What if Indiana Eliminated Personal Property Taxes?

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Economic Development, Tax Shifts and Revenue Losses

Eliminating the personal property tax—the tax on business equipment—could encourage more business investment in Indiana. That would mean more jobs, wages and benefits for Indiana employees, more goods and services at lower prices for Indiana consumers, and higher profits for Indiana business owners.

Personal property owners pay about a billion dollars in property taxes to local governments, which is about 16% of total property taxes. Eliminating a large part of local revenue would cause tax shifts and revenue losses under Indiana's local tax and budget system.

State rules limit the revenue that local governments raise from the property tax. The maximum property tax levy restricts most local government operating funds. This means that most of the levy is not affected by changes in assessed value.

Tax rates are calculated by dividing the levy by the taxable assessed value of property. If we eliminate personal property from assessed value, total assessed value would be smaller. Most tax rates would go up. Personal property owners would pay less, but higher tax rates would shift this tax burden to everyone else.

Or taxes would shift, except for the property tax caps. Indiana's Constitutional tax caps limit homeowner tax bills to one percent of assessed value before deductions. The caps limit rental housing, second home and farmland taxes to two percent of assessed value, and business land and building taxes to three percent.

Personal property tax elimination would raise tax rates and tax bills. For some taxpayers these higher tax bills would exceed the caps. Taxes paid by personal property owners would shift to other taxpayers, but the taxes above the caps would be unpaid. Local governments would lose that revenue.

A study by the Legislative Services Agency in December 2013 looked at the tax and budget effects of eliminating personal property taxes. The study found that about a third of the one billion dollars would shift to other taxpayers, and about two-thirds would be lost revenue for local governments. The average property tax bill statewide would rise by about 7%. The average tax bill increase would top 20% in half-a-dozen counties. Local governments in the average county would lose about 10% of their tax levies. Losses would top 20% in eight counties.

Alternatives and Consequences

Indiana can choose to eliminate the personal property tax, or not. If we eliminate the tax, we can choose to replace the revenue with taxes on other taxpayers. Or we can choose not to replace the revenue, and have local governments spend less. What might be the consequences of these policy alternatives?

- Eliminating personal property taxes could bring economic benefits to Indiana, but replacing the tax with other taxes, some of which businesses would pay, could lessen the added benefits.

- Shifting the tax burden to other taxpayers could create tax equity questions. If businesses pay less, households would pay more, and tax burdens could be altered across counties.
- Eliminating the personal property tax without replacement would reduce spending by local governments. This could cause problems for local service delivery. If public services valued by businesses deteriorate, the economic benefits of the tax reduction might be less.

The researcher can lay out the policy alternatives and their consequences, but there probably isn't an objective or "scientific" way to choose among these alternatives. It's up to the public and their representatives to choose, based on their evaluations of the consequences. And those evaluations will necessarily involve value judgments.

Business and Household Taxes

How much do businesses pay to support Indiana state and local government, and how much do households pay? Each year the Council on State Taxation (COST) provides a breakdown of state and local taxes paid by businesses. The most recent report is for 2012.

COST finds that Indiana's total state and local taxes were $26.8 billion in 2012, and that $10.7 billion, or 40%, were paid by businesses. (These are statutory tax payments—tax bills remitted—not measures of economic incidence after changes in employee wages or customer prices resulting from the taxes.)

Business taxes as a percentage of Indiana private gross state product (GSP) were 4.3% in 2012. Among the states (and the District of Columbia), Indiana's business tax percentage of private GSP ranks 12th lowest. Indiana has a relatively low business tax rate, according to COST.

Is this rate low because Indiana taxes are low generally, or because Indiana taxes business less than most states? The 40% of taxes paid by business ranks 11th lowest in the nation. Indiana's total taxes as a share of private GSP were 10.8% in 2012, which ranked 24th highest among the states. Indiana has an overall tax rate close to the middle of states, but a low business tax share.

