MONTANA LEGISLATIVE SERVICES DIVISION
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HJ 35: EQUITY AND THE TAX SYSTEM

EQUITY TERMINOLOGY

The terms defined below will be useful when considering the equity of the Montana tax system. Opinions about equity can vary widely so this overview uses ideas outlined in the National Conference of State Legislature's Tax Policy Handbook for State Legislators and adds specific analysis relevant to the Montana tax system.

> This overview provides information to assist the committee in its consideration of the equity of Montana's tax system.

The two types of equity used for consideration of a tax system are:

- Horizontal equity: taxpayers with similar incomes have similar tax burdens; and
- Vertical equity: the distribution of tax burdens among taxpayers with different incomes.

The following terms are commonly used when discussing equity:

- Progressive: a tax system under which the average tax rate increases with income;
- Proportional: a tax system under which the average tax rate is the same at each level of income;
- Regressive: a tax system under which the average tax rate decreases with income.

EQUITY AND THE MONTANA TAX SYSTEM

The following sections provide details about equity and Montana's top sources of revenue.

INDIVIDUAL INCOME TAX

Montana's individual income tax has a progressive rate structure and includes personal exemptions and itemized and standard deductions, which aligns with the principle of horizontal equity. The fairly low level of income to which the top marginal tax rate applies ($17,900 in 2018) as well as the considerable number of additions, subtractions, exemptions, and tax credits may detract from horizontal equity to some extent. However, the Earned Income Tax Credit (first available in tax year 2019), reinforces horizontal equity.

A progressive individual income tax contributes to the vertical equity of the tax system as a whole because most other taxes are proportional or regressive.

CORPORATE INCOME TAX

Taxes levied on corporations are generally considered to be passed on to consumers in the form of higher prices, to shareholders in the form of lower dividends, or to employees in the form of lower wages. The often-cited reason for taxing corporations is the benefits theory of taxation: those who benefit should pay. Corporations benefit from services provided by the government such as infrastructure, education, public safety, and the judicial system.

States like Montana that tax corporations based on net income score better on equity principles than states that tax on gross receipts, capital stock, or net worth. Montana does have a $50 minimum corporate income tax, but the low amount of the minimum tax probably has little effect on equity. A bigger equity concern related to the corporate income tax is tax credits, tax exemptions, and tax abatements. Promoting certain businesses over other businesses reduces the equity of the corporate income tax.

PROPERTY TAX

The property tax fares poorly on measures of both horizontal equity and vertical equity. Property taxes may be regressive because taxpayers pay the same amount of tax on property of the same value regardless of income, though there is likely a correlation between income and property wealth. There is also disagreement about how much property tax is passed to renters, and assumptions in this area influence notions of vertical equity.

Variations in property values resulting from differing valuations of similar property reduce horizontal equity. However, Montana's statewide assessment, constitutional requirement to equalize property value, and 1-year or 2-year property valuation cycle for most property may make this less of a concern. In addition, there are three income-based programs available to Montana residential taxpayers: the property tax assistance program, the disabled veteran program, and the income tax credit for residential property taxes paid by the elderly. These programs may increase the equity of the property tax for residential property taxpayers.

Residential property in Montana is mostly subject to the same tax rate[1] but non-residential property is classified by property type into 15 different classes with rates ranging from 0.9% to 15.12%. The classification system does not directly take income into account and different types of property are subject to different tax rates. The income a property is capable of generating is a factor when using the the income approach to value.

[1] The portion of residential taxable value that is greater than $1.5 million is taxed at 1.89% (the same rate as commercial property) instead of the residential rate of 1.35%.

SEVERANCE TAXES

Severance taxes are taxes imposed on the removal of natural resources, such as oil, gas, minerals, or timber. The purpose of the tax is to compensate the state for the removal of a natural resource and for related environmental and social costs.

