P4_ _ _ Painting a Picture of the Public Purse

Introduction to Taxation in Idaho: A Guide to Commonly Used State and Local Taxes[1]

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[1] Adapted from Circular 1305 Montana State University by V. W. House and M. E. Wolfe.

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Overview and Introduction

to the P4. . .Series[2]

Of all the money we spend, we seem to give it most grudgingly to pay taxes. Most of us have favorite public services, but no one seems to have a favorite tax. Disgruntled taxpayers often threaten to revolt, but they do not refuse to accept public services. Perhaps it is our distaste for paying taxes that has led to the construciton of an extremely complex system that determines who will pay how much and for what. The *P4 is. . .* series of publications was written to help citizens gain a basic understanding of taxation so they can evaluate various tax alternatives. This series of four publications includes:

I. An Introduction to Taxation (AEES 92-4)

II. A Guide to Commonly Used State and Local Taxes (AEES 92-5)

III. Criteria for Evaluating Taxes (AEES 92-6)

IV. A Tax Glossary (AEES 92-7)

Part II of this series surveys property taxes, income taxes, general retail sales and use taxes, excise taxes, severance taxes and value-added taxes. It offers general background information that can boost the layman's understanding of different "breeds" of taxation.

Characteristics of Commonly Used State and Local Taxes

PROPERTY TAX

The property tax is the oldest tax. Political rulers have always required revenue and they have frequently collected this on the basis of their subordinates' property ownership. In the United States during the 19th century and earlier, the property tax was the main source of government revenues. Today it still remains a major revenue

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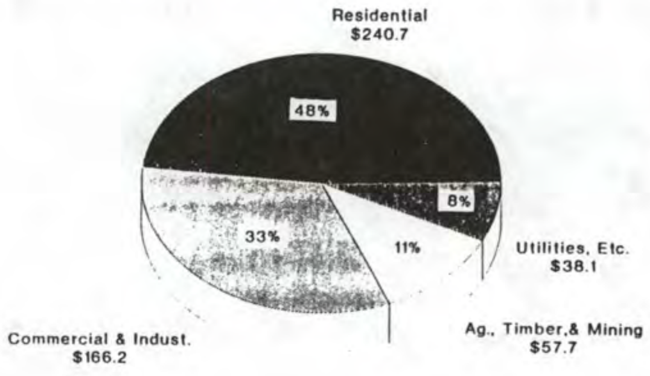
[2]Part of the series Painting a picture of the Public Purse.

source for local governments. In Idaho, property taxes are derived from 4 major types of property: residential; commercial and industrial; Ag timber and mining and utilities, etc.

Fig 1. Idaho's 1991 Property Tax by Category, $ Millions



Idaho Tax Equity Summit, Dec. 12, 1991

In recent years, the general pattern of development has been for tax systems to depend less on property taxes, but it seems likely that the property tax will remain the major source of local government revenue. The bulk of revenue currently raised in the United States by property taxes comes from taxes on real estate. In 1980 property taxes produced $68 billion in revenue for local governments, totaling more than 75 percent of all local revenue. Because local governments determine the nature of the tax, there is wide variation in property tax rates and in the definition of taxable property

Is All Property Taxed Uniformly?

Uniform taxation of all property might be expected, but usual property classification practice differentiates between: 1) *real property* (land and permanent improvements); 2) *tangible personal property* (business inventories and equipment, motor vehicles, farm machinery, livestock); and 3) *intangible personal property* (cash, bank deposits, stocks, bonds). Most states, including Idaho, no longer include intangible property in the property tax base because it is so difficult to assess.

Henry J. Aaron states in his book, Who *Pays the Property Tax:* "In practice (property tax) is very nearly a tax on real property only: 86 percent of the assessed value of locally assessed property is real estate. Not all real property is covered, however; perhaps one-third is exempt. This occurs because there are so many variations in administration and the laws, that the property tax has become a far cry from being uniform." In Idaho, county assessors are encouraged to use uniformity in assessing property and training is provided to assist in this effort.

How is the property tax base determined?