Does this imply that taxes on households are relatively high? COST does not make those calculations, but data are available elsewhere to provide a rough answer. The U.S. Bureau of Census provides data on state and local government revenues and expenditures each year. The most recent figures are for 2011. According to the Census, Indiana state and local governments collected $6.3 billion in property taxes, $6.3 billion in general sales taxes, $6.2 billion in individual income taxes, and $4.4 billion from all other taxes. (These figures are very close to Indiana's own numbers. The individual income tax total includes state and local income taxes.)

As percentages of personal income, out of which these taxes are paid, property, income and sales taxes were all near 2.6%, while the all other tax category was at 1.8%. Among the states, Indiana's property taxes were 34th highest, general sales taxes 16th highest, individual income taxes 16th highest, and all other taxes were 39th highest. Relative to the U.S., Indiana has lower property taxes and higher sales and income taxes.

Further evidence can be had from the Bureau of the Census's annual American Community Survey, which asks homeowners about property taxes on their homes. The median Indiana homeowner paid $1,053 in 2012. (This is close to the 2012 *average* figure calculated for homesteads from Indiana property tax data, $1,154. Since the distribution is limited below at zero, but not limited above, the average should be higher than the median.) Homeowner property tax payments as a percentage of median income were 2.2%, which was 11th lowest in the U.S. Indiana household property taxes are low relative to other states.

Indiana has shifted its state and local tax mix away from property and towards sales and income taxes over the past several decades. Since a greater share of the property tax is paid by businesses, compared to sales and individual income taxes, this helps account for Indiana's relatively low tax rate on businesses. Taxes on households are near the national average, because of relatively high sales and individual income taxes.

It is striking that Indiana's collections of property, sales and individual income taxes were so similar in 2011. In fact, one measure (a "Herfindahl Index") shows that Indiana had the most balanced tax system in the U.S. among those three taxes, with about one-third of revenue from each. In the U.S. in 2011 property taxes accounted for 43% of the three-tax total, sales 29% and income 28%. Broad tax bases with low tax rates are one desirable feature of a tax system, and balance is a means to that end.

Many studies show that lower taxes on businesses have a positive effect on firm location and investment. Indiana's low business taxes probably help with economic development.

State and Local Government Spending

How much do Indiana state and local governments spend? The Census's state and local expenditure data for 2011 show Indiana with $26.0 billion in state spending, and $26.7 billion in local spending. (Again, the state figure is close to Indiana's own numbers. The state budget for 2011 had appropriations of $26.9 billion. Spending below appropriations could account for a large part of the difference from Census state spending.)

State spending was 11.0% of personal income, which ranked Indiana 35th highest among the states. Local spending was 11.3% of income, ranking 30th among the states. Primary and secondary education is the largest part of local government spending. Indiana spent $9.7 billion on K-12 education in 2011, according to the Census. This was 4.1% of state income, which ranked Indiana 35th highest among the states. Indiana state and local government spending out of income ranks in the lower half of the states, as does its K-12 education spending.

Government spending is not an end in itself. Spending is a way to produce a desired outcome. Spending on police and fire protection is meant to produce safety from crime and fire. Spending on roads is meant to produce safe and convenient transportation. Spending on education is meant to develop the capabilities of Indiana's people.

There are many measures of these outcomes. To select a few, Indiana suffered 346 violent crimes per 100,000 people in 2012, which ranked 26th highest among the states. Indiana's rate of death from fire was 14.6 per million people in 2010, 13th highest in the U.S. The state's highway fatality rate was just under one person per 100 million vehicle miles traveled, 34th highest in the nation. Indiana's average 8th grade mathematics test score ranked 18th highest among the states in 2013. These outcomes range from pretty good to pretty bad, compared to other states.

There are many measures, but none directly measure the results of government spending. Spending is only one part of the "production process" for these outcomes. Successful fire protection is more difficult where buildings are taller and closer together. Roads are more expensive to maintain where there is frequent freezing and thawing. Education outcomes are more difficult to achieve where children are not ready to learn. Where the production environment is favorable, above average outcomes can be achieved with below average spending. Where the environment is unfavorable, large amounts of spending might not produce desired outcomes.

Then there's efficiency. Added spending has a bigger effect on outcomes where governments are well organized, responding to appropriate incentives, with high employee skills and morale. More spending by poorly organized governments may have little effect on outcomes.

