INDIANA CHAMBER FOUNDATION

INDIANA'S TAX SYSTEM

ACTIONS TO DRIVE FUTURE PROSPERITY

November 2024

The Indiana Legislature's two-year review of state and local tax systems is a pivotal moment for Indiana's economic future. The potential reforms being considered present both opportunities and challenges that could shape the state's business environment, fiscal health, and overall competitiveness for decades to come.

Recognizing the importance of this effort, the Indiana Chamber, through the Indiana Chamber Foundation, commissioned Ernst & Young to conduct an in-depth, two-phase analysis of Indiana's tax system. The first report provided a comprehensive assessment of the state's tax structure, benchmarking Indiana against neighboring and competitor states. This second report builds on those findings by modeling potential reforms, particularly to Indiana's property tax system, and assessing their fiscal and macroeconomic impacts.

The Indiana Chamber Foundation has a strong tradition of providing practical, data-driven research to guide policymakers in their deliberations. Our work has consistently supported forward-looking public policies that enhance Indiana's economic competitiveness and improve quality of life for Hoosiers. From energy resources to K-12 education and venture capital, our research has helped shape policy solutions to meet Indiana's most pressing challenges.

This Phase II report examines potential reforms to Indiana's tax system. These changes are evaluated for their ability to reduce burdens on capital-intensive industries, enhance competitiveness, and foster economic growth. Offering legislators a range of actionable insights as they prepare for the 2025 legislative session.

The Indiana Chamber Foundation remains committed to serving as a resource for evidence-based policy development that supports sustainable economic growth and strengthens Indiana's position as a leader in the Midwest and beyond.

We extend our sincere gratitude to the investors who made this critical work possible. Their support underscores a shared commitment to fostering a competitive and prosperous future for Indiana.

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Executive Summary

The analysis presented in this report summarizes initial estimates of the total revenue and economic impact of several potential tax reform options identified by the Indiana Chamber of Commerce Foundation. The total impact includes the static impact tax the occurs directly from the reform and the dynamic impacts that occur as taxpayers adjust their behavior in response to the tax change.

Potential reforms include new personal property exemptions and depreciation floor reductions, changes property tax maximum levy growth quotient calculation level, reductions in state income tax rates, increases in the local income tax rates, a state level qualified business income (QBI) exemption, and change in manufacturing sales tax exemption requirements.

For certain items, interactions between options or further specification of the options may materially change the cost of the reforms. The estimates in this report should be considered preliminary and subject to change based on additional data. Additionally, certain estimates incorporate assumptions which may be refined through discussion with stakeholders including Indiana local governments.

Summary of potential tax package reform options[1]

- **Exempt new business personal property:** Exemption of newly acquired personal property from taxation is estimated to reduce tax revenue by $1.2 billion once fully phased in and considering dynamic offsets.
- **Eliminate personal property depreciation floors:** Elimination of depreciation floors, both the 30% overall asset floor and individual asset pool depreciation floors, is estimated to decrease tax revenue by $35 million once fully phased in and considering dynamic offsets.
- **Calculate the maximum levy growth quotient (MLGQ) at the county level:** Changing the maximum levy growth quotient that limits growth of property tax revenue to be calculated at the county level instead of the state level would result in a $35 million reduction in tax revenue after considering dynamic effects.
- **Local income tax:** Allowing all counties to increase their local income tax by 5 basis points would increase revenue by an estimated $100 million after considering dynamic effects.
- **State income tax:** Reducing the individual income tax rate to 2.655% in 2027 would result in an estimated $560 million decrease in tax revenue after dynamic effects and reducing the corporate income tax rate to 4.5% in 2026 would result in an estimated $75 million decrease in tax revenue after dynamic effects.

[1] Impacts are fully phased-in differences from current law (e.g., difference from tax rate that would apply in ultimate year of any enacted future tax change), in FY23 dollars and include both static and dynamic tax effects. There may be additional interactions within the property tax options and the income tax options that would affect each proposed option's estimated impact. Estimates are rounded.

