

## Introduction to ITEP's Tax Incidence Analysis

Everyone agrees that tax “fairness” is important—even though there is often disagreement on what fairness means. A well-informed debate on who *should pay* the most taxes must start by assessing who actually *does pay* the most—and the least. Too often taxes are studied only with an eye towards tax rates instead of an understanding of how taxes impact people depending on their income. Tax incidence analyses answer basic questions by measuring how taxpayers at different income levels are affected by the current tax system and various tax reform alternatives. This policy brief provides a basic introduction to using ITEP’s tax incidence analyses.

### Understanding ITEP’s Income Groups

Before conducting an incidence analysis decisions must be made about which subset of the population is going to be studied. An analysis can include all families in a specific state or select groups of taxpayers. The population chosen for the analysis may depend on the tax change under discussion. For example, the table below shows the impact of reducing the sales tax rate on all Louisiana families (married couples, single people, and both non-elderly and elderly residents).

The next step is to divide the population into income groups. Most ITEP analyses define income as all sources of income including salaries, wages, investment income, and retirement income. ITEP’s analyses divide the population into five groups—ranging from the poorest 20 percent to the richest 20 percent. Each of these groups is called an “income quintile.” ITEP’s analyses also split the richest 20 percent into three subgroups: the richest 1 percent of all taxpayers, the next 4 percent just below them, and then the next 15 percent after that. This is done because families in the top 20 percent have more than half of all personal income nationally and, within this quintile, there are substantial differences in income levels and tax burdens between the “poorest” members and the richest members. Incomes in this group range from what might be called upper-middle class to the richest families in the country. From a tax policy standpoint, relatively lower-income families in this group should not be treated the same as the richest families because they have very different abilities to pay. This is why ITEP’s incidence tables show them separately.

The example at the bottom of this page shows the income quintiles for Louisiana in 2008. The analysis shows that the poorest 20 percent of Louisiana residents were those earning less than \$14,700 with an average income of \$8,800. The wealthiest 1 percent of taxpayers, with incomes over \$351,200, earned an average of \$975,100.

Impact of Reducing Louisiana’s Sales Tax Rate from 4.0% to 3.75%							
2008 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than	\$14,700 –	\$26,100 –	\$43,300 –	\$72,600 –	\$138,200 –	\$351,200 –
	\$14,700	\$26,100	\$43,300	\$72,600	\$138,200	\$351,200	Or More
Average Income in Group	\$ 8,800	\$ 19,200	\$ 33,400	\$ 55,100	\$ 97,400	\$ 206,200	\$ 975,100
Tax Change as % of Income	-0.2%	-0.2%	-0.2%	-0.2%	-0.1%	-0.1%	-0.0%
Average Tax Change	-22	-47	-66	-90	-119	-149	-425
Tax Change as Share of Income	6%	13%	19%	25%	25%	8%	6%

## Measuring Fairness: Effective Tax Rates

The next step in tax incidence analysis is to measure the impact of a tax change on different income groups. There are various ways to measure tax incidence. The most common approach is to analyze the *effective tax change* experienced by an income group as a percentage of that group's income. This approach measures each group's ability to pay most accurately. Two other helpful statistics are the average tax change for an income group and the share of the total tax change for that group. For example, the table shows that the impact of reducing Louisiana's sales tax for the middle twenty percent of state residents would be that their taxes are reduced by \$66, on average, or about 0.2 percent of their income.

It is important to note that because these statistics describe the overall averages for taxpayers in each income group, the actual impact on any individual in each quintile may differ from the overall average for that income group. For example, a low-income taxpayer in the bottom income group who spends more on taxable items may see a sales tax cut that is higher than the \$22 average for that income group. Conversely, someone who spends relatively little on taxable items may see a tax cut of less than \$22.

## Important Concepts: Initial and Final Incidence, "Exported" Taxes

The concept of tax incidence is used in two ways: *initial incidence* and *final incidence*. Initial incidence tells us who is legally responsible for paying a tax to the government. Final incidence tells us who actually does.

Sometimes the initial incidence and the final incidence of a tax are very different. For example, the property tax on residential apartment buildings is paid initially by the landlords who own the buildings. From an initial incidence perspective, this tax does not affect renters who live in these buildings at all. However, landlords pass some of these taxes through to renters in the form of higher rents. So from a final incidence perspective, some of this business property tax is a tax on individuals. In fact, all business taxes ultimately end up coming out of people's pockets (investors and ordinary workers). For this reason, ITEP's analyses look at final incidence. This means that ITEP's analyses always include an estimate of taxes (if any) paid initially by businesses that are passed through to individual taxpayers. For example, an incidence analysis that studies an increase in the sales tax rate must assume that a portion of the hike at each income level is business sales taxes that have been passed through to individual consumers.

Incidence analyses must also address how taxes are exported. While all taxes are ultimately paid by individuals, some state taxes are paid (directly or indirectly) by residents of other states. The Louisiana example assumes that about 20 percent of the sales tax reduction is passed through to consumers in other states. ITEP's incidence analyses generally estimate how much of a tax increase (or tax cut) is exported to residents of other states.

## Tax Incidence Analysis: An Important Tool for Evaluating Tax Fairness

Tax incidence analysis is an important building block for an informed debate on issues of tax fairness. Reporting of tax incidence effects can help state lawmakers understand the impact of complicated tax changes. Few states require a comprehensive, regular analysis of the overall tax system and of proposed changes—but states such as Minnesota and Texas have created a permanent capacity for regular analyses, and most states could build a capacity at a relatively low cost. In states lacking this capacity, ITEP offers valuable analyses so that lawmakers can make tax policy decisions knowing basic information about how their constituents are affected.

*In the many states that lack the ability to conduct tax incidence analyses, lawmakers are making important tax policy decisions with no clear understanding of how their constituents are being affected by these decisions.*

To find out more about this issue, contact ITEP at (202) 299-1066