Indiana's low spending on state and local government, relative to other states, might mean that we are willing to accept a lower level of services and less desirable outcomes. Or, it might mean that the production environment is favorable, so desired outcomes can be achieved with lower spending. Or, it might mean that Indiana's governments are particularly efficient, providing more "outcome-bang" for the "spending-buck."

According to many studies, added spending on public safety and more road mileage enhance economic development. Some studies show that added spending on K-12 education aids development as well.

Five Choices

Eliminate the Tax, No Replacement Revenue. Suppose Indiana decides to eliminate the personal property tax, and not replace the lost revenue with higher taxes on other taxpayers. This will not happen automatically under Indiana's tax and budget system. For the most part local governments could maintain their levies and recoup some of the revenue losses with higher property taxes on remaining taxpayers. The Constitutional tax caps prevent tax bills on other taxpayers from rising enough to fully replace the personal property tax payments. About one-third of the billion dollars in personal property taxes would be shifted to others. How can this tax shift be prevented?

- The maximum levies of each jurisdiction could be reduced by the amount of the personal property tax. This could be an annual subtraction from the maximum levy equal to the value of last year of personal property tax payments. Or, the maximum levy could be reduced once, in the year that the personal property taxes are eliminated. Since maximum levies are increased by a percentage each year, this latter option would reduce future maximum levy growth.
- A property tax credit could be calculated for each taxing district equal to the tax shift from personal property taxpayers. This percentage reduction in tax bills would be unfunded, meaning the revenue would not be replaced by an increase in another tax.

Lower taxes on businesses could increase incentives to invest in Indiana, resulting in more jobs and higher incomes for Indiana's people. With less revenue local governments might reduce services. Desired outcomes could be more difficult to achieve. The economic development benefits of the personal property tax cut could be reduced if public safety, transportation or education outcomes deteriorate.

Suppose, though, that we wish to replace the billion dollars lost to personal property tax elimination. Indiana has only three taxes that can raise a billion dollars at reasonable tax rates: the sales tax, the individual income tax, and the property tax itself.

Eliminate the Tax, Replace the Revenue with the Sales Tax. The sales tax is one of the traditional ways that Indiana has funded property tax reductions. In 1973 the sales tax increased from 2% to 4% to fund the property tax replacement credits. In 2002 a sales tax increase from 5% to 6% helped defend homeowners from the effects of the property tax reassessment. In 2008 the most recent hike to 7% helped fund the elimination of property taxes for school general funds.

Our 7% sales tax raises about $7 billion a year. That's about a billion dollars per percentage point. A sales tax rate of 8% could generate enough revenue to replace the local revenues lost from personal property tax elimination, and offset the shift of property taxes to other property owners.

The Indiana sales tax is collected by the state, while the personal property tax funds local government. A formula would be needed to distribute the state revenue to local governments. Creating the formula would pose many questions, including:

- Would the amount to be distributed be fixed at the original level of personal property taxes lost, or would the amount rise as sales taxes increase?
- If local spending was financed partly with a state formula, rather than local taxes, would local governments spend more? Local officials could spend without having to tax local residents directly. This would remove one of the constraints on local spending.
- Would the formula take account of how much each locality pays in sales taxes, as well as how much personal property taxes are to be replaced? Inevitably some counties would pay more in sales taxes than they would receive in replacement revenue and tax relief. A shift from personal property taxes to sales taxes would rearrange local tax burdens geographically.

Thirty-eight states have local sales taxes; Indiana does not. Some of the problems of a distribution formula could be overcome by using a local sales tax. A primary problem with this approach, however, is that some Indiana counties would not have enough taxable sales within their boundaries to replace lost personal property taxes at any reasonable sales tax rate.

An 8% sales tax rate would be the highest *state* rate in the country. But 38 states have local sales taxes, so as of 2014 there are 12 states with average combined state/local rates above 8%, and 22 states with maximum combined rates at 8% or more. An 8% rate would be *among* the highest, but not *the* highest rate in the U.S. Eliminating the personal property tax and increasing the sales tax would shift tax burden from business to households. Still, between 20% and 40% of sales taxes are paid by businesses on business-to-business sales. A higher sales tax rate could reduce the impact of the personal property tax cut on development. But it could maintain local government spending and service outcomes.