- **Qualified business income (QBI) tax deduction:** The introduction of a state level qualified business income tax deduction of $5,000 would result in up to a $75 million decrease in tax revenue after considering dynamic effects.
- **Sales tax:** Eliminating the double direct test requirement for exemption of sales tax on manufacturing inputs would result in an estimated $95 million decrease in sales tax revenue after considering dynamic effects.

Table ES-1. Summary of preliminary static revenue impacts and dynamic revenue and economic impacts

Long-run impacts, 2023 dollars in millions

	Static revenue impact	Dynamic economic impact		Dynamic fiscal impact ($ of state and local tax)	Net fiscal impact
		Jobs	GDP		
Exempt new business personal property from the property tax	-$1,500	+23,600	$3,100	$285	-$1,215
Eliminate business personal property tax depreciation floors	-$45	+600	$80	$10	-$35
Adjust calculation of property tax maximum levy growth quotient	-$45	+850	$120	$10	-$35
Allow local units to levy an additional 5 bps in local income tax	$110	-1,150	-$125	-$10	$100
State individual income tax rate reduction	-$600	+3,600	$415	$40	-$560
State corporate income tax rate reduction	-$110	+2,800	$395	$35	-$75
State qualified business income deduction for state individual income tax	-$70	+350	$35	$5	-$65
Eliminate double direct test for manufacturing and agriculture sales tax exemption	-$100	+400	$75	$5	-$95

Note: impacts have been rounded. Dynamic fiscal effects reflect incremental state and local tax collections that would result from a change in the level of Indiana economic activity. The net fiscal impact reflects the sum of the static revenue impact and the dynamic revenue impact. The static revenue impacts do not consider any interactions between provisions. The property tax and income tax reform options would have interactions to the extent multiple reforms were pursued.

1. Introduction

This report presents estimates of the static and dynamic fiscal and economic impacts of reform options selected by the Indiana Chamber of Commerce Foundation. EY was commissioned to prepare these estimates and this report to provide information useful to the Chamber and its stakeholders as it engages in discussions of tax reform alternatives.

The report is presented in several sections. Section 2 describes the reform options including potential adjustments to tax base, rates, and modeling assumptions. Section 3 presents the general estimation approach including a description of the dynamic economic and revenue estimation approach. Section 4 presents the results of the analysis including a summary of impacts and detailed results for each reform option.

2. Reform options

Table 1 presents tax reform options being considered by the Indiana Chamber Foundation based on the results of the Phase 1 analysis as well as feedback from members and other stakeholders. The reform options have been specified to a level sufficient to allow basic modeling, but certain additional details would need to be specified to produce more accurate revenue estimates. Three of the options relate to the local property tax, three relate to income taxes, and one relates to business sales taxes. In certain instances, there may be interactions between these reform options which has not been considered in this analysis since no packages are presented.

Table 1. Indiana Chamber Foundation proposed tax reform options

Proposed tax change		Description of tax reform option
Property tax	**PT-1. Exempt new business personal property**	Newly acquired business personal property is permanently exempt from personal property tax. This option slowly eliminates the personal property tax base in Indiana over approximately 12 years.[2]
	PT-2. Eliminate business personal property depreciation floors	Currently, personal property is depreciated over several years until it reaches a minimum value that is subject to tax until the property is disposed. Additionally, taxpayers' overall personal property must be valued at 30% or more of original value. The current article-specific depreciation floors and the 30% overall 30% floor would be eliminated such that property declines to 0% of original value at the end of its useful life.
	PT-3. Adjust calculation of maximum levy growth quotient	Current property tax rates levied by each government unit are limited to grow no more than the average state-level private non-farm personal income growth over previous six years, or 6%, whichever is lower. This reform would adjust the calculation of the limitation to use regional or county-specific personal income growth rather than statewide personal income growth.

[2] Most personal property is included in personal property pools with useful lives of 12 years or less.

