Tax Restructuring, Reassessment and Indiana Household Tax Payments

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The year 2003 will see the biggest changes in Indiana state and local taxation in at least 30 years. Reassessment will change property tax bills more than usual, because the courts have ordered that new assessments be done using market values. Tax restructuring, passed in June 2002, will change sales taxes, individual income taxes, corporate income taxes, cigarette taxes and gasoline taxes, as well as offer significant new property tax relief. How will Indiana households fare in the face of these changes?

This study uses a computer model to apply these tax changes to a series of average households with different characteristics to measure the overall effects on household tax bills. The model takes into account characteristics such as household members who are older than 65 or the number of parents and children in families at different income levels. Thus, the model allows us to view a "snapshot" of what the tax burden is like for a specific kind of family.

Who?

- Incomes $15,000 to $150,000
- Household sizes 1, 2 and 4
- Homeowners and Renters
- Under Age 65 and Over Age 65
- Smokers and non-smokers

The household tax incidence model includes 36 households with the following characteristics. Each household has one of six income levels: $15,000, $25,000, $50,000, $75,000, $100,000 and $150,000. Each household has one, two or four members. The four-member household is assumed to have two children. Households are either renters or homeowners. If they are homeowners, we assume that the value of the home increases with income. The two-person household can have its members be under age 65, or age 65 and over. The adults in the household may be smokers or non-smokers. Data from the U.S. Department of Labor's Consumer Expenditure Survey is used to determine the spending levels on goods and services by households with each of these characteristics.

Property Tax Reassessment

- Assessed values to market value
  - Assessment ratio from 48.1% to 100%
  - Increase by a factor of 2.1
- Gross tax rates fall
  - From \$3.37 per \$100 AV to \$2.26 per \$100 AV
  - Decline by one-third

In 1998 the Indiana Supreme Court found Indiana's property assessment rules to be unconstitutional. As a result, the current reassessment will be done on a market value basis, that is, based on predicted selling prices. Under the old rules, the average Indiana house was assessed at about 48.1% of its market value. Under market value assessment, property will be assessed at 100% of market value. The assessed value of the average house, then, will increase by a factor of 2.1. Keep in mind, however, that Indiana's state property tax controls prevent the tax levy—the amount of revenue collected—from rising in proportion to assessed values. This means that the tax rate will fall, because lower rates will be required to raise a given levy from the increased assessments. On the average across the state, the property tax rate is expected to fall from \$3.37 per \$100 assessed value to \$2.26 per \$100 assessed value, a decline of about one-third. With assessments doubling but rates falling by only a third, household tax payments would rise substantially (by about 33% for the average homeowner). Nonetheless, several provisions of tax restructuring will offset this potential tax hike.

Tax Restructuring

- Sales tax increase from 5% to 6%
- Cigarette tax increase from 15.5 cents to 55.5 cents per pack
- Gasoline tax increase from 15 cents to 18 cents per gallon

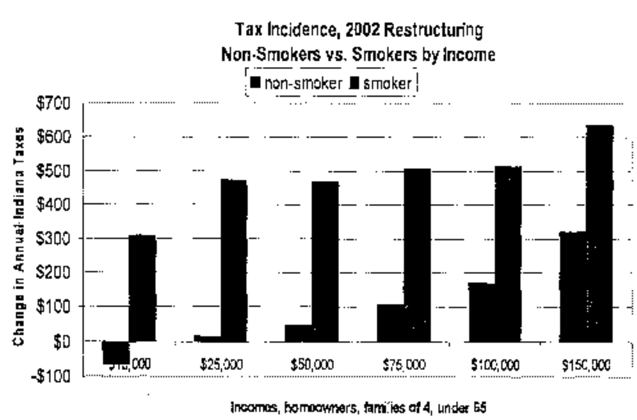
Tax restructuring was designed to provide funds for property tax relief, and to partially close the state budget gap resulting from the recession. The legislature passed about $1.5 billion in tax increases. More than half of this increase comes from the one-cent rise in the sales tax rate, from 5% to 6%. The sales tax hike took effect on December 1, 2002. The cigarette tax was increased from 15.5 cents to 55.5 cents per pack on July 1, 2002. The gasoline tax increased from 15 cents to 18 cents per gallon on January 1, 2003. An additional increase in riverboat gaming taxes is not considered in this study.