The property tax is based on wealth rather than income. Thus, mortgage debts ordinarily cannot be used to reduce taxable value. The value for tax purposes is usually *market value* of property or the value at which property would change hands between a willing buyer and willing seller, if neither was forced to buy. In some cases, capitalized earnings (income from the property divided by an interest rate) may be used as a partial determinant of taxable value.

About half of the states, including Idaho, have adopted a *use-value* rather than a market value method of calculating the values of agricultural land. These methods are usually based on so-called "greenbelt" laws designed to maintain land in agriculture. Adopted by most states in the 1970s, "greenbelt" laws are based on the idea that agricultural use of land cannot compete with non-agricultural uses (residential, industrial, business), so the land transfers to the higher-valued and more lucrative use. For example, land that has potential as a residential subdivision may be worth five or six times its value as agricultural property. Considerable incentive exists, therefore, for its transfer to the "higher" use. "Use value" under the greenbelt laws bases taxes on values estimated as if agriculture were the only use for the land.

It is interesting to note that not one of the many studies of these laws has found that use-value taxation accomplishes its stated goal, but it enjoys strong support from farmers. (It is unclear what the proposed 1% initiative will mean for use value taxation and the residential exemption.)

The Property Tax Percent Levy and Bill

Through the budget process the tax levy is determined. The ratio of the levy to the tax base determines the tax rate and how these rates then distribute the property tax cost of services to properties is then based on assessed value. The individual's bill is then his or her "share" of the property tax cost of local services. For example, if there were only one property owner in a jurisdiction, that person's share of the bill would be 100 percent. If there were two, one owning 60 percent of the taxable value and one owning 40 percent, the property tax cost of services would be divided accordingly.

The property tax bill sent to an individual is expressed in dollars due. In Idaho, it is derived by multiplying the market value of the property by the appropriate tax rate. But how is market value actually determined?

Most property is valued at its market value for property tax purposes. There are, however, exceptions. One exception is the property tax on minerals and timber (the severance tax) in which no tax is levied against the minerals or timber until they are severed" (mined or cut) from the land[3]. The tax is then levied on the basis of "net" or gross proceeds. A second option is based on annual production on the land.[4]

Once market value is assessed for tax purposes, property is taxed. Tax rates are expressed as a percent of market value. Levies are expressed in percentage terms as dollars per $1,000 of assessed valuation.

[3]Bare land and yield option.

[4]There is a second timber tax option paid on the land and the growth of timber.

Uniformity Within Property Classifications

While there are many departures from the original concept of uniformity in property taxation, attempts are made to achieve uniformity *within* classes of property

Evidence of legislative attempts to treat similar groups uniformly can be seen in the example of certain kinds of property that are exempt from taxes. Property owned by governmental agencies and by religious and charitable institutions are examples of exempt property. Land that produces crops is assessed on the basis of its potential to generate income. As a general rule, however, the same tax rates apply to all classes of property

Assessing Property Values

In most states, assessment and valuation of property are made locally with guidance from state authorities who attempt to make procedures consistent throughout the state. Consistent assessments are quite important to ensure equitable tax collections at the local level and fair revenue disbursements from the state level. State government makes four distributions (City County Revenue Sharing, Business Inventory Replacement, Highway Users Distribution, and Liquor Sales Distribution) according to formula, which takes into account local capacity to raise tax revenues among other factors.

To illustrate, assume first that there are uniform tax rates statewide; and second, that there is state aid to local units based in part on the ability of recipient localities to raise revenues. Under these conditions, a county that gives low property assessments relative to all other counties in the state would 1) pay less than its fair share of taxes to the state and 2) receive greater than its fair share of state aid. Distribution formulas attempt to correct for this condition.

County assessors usually make property listings and valuations. Property owners then have the option of accepting the valuation or appealing. Generally, attempts are made to equalize assessments among various taxing units and classes of property.

Property Taxes from the Individual's Point of View

For the individual citizen, the property tax represents a familiar part of the local tax system. It clearly links the individual's tax cost to government expenditures for many local public services. It gives the individual some opportunity to perform his or her own cost-benefit analysis. in addition, the law allows the deduction of the property tax from income taxes. This deduction has been included in property values (which may change under federal tax law revisions).

