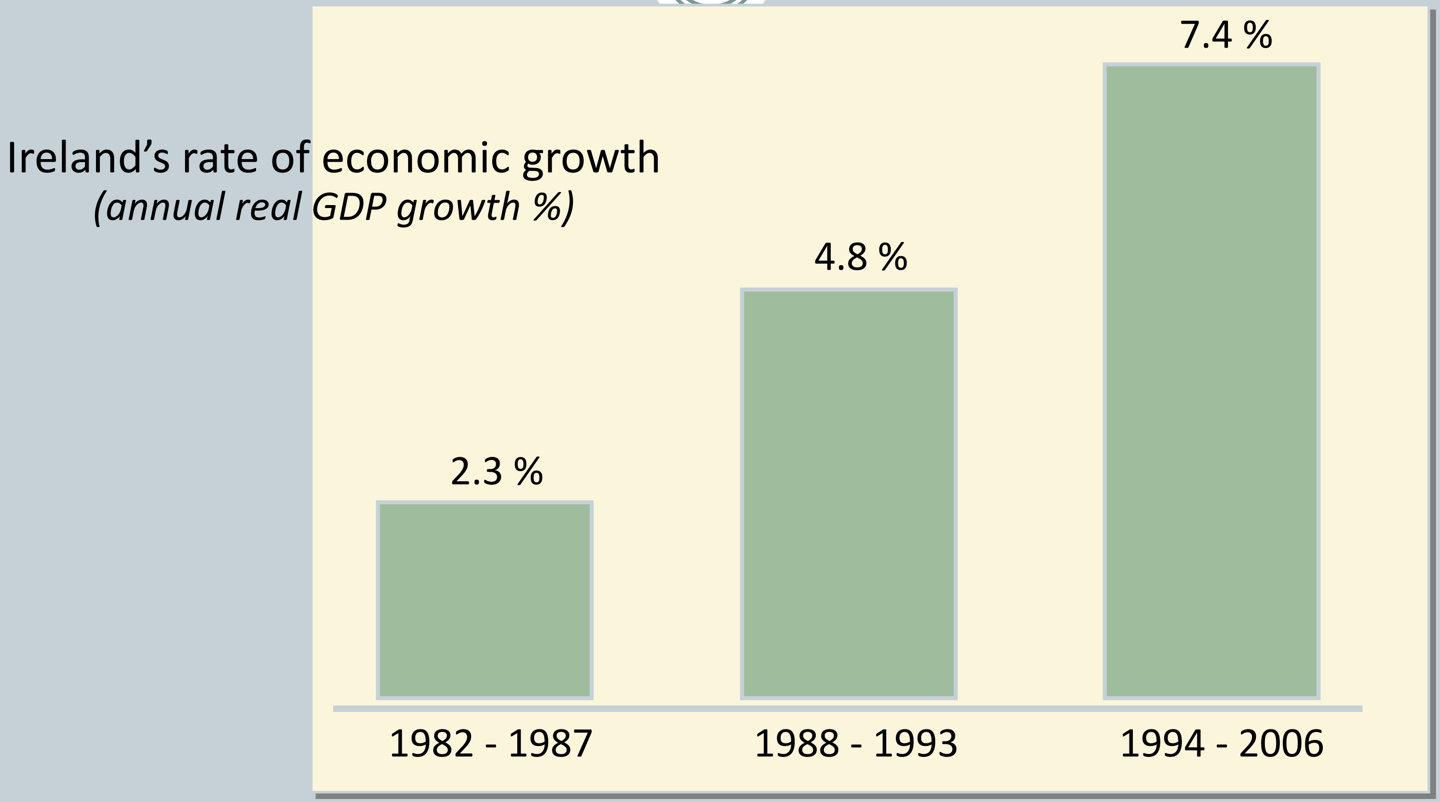
- As shown here, Ireland has reduced both personal and corporate income tax rates substantially since the mid-1980s.

Ireland's Trade Sector



- The size of the international trade sector *(exports plus imports)* increased substantially as a share of the Irish economy during the 1990s.

