The Distributional Impact of the Indiana Tax System: Past, Present & Future

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Objectives

- Put the level of Indiana's taxes in national perspective
- Put the distribution of Indiana's taxes in national perspective
- Highlight Indiana's tax treatment of low-income families
- Draw implications for future changes in tax policy

Indiana is a low- tax state

- Combined state/local taxes as share of total personal income (FY2000)
  - Indiana: 10.2%
  - U.S. average: 10.8%

Indiana ranks 39th out of 50 states

- Highest: New York — 13.9%
- Lowest: New Hampshire — 8.3%

Tax collections data used to prepare all rankings reported here are collected by the U.S. Census Bureau and published in the "Government Finances" series. FY2000 is the most recent year for which such data are available.

State/Local Taxes as Share of State Personal Income, FY00

		Indiana's Rank
Indiana	10.2%	
Neighbors	10.7%	Lowest of 5
Great Lakes	11.0%	Lowest of 6
Industrial	10.6%	Lowest of 6
High-tech	10.6%	2nd lowest of 7
"Competitors"	10.6%	6th lowest of 21
All	10.8%	12th lowest of 50

"Neighbors" are IN, IL, KY, MI, OH.
"Great Lakes" are IN, IL, MI, MN, OH, WI
"Industrial" are IN, IL, MI, NJ, OH, PA
"High-tech" are IN, CA, MA, MN, NC, TX, WA
"Competitors" are all of the above plus AR, CT, FL, IA, ME, MO

State/Local Taxes as Share of State Personal Income, FY00

Indiana's low <u>combined</u> state and local tax level reflects varying rankings for "Big Three" taxes

- **Sales tax**
- **Income tax**
- **Property tax**

State/Local Sales Taxes as Share of State Personal Income, FY00

		Indiana's Rank
Indiana	**2.2%**	
Neighbors	**2.3%**	**2nd lowest of 5**
Great Lakes	**2.3%**	**2nd lowest of 6**
Industrial	**2.1%**	**3rd highest of 6**
High-tech	**2.8%**	**3rd lowest of 7**
"Competitors"	**2.7%**	**6th lowest of 21**
All	**2.7%**	**10th lowest of 45**

Note, of course, that this ranking was calculated before the recent increase in the sales tax rate from 5% to 6%

State/Local Income Taxes as Share of State Personal Income, FY00

		Indiana's Rank
Indiana	2.7%	
Neighbors	2.8%	2nd lowest of 5
Great Lakes	2.9%	2nd lowest of 6
Industrial	2.6%	3rd highest of 6
High-tech	2.6%	2nd lowest of 7
"Competitors"	2.4%	middle of 21
All	2.6%	18th lowest of 41

The lower reliance on the income tax of "high tech" states than of Indiana shown in this slide is significantly distorted by fact that Texas, a very large state, does not have an income tax. Among "high tech" states WITH an income tax, Indiana ranks lowest in reliance on that tax.

State/Local Property Taxes as Share of State Personal Income, FY00

		Indiana's Rank
Indiana	3.5%	
Neighbors	3.3%	2nd highest of 5
Great Lakes	3.4%	3rd highest of 6
Industrial	3.5%	3rd highest of 6
High-tech	2.9%	highest of 7
"Competitors"	3.1%	6th highest of 21
All	3.1%	13th highest of 50

Level and Mix of Indiana Taxes As of FY2000

- Low-tax state overall
- Below-average reliance on sales tax
- Above-average reliance on property tax
- Average reliance on income tax

Indiana's Taxes: Low for Everyone?

- While Indiana's taxes are relatively low overall, this can't be said of taxes on low-income Hoosiers
- According to new *Who Pays?* study by Inst. For Taxation & Econ. Policy (ITEP), 20% of (non-elderly) Indiana households with lowest incomes devote 11.7% of income to paying state/local taxes

Who Pays? is available at http://www.itepnet.org/whopays.htm

Indiana's Taxes: Low for Everyone?