Proposed tax change		Description of tax reform option
Income tax	IT-1. Allow local units to levy an additional 5 bps in local income tax	This reform option provides counties with the ability to levy additional income tax rates. The tax base and other features remain the same.
	IT-2. State income tax rate reductions	This reform option would provide rate reductions for both the corporate and individual income taxes: • Individual income tax rate reduced to 2.655% on January 1, 2027. Estimates based on difference to current law – i.e., individual income tax rate of 2.9% in 2027. • Corporate income tax rate reduced to 4.5% on January 1, 2026
	IT-3. State qualified business income deduction	This reform option would establish a deduction for passthrough business income for Indiana's individual income tax, using the same definition of income as the federal Section 199A deduction with exemptions of $2,500, $5,000, or $7,500 per taxpayer.
Sales tax	ST-1. Eliminate double direct test for agriculture and manufacturing	The double direct test requires that tangible personal property has to be directly used in the agricultural or manufacturing process, and the direct use of the property has to be in direct production. Use in ancillary activities that support the production process (e.g. storage, material moving, pre-production, post-production) do not meet the test. Eliminating the test would allow a broader set of production related inputs and equipment to receive the exemption.

3. Estimation approach

Four types of estimates are presented in this report: (1) static revenue impacts, (2) dynamic economic impacts, (3) dynamic revenue impacts, and (4) net fiscal impacts, which include a dynamic feedback effect and a net fiscal effect after considering the static effect and dynamic feedback. The approach for each of these estimates is described below.

Static revenue estimates. The approach used to estimate static revenue impacts for each reform is specific to that option, but in general the static revenue impacts rely on the most recent year of actual taxpayer and tax base information available, current law, and no behavioral or economic changes.

- **Current law:** The analysis compares each option to current law in place at the time of the analysis. In certain instances, current law differs from current policy. That is, the current law contains provisions that change tax rates or other tax system features in the future. The static revenue estimates contained in this analysis compare tax liabilities under the proposed reform to tax liabilities under current law assuming all future legislated changes had been phased in. This is relevant, in particular, for the state income tax rates adjustment impacts for which the reform option is compared to the phased-in lower rate, not the current rate, and for the growth limitation factor, which has a temporary cap that will revert back to a formulary cap.
- **No behavioral changes:** The static revenue impacts assume there are no changes in taxpayer behavior or the size of the real economy in response to the tax change or other factors. These changes are considered in the dynamic economic and revenue impacts.

- **No inflation.** The estimates are presented in current dollars to allow for comparisons across each option, even though certain options may not be fully in effect for several years. For certain reform options, real growth has been considered when the change will occur in the future.
- **No interactions.** Certain reform options may interact such that the net static impact of the two options estimated simultaneously would be different than the sum of the individual estimates. An example of an interaction would be the net impact of providing an income tax exemption while also providing a tax rate reduction, where the cost of enacting both reforms would be less than sum of the estimated cost of the two reforms in isolation. These interaction effects are not quantified but should be considered if packages are developed.

Dynamic economic impacts. Dynamic effects generally refer to responsiveness of economic actors in response to changes in incentives. In this case, the dynamic effect describes changes in taxpayer behavior to changes in taxes. The dynamic effects estimated in this study arise from two sources: (1) changes in the cost of capital and (2) changes in labor supply.

- **Changes in the cost of capital.** Taxes that are levied on capital assets or income generated by investment (including taxes generated on business income) are considered to impact the after-tax cost of capital. That is, these taxes impact the after-tax income that investors would expect to receive on their investments and may affect their incentive to invest because some portion of these investment opportunities would now generate returns lower than the investors' hurdle rate of return. In general, as the after-tax cost of capital decreases, investments become more attractive and there would be more investment. Conversely, as the cost of capital increases due to tax changes or other factors (such as interest rates) there would be fewer attractive opportunities to invest and less investment would occur. The economic literature suggests that for every 1-percentage-point decrease in the after-tax cost of capital, investment will increase by 0.835%. Based on the estimated change in the cost of capital, the change in annual investment is estimated and accumulated into a long-term change in the level of capital stock. The change in the level of capital stock is translated into a change in the level of output for each major industrial sector in Indiana using capital intensity ratios for each that would reflect the importance the affected type of capital stock to producing the output of each industrial sector. Additional economic impact metrics are estimated using the IMPLAN model of Indiana.
- **Changes in returns to labor.** Certain tax increases impact the after-tax wage rate that workers expect to earn from working, and in turn impact their willingness to supply labor. In this analysis, a portion of the income tax changes are attributed to labor income and exert such effects on labor supply. The change in labor supply arises through two countervailing mechanisms: (1) a change in the total return to total labor due to changes in the average tax rate and (2) a change in the marginal returns to marginal labor due to changes in the marginal tax rate. When the average income tax rate decreases, a worker has more after-tax income for the same amount of work and can support a current lifestyle on less hours worked, resulting in an incentive to decrease the number of hours worked. When the marginal tax rate decreases, the worker gets more income from every additional hour worked as compared with the same amount of utility from leisure time (the complement to time worked), resulting in an incentive to increase the amount of time worked. The economic literature suggests that the total after-tax wage elasticity is positive but very low – such that reductions in individual income tax rates would generate a positive but very small increase in labor supply.