Ireland’s Rate of Economic Growth



- Responding to the policies of the last 20 years, the growth rate of the Irish economy increased from 2.3% in 1982-1987 to 4.8% in 1988-1993 and 7.4% in 1994-2006.

Lessons from Ireland and Elsewhere

- The Irish growth experience is not unique.
- Hong Kong, Singapore, and Taiwan followed similar policies during the 1960s and 1970s and have achieved similar results.
- More recently, countries as diverse as Chile, Mauritius, Iceland, and Estonia have adopted policies much like those of Ireland and achieved similar results.

Source: Gwartney, James, et. al. Economics: Private and Public Choice, 12th ed. Cengage Learning, 2010.

From Tax Strategy I to Strategy II and return

- Ireland pulled itself from a Strategy I country to a Strategy II country
- In recent decade has reverted to Strategy I.
  - Debt downgraded
  - Significantly lower growth and higher unemployment
  - Poor economic outlook

Evidence From the United States

- Look at difference in rates of growth and economic power between states with high reliance on personal income tax versus low with low PIT.
  - Top panel summarizes states taxing toward the top right of our chart-fewer distortions.
  - Bottom panel states tax towards the lower left of our chart.

Tax Structure and Economic Growth

	Top PIT Rate	Gross State Product Growth	Personal Income Growth	Personal Income Per Capita Growth	Population Growth
9 States w/o PIT*	**.00%**	**82.38%**	**84.12%**	**58.70%**	**15.62%**
9 States with Highest Marginal PIT	**9.17%**	**62.35%**	**63.82%**	**52.65%**	**6.33%**

Source: ALEC-Laffer State Economic Competitiveness Index, 2nd ed.

Tax Structure and Economic Growth

- Consider the growth response to lower tax and fewer distortions and consider what Georgia's could have been…..

Growth in Lowest and Highest Tax Burden States

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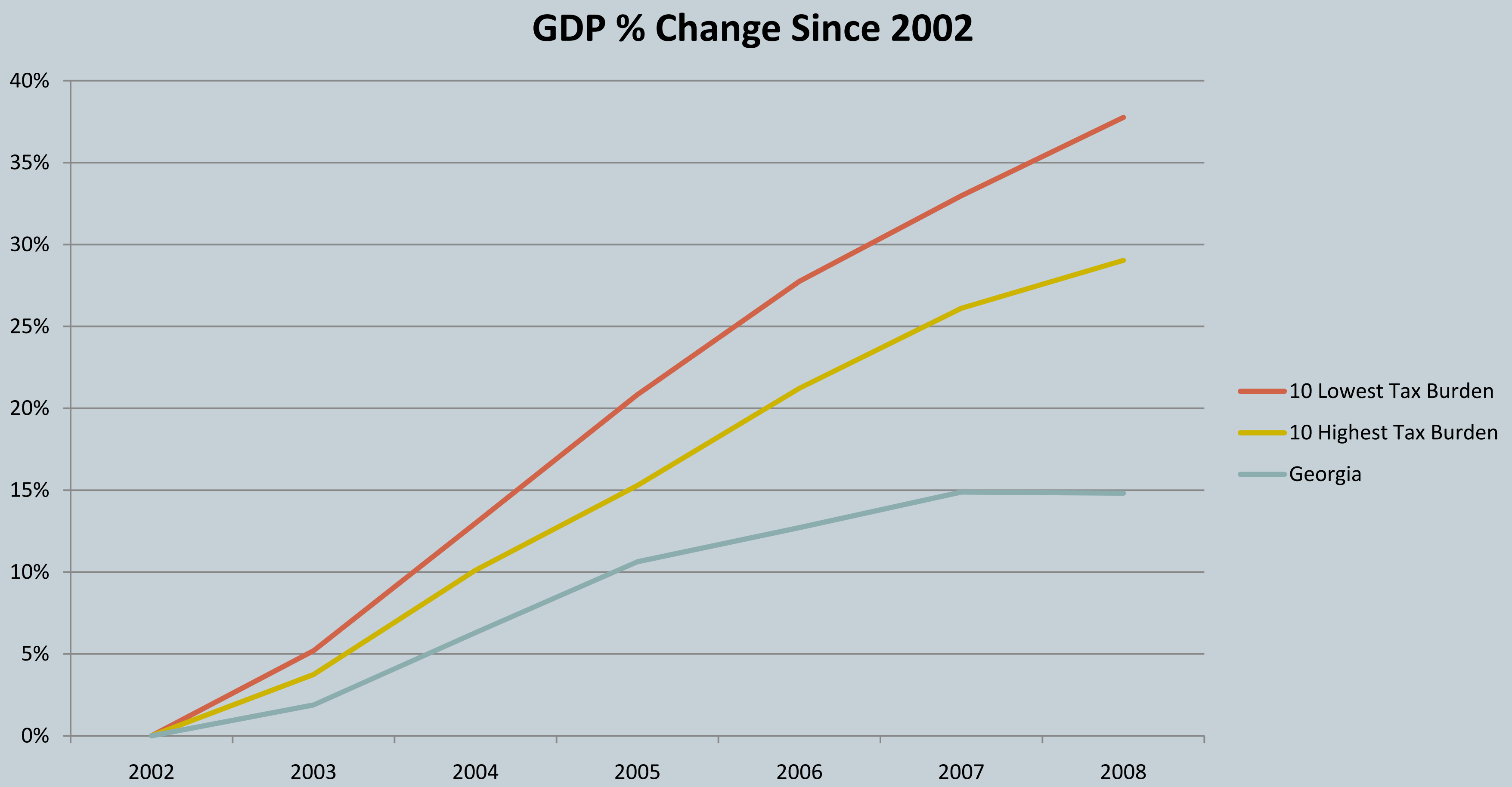