- *An Impersonal Tax.* In spite of the fact that the property tax is a familiar one and bears a close relationship to local expenditures for public services, it is an impersonal tax. This is because the taxing jurisdiction is determined by the location of the property, not the residence of the owner. The tax is, therefore, a lien against the property, not against the owner's general assets.
- *An Equitable Tax?* If an individual's income is derived primarily from sources not subject to property tax, that person pays a small part of the total property tax bill regardless of income level. If, on the other hand, an individual's income is derived principally from sources subject to property tax, that person pays high property taxes in relation to income. Frequent criticism results from such differing impacts and leads to the charge that the property tax fails to pass the equity or fairness tests of "ability to pay" and "benefits received"[5]

Owning property is not necessarily a valid indication of ability to pay taxes. Idaho farmers and ranchers with large investments in property find property taxes burdensome when low prices or rising costs create severe cash flow and borrowing problems. The opposite may also be true. We live in an economy where a person can

[5]For further explanation of these ideas, see **P4...Criteria for Evaluating a Tax System, Part III.**

generate a large income as a corporate manager, a broker or a financial trader without owning much more than pen and paper or a computer. Obviously, possession of property alone does not predict a certain ability to pay.

Nor does the absence of property ownership indicate no payment of property taxes. Renters and customers are generally thought to pay the property taxes of their landlords and the businesses that they frequent.

The property tax does not necessarily treat all taxpayers alike. Homeowners in Idaho have the opportunity to shift part of the burden of the tax (its incidence) onto someone else through the residential exemption and, therefore, may be less impacted. In contrast, businesses taxed on production or total investment have the opportunity to transfer the incidence of the tax onto the consumer or others through pricing, thereby shifting their own tax burden.[6]

- *A Regressive Tax?* The property tax is considered by many to be regressive relative to income, although interpretations differ when the tax base is defined as wealth or "permanent" income. Drought, economic conditions, decline in earning power due to old age, sickness and death can change the average taxpayer's ability to pay. The property tax does not reflect such changes and, consequently, often results in higher tax payments by low-income people than those with higher incomes. In practice, the assessment of low-value property tends to be at or above actual value while high-value property tends to be undervalued. This further tends to make the property tax regressive, especially as it applies to homes.

Some people, however, have called the property tax progressive, arguing that "rich people own more property than poor people, so they pay more taxes." This view argues that the property tax is progressive relative to wealth rather than income.

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[6]See **P^4...A Tax Glossary, Part IV**, Cooperative Extension Service Circular (AEES 92-7) for a more detailed explanation of these terms.

- *A Hidden Tax?* When property taxes are included in house payments, homeowners may be unaware of the amount of their property tax. In addition, renters who pay a property tax indirectly on homes and other property frequently are unaware of how the property tax is shifted to them.

Property Taxes from Government's Point of View

From a governmental standpoint, the property tax has a number of advantages. First, property provides a large tax base, so a tax on it is capable of yielding large amounts of revenue. A second advantage of the property tax from government's point of view is that it *provides flexibility*. Unless prevented by statutory or constitutional provisions, the rate can easily be raised or lowered to meet revenue needs.

Third, the property tax provides considerable revenue *stability* because property values change slowly from year to year and real estate cannot be moved from the taxing district. However, there are instances of movable personal property being shifted from one district to another on dates of assessment to take advantage of lower tax rates, different assessment dates, or to avoid the tax completely.

Fourth, the property tax provides a relatively *stable* source of revenue because taxes are due regardless of economic conditions. Such revenue is not subject to the fluctuations in income.

Fifth, the property tax is paid in the state regardless of the legal residence of the owners. This means that people living outside the taxing community sometimes pay Idaho property taxes. Such taxes are said to be "exported" to outsiders.

Sixth, the property tax rate is set annually depending on spending levels. As a result, it closely links the taxers and the spenders. It therefore encourages government officials and elected official accountability.

