

**AN INDIANA LAND TAX: AN EXEMPTION PROPOSAL FOR GROWTH AND
LOCAL GOVERNMENT FISCAL SUSTAINABILITY***

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Providing quality public services and levying low taxes will help keep Indiana competitive in the economy. The state's property tax caps serve as a barrier to both these efforts by encouraging local governments to cannibalize revenues away from one another with higher property tax rates, while also cutting off the amount of revenue they'll actually receive. This essay argues the possible merits of Indiana moving towards a pure land tax system by exempting all personal property and land improvements.

Many tax economists regard the property tax to be a two-faced bundle of the "worst tax" and the "best tax." Intangible and tangible personal property, as well as land improvements, represent the worst side of the tax. Taxation upon land only, however, is thought to represent the best. Historically, Indiana has made gradual steps toward improving the tax by striking out intangible and tangible personal property. Recent attempts involve the removal of business inventory, phased-out during the 2000's, and the 2014 legislation that gives counties the option to exempt business personal property. The key difference between the efforts of the 2000's to remove business inventory and the 2013-2014 effort to eliminate the business personal property tax is the implementation of property tax caps (aka "circuit breakers"). Both policies represented a shift in the tax burden, but the circuit breakers added to the challenge of eliminating the business property tax because it also represented revenue losses to local governments.

The proposal to exempt non-land property is a much more aggressive policy than has traditionally been Indiana's modus operandi. Structured correctly, exempting all non-land property could be more equitable and efficient than continuing the piecemeal property exemptions of the past. Further study of property records would be very informative of its merits.

THE SPECIFICS

Net assessed value is used for calculating tax rates for local governments and tax bills for individual taxpayers. Gross assessed value is for determining a property's maximum tax bill allowable under the tax caps. Homeowners, for example, have many exemptions that separate gross assessed value from net assessed value (e.g. Homestead, supplemental homestead, mortgage, etc.).

A tax exemption equal to the value of any non-land property would simultaneously increase tax rates and lower the taxable portion of property. For any given owner, the effect on their tax bill would depend on the ratio of land-to-improved value as compared to all other property taxpayers.

In principle, any development or improvement to land would have no effect on the net assessed (taxable) value. Said development would, however, increase the gross assessed value that is used for determining the maximum allowable property tax bill. In transitioning from the current system to a land tax system, the property tax caps would protect individual taxpayers from large changes in their tax bills. In the longer term, eliminating non-land property taxation lifts a

barrier to economic development and property values grow local governments out of the circuit breakers.

THE MERITS

A tax on land is known as “the best tax” for several good reasons. In its ideal structure, it is progressive, economically efficient, and friendly to both development and the environment. To summarize:

1. Higher value properties pay more property taxes. Higher income households holding more valuable property will contribute more to the local tax system than lower income households with less valuable property.
2. The supply of land is relatively fixed. Unlike movable property, labor, sales, and other taxed items, land cannot easily disappear in the presence of a tax. This makes it a relatively efficient tax.
3. There is no additional tax burden to adding capital to land, so the choice to develop property is undistorted by a tax on land. The ability to develop, however, is capitalized into the market value of land, so land owners have an incentive to develop land into its most valuable form. This makes the tax pro-economic growth.
4. A land tax incentivizes development to use land more conservatively, “building-up” rather than “building-out.” This reduces the progression of urban sprawl.

In addition, Indiana local governments would see the advantage of gross assessed values rising more quickly than net assessed values, which will diminish the effect of the circuit breakers on revenues over time.

ILLUSTRATIONS

To make clear how the policy impacts taxpayers and local government, some illustrations are provided.

1. A simple demonstration of how the proposed exemption would work in a case where a government had only one residential taxpayer.
2. A simple extension of the first illustration using two taxpayers (one residential and one commercial).
3. A demonstration of the effects of the policy on a single industrial property over time.

Illustration 1 For simplicity, imagine a single local government with only one residential homestead property taxpayer. The “Current Policy Column” demonstrates gross assessed value (AV), and assumes the taxpayer takes the standard, homestead, and homestead supplemental exemptions in order to arrive at the net AV. In order to finance a \$5,000 property tax levy, a property tax rate of 5.88% is required. The resulting tax bill is in excess of the maximum allowable under the property tax caps. Hence, the local government collects only 1% of the gross AV (\$2,000), which is less than 5.88% of the net AV (\$5,000) so that circuit breakers are the \$3,000 difference between them.

Illustrated Fiscal Analysis of Exempting All Development		
	Current Policy	Land Tax Policy
<i>Taxpayer Property Info</i>		
Land	\$40,000	\$40,000
Improvements	\$160,000	\$160,000
Gross AV	\$200,000	\$200,000
Exemptions	\$115,000	\$160,000
Net AV	\$85,000	\$40,000
<i>Taxpayer Property Tax Bill</i>		
Calculated Tax Bill	\$5,000.00	\$5,000.00
Max Tax Bill	\$2,000	\$2,000
Circuit Breaker Credits	\$3,000	\$3,000
Net Tax Bill	\$2,000	\$2,000
<i>Local Government Finance</i>		
Property Tax Levy	\$5,000	\$5,000
Total Net AV	\$85,000	\$40,000
Rate	5.88%	12.50%
Circuit Breaker Losses	\$3,000	\$3,000
Property Tax Revenue	\$2,000	\$2,000

This illustration demonstrates the mechanics of the rate and bill changes. Exempting all land improvements reduces the net AV to \$40,000 which automatically causes the tax rate to increase from 5.88% to 12.5%. The maximum allowable tax bill is unchanged, because that is 1% of the gross AV. Likewise, there is no effect on net tax bill or circuit breaker revenues. This will be true for any taxpayer whose tax bill is in excess of the tax bill...there is no impact from the policy change. For the local government, there is also no effect of the policy on revenues, which would only generalize in a case where all taxpayers are identical.