About $500 million from this tax hike will be added to the state budget, with the remaining one billion dollars to be used to fund tax cuts. Two changes were made in individual income taxes. The renters deduction was increased from $2,000 to $2,500. At the 3.4% state income tax rate, this will save renters an added $17, more if the renter lives in a county with a local income tax. Indiana's earned income credit was calculated with a $12,000 maximum income. It will be revised for the 2004 tax year to be 6% of the Federal earned income credit. Households with two children are eligible for this credit at incomes up to $34,000, meaning the new Indiana credit is much more generous than the old. Most of the tax relief offsets property taxes, however. The state will remove 60% of the school general fund from the property tax, to be replaced by state aid. The existing property tax replacement credit (PTRC) will be revised.

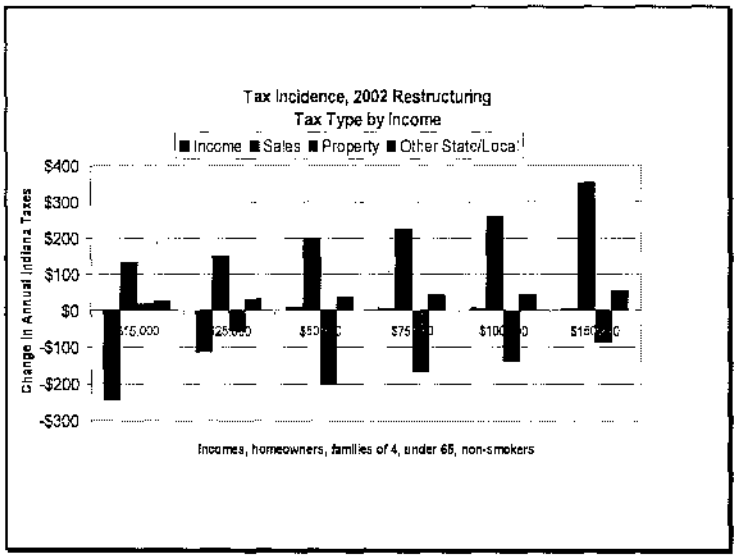
Tax Restructuring

- Renters income tax deduction from $2,000 to $2,500
- Indiana Earned Income Credit to 6% of Federal credit
- School PTRC, 60% of school general fund
- Revised existing PTRC, applies only to real property
  - Combined PTRC about 30% of tax bills
- Homestead credit from 10% to 20%
- Homestead exemption from $6,000 to $35,000

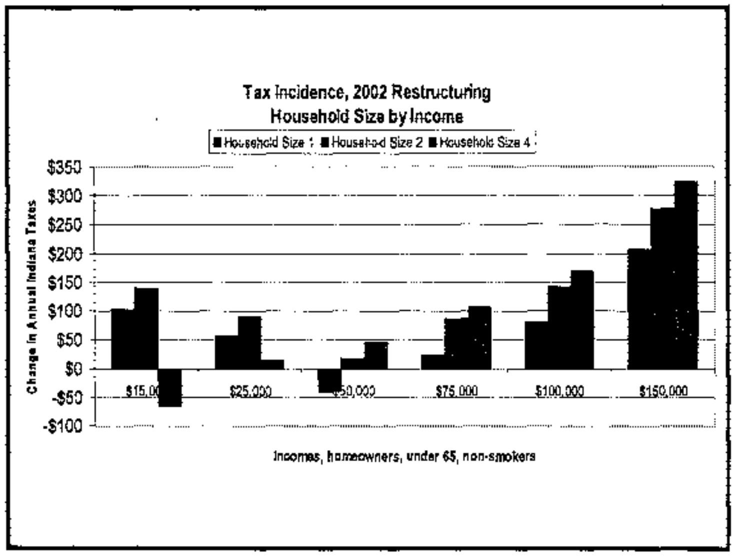
Combined, these two credits will reduce property taxes about 30%, compared to 14% under the current PTRC program. The homestead credit will rise to 20% from 10%, and this is applied to homeowner tax bills after they are calculated. The homestead exemption will subtract $35,000 from the assessed value of homes, rather than $6,000. (Note: the recent discovery that the homestead credit has been overpaid for the past 17 years is not included in this study. Homestead credit payments will likely be reduced by about 40% if the correct rules are used). But what influences tax incidence the most?



What matters most for tax incidence under reassessment and restructuring is whether or not the adults in the household smoke. Based on Indiana survey data and cigarette revenue collections, it is estimated that the average Indiana smoker smokes one and a third packs a day. About a quarter of Hoosiers smoke. If both adults smoke in a four person, $50,000, home-owning household, their tax payments will rise by almost $500 under reassessment and restructuring. A non-smoking household with the same characteristics would see a tax hike of about $50. The rest of the tax comparisons made in this study will assume that the members of the households are non-smokers.