Eliminate the Tax, Replace the Revenue with Local Option Income Taxes. Local option income taxes are the other main way Indiana has funded property tax relief in the past. The original County Adjusted Gross Income Tax (CAGIT) was created as part of the Bowen property tax relief package in 1973. The 1984 County Option Income Tax (COIT) allowed counties to fund local homestead credits. An extension of the County Economic Development Income Tax (CEDIT) was authorized in 2002 to prevent a tax shift to homeowners when inventory taxes were eliminated. And in 2007 two additional Local Option Income Taxes (LOIT) were created for property tax relief, one to freeze levies and one to provide local property tax credits.

Combined, these local income taxes raise about $1.9 billion with local rates ranging from 0.2% (in Vermillion County) to 3.1% (in Pulaski County). The state tax rate is 3.4% and raises about $5 billion, so a billion dollars could be had with an additional 0.7%. This would be a substantial increase in local rates for most counties, and elected officials probably would think hard before making such a choice.

There are seven kinds of local option income taxes: CAGIT, COIT, CEDIT, CEDIT for inventory tax relief, LOIT to freeze levies, LOIT for local credits, and LOIT to fund public safety services. Would we add an eighth to this confusing mix, or is it time for some simplification of our local income tax options?

There are just a few decisions that must be made about any local income tax.

- What will be the tax rate?
- How much of the revenue will be used for added spending, and how much for property tax relief?
- Will the relief be provided through limits on the property tax levy, or credits on property tax bills?
- How much of the county total will each local unit of government receive for added spending?
- How much of the property tax relief will homeowners, other residential property owners, and business owners receive?

One can imagine a single LOIT with a series of options that would answer these questions. The law could restrict choices as desired.

Replacing personal property taxes with income taxes would shift the tax burden from businesses and towards households. Since businesses pay only a small share of the individual income tax, little of the development benefits of lower personal property taxes would be offset. Again, a primary problem with local income taxes is that some counties would not have enough taxable income replace lost personal property taxes at reasonable rates. Counties that could not replace lost revenue might see service decreases. Larger income tax rate differences among counties eventually might affect population migration and even development.

Eliminate the Tax, Replace the Revenue with Real Property Taxes. If property taxes on personal property are eliminated, perhaps they could be replaced by property taxes on real property—land and buildings. But how? The Constitutional tax caps limit the revenue that can be raised from property taxes.

The Constitution provides one possibility. Property tax rates approved by referendum are outside the tax caps. Currently all larger debt-financed capital projects are subject to referendum, and school corporations are allowed to propose tax referenda to approve rates for operating costs. Between November 2008 and May 2014 school corporations proposed 54 tax referenda for operating costs, and voters have approved 31 or 57%.

Counties, cities and towns, library districts and other local units could be authorized to propose tax referenda. Jurisdictions could propose higher property taxes to replace revenue lost through personal property tax elimination. If the voters agreed, the tax rate would rise.

Businesses pay more than a third of real property taxes. Higher property taxes would mean that the overall tax reduction for business would be reduced, which could reduce the positive effect on development. Taxes would shift from businesses that own equipment, to homesteads, other residential property and businesses that own real property.

Do Not Eliminate the Tax. Indiana has taxed personal property for its whole history, and we could continue to do so. Our business taxes are already low relative to other states. Our household property taxes are also low, but our sales and individual income taxes are higher. Eliminating the personal property tax would further reduce business taxes, and most replacement tax options would shift the burden to households.

Indiana already has low government spending out of income, compared to other states. Measured outcomes of spending—public safety, highway transportation and educational achievement, for example—are mixed, some favorable, some unfortunate. Eliminating the personal property tax without replacement revenue would reduce local government spending. Outcomes might not suffer proportionately, if governments can become more efficient, or if Indiana's "production environment" is favorable. If efficiencies or environment do not offset lost spending, however, Indiana residents—and businesses—would have to accept less desirable local outcomes.

References

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