

Designing a State Tax System for the 21st Century: A Difficult Path for Rescue and Restructure

John L. Mikesell

Chancellor's Professor of Public and Environmental
Affairs Emeritus

Indiana University



SCHOOL OF PUBLIC AND
ENVIRONMENTAL AFFAIRS

INDIANA UNIVERSITY

Never forget...

- **Raising revenue** is the unique role of the tax system in market economy
 - Objective: Behave like a pickpocket, not a mugger.
-

Patriotism and Taxation – Never Easy

- “We have shed our blood in the glorious cause in which we are engaged; we are ready to shed the last drop in its defense. Nothing is above our courage, except only (with shame I speak it) the courage to tax ourselves.” --James Madison, 1782
-

Impossible Dream? News Flash: There is a popular tax in Chinatown, NYC!



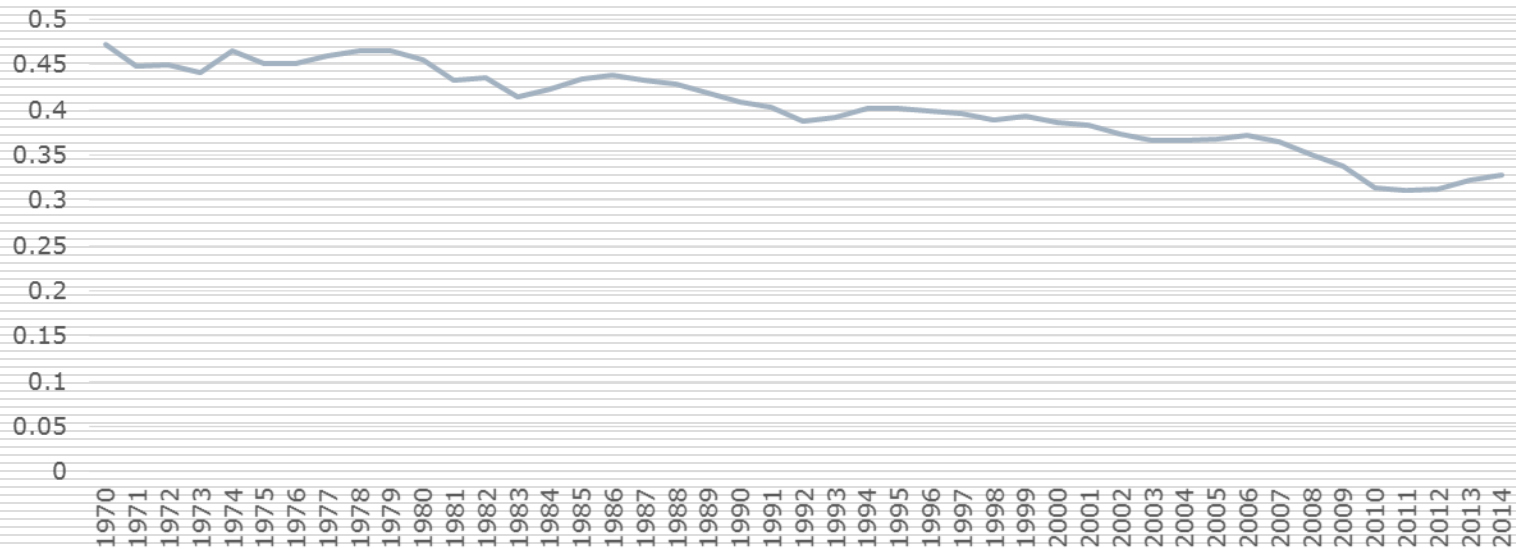
A pretty good guide for restructuring for 21st Century...

