



Tax Simplicity & a Sound Tax System in Indiana

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THE SIMPLICITY OF A TAX SYSTEM has long been viewed as an important, universal aspect of sound tax policy. However, other goals of tax policy do exist. These include the *stability* of revenues, which provide certainty to governments and taxpayers and *neutrality*, or a tax system that minimally distorts economic decisions. As may be evident, the goal of *simplicity* in a tax system may conflict with the stability and neutrality of a tax system. Balancing these competing goals should be part of a comprehensive review of a tax system and any effort towards achieving overall improvements in a tax system.

Extreme simplicity in a tax system could be achieved by applying a single tax, with a single rate, on a single activity. Flat consumption or payroll taxes are common examples of this. However, the simplicity gains of such a system come at the expense of stability and neutrality. A single tax instrument will obviously lead to highly unstable tax revenues as structural or cyclical changes in economic activity alter the size of the tax base. Indiana's experience with gaming-related tax revenues, or national revenues from FICA taxes during the Great Recession, provide two examples of

simple, but unstable, revenue sources.

Tax revenues drawn from a single source, or fewer sources, are also less neutral than a tax system drawn from multiple tax instruments or activities. This is true for two reasons. First, the effects of tax rates on behavior are not linear. A 10 percent marginal tax rate will likely distort behavior more than twice as heavily as a 5 percent marginal tax rate.⁽¹⁾ Because a single tax instrument will have a higher rate than a broader set of taxes when providing the same level of revenue, it will necessarily be more distortionary.⁽²⁾

Second, fewer tax instruments apply to a more narrow tax base. For example, a tax on payroll applies only to earned income, not to accumulated wealth, consumption, or transfer payments. This, too, necessarily results in a more distortionary or less neutral tax system that collects the same level of revenues against a more narrow base incentives firms and households to alter their type of economic activity in response to higher relative tax rates. For example a single payroll tax would incentivize the shift to a more capital-intensive production process by businesses that will bear part of the burden. This will reduce the demand

1. See MacKie-Mason 1990 for a theoretical example.

2. There are also equity issues associated with broadening the tax base that are not addressed here.

for labor. Likewise, households who pay part of the tax will reduce their labor supply in response to lower real compensation. It is important to note that the actual incidence of the tax is not solely dependent upon the administrative incidence of the tax. For example, while the sales tax is collected on consumers, both consumers and producers “pay” part of the tax because the existence of a sales tax will influence pricing and consumption decisions.

Achieving both tax stability and neutrality involves what is likely the most strongly held belief regarding a good tax system – that it should enjoy low rates and a broad base. The low rate, broad base feature of a tax system enables it to tax the most activity, thus lowering any one particular rate. This makes the tax system less sensitive to business cycles or structural changes in the economy, and it makes it less likely to distort the behaviors of businesses or households as they seek to avoid taxes. However, a low rate, broad base characteristic of a tax system conflicts with overall simplicity in a tax system. To accommodate this, economic research has tended to focus on the simplicity of individual tax instruments and their effect on compliance costs.

The remainder of this policy brief explores these two issues in Indiana. We begin with some brief empirics on the simplicity of individual tax systems, with an eye on Indiana. Here we argue that there are gains to be made in compliance cost reductions, but leave specific recommendations to others. In the following section, we review the overall balance of tax instruments, with a focus on the current conditions and their implications for Indiana. Finally, we summarize and conclude with additional areas of research.

Tax Simplicity in Indiana

Indiana taxes income, consumption, and wealth. Income is primarily taxed through state personal income taxes levied on households and non-corporate businesses, although there are six local option taxes levied on income as well. Corporations are taxed through the corporate income tax. Consumption is taxed through a sales tax on goods and an excise tax on some fuels. Businesses pay a high share of these taxes, perhaps 44 percent of sales tax (Thaiprasert, Faulk, and Hicks 2013), while households from Indiana and elsewhere pay the remainder. Services and some goods are not taxed. Wealth is taxed through a local tax on property, both real and personal on households and businesses. Counties in Indiana assess these taxes with between five and 61 separate taxing districts (Faulk and Hicks 2011). The result is that a typical individual tax parcels may be subject to tax levies from between 6 and 12 different tax districts.

