

HJ 35: ECONOMIC NEUTRALITY

OVERVIEW OF PRINCIPLE

Taxes are not economically neutral because they change the prices of goods and services, impact decisions about working, saving, and investing, and influence business decisions. A tax system should be designed to minimize economic distortions. This is generally achieved by designing a tax system that is spread across the economy with a broad base and low rates. If tax policy is specifically used to impact taxpayer behavior or for budgeting purposes, the Legislature should review those policies on a regular basis and be explicit about the intent.

This overview uses ideas outlined in the National Conference of State Legislatures' [Tax Policy Handbook for State Legislators](#) and adds specific analysis relevant to the Montana tax

ECONOMIC NEUTRALITY BY TAX TYPE

INDIVIDUAL INCOME TAX

Taxing income likely affects taxpayer decisions about how much to work, save, and invest. Montana, like most states, uses the federal income tax as a starting point; however, federal income tax policies may have a greater influence on taxpayer decisions than Montana's income tax policies.

The Montana individual income tax system includes a number of deductions, exemptions, and tax credits that may change taxpayer behavior. The Department of Revenue lists these tax expenditures in its [Biennial Report](#) and provides information on the cost to the state. The 2019 Legislature enacted [HB 723](#) to require review of income tax credits. Good tax policy suggests that, because tax expenditures promote non-neutrality, they should be reviewed periodically, and the Legislature should state the reasons for the tax expenditure.

CORPORATE INCOME TAX

The consideration of economic neutrality and the corporate income tax raises concerns about tax expenditures similar to those for the individual income tax. An additional economic neutrality consideration for corporations is the kind of financing used. Debt financing allows a corporation to deduct interest payments on the debt while equity financing does not.

In addition, differences in the individual income tax and corporate income tax may affect business structure decisions. Some businesses form as pass-throughs and income tax is passed through to the owners and paid under the individual income tax, while other businesses form as corporations and are subject to the corporate income tax. Like the individual income tax, much of the state's corporate income tax law is based on federal law.

PROPERTY TAX

There are two main aspects of property taxation that raise economic neutrality concerns: a classification system and exemptions for intangible personal property. A property classification system is a mechanism used to tax different properties at different rates. Montana has 15 classes of property with tax rates ranging from 0.9% to 15.12%.

Intangible personal property is exempt from taxation in Montana. This includes licenses, patents, software, franchises, and good will. The exemption of intangible personal property tends to benefit knowledge-based businesses and may result in manufacturing businesses paying a disproportionate share of property taxes.

SEVERANCE TAXES

Severance taxes are often intended to compensate the citizens of the state for removal of natural resources such as oil, gas, coal, and minerals. Some states, including Montana, have a tax system that excludes one of the major tax types (income, property, or sales) because of the availability of severance tax revenue. Alaska, Texas, and Wyoming, all states that produce oil, do not levy an individual income tax.

Many states with severance taxes also have production incentives, especially for oil production. These incentives came about in the 1990s as a response to concerns about energy independence. Oil and gas production in Montana is taxed at a lower rate for the first 12 months of production and production from wells that are less productive is also taxed at a lower rate, often subject to certain price triggers.

GASOLINE AND SPECIAL FUEL TAXES

Gasoline, diesel, and other special fuels such as compressed natural gas and liquified petroleum gas are levied in Montana and used for highway construction and Highway Patrol administration. Montana's higher tax on gasoline than on diesel could create an economic neutrality concern. The gasoline tax is currently 2.55 cents per gallon higher than the diesel tax. (The differential will be 3.25 cents by FY23 when 2017 statutory changes are fully phased in.)

Compressed natural gas (CNG) and liquified petroleum gas (LPG) are subject to tax but the tax is lower than the equivalent tax on gasoline and diesel. This lower rate may be purposeful because alternative fuels are generally considered to be less polluting. The Legislature did not increase the CNG and LPG tax rates in 2017 when gasoline and diesel taxes were increased.

CIGARETTE AND TOBACCO TAXES

Taxes on tobacco products purposely violate economic neutrality to increase the price of a product believed to be harmful. The different methods of taxing cigarettes, moist snuff, and all other tobacco products may cause additional economic neutrality concerns. Cigarettes and moist snuff are taxed on a per unit basis (\$1.70 per package of 20 cigarettes and 85 cents per ounce of moist snuff) while other tobacco products are taxed at 50% of the wholesale price.

Some states are moving in the direction of taxing vapor products, which do not contain tobacco but do contain nicotine, and are considered by some to be a substitute for cigarettes and tobacco products.

ALCOHOL TAXES

Alcohol taxes are intended to tax specific products that some consider to have social costs. Although the stated reasons for the tax may be to reduce consumption or provide revenue for treatment and prevention of alcohol-related impacts, many states also use the taxes to raise revenue for general government purposes. This is true in Montana where much of the alcohol tax revenue goes to the General Fund.

As with tobacco products, different kinds of alcohol are taxed differently. Beer and wine are taxed at a dollar amount per volume, while liquor is taxed on a percentage of sales price. Historically, this could be because the consumption of liquor (with its higher alcohol content) was thought to lead to greater social costs.

Another economic neutrality consideration related to alcohol taxation is that beer tax rates vary based on production levels and liquor tax rates vary based on sales volume. This results in similar products being subject to different tax rates.

SALES AND USE TAXES

The main concern related to economic neutrality and a general sales tax is whether services are included in the tax base. The prices of goods and taxed services are higher relative to the cost of untaxed services and may affect consumer purchasing decisions.

Montana does not have a general sales tax. The state taxes lodging and rental vehicles and some local governments levy a resort tax.

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