11.7% of income devoted to paying state & local taxes is 13th-heaviest burden among 50 states for bottom 20% of income distribution

- heaviest: WA (17.6% of income)
- lightest: AL (3.8% of income)

This estimate does incorporate 2002 tax changes (e.g., expanded EITC)

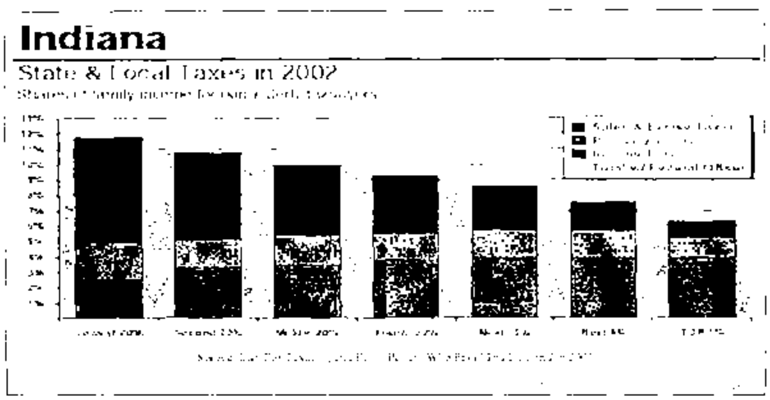
Source: ITEP, *Who Pays?* "EITC" refers to the Earned Income Tax Credit.

Indiana's Taxes: Regressive

A tax — or an entire tax system — is "regressive" when lower-income taxpayers devote a greater share of their income to paying the tax(es) than do higher-income taxpayers

Indiana's tax system — like that of all but 8 states — is regressive.

Indiana's Taxes: Regressive



As ITEP's data indicate, the 20% of households with the lowest incomes must devote 11.7 percent of their incomes to IN state/local taxes, while the top 1% of households devote just 6.3 percent of their incomes to taxes. The 60 percent of households in the middle of the income distribution devote 10.0% of their incomes to IN state/local taxes.

Indiana's Taxes: Among the [illegible] Regressive

6.3% : 11.7% ratio of share of income devoted to s/l taxes by top 1% of households as compared to bottom 20%

Is the 15thth lowest ratio among all 50 states

By this measure, Indiana has the 15th most regressive state/local tax structure in the country

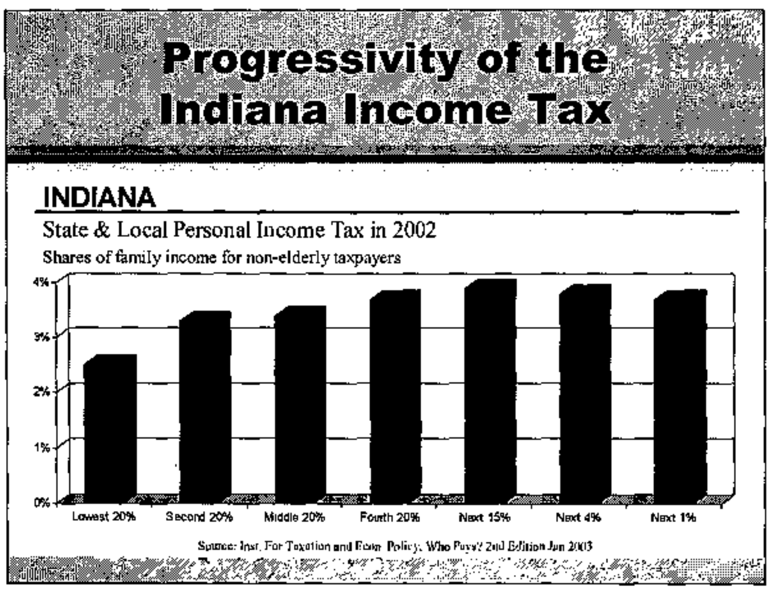
Q: Why does Indiana have a regressive tax system?

Answer:
Indiana's personal income tax

Is barely progressive, and

Is not sufficiently progressive to significantly counteract the regressivity of sales, property, and sin taxes.