Dynamic revenue effects and net fiscal impacts. The dynamic economic effects that arise from changes in the tax system equate to a larger economy when taxes are reduced. This growth in the size of the economy, in turn, generates additional tax revenue across all tax types which offsets a portion of the initial static revenue loss. For example, a reduction in income tax rates would be expected to slightly increase investment and labor supply, resulting in a slightly larger economy and marginal increases in income taxes, sales taxes, property taxes, and other state and local revenue streams that reasonably vary with the size of the state economy. Such an increase in these revenue streams would offset a portion of the initial cost of providing the tax cut. The net fiscal impact of the tax change would therefore be the initial static revenue loss plus the dynamic revenue feedback through increases in other revenue streams.

4. Estimated static revenue impacts and dynamic effects

The section below presents estimates of the static and dynamic effects for each reform option, considering the static fiscal impact, the dynamic economic effect, the dynamic revenue feedback, and the net fiscal impact. Table 2 presents a summary of these impacts.

Table 2. Summary of static revenue and dynamic economic and revenue impacts
Long-term impacts, 2023 dollars in millions and jobs

	Static revenue impact	Dynamic economic impact		Dynamic fiscal impact ($ of state and local tax)	Net fiscal impact
		Jobs	GDP		
PT-1. Exempt new business personal property	-$1,500	23,600	$3,100	$285	-$1,215
PT-2. Eliminate business personal property depreciation floors	-$45	600	$80	$10	-$35
PT-3. Adjust calculation of maximum levy growth quotient	-$45	850	$120	$10	-$35
IT-1. Allow local units to levy an additional 5 bps in local income tax	$110	-1,150	-$125	-$10	$100
IT-2.1 State income tax rate reduction - Individual income	-$600	3,600	$415	$40	-$560
IT-2.2 State income tax rate reduction - Corporate income	-$110	2,800	$395	$35	-$75
IT-3. State qualified business income deduction	-$70	350	$35	$5	-$65
ST-1. Eliminate double direct test	-$100	400	$75	$5	-$95

Note: impacts have been rounded. Dynamic fiscal effects reflect incremental state and local tax collections that would result from a change in the level of Indiana economic activity. The net fiscal impact reflects the sum of the static revenue impact and the dynamic

revenue impact. The static revenue impacts do not consider any interactions between provisions. The property tax and income tax reform options would have interactions to the extent multiple reforms were pursued.

Property tax option 1. Exempt new business personal property. Indiana is one of 37 states which tax business personal property, including machinery, equipment, furniture, and fixtures. This reform option would exempt newly acquired business personal property from the property tax, resulting in a 0% marginal effective tax rate on such property and providing a benefit to equipment-intensive businesses in the manufacturing sector.

In a single year, Indiana collects around $1.5 billion in business personal property taxes and this proposal would eliminate those collections over time. Although the full revenue impact would take many years to occur as existing, taxable property depreciates, declines in value, and is eventually removed from the tax rolls, the revenue impact at FY2023 levels is estimated to be $1.5 billion, or about 15% of total real and personal property taxes.