Property Tax Administration

Administration of property taxes at the local level does not ensure efficiency, but it does allow local people to see what is going on. While visibility may be a bonus to citizens, they may be entirely unaware of the complexity of administering the tax.

Obtaining a complete assessment of all property, especially intangible personal property, is difficult. Determining the value of certificates of stocks, bonds, promissory notes and franchises is extremely complex. Because of this, most states, including Idaho, no longer use intangible property in their property tax base.

The complexities of tax administration indicate the need for special skill in tax assessment. In Idaho, the concern for skilled assessors has been addressed through assessor school training.

Property Tax Exemptions

Property tax exemptions have been few during the earlier years of tax history, but over time, they have increased in number,

The property tax gives preferential treatment to organizations using tax exempt property, such as religious, charitable and educational organizations. Further, more and more states are exempting part or all of business inventories and part of residence value.

Because the property tax may have the effect of discouraging the addition to or maintenance of property, some states are giving new and existing businesses a tax exemption that attempts to correct for this tendency. (For example, an individual may be reluctant to improve his of her house if he or she thinks that, in addition to the initial costs, it is going to increase taxes. The business owner is likely to think in a similar fashion.)

Therefore, in some states, new firms can be exempt for as long as 10 years. In Idaho, certain new plants of newly remodeled or expanding industries are given a preferential treatment for a limited time.

In summary, the property tax, based on the relatively simple idea of property ownership, is quite complex. It is not necessarily based on ability to pay or benefits received (that is, if these criteria are determined by income). In fact, unequal assessments and uneven distribution of property taxes are possible. The existence of different property classifications almost guarantees preferential treatments, and differential growth in each class of property can distort the revenues the system obtains over time.

On the other hand, one of the chief assets of this type of tax is that it provides certainty of revenue. Since ownership of private property is fundamental to our way of life, then property taxation ensures an ongoing, stable, flexible means for generating the revenue required to provide local government services the public desires. But in the final analysis, widespread participation in paying the property tax depends on the distribution of property ownership and the extent to which shifting is possible.

INCOME TAX

Individual income taxes are used by 43 states (86 percent) and by some municipalities. Corporate income taxes are imposed by 46 states. In Idaho 30 percent of the 1989-1990 tax dollar was derived from individual and corporate income taxes.

Income is generally defined as the total realized economic gain of a person or corporation during a specified period. Items usually included in the determination of income are:

1. Personal Income
    - a. salary
    - b. wages
    - c. profits of proprietorships and partnerships

d. rent received

e. pension income

f. interest received

g. dividends

2. Corporate Profits

Common practice is to base the income tax upon net income. so in effect, income taxes closely adhere to the ability-to-pay criterion. But income tax payments may bear little direct relationship to benefits received from government. in fact, widespread participation in paying the total tax bill will depend on the level of income and exemptions allowed.

Unlike the comparatively stable source of revenue provided by the property tax, the income tax is subject to variability in personal and corporate income. In particular, it would not be a stable source of revenue in situations of high-income variability. In some cases, aggregate income does not vary as much as individual income; so, for some states, a fixed-rate income tax can provide a fairly stable revenue source.

How Can Income Tax Rates Be Adjusted To Vary Their Impact?

Income taxes can be designed to be progressive, proportional or regressive[7]. The usual approach is to make income taxes progressive, but this is much less likely at the state level than with the federal income tax. The corporate income tax is similar to individual income taxes, but, since it taxes corporate earnings, it may have different effects.

One argument is that a corporate income tax is shifted to stockholders, suppliers, employees and consumers, so needed revenue can be obtained more equitably through an individual income tax than through a corporate income tax.

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[7]These terms are defined in **P^4... A Tax Glossary, Part IV** and discussed at some length in Part III, Criteria for Evaluating Taxes.

Another negative attribute of this type of tax, some people feel, is that it can be somewhat difficult to administer corporate taxes on corporations that do business in more than one state.