- “Tax reform should also broaden the overall tax base by closing special interest loopholes that distort the marketplace, limit innovation, and waste time and resources.” -- Fiscal 2017 Budget Resolution, U. S. House of Representatives
 - Basic Guide for 21st Century Rescue Mission: Pick sound bases, include broadly, and tax lightly.
-

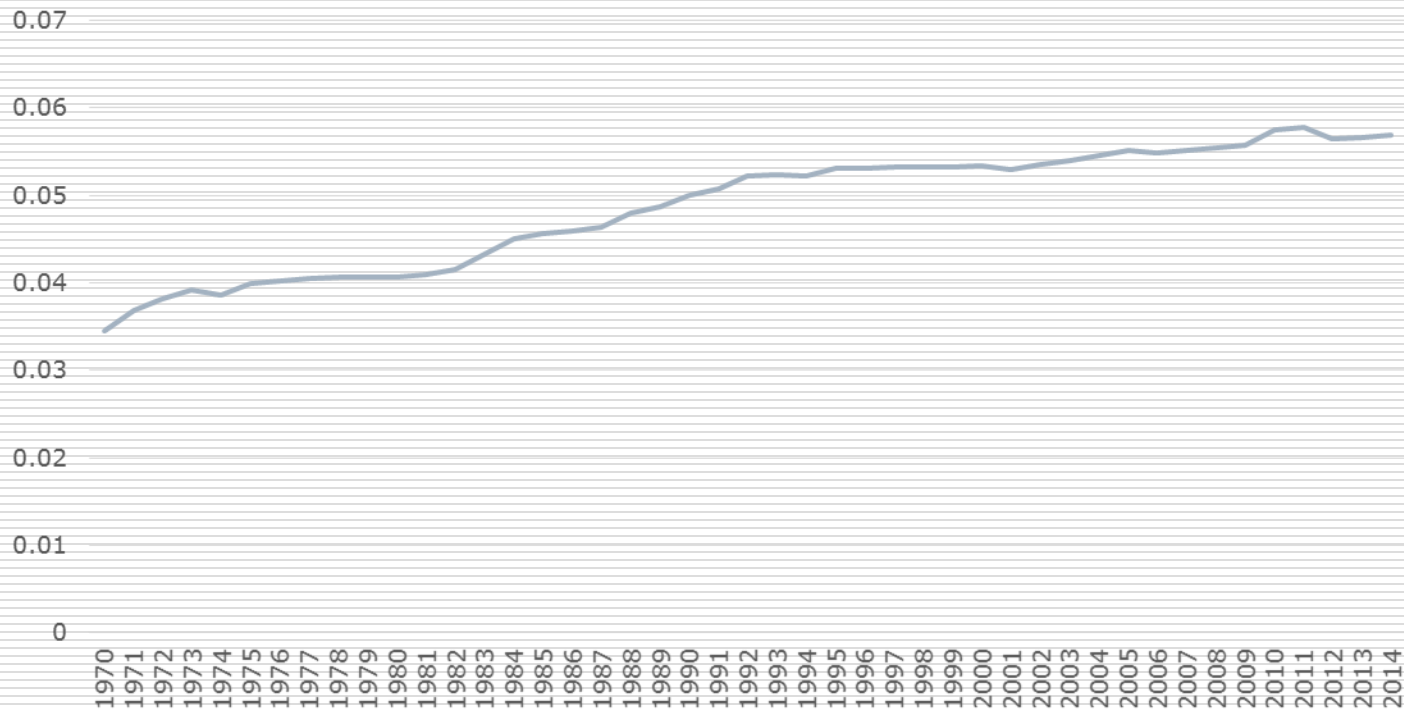
Where Are We? Some State – Local Tax Facts

Taxes Levied by State or Local Government	% Own Source General Revenue (2012-13)
States	
Individual Income Tax	26.7
Retail Sales Tax	22.2
Corporate Income Tax	3.9
Motor Fuel Tax	3.5
Charges	15.8
Local Governments	
Property Tax	46.7
Charges	27.5

RST Problem: Disappearing Retail Sales Tax Base (Graph is National Aggregate Base Relative to Total Personal Income)



That has required: Upward Creeping National Effective RST Rate (and no good comes from higher tax rates)