Evidence and Comparison: Georgia and a Strategy II State

- New Mexico adopted a pro-growth, Strategy II program
- Consider the growth response to lower tax and fewer distortions and consider what Georgia's could have been…..

Tax Reform: Georgia In Comparison

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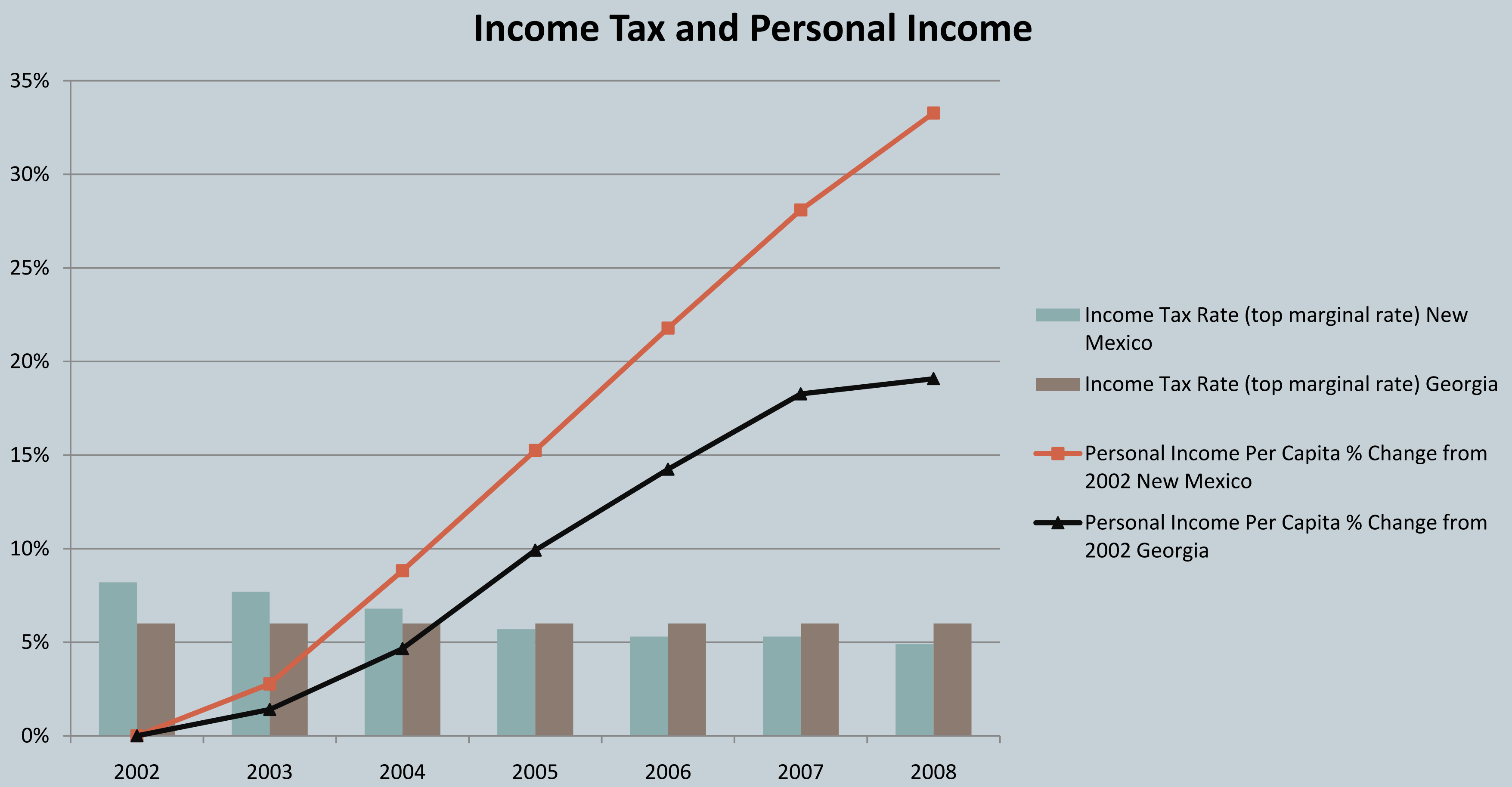
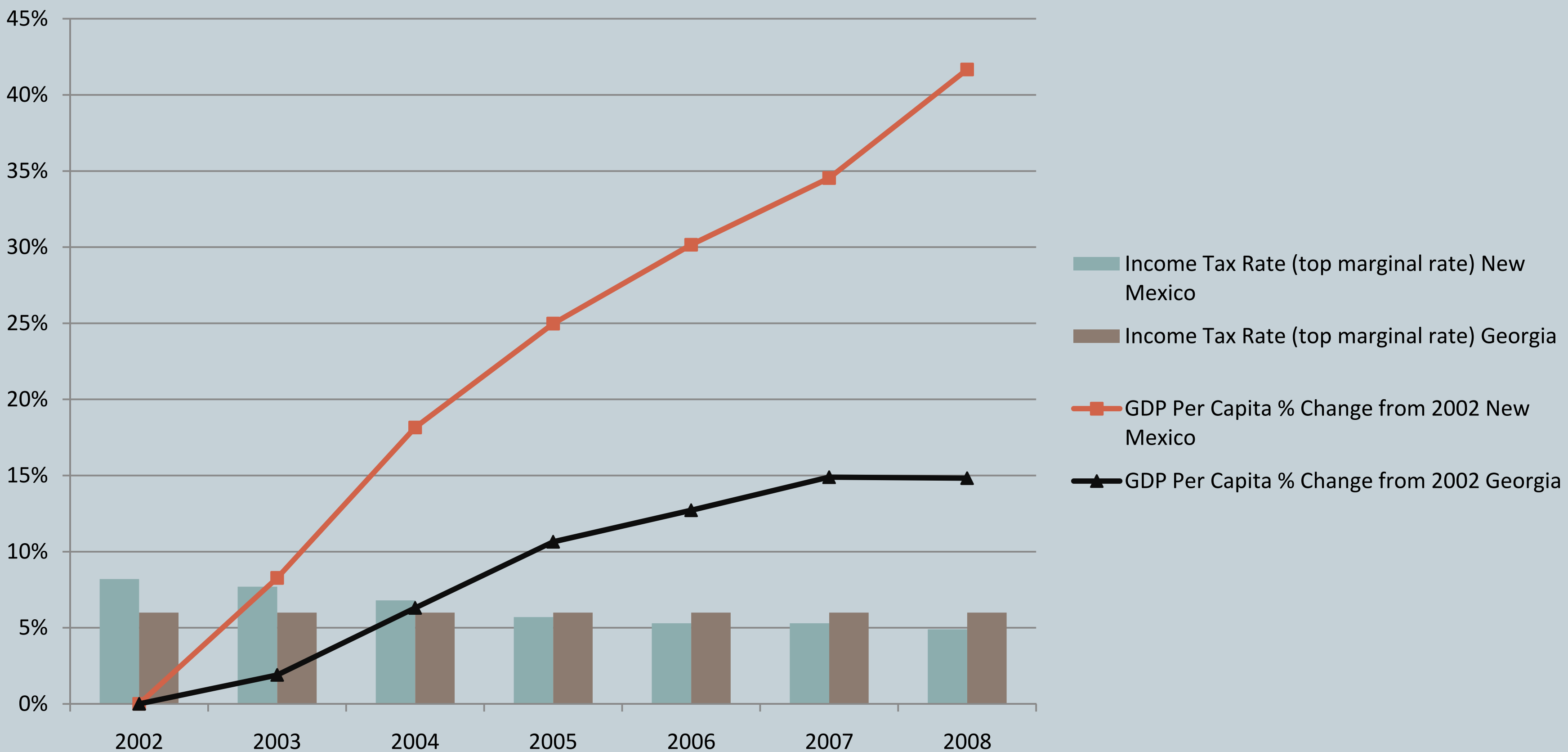