Two important goals of tax simplicity are first to reduce uncertainty by taxpayers regarding their tax obligations and second to reduce compliance costs. Compliance costs can accrue to taxpayers in business and households and to government.

The complexity of Indiana’s local government property taxes offers an insight into the size and scope of compliance costs to government.



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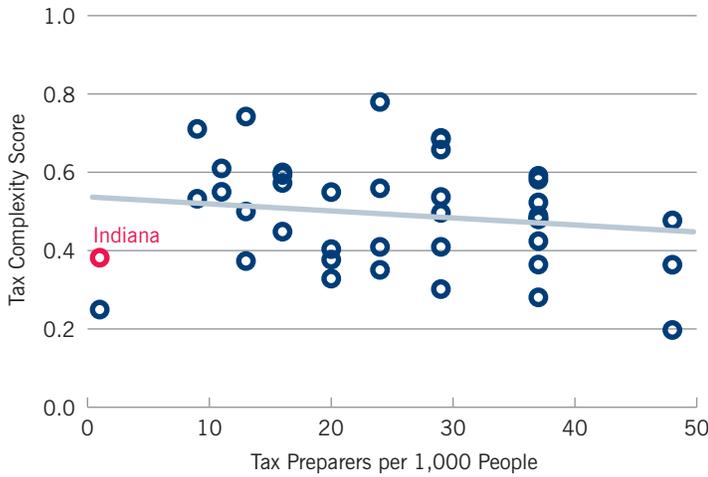
Tax rates are constitutionally capped, and local governments set budgetary needs for up to 61 separate units of governments in a county. Because these governments overlap, the share of taxes paid by an individual parcel is not visible to local governments. The budgetary requests are forwarded to the Indiana Department of Local Government Finance, which then compiles individual parcel obligations from which the share of taxes to each overlapping taxing district. This atypically cumbersome system involves the creation of a separate state agency simply to process local taxes. In addition to imposing high administrative costs on state government, the system reduces the ability of local governments to manage their fiscal environments.

Taxpayer compliance costs are also influenced by tax simplicity. Several studies have identified the role of tax complexity in increasing transactions costs for businesses, reducing certainty about tax liability and reducing investment.³ One method of chronicling this effect is to link a measure of tax complexity to direct expenditures related to tax compliance. We do this in two ways. First, we provide a simple graphic between a measure of tax complexity created by the Progressive Policy Institute (Weinstein 2014) at the state level to the number of workers listed as tax preparers per 1,000 workers in each state, using the 2013 Occupational and Employment Classifications of the Bureau of Labor Statistics. Importantly, a low number in this index implies high tax complexity or low simplicity. *Figure 1* ranks the tax complexity score for states with an income tax against the number of tax preparers per 1,000 workers in a state.

It is clear from this data that there is a strong correlation between the tax complexity index ranking and the number of tax preparers per 1,000 employees. This suggests that higher tax complexity requires

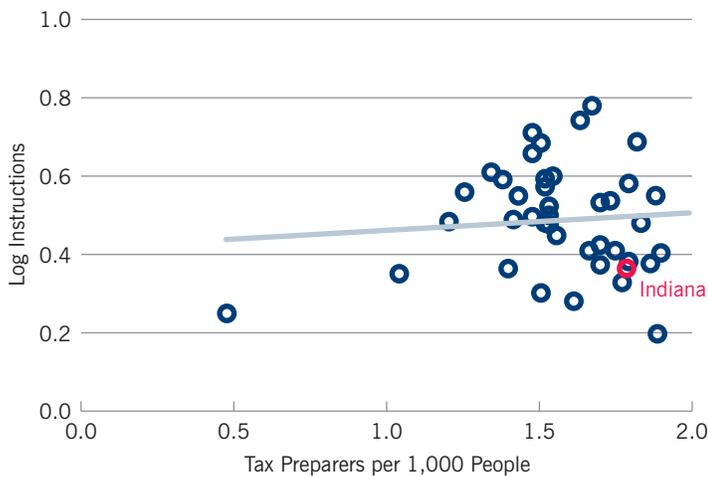
3. See Edmiston, Mudd, and Valev 2003; and Warksett, Winer, and Hettich 1998.