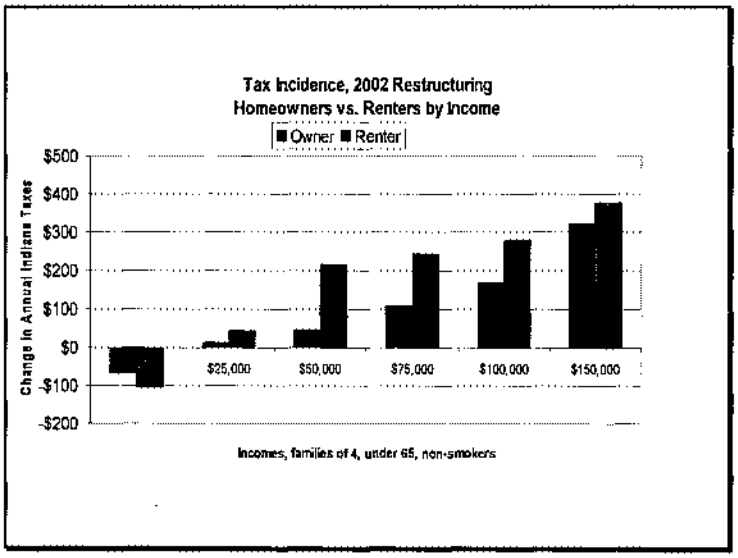


This chart divides the tax changes into four components, by tax type. The first bar shows changes in income tax payments for a family of four, homeowner, under age 65, non-smokers, by income level. The households with incomes of $15,000 and $25,000 are eligible for the new Indiana earned income credit. They were not eligible for the old credit. This reduces their income tax payment (in fact, they receive refunds greater than their tax liabilities). There are no significant changes in individual income tax payments for households with higher incomes. Sales taxes increase for every household, more for those with higher incomes because they spend more on taxable goods. Note, however, that the $130 sales tax hike probably hurts the lowest income household more than the bigger $350 hike hurts the highest income household. As a share of income, the lower income households see bigger sales tax increases. The sales tax is often called regressive for this reason. Property taxes decline most for the middle-income homeowners. The "other state/local" tax bar represents only the gasoline tax (since these households are non-smokers). Households pay added gasoline tax based on the amount of gasoline they buy. Higher income households buy more.

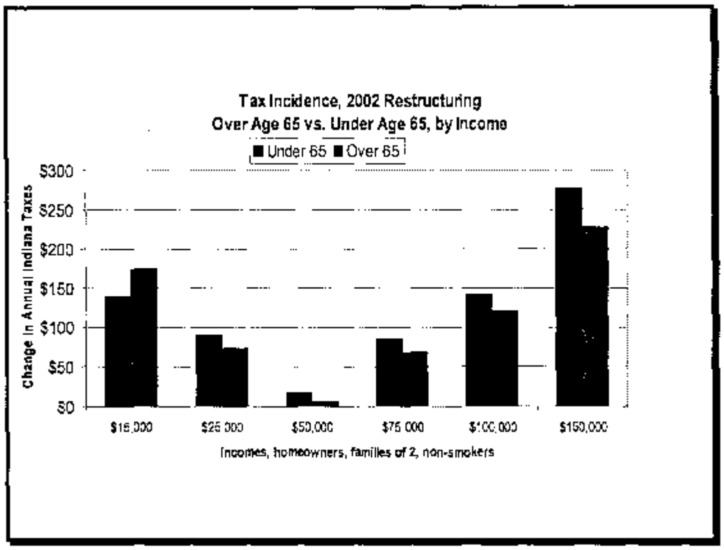


Here we see the overall changes in tax payments by income and household size. Lower income households with four people, including two children, are eligible for the new earned income credit, and so see overall tax cuts (at $15,000) or small tax increases (at $25,000). The other households pay more as incomes increase, mostly because of rising sales tax payments. For households with incomes $50,000 and over, bigger households see bigger tax hikes. This is because a family of four with a particular income will spend more than a one or two-person household with the same income. More spending means more sales tax payments. For one and two-person households, not eligible for the earned income credit, the chart shows a U-shape. The household with $50,000 income has the