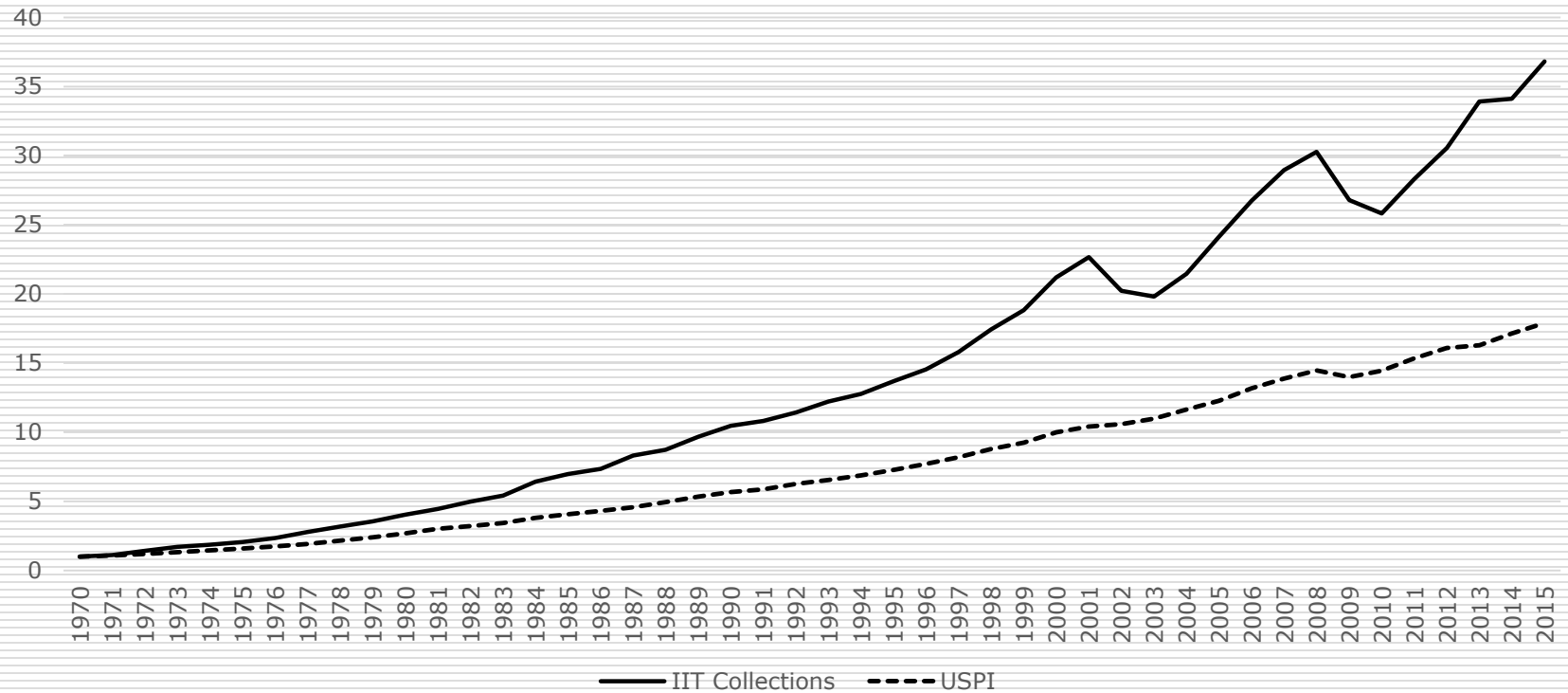
RST Objective

- ❑ **Broad** consumption base taxed at uniform and **low** statutory rate. Not a tax on “luxuries” that exempts “necessities.”
 - ❑ Avoid distortion, discrimination
 - ❑ Tax all household consumption purchases, exempt all business input purchases
 - ❑ General tax on household consumption expenditure is goal (to base tax distribution on self-evaluated capacity to afford purchases from private sector)
-