Figure 1. PPI Tax Complexity Score and Tax Preparers per 1,000 Employees



Source: U.S. Bureau of Labor Statistics and Progressive Policy Institute.

Figure 2. Log (Tax Instruction and Form Pages) and Tax Preparers per 1,000 Employees



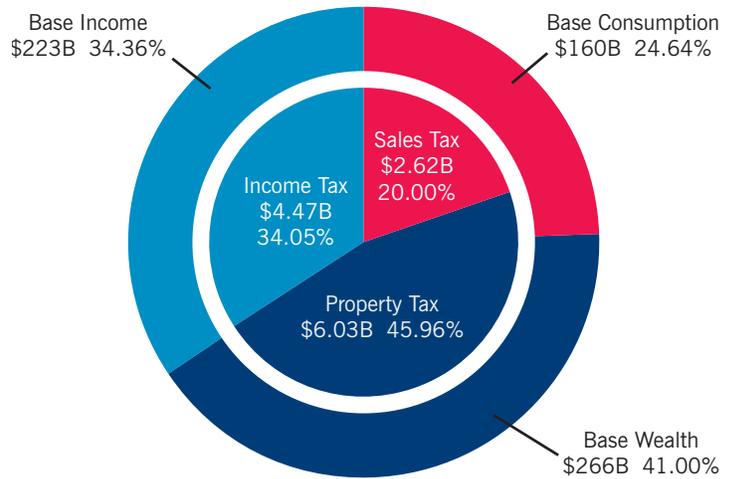
Source: U.S. Bureau of Labor Statistics, state departments of revenue, and author calculations.

households and businesses to employ or contract with more specialized tax preparers, a very clear proxy for higher compliance costs in more complex tax systems.

In a second approach, we compiled the number of instructional and tax form pages for each state’s income tax form. For visual ease, we report the logarithm of the number of total instructional and tax form pages for each state, and plot them against the number of tax preparers per 1,000 employees in a state. See *Figure 2*. This graphic clearly indicates that there is a positive correlation between the number of instruction and tax form pages in each state’s income tax and the number of tax preparers per 1,000 employees in a state. This is further evidence that tax complexity increases the cost of compliance by households and businesses.

These visual comparisons of the relationship between complex taxes and higher compliance costs for businesses provide anecdotal

Figure 3. Relative Tax Rates and Relative Tax Bases



Source: U.S. Bureau of Labor Statistics, Indiana Department of Local Government Finance, Indiana Department of Revenue, and author calculations.

evidence of a problem that is potentially solvable through policy intervention. The higher quality scholarly work in this area of the type cited earlier suggests a review of tax simplification for compliance with individual tax instruments in Indiana is warranted.

Does Indiana Have a Broad Tax Base?

Examining Indiana’s tax instruments across different taxes is outside the scope of this brief, but a preliminary snapshot of the tax base suggests some areas of improvement. In examining three large taxes – sales, property, and income – we can compare the total taxes against a proxy for the tax base in each case. See *Figure 3*.

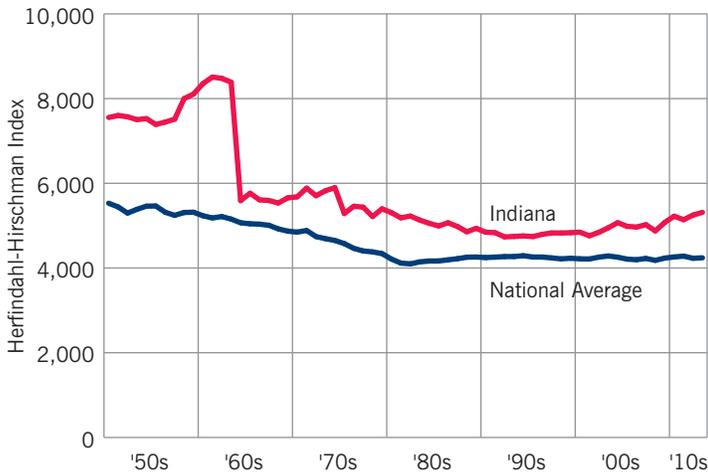
For sales tax, we find that while the state collects a 7 percent sales tax on goods, the taxable sales in the state is only 16 percent of personal income in 2010. This suggests that a significant base of sales taxes may not be subject to taxes. These include health care expenditures, food, and services.