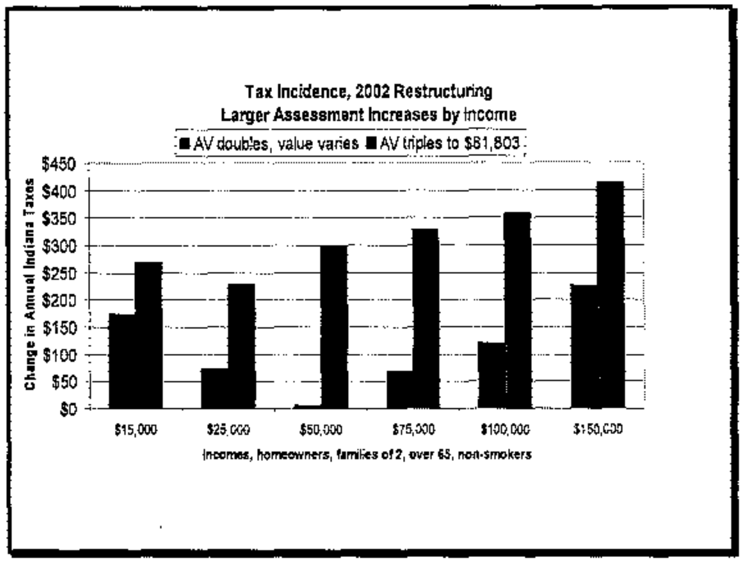
smallest tax hike, those with lower or higher incomes see bigger tax hikes. The reason for this is a quirk in the homestead exemption. This exemption subtracts $35,000 from the assessed value of homes, up to 50% of the home's assessed value. The homeowners in this model with incomes of $15,000 and $25,000 own homes assessed at less than $70,000, so they cannot take full advantage of the exemption. Their property taxes are not cut as much. Upper-income homeowners have houses with much higher assessments. The $35,000 exemption is relatively insignificant for their overall tax bills. The middle-income homeowner can take full advantage of the exemption, and it reduces the home assessments by a large percentage. This household sees the greatest benefit from this tax break, and so sees the smallest overall tax hike.



Most of the tax relief provided by restructuring was aimed at reducing the property taxes of homeowners. It is no surprise, then, that renters do not fare as well. Households with incomes $25,000 and up see bigger tax hikes if they are renters. At the lowest income level, the value of the increased renters income tax deduction is greater than the small tax benefit homeowners receive from the $35,000 homestead exemption (capped at 50% of value). Both are eligible for the new earned income credit. The lowest income renters see bigger tax cuts than the lowest income homeowners.



In general, households 65 years old and older see smaller tax hikes than those under age 65. This is because a larger share of older people's spending is on medical care and drugs, which are not sales taxable. A larger share of their spending is not subject to the higher sales tax, so their sales tax increases are smaller. However, at the lowest income level, households over age 65 see bigger tax increases. Homeowners with incomes this low are eligible for the over-65 property exemption. The exemption subtracts up to $6,000 from the taxable value of the home. Tax restructuring did not increase this exemption, however. With the fall in the property tax rate due to reassessment, the exemption is worth less than it was under the old higher rates. The decline in the value of this exemption is enough to offset the lower sales tax bills of over-65 households with the lowest incomes.



A concern with reassessment is that older homeowners on fixed incomes, with older houses, will see particularly large tax increases. It appears that this concern is appropriate. Here it is assumed that all households over age 65 own houses assessed at about $82,000, the value of the $50,000 income family home. It is also assumed that this is an older house, which, under the old assessment rules, was valued at about $27,000. Older houses under the old assessment rules were valued less than newer houses, even if they had the same market value. This will not be true under the new rules. This means that the assessments of older homes will increase more than the assessments of newer homes. Here it is assumed that older home assessments will triple. Under these conditions, all households see tax increases of at least $275, and each household sees an increase higher than under the usual doubling of assessments.

Incidence Results

- Smoking matters most—smokers pay a lot more added tax
- Higher income households spend more, pay more in added sales taxes
- But low income households pay more in added sales taxes as a share of their incomes
- Bigger households pay more added sales tax
- New Indiana earned income credit is more generous than the old credit, which cuts taxes of lower income households, especially those with children

Incidence Results

- $35,000 Homestead Deduction has a cap at 50% of assessed value, so owners of mid-valued homes benefit most
- Most tax relief went to property owners, so renters pay more added tax
- Higher renters income tax deduction means lower income renters see bigger tax cuts than lower income homeowners

Incidence Results

- Medical care and drugs are not sales taxable, so most older households pay less added tax
- Size of the over-65 property tax deduction did not increase, so lower income households over age 65 pay more added tax
- Low income households over age 65 with older homes could see sizable tax increases, because of bigger assessment increases

These tables summarize the findings of this study. In general, lower income non-smoking households with children benefit from reassessment and restructuring, because of the new, more generous Indiana earned income credit. These households may see tax cuts; most others see tax increases. Smokers in particular see large tax hikes. Otherwise, the smallest tax increases appear to go to middle income homeowners, mostly because they can take full advantage of property tax relief, and the relief is significant relative to the values of their houses.