Tax Reform: Georgia In Comparison

Georgia Public Policy Foundation

Income Tax and GDP



What is Happening in Other States Now?

- All states are doing something they are calling "reform."
- States that are following Strategy II say they are making the move, even in tough recession, so they will be competitive and 'ready' when the national economy turns up
- States following Strategy I are generally saying their tax increases are temporary responses to the poor economy and will be reversed later

Case Studies: What It Looks Like on the Ground

Some examples of both strategies and one state 'in process' of reform.

First Oregon. A Strategy I state.

Strategy I Philosophy: Rather than cut expenses, raise taxes on a small and shrinking group…the higher income earners…whether individuals or businesses. Shrinking…because those higher earners are the most capable of tax-minimizing strategies such as when to realize capital gains…or, leave the state… (We all know the example of the Maryland millionaires tax and its consequences).. No sales taxes. More brackets and higher rates on higher income individuals and small business.

..tax the fellow behind the tree

The Tax Foundation - Oregon Referendum Could Reinstate Higher Income Tax Rat.pdf

Oregon Passes Tax Boost on Wealthy, Corporations.pdf

Case Studies: What It Looks Like on the Ground

State of Washington (I couldn't resist this recent WSJ editorial.....)

Strategy I writ bold

[Washington State Income Tax.pdf]

Case Studies: What It Looks Like on the Ground

Now an example of the other strategy – New Mexico. Note the differences in growth rates of economic growth and personal income. The difference grows as New Mexico progressively reduces its tax on one of the more distorting taxes.