Table 3. Property tax option 1:
Exempt newly acquired business personal property from property tax
Long-run impacts, 2023 dollars in millions

Static fiscal impact	
Current law revenue	$1,500
Proposed law tax revenue	$0
Static impact ($)	**-$1,500**
Static impact (%)	-100.0%
Economic impact	
Change in Jobs	+23,600
Change in GDP ($)	+$3,100
Change in income ($)	+$1,650
Dynamic and net fiscal impact	
Dynamic fiscal impact	+$285
Net static and dynamic fiscal impact	-$1,215

Note: Estimates are based on fully phased-in exemptions of property in FY23 millions of dollars. Results are based on data from Indiana's Data for Local Governments and the Bureau of Economic Analysis.

The economic impact of this policy change would occur through the cost of capital for new business investment in equipment. We estimate the change in the cost of capital for new equipment would be a 4.85% reduction, which would imply an increase investment and over the long run, which would translate to an increase in output of those industries and 23,600 ongoing jobs (given current levels of employment). This increase in economic activity would imply a $285 million increase in total state and local taxes related to this activity, which would offset 19% of the static revenue cost.

Property tax option 2. Eliminate personal property tax depreciation floors. Indiana has individual depreciation schedule floors that range from 10% to 20% of the original value of the property in addition to a 30% floor for a taxpayer's entire personal property asset pool (across all asset classes). Removing the 30% floor without eliminating depreciation floors for specific articles of personal property would have minimal impact as the assessment of a business's entire stock of property is likely to be near or above 30%, due to both periodic addition of new property that would be assessed far above 30% of value, as well as individual depreciation floors keeping property from being assessed at 0% assessed value.

Removing both the 30% total asset floor and the individual depreciation schedule floors would result in an estimated $45 million reduction in property tax revenue (Table 4).

Table 4. Net fiscal and economic impacts of removing personal property depreciation floors
Long-run impacts, 2023 dollars in millions

Static fiscal impact	
Current law	$1,500
Proposed law tax	$1,455
Static impact ($)	**-$45**
Static impact (%)	-3.0%
Economic impact	
Change in Jobs	+600
Change in GDP ($)	+$80
Change in income ($)	+$45
Dynamic and net fiscal impact	
Dynamic fiscal impact	+$10
Net static and dynamic fiscal impact	-$35

Note: Estimates are based on fully phased-in exemptions of property in FY23 millions of dollars. Results are based on data from Indiana's Data for Local Governments and the Bureau of Economic Analysis.

The economic impact of this policy change would occur through the cost of capital for new business investment in equipment. We estimate the change in the cost of capital for new equipment would be a 0.1% reduction, which would slightly increase new investment over the long run, which would translate to an increase in output of those industries and 600 ongoing jobs (given current levels of employment). This increase in economic activity would imply a $10 million increase in total state and local taxes related to this activity, which would offset 22% of the static revenue cost.

Property Tax Option 3. Maximum levy growth quotient (MLGQ). The maximum levy growth quotient (MLGQ) limits the annual increase in property tax collections based on the previous six years of private non-farm personal income growth. The calculation averages nonfarm personal income year-over-year growth for the six years preceding the year the budget is adopted, limiting the result to a maximum of six percent. It is currently calculated using income at the state level.

The impact of changing the MLGQ calculation to reference county or personal income growth rates would reduce property tax collections by $45 million (Table 5). The MLGQ is limited at 6% and current calculated MLGQ would be 5.5%[3], so moving to a local region-based calculation approach puts greater restriction on slower growth counties, but counties that have experienced higher-than-average growth will still be capped at 6% each year, resulting in a net negative impact on statewide collections.[4]

Table 5. Impact of alternate maximum levy growth quotient (MLGQ) calculations
2023 dollars in millions

Static fiscal impact	
Current law	$9,550
Proposed law tax	$9,505
Static impact ($)	**-$45**
Static impact (%)	-0.5%
Economic impact	
Change in Jobs	+850
Change in GDP ($)	+$120
Change in income ($)	+$60
Dynamic and net fiscal impact	
Dynamic fiscal impact	+$10
Net static and dynamic fiscal impact	-$35

Note: Maximums calculated with no COVID adjustments use the average annual personal income growth rates for 2017 - 2022. Pre-COVID growth rates are for 2014-2019. The temporary MLGQ cap of 4% is excluded for this analysis. Figures are in 2023 millions of dollars. Results are based on data from Indiana's Data for Local Governments and the Bureau of Economic Analysis.
*Results are rounded, this impact would be more than $0 but less than $50 million.