It was shown above that Indiana relies on the personal income tax somewhat more than most states. So it is the structure of the personal income tax rather than a low level of reliance on this tax that contributes to the regressivity of Indiana's overall tax structure.



The top 1% of Indiana families devoted an average of 3.7 percent of income to Indiana state and local income taxes, barely more than the bottom 20% of families, who devoted an average of 2.5 percent of income to personal income taxes.

The 60 percent of households in the middle of the income distribution paid an average of 2.9 percent of income in Indiana s/l income taxes

Progressivity of the Indiana Income Tax

Indiana's Personal Income Tax (PIT) is 2nd least progressive of all 41 broad-based state PITs

This is true even after 2002 expansion of earned income tax credit (EITC)

Only 5 of these 41 states (AL, IL, LA, ND, PA) place lower PIT burdens on highest-income households than does IN

Source: ITEP, *Who Pays?*

Progressivity of the Indiana Income Tax

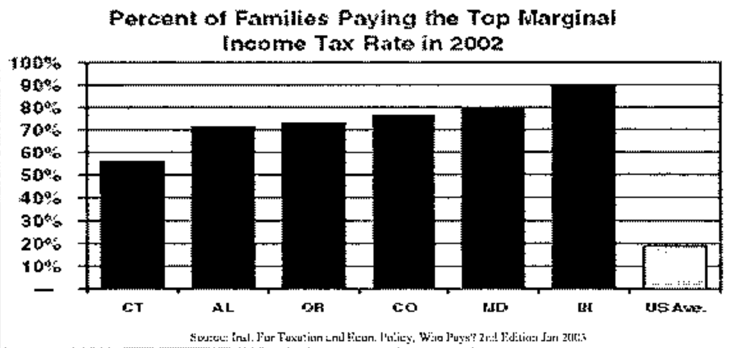
35 states have progressive bracket structures like federal PIT

Only 6 states have flat-rate PITs like Indiana's (CO, IL, IN, MA, MI, PA)

Some states with flat rates have higher personal exemptions & standard deductions than Indiana, so tax effectively is somewhat more progressive

A progressive bracket structure is one in which higher segments of income are taxed at higher rates, for example, income between $0 and $10,000 is taxed at 3%, income between $10,000 and $20,000 is taxed at 4%, etc..

Progressivity of the Indiana Income Tax



The top marginal rate is the highest income tax rate imposed on any segment of income. Even though Indiana has a flat rate income tax, not all families pay at that rate; some families that file a return pay at a 0% rate (because their incomes are too low to have a tax liability) and some receive refundable EITCs.

Indiana Income Taxes and the Poor: Half Full or Half Empty?

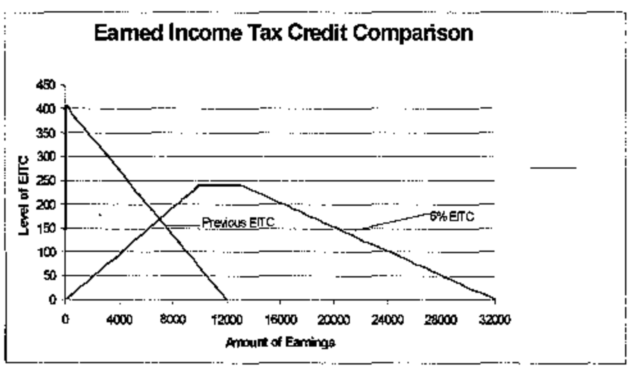
- **In recent years, Indiana has substantially reduced income tax burden on poor**
  - **Increased extra dependent exemption from $500 to $1500**
  - **Enacted earned-income deduction, converted to refundable credit, then expanded credit effective 1/1/03 by piggybacking on federal EITC**

Indiana Earned Income Tax Credit

6% of federal EITC, effective with 2003 tax year

Refundable, so credit in excess of PIT liability partially offsets sales and property tax liability of low-income households <u>with earnings</u>.

Indiana Earned Income Tax Credit



Under the old EITC, families with earnings above $12,000 received no credit. The piggybacking of the Indiana EITC onto the federal EITC will enable families with earnings of up to $32,000 to receive some amount of credit.