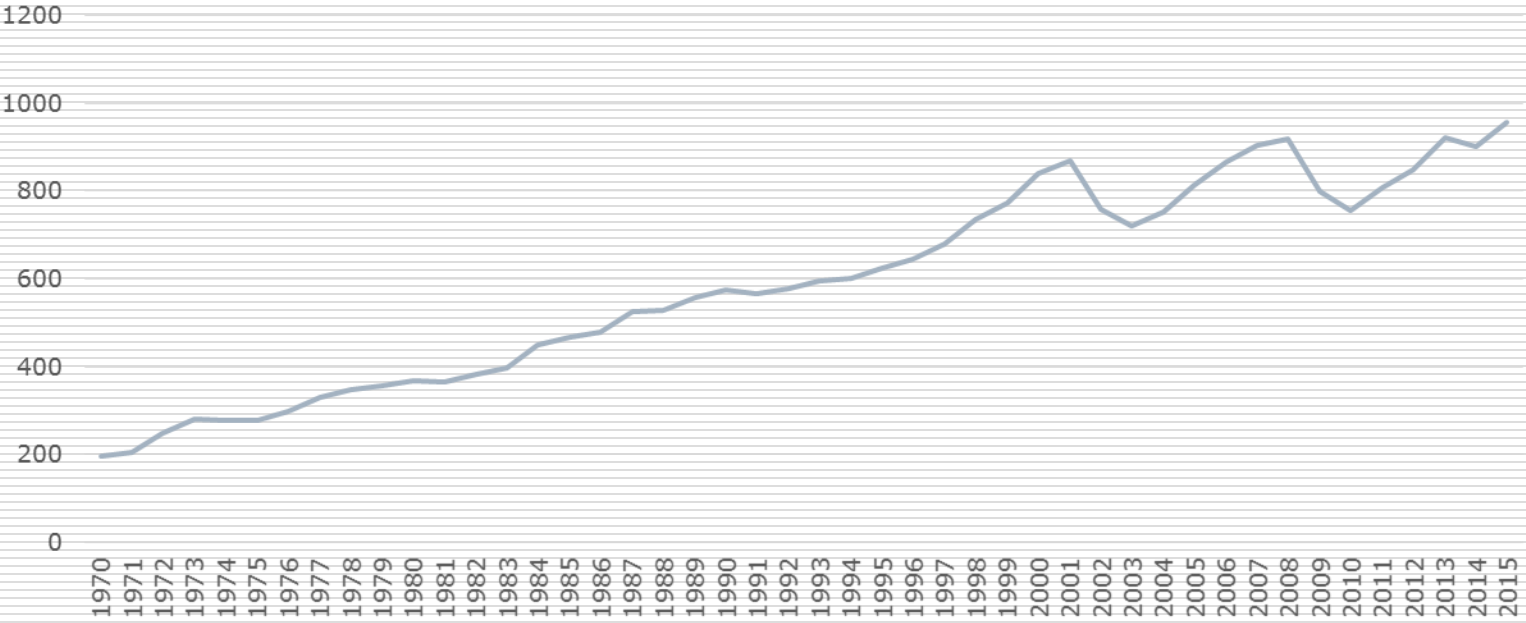
Specific 21st Century RST Rescues

- ❑ Tax food, clothing, medicine, other household consumption purchases (SNAP exempt)
 - ❑ Tax household service expenditures
 - ❑ Exempt business input purchases
 - ❑ Tax nonprofit organization sales; exempt nonprofit organization purchases
 - ❑ Eliminate tax holidays
 - ❑ Collect use tax: distribution centers create nexus, affiliate relationship creates nexus (NY), require reporting by remote vendors (CO)
-

State Individual Income Tax Collections and National Personal Income Relative to 1970 Levels