New mexico.pdf

Tax Reform: Georgia In Comparison

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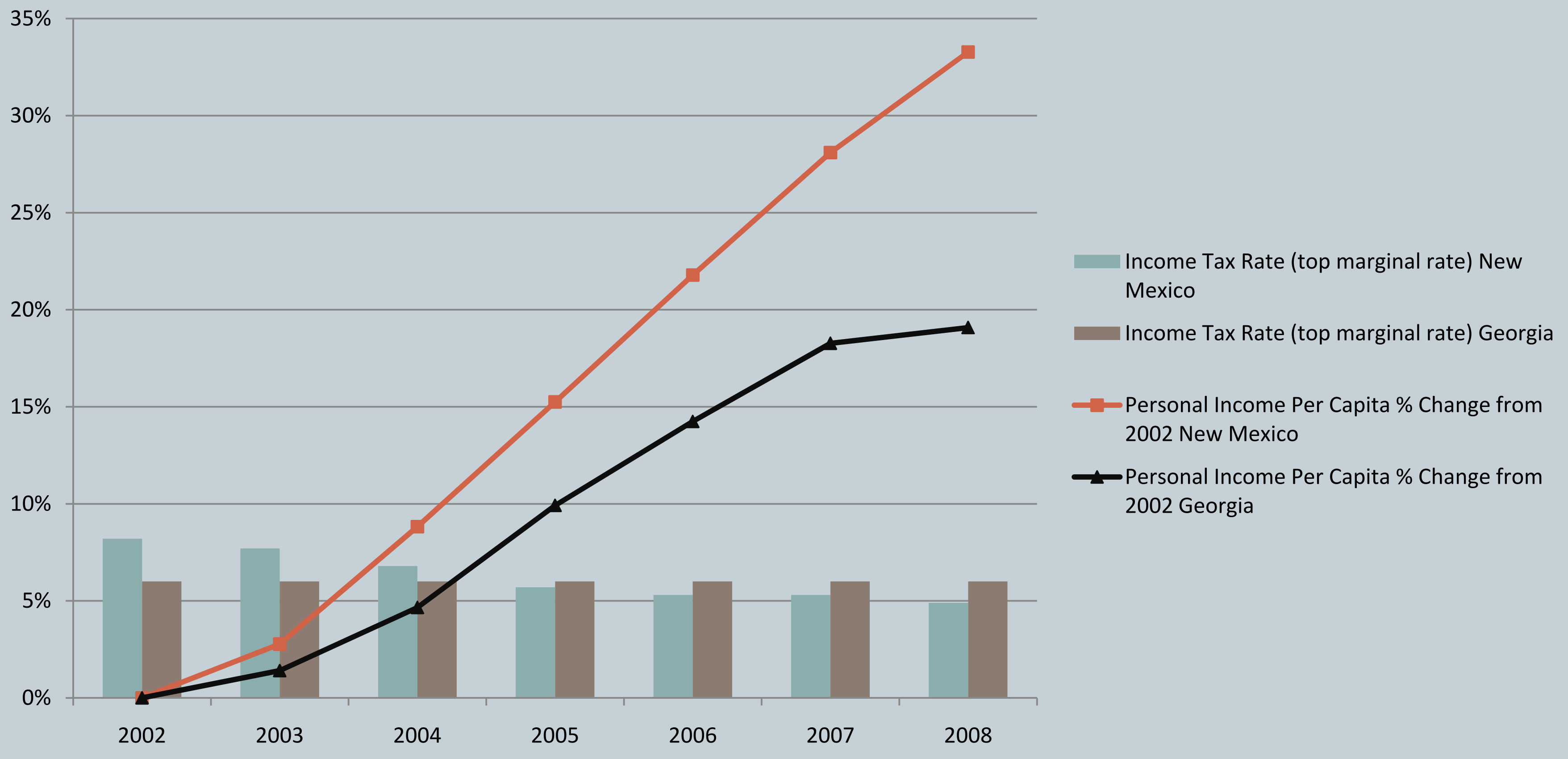
Income Tax and Personal Income