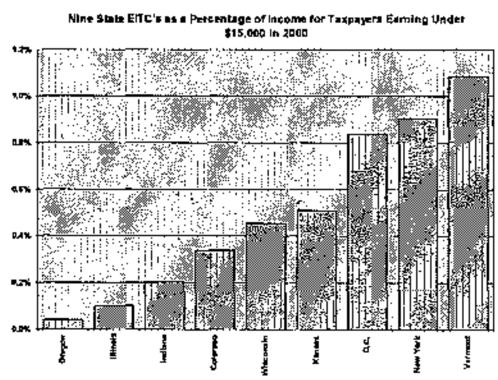
Indiana Income Taxes and the Poor: Half Full or Half Empty?

Even had more generous 2003 (6%) EITC been in effect in tax year 2001:

- **Only 9 states would have begun imposing state income tax at lower income level than IN's $13,800 (2-parent family of 4)**
- **IN would have imposed $200 PIT on family with $18,104 poverty-level income (12th highest among states)**
- **IN would have imposed $411 PIT on family with 125% of poverty level income, $22,630 (11th highest among states).**

Source: Center on Budget and Policy Priorities annual report on state income tax treatment of low-income families. The most recent report deals with 2001 income taxes.

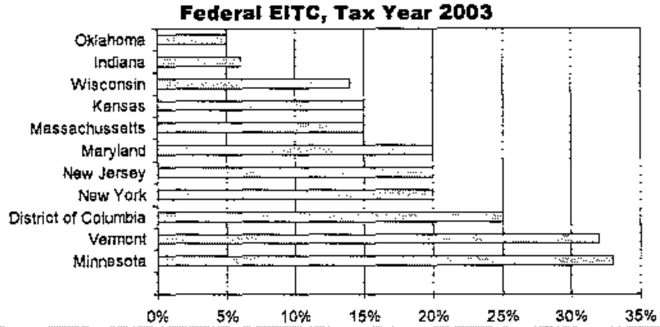
Not All State EITCs Are Created Equal



Source: Inst. For Taxation and Econ. Policy, Who Pays? 2nd Edition Jan 2003

Not All State EITCs Are Created Equal

Refundable State Earned Income Tax Credits as Share of Federal EITC, Tax Year 2003



Indiana Sales Tax

Of 45 states with sales tax, IN's absorbed 10th-lowest share of personal income (2000)

Low reliance due to

- **Relatively low rate (until recent increase)**
- **No local sales taxes**
- **Narrow "base" (goods/services subject to tax); 18th most narrow base in 2001 (Source: Prof. John Mikesell, IU)**

Sales taxes are not deductible for federal tax purposes

Property and income taxes are deductible on federal tax returns for those who itemize

Below-average reliance on sales tax and above-average reliance on income & property taxes maximizes federal tax savings for Indiana itemizers, reduces net cost of Indiana taxes for Indiana citizens

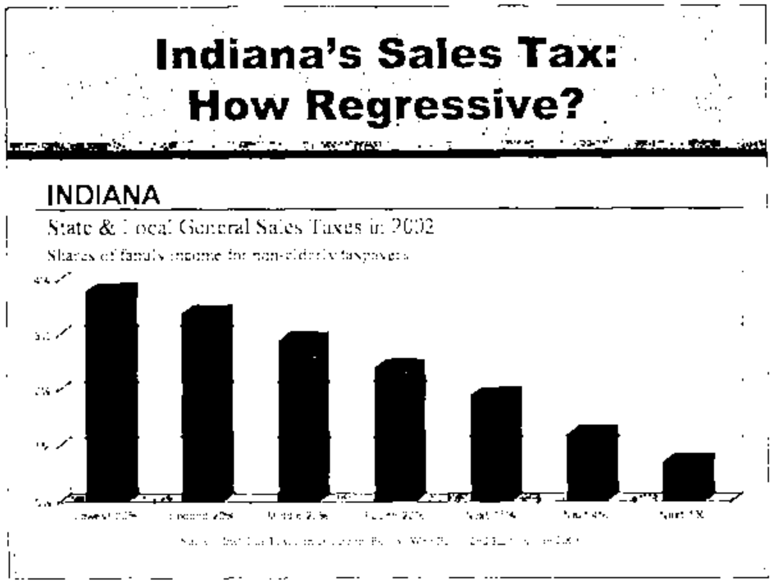
Sales Taxes Are Regressive

- Sales taxes inherently regressive: upper-income households save rather than consume larger shares of income
- Relatively low reliance on sales tax helped counteract low progressivity of Indiana's income tax – preventing highly regressive tax system from being even more so