Including these estimates into the tax base yields an effective tax rate on all potentially sales taxable items of 1.6 percent. However, for most goods the tax rate is 7 percent, and for most services it is zero percent.

Similar calculations against the income taxes collected, and total income and property taxes collected against total net assessed value (property minus exemptions) provide effective tax rates of 2.0 percent and 2.3 percent respectively.

We also estimate the distribution of taxes across all instruments as a measure of the share of total tax revenues draw from separate economic activities. Using a tool known as the Herfindahl-Hirschman Index, we provide a relative index of the concentration of the state’s total tax revenues on different tax instruments. The HHI is the sum of the squared share (expressed from 0 to 100) of each major tax instrument. If all taxes are collected from a single tax instrument, the index would be 10,000. As total taxes are collected evenly against more tax instruments the index decline, and so offers a relative degree of collection of taxes against a base. The higher the number, the more

Figure 4. Tax Revenue HHI,* 1950-2013



* HHI: The Herfindahl-Hirschman Index is the sum of the squared share (expressed from 0 to 100) of each major tax instrument. If all taxes are collected from a single tax instrument, the index would be 10,000.

Source: U.S. Bureau of the Census and author calculations.

narrow the tax base; the lower the number, the broader the tax base. *Figure 4* illustrates this for Indiana and the average U.S. state from 1950 through 2013.

Figure 4 clearly illustrates that Indiana’s tax revenues have become more concentrated since 2001, meaning that the bulk of revenue is raised from fewer sources. In 1950, Indiana was the 12th most concentrated tax state. At its peak in 1961, Indiana was the second most concentrated state for tax revenues, behind only South Dakota. In 2001, when Indiana had the most broadly spread taxes relative to other states, it ranked 14th, and by 2013 it had moved to 8th place behind only states without an income tax.

Economic research has not yet convincingly connected the broad base benefit of a tax system to overall economic performance, such as GDP or personal income growth. However, very high levels of tax collected on one instrument tend to offer a less neutral overall tax system. In Indiana’s case, the narrow sales tax base is an obvious target for policy consideration. Indeed, a broad expansion of the sales tax base to include all non-business services would likely permit the Indiana sales tax rate to be reduced to between 4 percent and 5 percent without reducing overall tax revenues.

Summary

The goals of tax simplicity are well recognized and enjoy broad agreement among tax researchers of all stripes. However, improvements in Indiana’s tax code should target individual compliance costs for existing tax instruments.

A possible more urgent problem for Indiana is that the current tax base is far narrower, with tax revenues collected less broadly across differing tax instruments than is typical in other states. This argues for a broadening of the tax base as part of an overall review of the tax code, in concert with efforts to succeed at tax simplification.

In this context, we have discussed both simplifications in individual instruments and broadening of the tax base (which is often referred to as reduced simplicity across instruments) as a potential policy goal. We believe a tax code that is easier to administer and comply with, and one that has a broader base and lower rates is a non-partisan improvement in our tax code. We are not so naïve to suppose there will be no interest group opposition to both steps, especially among those whose business models thrive on tax complexity and among businesses and occupations who provide services that are not subject to sales taxes. Still, we recommend the legislature seriously consider a broad suite of options in both areas.

Finally, we have discussed these changes within the context of revenue neutrality. Unlike national tax schemes, which are levied against factors of production and households who are relatively immobile, and for whom the benefit of services is diffuse and not immediately clear, this policy brief is about state and local taxes. It should be clear that at the state and local level, overall marginal tax rates are lower, and thus less distortionary; services such as schools, infrastructure and public safety are more immediately observable; and businesses and households balance both tax rates and the quality of services when making location decisions. We frame this discussion within the context of revenue neutrality, because in our judgment, while the tax rates are favorable to both households and business relocation to Indiana, the quality of services plays a larger role in the prosperity of many regions. So, for Indiana, tax revenues effectively allocated to service quality improvements are a more immediate concern than reductions in the overall effective tax rate.



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