Tax Reform: Georgia In Comparison

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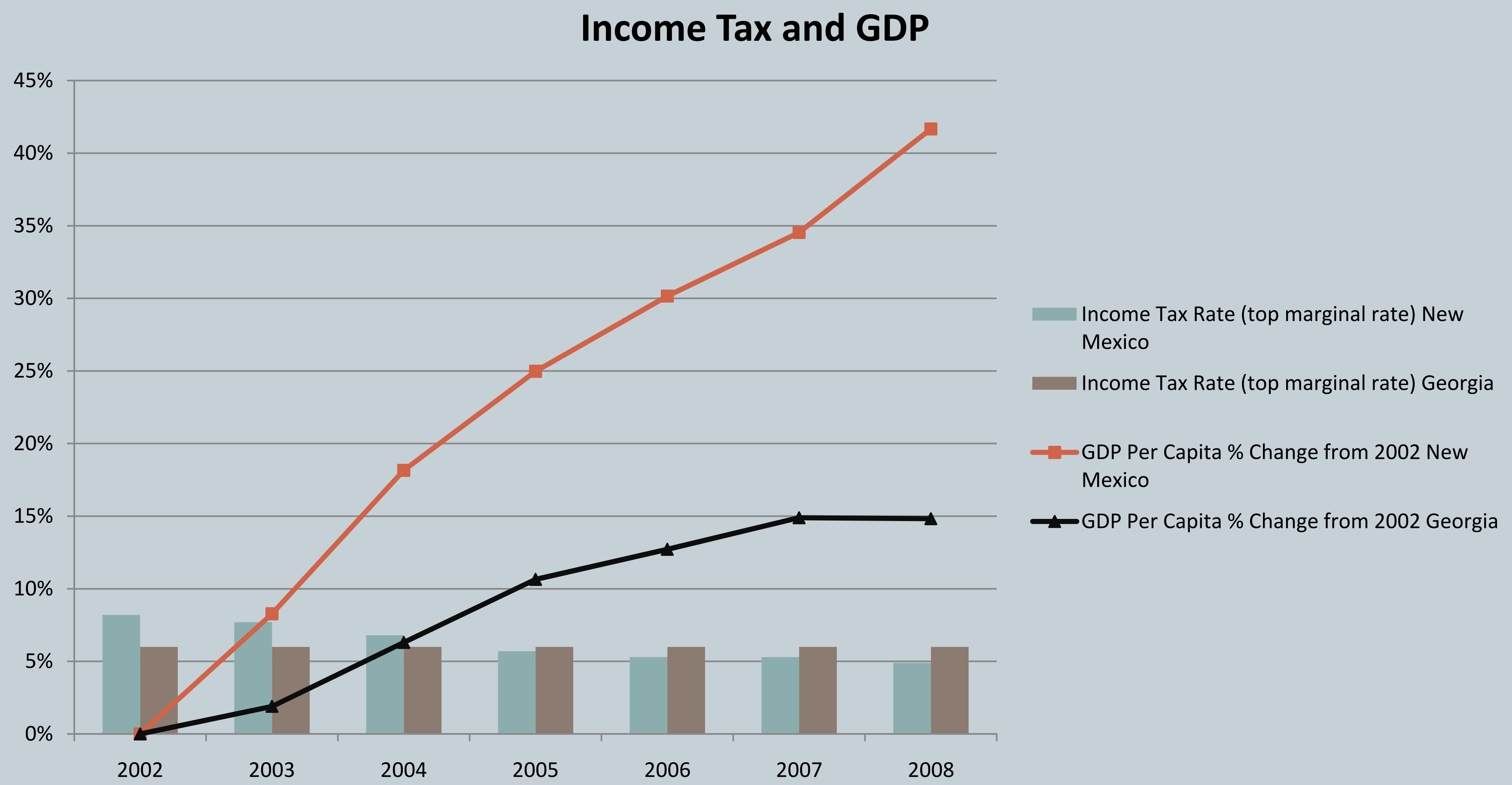

Case Studies: What It Looks Like on the Ground

And, at last, Rhode Island – a state in midpoint…(where most states are, especially with the tremendous economic and political pressures.)

RI Tax Reform comments.pdf

Homework

- So take a sheet of paper…make two columns …label them Strategy One and Strategy Two.
- Put Oregon and Washington in first column and New Mexico and Rhode Island in second.
- Now just fill in the rest…

  I'll bet most of you will add put states in the right columns with GREAT accuracy.

Georgia's Tax Reform Council

- Our job is to first to recommend the column into which Georgia will fall..
  - Strategy 1
  - Strategy 2