But on the other hand, it is generally true that corporate income taxation provides a means of taxing out-of-state corporations that earn income in the state, thereby exacting some corporate cost for the use of the state's human or land resources and government services. In addition, it provides access to a large body of taxable wealth. Finally, the corporate income tax may make the individual income tax somewhat more politically acceptable[8] .

GENERAL RETAIL SALES AND USE TAXES

The sales tax is a tax on spending. Sales taxes are usually collected by the seller and remitted to the state tax collection agency. To the individual paying this tax, it appears as part of the price of the item. Forty-five states use some type of sales tax. But Idaho, Oregon, New Hampshire, Delaware and Alaska have refrained from instituting this type of tax.

How Does the Sales Tax Work?

The usual procedure is to apply the tax to items bought for consumption rather than resale and to exempt producers' goods and services.

A common practice is to exempt certain classes of items from a sales tax. For instance, food and medicine are sometimes exempted to decrease the regressivity of the sales tax.

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[8] See **Taxation and Revenue Systems in Idaho**, Cooperative Extension Service, University of Idaho, 1992 for more detailed information regarding the specifics of income taxes.

A Regressive Tax?

The sales tax is generally thought to be regressive. However, some economists (Beattie and Young) argue that a general retail sales tax is proportional to one's lifetime income. Others argue that when different measures than income are employed to evaluate the sales tax, such as consumer spending, the sales tax can be in agreement with standards of ability to pay. Regardless of the legitimacy of these arguments, it is apparent that the sales tax can be made much less regressive by exempting necessities such as rent, food, medical services and so on. For this reason, some states with a sales tax use such exemptions, hoping to ease the tendency for the incidence to fall most heavily on low-income groups and large families who spend a higher percentage of their income for consumption goods. Rebates are another means for controlling the regressivity of this type of tax. (Idaho uses a credit on income tax to reduce the regressivity.)

A Progressive Tax?

Regressivity can be partially offset if services as well as tangible consumption goods are subject to the tax. Taxation of services is becoming more common. In addition, tax credits are allowed in some states to offset tax liability, making the tax more progressive. This is accomplished by first establishing a base amount for subsistence, then levying a tax rate that is proportional to the number of family members.

The Sales Tax from the Individual's Point of View

From the individual's standpoint, the sales tax may be considered convenient since it is a small tax paid with each purchase. Or it may be considered a nuisance since it must be paid with each purchase. At the very lcast, the general retail sales tax is a simple tax and easy to understand. In addition, this type of tax ensures widespread participation in the paying of tax revenues.

Administering the Sales Tax

From the standpoint of the taxing unit, the sales tax is a fairly easy tax to administer; and it provides a relatively stable source of revenue because it taps a large tax base[9]. It also is relatively economical for government to collect, since most of the collection costs are borne by merchants.

But the sales tax is not well-adapted to local government use unless administered by the state, since its effect is to shift purchases from one taxing jurisdiction to another. Furthermore, in practice, the sales tax is not flexible since the rate is set by law and can be difficult to change.

A Use Tax?

Because there is some possibility that residents will buy out of state where nonresidents may not be subject to the sales tax, many states have resorted to a use tax. This is essentially an attempt by the homc state to collect the sales tax that it would have collected had the sale been made within the home state. For instance, the incentive to buy a car out of state and avoid sales tax is eliminated if the purchaser knows when he registers the car he will have to pay a use tax equal to the sales tax on a car purchased in his own state.

The Sales Tax from Society's Point of View

From the standpoint of society, a sales tax does not appear to retard economic growth if it does not apply to producer purchases such as farm machinery. However, it

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[9]The term "tax base" is defined in **A Tax Glossary, Part IV** of this series and discussed in **Criteria for Evaluating Taxes, Part III.**

may have some tendency to encourage spending on items or services that are exempt, as well as to encourage more savings.

In summary, retail sales and use taxes are often believed to be regressive because, when using income as a standard, they are not necessarily based on ability to pay. However, when examined as one part of a total tax system, this type of tax may not violate the ability to pay criterion as much as it appears when it is considered alone. Some argue this is true because people in lower income brackets who spend a larger percentage on subsistence and, thus, pay more sales tax relative to income tend to pay relatively less property and income tax.