National Real State Individual Income Tax Collections per Capita



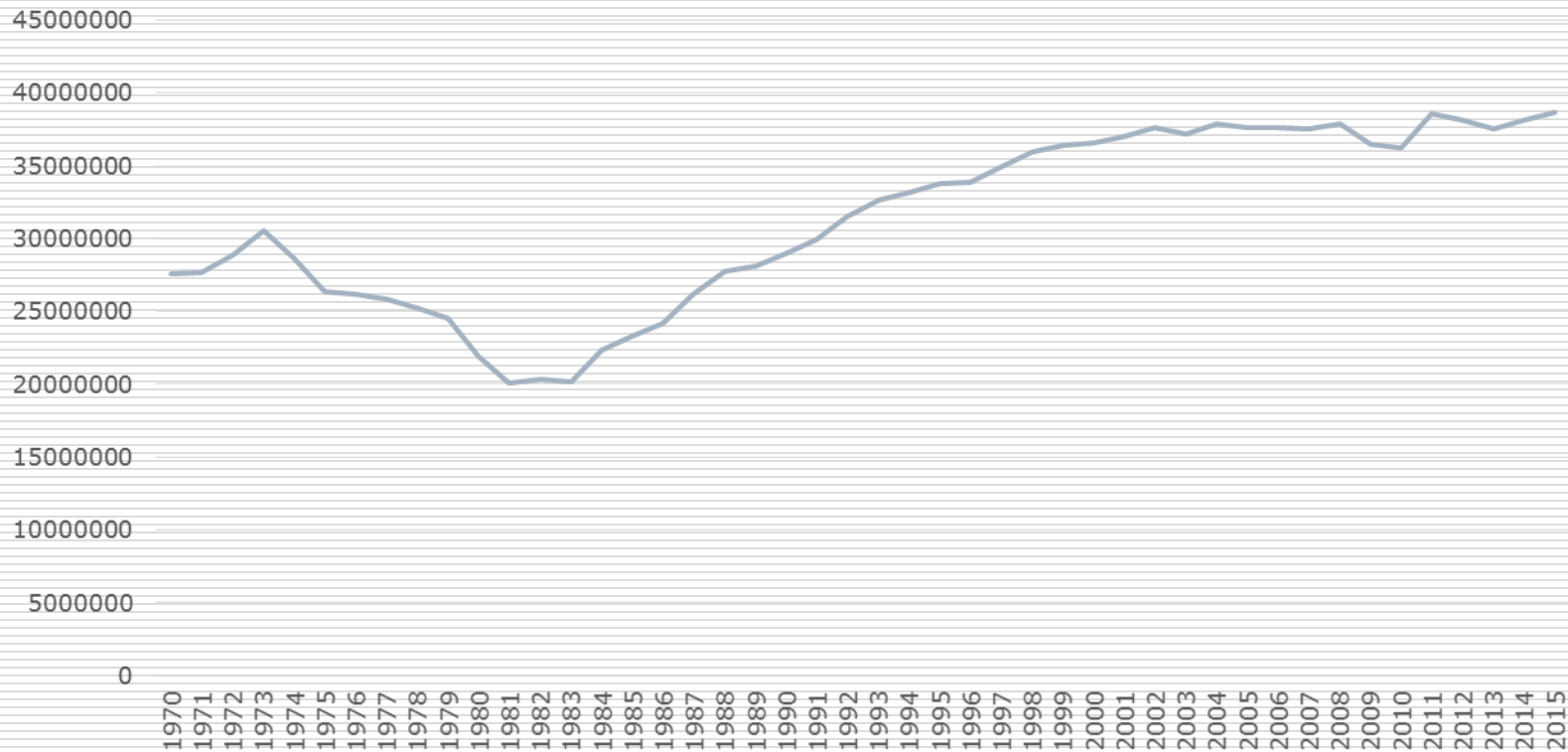
Problems

- ❑ Cyclical sensitivity
 - ❑ Political – adding preferences and quest to eliminate
 - ❑ But – collections continue to increase faster than personal income
 - ❑ With crippled RST, heavier IIT reliance probably necessary
-

