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John Ketzenberger: Taxation transparency

For a governor who considers **management** one of his strong suits, Mitch Daniels managed to hide his likely chagrin in December when his administration revealed it took nearly four years to find \$320 million in corporate income tax revenue parked in a forgotten account.

Daniels put on a happy face, sporting a Monopoly card and declaring a windfall in the state's favor. After all, he reasoned, the error was found in time for lawmakers to consider new spending during the upcoming session.

By March Daniels and the General Assembly had spent that windfall on full-day kindergarten and a phase-out of the inheritance tax, and they even managed to maintain enough in reserves to grant at least a \$60 credit for Hoosiers on next year's state taxes.

The no-harm, no-foul approach didn't sit well with political opponents, but it seemed the administration had managed to blot any real stain to its legacy.

So imagine being the poor **soul** who had to call Daniels recently to let him know investigators found another accounting error. Worse, this one had more serious implications because it shorted local

governments \$206 million. Many counties already had fired employees and cut important programs to make up for a shortfall that wasn't.

Although the error was a third less expensive, **itcost** the administration far more in credibility with the public and good will among local officials. Yet lost amid the howls from Republicans and Democrats for an independent audit was the essential truth that Indiana's local option income tax system is complex and difficult to administer.

Even before the shortfall was found, lawmakers were considering how to recoup more than \$600 million in overpayments to most of the state's counties. While local governments enact local option income taxes, the state collects the tax and redistributes the proceeds based on a series of formulas. This process produces a long lag time -- up to 18 months -- between when the tax is collected and when it's actually received. That is enough time for economic conditions to **change**

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considerably and cause the distributions to vary widely from actual tax collections.

Local and state governments use estimates to make timely tax distributions, but inevitably there is a reckoning required when the state adjusts the amount up or down. The glitch that caused the state to short the locals created a massive disruption.

It also may have created the opening necessary to revisit Indiana's local option income tax system. Certainly now is the time to reconsider how the taxes are collected and redistributed. But there are other considerations, too, since the number of local options has doubled in the last five years.

Among issues to consider:

The overall capacity of local option income taxes.

Are local governments turning to local option income taxes as an alternative to property taxes since tax caps were enacted?

How does the effective overall state income tax rate compare by county and what are the implications for varying rates? Hoosiers in some counties pay a 6 percent rate in state and local income taxes.

Do local option income taxes compare equitably to other forms of local taxation?

The Indiana Fiscal Policy Institute is in the midst of a [study](#) that hopefully provide

answers. But it's not too soon to declare the system's complexity a real concern.

Many counties have adopted more than one local option income tax and they are earmarked for different purposes -- sometimes property tax relief, economic development, public safety or general operations. The system of collecting and then redistributing these taxes requires many estimates plugged into formulas. As we saw with the recent problem, a single mistake in a formula can result in massive distortions to the system.

Reducing this complexity is difficult, but a simpler system has two distinct advantages. Obviously, it will be easier to administer. More importantly, though, the public will be able to grasp how much it is paying in taxes and what that money is purchasing.

The independent audit is an important part of restoring the public's faith in the state's ability to account for tax revenue. It's also important, though, that the state makes

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taxation transparent. The recent snafu makes the local option income tax systems ripe for reform with an eye toward transparency.

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