The design of the sales tax ultimately determines the degree to which it tends to be either regressive or progressive. And as a broad-based tax, the sales tax does make it possible for all members of society to pay the costs and contribute support for the governmental activities they require.

EXCISE TAXES

Excise taxes (or "special sales" taxes) are similar to general retail sales taxes except that they tend to be somewhat less regressive. An example of the excise tax is the motor fuel tax that, in most instances, adheres most closely to the benefits received criterion. Its revenue goes primarily to support roads used by fuel buyers. Other excise taxes include those on alcoholic beverages, tobacco and entertainment. In fiscal 1989-90, 15 percent of Idaho tax revenues were from excise taxes: highway users, alcoholic beverage and cigarette and tobacco taxes.

Excise taxes tend to be dependable revenue producers because they usually apply to a product which people continue to buy even though the price goes up as a result of the tax. Excise taxes can be productive enough to assist in cases of small budget shortfalls, however, at present they provide relatively minor sources of revenue for most states.

SEVERANCE TAXES

A severance tax is a tax levied on the production of natural resources severed or removed from land or water. As an alternative to a property tax, the severance tax is one alternative means for taxing minerals not subject to a regular property tax on assets.

Severance taxes generally are levied to compensate the state for environmental damage, to finance public services, to support conservation, or a combination of the three. In Idaho, severance taxes were instituted to help level the impact of the "boom-bust" cycle of resource development by providing funds for increased public services caused by natural resource development. The revenues from this tax source are relatively unimportant of the total Idaho state-local tax dollar.

Why would a severance tax be chosen over another form of tax? Before severance taxes, states relied almost entirely on property taxes. Property held in mineral resources was generally taxed according to value (ad valorem). But applying an ad valorem tax on mineral property was difficult because the worth of the minerals in the ground was largely unknown until mined. Consequently, assessments and the equity of the tax were called into question.

In addition to problems of equity and assessment, additional difficulties stemmed from fluctuations in price, the unknown nature of the deposit and the unpredictability of future extraction costs. Ad valorem taxes also accelerated depletion of the resource because the tax depended entirely on the value of the resource and it became due whether or not the resource was being mined.

Because of the ad valorem tax's administration problems and its adverse effects on resource use, states devised an alternative, the severance tax, which attempted to correct for some of the deficiencies of its tax forerunner.

VALUE-ADDED TAXES

One alternative to the complex variety of taxes often placed on businesses (through assorted income, sales and severance taxes, for example) is the value-added tax or VAT. This type of tax is levied on firms according to the value added by each firm. Value-added is simply the firm's gross receipts minus the cost of intermediate goods that have already been taxed at an earlier stage of production. In short, it is a multi-stage sales tax that excludes intermediate transactions from taxation. An example would be a tax on retail sales minus purchases of inputs from other companies.

In contrast to the corporate income tax, which is based on the criterion of ability to pay, the value-added tax is more closely based on the value of the public service received. Since it is broad-based, it can be a powerful revenue-raising device once the administrative transition to its implementation has been accomplished. For some time, the value-added tax used by Michigan has served as a model for other states that have created their own value-added taxes[10] .

Summary

Prior to making adjustments or reforms in the existing tax structure, the interested citizen and political decisionmaker alike must be familiar with some general characteristics of commonly used forms of taxation. Property taxes, income taxes, general sales, special sales and use taxes, as well as severance taxes, excise taxes and value-added taxes, have different characteristics[11] . Because of this, they also have different assets and liabilities when used to generate income for government services.

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[10] See Paul V. Teplitz and Stephen H. Brooks, **Alternative Tax Proposals**, Lexington. Massachusetts: Lexington Books, 1986, pp. 19-20 and Roger J. Vaughan, **State Taxation and Economic Development,** Washington, DC: Council of State Planning Agencies, 1979, pp. 87-93.

[11] See **A Tax Glossary, Part IV of the P4**...series for a handy reference source for the non-professional student of taxation and revenue policy.