The economic impact of this policy change would occur through the cost of capital for new capital investment. We estimate the change in the cost of capital would be a 0.03% reduction, which would slightly increase new investment over the long run, which would translate to an increase in output of those industries and 850 ongoing jobs (given current levels of employment). This increase in economic activity would imply a $10 million increase in total state and local taxes related to this activity, which would offset 22% of the static revenue benefit.

[3] There is a temporary cap on the MLGQ of 4%. This is cap is not considered in order to show the impact on future years, otherwise changes in the calculation would have no impact.

[4] The previous six years of personal income growth includes 2021 and 2022 which had abnormal income growth during the recovery from the COVID-19 pandemic. This results in a higher than typical MLGQ during the years where those growth rates will be included in the calculation. If the six years prior to COVID were used for the personal income growth rates, assuming they are more representative of typical years moving forward, the MLGQ would have been 4.1%, 1.4 percentage points lower than the current calculated rate, resulting in $200 million less in property tax collections.

Income tax option 1. Local option income tax increase. Local jurisdictions in Indiana are allowed to levy an income tax, with current rates between 0.5 and 3 percent. An increase in local option income tax could be used to offset tax revenue lost from a reduction in business personal property tax if either property tax option previously discussed is adopted. Allowing for a 5-basis point increase in all counties would result in a $100 million net increase in revenue (Table 6), which would cover the $35 million net impact from the personal property tax floor elimination. However, counties are not equally reliant on business personal property (BPP) tax, so a 5-basis point rate increase in every county could result in net negative revenue in regions that currently have high business personal property tax collections and net positive revenue in regions that do not.

Table 6. Impact of local option income tax (LOIT) increase

Long-run impacts, 2023 dollars in millions

Static fiscal impact	
Current law	$3,650
Proposed law tax	$3,760
Static impact ($)	**+$110**
Static impact (%)	3.0%
Economic impact	
Change in Jobs	-1,150
Change in GDP ($)	-$125
Change in income ($)	-$75
Dynamic and net fiscal impact	
Dynamic fiscal impact	-$10
Net static and dynamic fiscal impact	+$100

Note: High personal property share counties are defined as counties with personal property tax collections share of total property tax collections of 20% or higher. Figures are in 2023 millions of dollars. Results are based on data from Indiana State Budget Agency.

The economic impact of this policy change would occur through the cost of capital for business capital investment and through the responsiveness of labor supply to changes in marginal tax rates on wage income. We estimate the change in the cost of capital would be a 0.01% increase. This increased cost of capital would slightly decrease new investment, and the increased income tax would slightly decrease employment over the long run. Together these changes would translate to a decrease in output of those industries and reduction of 1,150 ongoing jobs (given current levels of employment). This decrease in economic activity would imply a $10 million decrease in total state and local taxes related to this activity, which would offset 9% of the static revenue benefit.

Income tax option 2. Income tax rate reductions. Indiana's state individual income tax (IIT) rate is set to decrease by 0.05% each year until it reaches 2.9% on January 1, 2027. The potential rate change would reduce the rate even further to 2.655% in 2027 and would result in a $560 million dollar reduction in tax revenue. Indiana's corporate income tax (CIT) is currently 4.9%, and the proposed reform would reduce it to 4.5% on January 1, 2026. This rate change would result in a tax reduction of $110 million.

The economic impact of the individual income tax rate reduction would occur through the cost of capital for new capital investment. We estimate the change in the cost of capital would be a 0.1% decrease, which would slightly increase new investment, and the decreased income tax would slightly increase employment over the long run, which would translate to an increase in output of those industries and 3,600 ongoing jobs (given current levels of employment). This increase in economic activity would imply a $40 million increase in total state and local taxes related to this activity, which would offset 7% of the static revenue benefit.

The economic impact of the corporate income tax rate reduction would occur through the cost of capital for corporate businesses. We estimate the change in the cost of capital would be a 0.03% reduction, which would slightly increase new investment over the long run, which would translate to an increase in output of those industries and 2,800 ongoing jobs (given current levels of employment). This increase in economic activity would imply a $35 million increase in total state and local taxes related to this activity, which would offset 32% of the static revenue benefit.