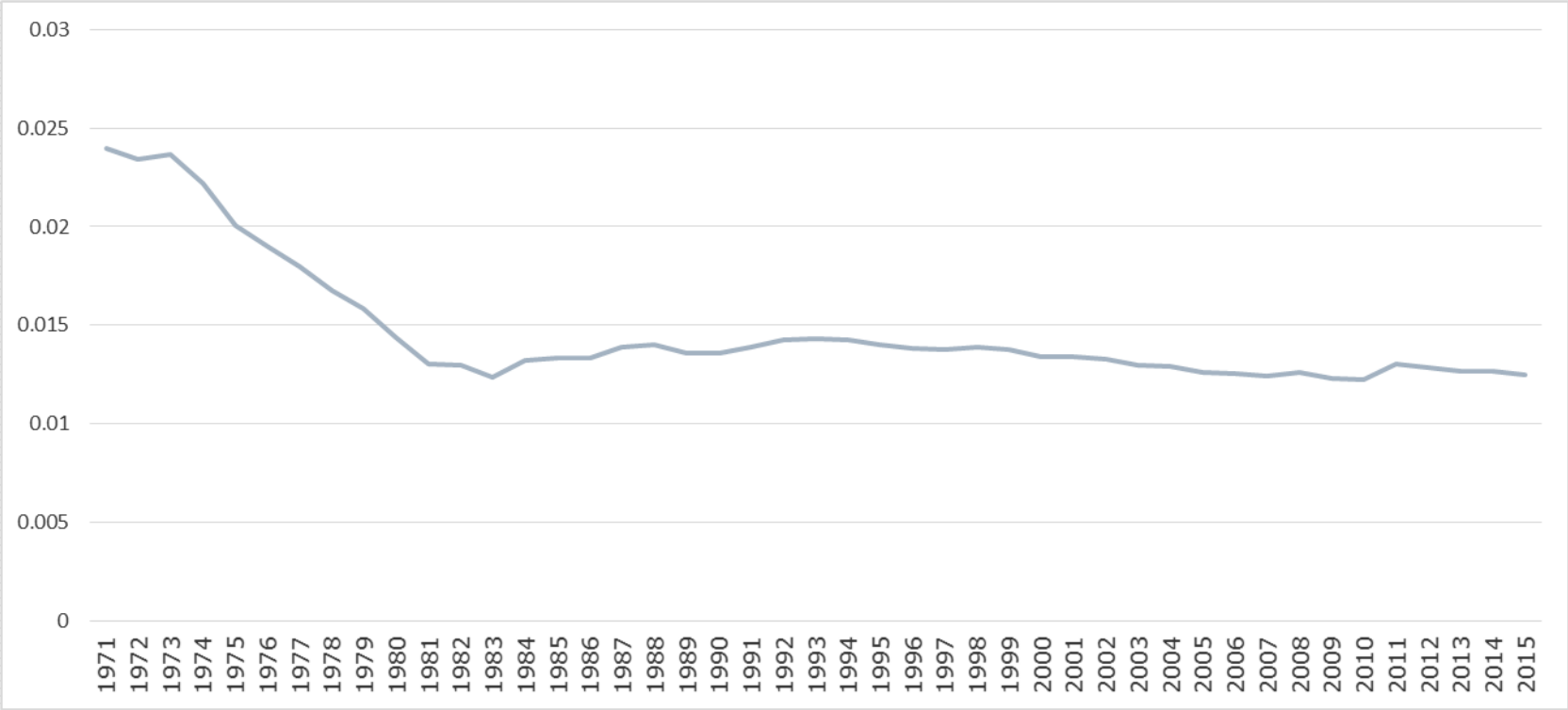
Rescuing Individual Income Tax: Remove Non-revenue Objectives

- ❑ BROAD: Eliminate preferences built into the state structure: deductions, exclusions, etc.
 - ❑ Eliminate graduated rate structure, use personal exemption to provide any progression
 - ❑ Retain EITC if desired – it is targeted, use sales tax credit to reduce RST regressivity
 - ❑ Progressivity is best left to the federal government and the federal tax is steeply progressive
-

State Motor Fuel Tax Collections Have Stopped Increasing in Real Terms (National Totals Adjusted to 2009 Prices)



