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Executive summary

The South's economy has changed considerably since the 1930s and 1940s. The days of travel on dusty, bad roads or by train are gone, only to be replaced by Interstate highways and airplanes. Gone are most afternoon newspapers, a lot of mill villages and corner stores. In their place are modern communications networks, factory farms and consumer superstores.

But as the economy has changed and millions of new residents have flocked to the Sunbelt, many aspects of Southern tax systems have remained static. Income tax structures, for example, have changed little from the times when \$12,000 was a good annual income. Likewise, the sales tax has continued to focus on goods purchased from local merchants, even as more and more Southern shoppers are buying services and shopping online.

In this policy book offered by the Center for a Better South, we argue it is incumbent for lawmakers across the South to revisit their state tax codes in a holistic manner to bring our tax systems into the 21st century. All components—the income tax, sales tax, property tax and others—should be thoroughly examined and modernized to

improve and ensure the fairness, adequacy and integrity of our tax systems. In other words, lawmakers can truly represent people across the South by restructuring state tax codes to make them more representative of today's complex and rapidly changing economy.

This publication is the first of a Better South series that will examine tax and budget issues in the Southern states. The 11 ideas presented in this discussion are an introduction to progressive tax reform that can lead us to a truly better South. Among the ideas explored in *Doing Better: Progressive tax reform for the American South* are:

Idea 1: Broaden the sales tax base. Each Southern state should abolish sales tax holidays and review sales tax exemptions to eliminate those that don't meet contemporary economic needs.

Idea 2: Modernize sales taxes for the new economy. Each Southern state should modernize its policy on taxing services and Internet sales to respond to the region's shift to the knowledge and service economy.

Idea 3: Raise cigarette taxes to promote public health. Each Southern state should raise cigarette taxes to the national average of \$0.92 per pack to reduce smoking and promote public health.

Idea 4: Enact a state Earned Income Tax Credit. Each Southern state with an income tax should enact a refundable earned income tax credit to bring working families' incomes above poverty.

Idea 5: Modernize state income brackets.

Each Southern state with an income tax should modernize its income tax structure by adjusting brackets and consider creating a new top rate to provide progressive balance.

Idea 6: Deal with hidden income tax

increases. Each Southern state with an income tax should modify its tax policies to account for inflation to preserve long-term fairness and reduce back-door inflationary tax hikes.

Idea 7: Rethink tax relief based on age alone.

Each Southern state should redesign tax codes to provide fair tax treatment to seniors so benefits are based on ability-to-pay instead of age alone.

Idea 8: Eliminate corporate tax loopholes.

Each Southern state should review and update its income tax structures to eliminate corporate tax loopholes and promote fairness.

Idea 9: Enact a property tax circuit breaker.

Each Southern state should consider enacting a property tax circuit breaker to shield residents from excessive taxation and connect property taxes with ability-to-pay.

Idea 10: Strengthen accountability for better

decisions. Each Southern state should annually publish a comprehensive tax expenditure report to provide more accountability and information to lawmakers so they can make better decisions.

The report should highlight missed revenue opportunities due to tax exemptions, breaks and deductions.

Idea 11: Conduct performance reviews. Each Southern state should conduct a comprehensive performance review to boost government efficiency, save money and improve customer service.

To learn more about the Center for a Better South, go online to:

www.bettersouth.org

For frequent postings of news articles and discussions related to issues followed by the Center, visit our ThinkSouth blog at:

www.thinksouth.org

A few words about terms

Throughout this publication, you will find words like fairness, equity, adequacy, transparency and neutrality in *italics*. If you're unsure of the meaning of an italicized term while reading any of the ideas that follow, we encourage you to refer to this opening section of definitions to refresh your memory.

These economic terms are fundamental tax principles that describe the benefits of the 11 tax modernization and reform ideas presented in this publication. Each of our ideas strengthens one or more of these principles.

If Southern lawmakers use the ideas in this book holistically—as the backbone of several institutional reforms for their state's tax code—the tax system of their states should become more *progressive*. These long-standing tenets of good tax systems are accepted by many economists throughout the nation:

Fairness. “*Fairness*” refers to the treatment of taxpayers according to their *ability-to-pay*. *Fairness* can be achieved through both *horizontal* and *vertical equity*.