Table 7. Impact of income tax rate reductions

2026-2027 static impacts with long-run dynamic impacts presented in 2023 dollars in millions

Static fiscal impact	**Individual**	**Corporate**
Current law	$7,350	$1,400
Proposed law tax	$6,750	$1,290
Static impact ($)	**-$600**	**-$110**
Static impact (%)	-8.2%	-7.9%
Economic impact		
Change in Jobs	3,600	+2,800
Change in GDP ($)	$415	+$395
Change in income ($)	$250	+$200
Dynamic and net fiscal impact		
Dynamic fiscal impact	$40	+$35
Net static and dynamic fiscal impact	-$560	-$75

Note: Impact is based on current law for the year the rate decrease would come into effect, in 2023 millions of dollars. Results are based on data from Indiana Annual Comprehensive Reports and forecast data from Oxford Economics

Income tax reform option 3. Qualified business income (QBI) deduction. At the federal level, pass-through businesses such as partnerships, sole proprietors, and S-corps can claim a deduction of up to 20% of qualified business income on their federal individual income tax return. Indiana is considering a similar deduction at the state level but using a flat deduction for each pass-through business. A $5,000 deduction would result in estimated tax reduction of $70 million (Table 8).

The economic impact of this formulation of the qualified business income deduction is limited due to its low level and its lump sum form. Economic impacts arise from changes in marginal tax rates that influence marginal expansions in investment and economic activity and this reform option would only provide a marginal reduction to businesses with less than $5,000 of income. Accordingly, no cost of capital change is estimated for this option, however the increase in disposable income for passthrough income recipients is estimated in terms of a demand effect which supports 350 jobs. $35 million of GDP, and $5 million of state and local tax dynamic effect.

Table 8. Impact of qualified business income (QBI) deduction

Long-run impacts, 2023 dollars in millions

Static fiscal impact	
Current law	$7,350
Proposed law tax	$7,280
Static impact ($)	**-$70**
Static impact (%)	-1.0%
Economic impact	
Change in Jobs	+350
Change in GDP ($)	+$35
Change in income ($)	+$20
Dynamic and net fiscal impact	
Dynamic fiscal impact	+$5
Net static and dynamic fiscal impact	-$65

Note: Results are based on data from the Internal Revenue Service Statement of Incomes data. Figures are in 2023 millions of dollars. Based on fully phased down individual income tax rate of 2.9%.

*Results are rounded, this impact would be more than $0 but less than $50 million.

Sales tax option 1. Double direct test elimination. The double direct test is used in Indiana to determine if purchases used in manufacturing or agriculture will be exempt from sales tax. It requires that purchases are used directly in production and only in production. This exemption test is more restrictive and requires additional administration compared to other state exemption rules such as the predominant use rule which only requires the primary use of a purchase be exempt, even if a portion of the use would otherwise be taxable. Removing the double direct test in favor of a less strict exemption rule would result in greater exemptions claimed and reduced sales tax revenue of $100 million (Table 9).

The economic impact of this policy change would occur through a reduction in the cost of capital for the manufacturing and agriculture sectors. We estimate the change in the cost of capital for new equipment would be a 0.1% reduction, which would slightly increase new investment over the long run, which would translate to an increase in output of those industries and 400 ongoing jobs (given current levels of employment). This increase in economic activity would imply a $5 million increase in total state and local taxes related to this activity, which would offset 5% of the static revenue cost.

Table 9. Impact of removal of the "double direct test" for manufacturing purchases
Long-run impacts, 2023 dollars in millions

Static fiscal impact	
Current law	$3,500
Proposed law tax	$3,400
Static impact ($)	**-$100**
Static impact (%)	-2.9%
Economic impact	
Change in Jobs	+400
Change in GDP ($)	+$75
Change in income ($)	+$35
Dynamic and net fiscal impact	
Dynamic fiscal impact	+$5
Net static and dynamic fiscal impact	-$95

Note: Results are based on data from the Bureau of Economic Analysis and the U.S. Census Bureau Annual Survey of State and Local Government Finances.