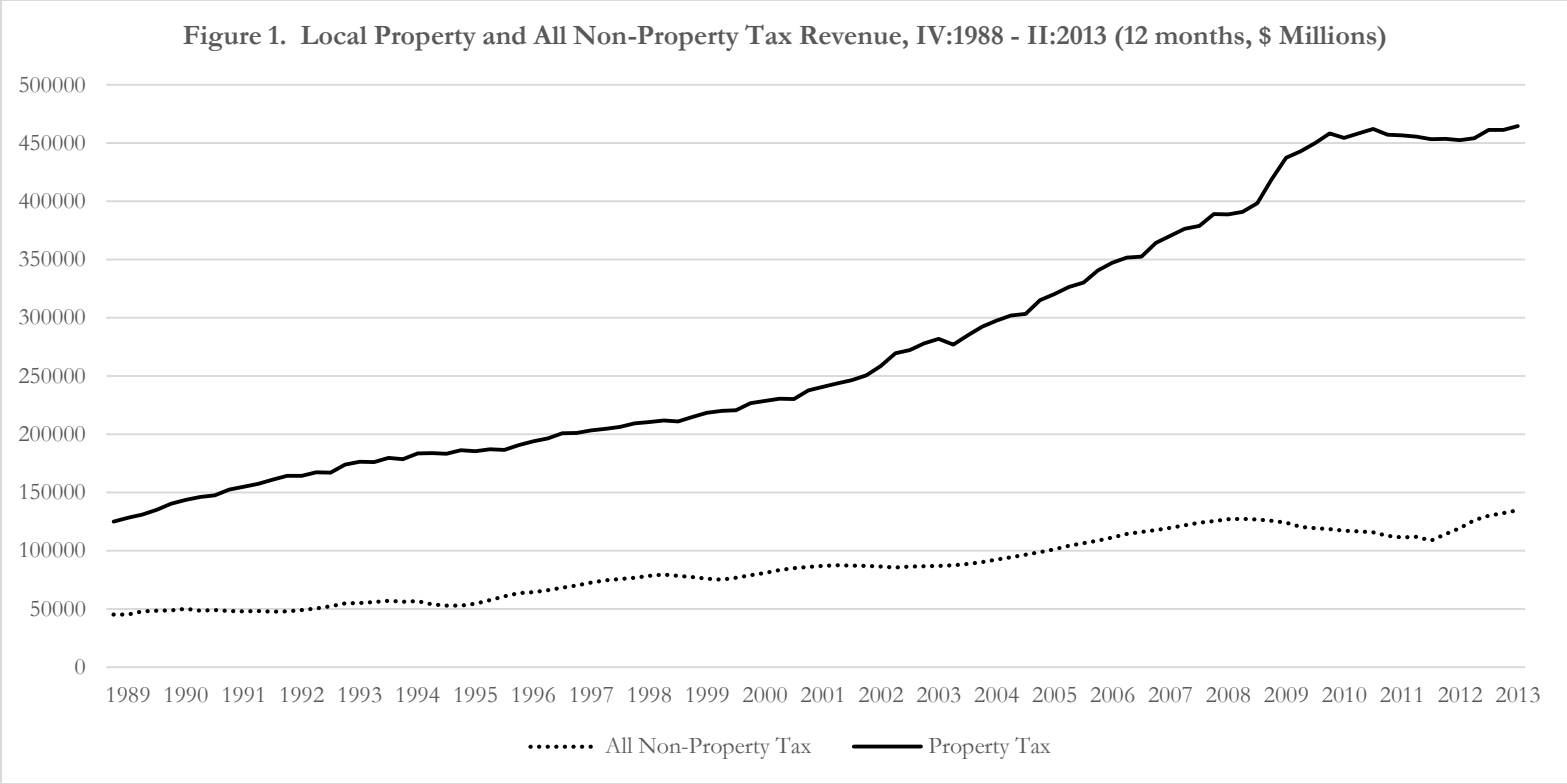
National Real State Motor Fuel Tax Collections per Vehicle Mile Traveled (1970-2015)



Rescuing the Motor Fuel Tax: Failure to Keep Up With Highway Construction, Operation, and Maintenance Requirements

- ❑ Benefit logic is sound but old system is dying
 - ❑ Problems: tax on gallons, increased fuel economy, hybrid and all-electric vehicles, and political reluctance to increase fuel tax rate doom the traditional MFT
 - ❑ Technology permits direct charge system, probably only way to retain anything like a user-pays system of highway finance (Oregon system of using pay-at-pump as advance collection of mileage charge)
 - ❑ MFT in current form possibly not rescuable
-

Local Government Property Tax Revenue



Rescuing the Real Property Tax

- ❑ Local fiscal viability is important for state government finances
 - ❑ Real property tax is nearly ideal financing instrument for local government in 21st century. Immobile tax base!
 - ❑ Why? Stability, visibility, flexibility, proxy charge for local services, collectable by localities
 - ❑ Constraints preventing current market value assessment, ceilings on statutory rates, special assessment systems for certain property types, and exemptions prevent property tax from achieving its potential ← avoid all.
 - ❑ Traditional circuit breakers and deferrals provide useful safety value for continued use of the tax
 - ❑ BROAD and low
-

Rescuing / Revitalizing User Charges

- ❑ Service benefitting identifiable households and businesses are good candidates for charge finance (selling services)
 - ❑ Relieve tax system of need to finance those services, relieves those not using the service from paying for them, collects from entities with tax exemption
 - ❑ Technology can help
-

To do list:

- Stop RST disappearance
 - Close individual income tax holes
 - Find sustainable user-based system for highway finance
 - Preserve real property tax for local governments
 - Explore greater use of user charges
 - Build “rainy day fund”
 - Verify quality of tax expenditure budget – what is “normal?” Should be guide for broadening base.
 - Reminder: heavy reliance on any single tax brings out the worst consequences from use of that tax
-