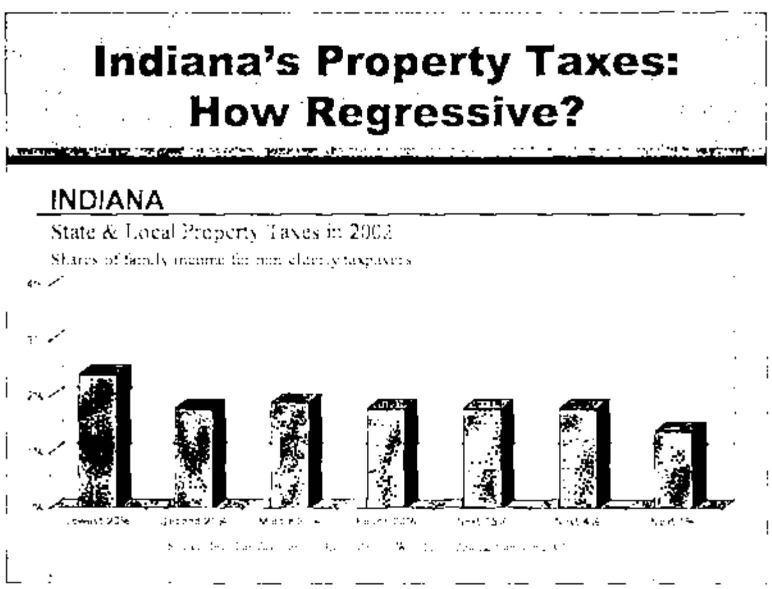
Indiana's Sales Tax: How Regressive?

- Indiana has mitigated regressivity of sales tax by exempting food – which represents a large share of income for low- and moderate-income families
- By not taxing services – many of which are disproportionately bought by upper-income families – Indiana has foregone opportunity to reduce regressivity of its sales tax
  - As of 1996, IN taxed only 22 of 164 services; only 6 of 45 states with sales taxes taxed fewer services

See: Federation of Tax Administrators, *Sales Taxation of Services, 1996 Update.*
Available at http://www.taxadmin.org/fta/pub/services/services.html



The bottom 20% of Indiana families devote 3.8% of income to paying state sales taxes; the top 1% devote just 0.7% of income. The chart does incorporate the effect of the recent increase in the sales tax rate.



The bottom 20% of Indiana families devote 2.4% of income to paying property taxes; the top 1% devote just 1.4% of income to paying this tax. The property tax is regressive, although not as regressive as the sales tax. Again, note that this chart incorporates policy changes that were enacted last year to mitigate the regressivity of the property tax, such as the increased homestead exemption.

Indiana's Property Taxes: How Regressive?

Indiana property taxes are well below average among all states in their regressivity

- **Ratio of property tax share of income for bottom 20% of households to property tax share of income for top 1% of households is about 1.7 : 1**
- **This ratio lower in Indiana than in all but 15 states**

The fact that the property tax is not as regressive in Indiana as it is in other states is attributable to the broader array of property tax relief policies in effect in the state.

Indiana's Property Taxes: How Regressive?