The coal severance tax, oil and natural gas production taxes, and metalliferous mines tax are all levied on the gross value of the resource. Basing the tax on net proceeds or net value would be more consistent with taxation based on ability to pay because only profitable operations would be taxed. However, the following characteristics of each tax includes a component that gets at ability to pay:

- The metalliferous mines tax includes an exemption of the first $250,000 of value.
- The oil and natural gas production taxes vary considerably based on the age of the well and the type of production. The tax rate is lower for the first 12 months of regular production and for wells that produce less oil or gas (such as stripper wells and horizontally completed wells).
- The coal severance tax rate varies based on the heating quality and type of production. The rate is lower for coal with lower heating quality and for mining operations that require more effort to mine the coal.

GASOLINE AND SPECIAL FUEL TAXES

Taxes levied on gasoline and special fuel are earmarked for highway construction and maintenance and Highway Patrol administration. The taxes are levied on a per-gallon basis and are generally considered a fee for use of roads and highways. Low-income taxpayers pay a higher share of their income in fuel taxes and this regressivity is exacerbated if low-income taxpayers drive longer distances and if their vehicles are less fuel-efficient.

Another equity consideration related to fuel taxes is whether large vehicles that cause a disproportionate share of highway wear and tear bear enough of highway maintenance costs. These large vehicles generally operate on diesel. Montana's 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.) A counterpoint to the notion that vehicles that generate higher maintenance costs should pay a larger share of highway costs is that higher transportation costs will be passed on in the form of higher prices for consumer goods.

CIGARETTE AND TOBACCO TAXES

Taxes on cigarettes and tobacco products are considered to be regressive with low-income taxpayers paying a larger share of their income in this tax than taxpayers who are not low-income.

Tobacco taxes are often considered to be a method for paying health care costs associated with tobacco use. One argument is that tobacco taxes are equitable for this reason. A portion of Montana's cigarette tax, tobacco tax, and tobacco settlement revenue is distributed to accounts for Health and Medicaid Initiatives, tobacco prevention and cessation, and Children's Health Insurance Programs. Fifty percent of tobacco tax revenue, about 45% of cigarette tax revenue, and 11% of tobacco settlement revenue are distributed to Montana's General Fund. Cigarette tax

revenue is also used to fund state veterans' nursing homes (the greater of 8.3% or $2 million) and the Major Repair Long-Range Building account (2.6%).

ALCOHOL TAXES

Like tobacco taxes, alcohol taxes are intended to tax the social cost of a product and are considered to be regressive. Montana's beer and wine taxes are levied on a quantity basis rather than on a price basis and, as such, raise equity concerns because low-cost products are subject to the same tax as high-cost products. The liquor excise tax and liquor license tax are based on the retail sales price, which scores better in terms of equity. However, there may be equity concerns related to the liquor excise tax, the liquor license tax, and the beer tax because rates vary based on production or sales: alcohol produced by lower volume producers or producers with fewer sales is taxed at a lower rate.

Some alcohol tax revenue is designated for the treatment and prevention of alcoholism and chemical dependency and the rest is deposited in the General Fund as follows: beer tax, 76.74% General Fund/23.26% treatment and prevention; wine tax, 69% General Fund/31% treatment and prevention; 1 cent tax on wine sold to an agency liquor store, 100% General Fund; liquor excise tax, 100% General Fund; liquor license tax, 34.5% General Fund/65.5% treatment and prevention.

SALES AND USE TAXES

General sales taxes are regressive because lower-income taxpayers pay a larger share of their income in sales taxes. Many states with a general sales tax exempt necessities such as groceries and medicine. The regressivity of a sales tax also depends on whether services are included in the tax base. Including services in the sales tax base tends to reduce the regressivity of a general sales tax. Prior to the decision in *South Dakota v. Wayfair* in 2018, Internet purchases were largely untaxed, which reduced the equity of the sales tax. Many states with a general sales tax are now taxing Internet sales since the Wayfair decision.

Montana is one of six states without a general sales tax, but the state does levy selective sales taxes on lodging and rental vehicles and a limited number of local governments levy the resort tax on a broader array of sales. The lodging taxes, rental vehicle tax, and resort tax are often discussed as mechanisms to collect revenue from the impacts of tourism. However, tourists are not the only people who stay in hotels, rent vehicles, and pay resort taxes.

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