Horizontal equity means taxpayers with a similar *ability-to-pay* or circumstance receive similar treatment under the tax system. For example, a property tax system has *horizontal equity* when neighbors along the same street pay the same rate of tax, regardless of the worth of their tax.

Vertical equity, on the other hand, refers to taxpayers with differing abilities-to-pay. In terms of *vertical equity*, a *regressive* tax system takes a greater portion of income from lower-income citizens than from higher-income citizens. Sales taxes, for example, are *regressive* because poorer people generally pay a greater share of their income to pay these taxes, compared to wealthier people. On the other hand, a *progressive* tax system places a higher tax rate on higher levels of income. Therefore, those with a higher *ability-to-pay* spend a larger share of income in taxes. The income tax system, when set up three generations ago, was set up as a *progressive* tax system because people with higher incomes were to pay more in income taxes.

Note: When the term “progressive” is used in economic discussions, it should not be confused with the political term “progressive.” The former has a specific economic meaning, as outlined above. The latter, which is not italicized when used in this book, has a broader non-partisan meaning that can be equated to “moving things forward to benefit all in a fairer way.” A progressive policy idea moves political debate forward toward a new solution or policy.

Adequacy. A tax system is “adequate” if it raises enough revenues to fund the government services that citizens call for. To achieve this *adequacy*, the tax system should grow as the economy grows and do so at a stable, predictable pace. Other tax terms associated with *adequacy* are elasticity, stability and predictability.

Neutrality. A “neutral” tax system does not affect the economic decisions of taxpayers. For example, if a taxpayer purchases one item over another because of taxes, then the tax system is not neutral.

Transparency and simplicity. “*Transparency*” and “*simplicity*” refer to the ease with which taxpayers can understand and comply with their tax obligation and government can administer and enforce the tax system. Simplifying a tax system removes obstacles that make the tax system more complex to follow and administer.

There are other principles of tax policy, such as accountability, exportability and economic efficiency, that can also strengthen or improve state tax systems. This publication, however, will focus primarily on the principles detailed above. Due to the *regressive* nature of state and local tax systems across the South, we will take a particular look at ways to improve *fairness* and *progressivity* in Southern tax systems.

Readers also might benefit from a brief explanation of a few other tax-related terms used in this publication:

Ability-to-pay. Often considered a form of “means-testing,” “*ability-to-pay*” is a term that refers to a taxpayer’s capacity to pay a particular tax based on their income or wealth. For example, a family making \$15,000 will feel a sales tax increase more than a family making \$250,000 since the lower-income family already consumes most, if not all, of its income. The lower-income family is said to have a lower or limited *ability-to-pay*. In tax systems, the income tax recognizes *ability-to-pay* by having a *progressive* rate system that places a higher tax rate on higher levels

of income. In contrast, sales taxes, which have a flat rate, do not recognize *ability-to-pay* and take the same amount of money from low and high income consumers.

Performance review. As outlined in Idea 11, a *performance review* is a management tool to review government functions to find savings, remove duplication, improve government efficiency and provide better service to state residents.

Tax expenditure. A *tax expenditure* is an amount of revenue that a government will lose because it extends a tax credit, tax exemption or tax break to a group or organization. For example, if a state loses \$1 million because it doesn't charge sales tax on newsstand newspaper sales, the state has a *tax expenditure* of \$1 million in potential lost revenue.

Tax preference. As used in this publication, "*tax preference*" is a broad term used infrequently to refer to a preferable tax treatment given to one group over another. For example, providing a lower property tax rate through homestead exemptions for seniors gives them a property *tax preference* because of their age alone. This term often is related in discussions to *ability-to-pay*.

Tax threshold. The *tax threshold* for any taxpayer is the point at which they start paying taxes. If, for example, all families in a state have a \$10,000 income tax exemption, their income *tax threshold* is \$10,000 because they won't be charged income taxes on income up to \$10,000.

For a fuller discussion of economic terms used throughout this work, you may want to go online to the following link:

http://www.irs.gov/app/understandingTaxes/jsp/tools_glossary.jsp