Indiana property taxes are much less regressive than Indiana sales taxes

- **Bottom 20% of households devote 1.7 times as great a share of their incomes to property taxes than do the top 1% of households**
- **Bottom 20% of households devote 6.8 times as great a share of their incomes to sales taxes than do the top 1% of households**

Trading Higher Sales Taxes for Lower Property Taxes (2002)

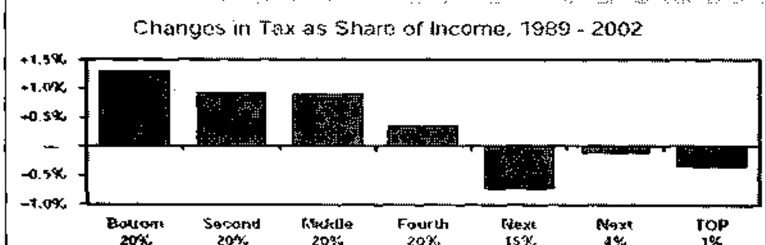
So, by choosing to fund property tax relief with 1¢ sales tax increase rather than income tax increase:

Indiana made tax system more regressive

Indiana ensured that more of Hoosiers' aggregate incomes would flow to federal Treasury rather than be spent and re-spent in Indiana

Recall that sales tax payments are not deductible from the federal income tax, while state income tax and local property tax payments are deductible. Using sales tax revenues to reduce property taxes substituted a non-deductible tax for a deductible tax, meaning that Hoosiers will have higher aggregate federal income tax liabilities. This represents a drain of income out of Indiana.

Over the last decade, Indiana's taxes have become more regressive



	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Sales & Excise	+0.8%	+0.4%	+0.3%	+0.2%	+0.1%	+0.1%	-0.0%
Property	+0.6%	+0.5%	[illegible]	+0.2%	+0.8%	-0.1%	[illegible]
Income	-0.0%	+0.2%	+0.1%	+0.2%	+0.2%	+0.2%	+0.2%
Federal Offset	-0.0%	-0.6%	-0.1%	-0.2%	-0.3%	-0.3%	-0.5%
Overall Change	+1.3%	+0.9%	+0.9%	+0.4%	-0.7%	-0.1%	-0.3%

Source: ITEP, Who Pays? Last year's increase in sales and cigarette taxes more than offset all of the income and property tax relief provided to low- and moderate-income families over the last decade. The bottom 20% of families end 2002 devoting 1.3 percent more of their incomes to state and local taxes than they did in 1989.

Conclusions and Policy Options (I)

Indiana already has one of the more regressive state/local tax systems in U.S.

Recent tax policy has made it more so, on balance

Increasing EITC has not offset higher sales tax for many families with earnings, let alone families without (e.g., retirees)

Conclusions and Policy Options (II)

Indiana could further mitigate regressive impact of recent sales tax increase by enacting refundable income tax credits

- tied to estimated sales tax liability of low-income households
- non-income-tax filers should be eligible
- could phase out as income increases
- 5 states have somewhat similar credits

Conclusions and Policy Options (III)

If sales taxes must be increased further to address budget shortfall, IN could mitigate impact on low-income families by

Forgoing further increases in sales tax rate

Enacting refundable credits to offset impact

Conclusions and Policy Options (IV)

If sales taxes must be increased further to address budget shortfall, IN could mitigate impact on low-income families by

Broadening sales tax base to encompass goods and services disproportionately purchased by upper-income households

- Financial planners, health club memberships
- Purchases from Internet affiliates of retail stores

Conclusions and Policy Options (V)

Further tax increases to address budget shortfall could focus on income tax, particularly on upper incomes

State income tax burdens on affluent families in IN among lowest in country

IN only flat-rate state able to enact progressive rates without constitutional amendment

? 1/3 of any income tax increase on affluent will be offset by reduced federal income tax liability through federal deductibility

Conclusions and Policy Options (VI)

- Eliminating income tax burdens on families below poverty line should have high-priority claim on any future tax relief when state's fiscal condition improves

- Indiana state government needs in-house ability to analyze distributional impact of tax policy changes

It is unfortunate that the major restructuring of Indiana's tax system last year was undertaken with very little information made available to policymakers or the public about the overall distributional impact of the changes. See: Michael Mazerov, *Developing the Capacity to Analyze the Distributional Impact of State and Local Taxes,* Center on Budget and Policy Priorities, January 2002.
Available at http://www.cbpp.org/1-15-02sfp2.htm.