Illustration 2 Consider another example in which a single local government has only two taxpayers – the residential homestead from the previous illustration plus one commercial with \$0 in exemptions whose land and improvements are worth 10 times that of residential. Assume that the local government is financing an \$80,000 property tax levy, resulting in a rate of 3.84% under current policy.

Illustrated Fiscal Analysis of Exempting All Development				
	Current Policy		Land Tax Policy	
	Residential	Commercial	Residential	Commercial
Taxpayer Property Info				
Land	\$40,000	\$400,000	\$40,000	\$400,000
Improvements	\$160,000	\$1,600,000	\$160,000	\$1,600,000
Gross AV	\$200,000	\$2,000,000	\$200,000	\$2,000,000
Exemptions	\$115,000	\$0	\$160,000	\$1,600,000
Net AV	\$85,000	\$2,000,000	\$40,000	\$400,000
Taxpayer Property Tax Bill				
Calculated Tax Bill	\$3,261.39	\$76,738.61	\$7,272.73	\$72,727
Max Tax Bill	\$2,000	\$60,000	\$2,000	\$60,000
Circuit Breaker Credits	\$1,261	\$16,739	\$5,273	\$12,727
Net Tax Bill	\$2,000	\$60,000	\$2,000	\$60,000
Local Government Finance				
Property Tax Levy	\$80,000		\$80,000	
Total Net AV	\$2,085,000		\$440,000	
Rate	3.84%		18.18%	
Circuit Breaker Losses	\$18,000		\$18,000	
Property Tax Revenue	\$62,000		\$62,000	

Once again, the policy swing has no change in the property tax revenue, individual property tax bills, or circuit breakers. The exemptions have increased for both taxpayers so the shrinking net AV has caused the tax rate to increase from 3.84% to 18.18% without fiscal implication for local governments or taxpayers.

These first two examples simply mean to demonstrate how circuit breaker calculations and property tax bills would be calculated under the proposed and current policy. Estimations using actual taxpayer data would be extremely useful in considering the effects of the policy.

Illustration 3 Let's conclude with an example that demonstrates the dynamic incentives created under the land policy. The following illustration is a industrial establishment with \$50,000 in land and \$500,000 in land improvements both under current policy and under the proposed land tax policy. For the purpose of the illustration the new higher tax rate (44%) will be ten times what would occur under current policy (4%), matching the improvement to land ratio, so that "Year 1" will be the same under both policies in the tax bill and circuit breaker calculations. Deviations occur over time because it is naively assumed that land improvements grow at 15% per annum.

Industrial Development with 15% Annual Investment in Land Improvements				
	Current Policy			
	Year 1	Year 2	Year 3	Year 4
Land	\$50,000	\$50,000	\$50,000	\$50,000
Improvements	\$500,000	\$575,000	\$661,250	\$760,438
Gross AV	\$550,000	\$625,000	\$711,250	\$810,438
Exemptions	\$0	\$0	\$0	\$0
Net AV	\$550,000	\$625,000	\$711,250	\$810,438
Max Tax Bill	\$16,500	\$18,750	\$21,338	\$24,313
Calculated Tax Bill (4%)	\$22,000	\$25,000	\$28,450	\$32,418
Circuit Breakers	\$5,500	\$6,250	\$7,113	\$8,104
	Land Tax Policy			
	Year 1	Year 2	Year 3	Year 4
Land	\$50,000	\$50,000	\$50,000	\$50,000
Improvements	\$500,000	\$575,000	\$661,250	\$760,438
Gross AV	\$550,000	\$625,000	\$711,250	\$810,438
Exemptions	\$500,000	\$575,000	\$661,250	\$760,438
Net AV	\$50,000	\$50,000	\$50,000	\$50,000
Max Tax Bill	\$16,500	\$18,750	\$21,338	\$24,313
Calculated Tax Bill (44%)	\$22,000	\$22,000	\$22,000	\$22,000
Circuit Breakers	\$5,500	\$3,250	\$663	\$0

Under current policy, investments cause gross AV to increase the maximum tax bill and the circuit breaker losses to the government. In other words, the percent of levy collected on this taxpayer is only 25% in all years, and the tax growing tax bill serves as a disincentive to invest and therefore discourage growth in the economy.

Under the land tax only policy, the 15% investment has no effect on the calculated tax bill, but does increase the maximum allowable tax bill. In years 1-3, the land tax policy is no worse of a disincentive for the owner to invest than current policy, but after year 4 there is no tax

disincentive to investing in land improvements. Simultaneously, the local government is collecting a larger percent of its levy, eliminating circuit breakers altogether by year 4.

CONCLUSION

It is proposed that all non-land components of the property tax be exempted from net assessed value used in calculating tax rates and tax bills. Further study of Indiana data is required to more fully assess the potential impacts on taxpayers and local governments. The basis of the argument is that such a reform would encourage economic growth that would benefit the taxpayers living under the cap and provide local governments with property tax revenue free of circuit breakers.