

The Navajo Tax Commission has passed two resolutions that propose amendments and changes to the Navajo Tax Code. Legislation 0111-21 proposes raising the maximum sales tax rate from 6% to 10%. If the resolution passes, the Navajo Tax Commission could choose to impose a 10% sales tax. Legislation 0112-21 recommends increasing the late penalties for tax payments from \$50 to \$200. The Navajo Tax Commission is the only entity that benefits from the proposed amendments to the Tax Code, and the negative impact on the Navajo economy will outweigh that benefit.

How increased tax rate and penalties impact the Navajo Nation

1

Increases burden on Navajo businesses

When setting tax rates, it is critical to consider small businesses, the backbone of a healthy economy. The cost of taxes, both in the amount paid and the amount of time and resources required to remain compliant, makes up a larger share of revenue for small businesses compared to larger companies and corporations. Small businesses are also less likely to have the resources to file and pay taxes efficiently like larger companies and corporations. **Because small businesses are more sensitive to tax increases, they are more likely to move to the informal sector or, even worse, cease operations.** Tax relationships with small businesses is particularly relevant on Navajo Nation, where the economy comprises several micro and small businesses, of whom are more likely to operate in the informal sector.

2

Stifles economic growth in Navajo communities

The amount of tax that businesses pay matters in terms of investment and growth. Evidence shows that **higher tax rates are associated with fewer formal businesses and lower private investment, meaning that in places with high tax rates there are fewer businesses and investment in the community.** In one study of over 85 countries, a 10-percentage point increase in the corporate income tax rate resulted in a 17.5% decrease in the average rate of new business registrations and a 10% reduction in the investment rate. Lower investment rates and a low rate of new business registrations have long-term, negative effects on an economy. One study showed that a tax increase equivalent to 1% of GDP reduces output over the next three years by nearly 3 percent. Creating an environment that incentivizes entrepreneurship and fosters business growth is an important tool for creating a sustainable economy and alleviating poverty. Consequently, it is important to consider the impact that increased tax rates can have on businesses within the context of Navajo Nation.

3

A regressive impact on Navajo families

Sales taxes can either be paid by the business owner, eating into profits, or the business can pass the tax on to the consumer in the form of higher prices. Either option is a cost to the business owner. Even if the business passes the tax on to its consumers, it must consider that higher prices mean less demand and fewer customers.

Moreover, sales tax has an inherently regressive nature, meaning that low- and middle-income families feel the effect of sales tax more than rich families. A family with an annual income of \$200,000 is less likely to feel the effect of a 6% sales tax on products than a family with an annual income of \$40,000. **Since high earners are able to save a much larger share of their incomes than middle-income families—and since the poor can rarely save at all—the tax is inherently regressive.** Furthermore, according to Consumer Expenditure Survey data, ITEP estimates that low-income families typically spend three-quarters of their income on sales-taxable items, while middle-income families spend about half, and upper-income families spend roughly one sixth. This has particularly far reaching implications for Navajo Nation, where the average annual income substantially low and a majority of the population falls into the category of consumers that will be strongly affected by the regressive nature of the tax.

Alternative ways to increase tax revenue

While the imposition of an increased sales tax may lead to increased revenue for the Navajo Nation and Navajo Tax Commission in the short term, the research conducted here signals the need to understand the long-term impact on the Navajo economy and small businesses. While sales tax may offer one avenue for generating much needed revenue for government services and tax administration, there are other solutions that could result in increased revenue for the Navajo Tax Commission and reduce the financial burden on the Navajo small business community. Given that tax compliance is sufficiently low, multiple solutions should be discussed and explored by the Navajo Nation with input from the business community. The following examples show instances where improvements to the tax system has achieved many benefits without negatively impacting the small business community.

1

Improve tax administration to increase the number of tax payers

Efficient tax administration can help encourage businesses to become formally registered, thereby expanding the tax base and increasing tax revenues without increasing rates. The research shows that an important determinant of firm entry is the ease of paying taxes, regardless of the corporate tax rate. **A study of 118 economies over six years found that a 10% reduction in the tax administrative burden—as measured by the number of tax payments per year and the time required to pay taxes—led to a 3% increase in annual business entry rates.**

Making it easier to pay taxes has been shown to have a particularly strong impact for small businesses. In Brazil, the government created Simples Nacional, a tax regime designed to simplify the collection of taxes for micro and small enterprises. The program reduced overall tax costs by 8% and contributed to an increase of 11.6% in the business licensing rate, a 6.3% increase in the registration of microenterprises and a 7.2% increase in the number of firms registered with the tax authority. Revenue collections rose by 7.4% because of increased tax payments.

2

Introduce Tribal-State tax revenue sharing agreements

Tax Sharing Agreements between tribes and states have the potential to eliminate dual taxation and lower administrative costs of tax collection for the Navajo Nation. The tribe and the state can share collection costs and tax revenues in areas where dual taxation is permitted. In the case of sales tax, the tribe could levy tax on all businesses operating on the reservation at a tax rate identical to the state tax rates. The State Tax Department serves as an agent of the tribe in collecting the tax, then shares a predetermined percentage of the tax revenue back to the tribe. For example, **the state of North Dakota and the Standing Rock Tribe have an agreement that provides an 80/20 tribal/state split of tax collections for sales and use taxes.** They have similar agreements that pay a 87/13 tribal/state split for cigarette and tobacco excise taxes and for fuel taxes.

Navajo Nation has some existing tax agreements for tobacco and fuel taxes, but none for sales taxes. This solution has the benefit of reducing tax incidence on businesses, which can lead to increased business activity and compliance, but also lower administrative costs for collecting taxes.

3

Introduce electronic filing and e-payment systems

Introducing an electronic filing and payment system has the potential to drastically improve compliance and tax revenues, without the need to raise tax rates. Additionally, they can lower administrative costs associated with processing tax filings. Furthermore, an electronic system has repeatedly been shown to improve compliance in jurisdictions with similar infrastructure and economic statistics as the Navajo Nation. For example, in Tajikistan, **the introduction of an electronic filing and payment system reduced the time for a firm to comply with taxes by 24%. As a result, the number of businesses filing taxes doubled and revenue collections rose strongly.**

In the first five years on implementing a similar electronic system in Malaysia, the percentage of individuals and businesses filing increased from 5% to 34%. At the same time, tax collections increased from 14.5% of GDP to 15.3%. Also, the time spent taxpayers spent maintaining compliance with tax laws decreased by over 12% for small and medium-size companies.

TAX POLICY MEMO

The impact of sales tax rate increases and penalties on the Navajo economy

An analysis of Legislation 0111-21 and 0112-21

Prepared by the
Navajo Entrepreneurship Coalition

Change Labs
Heather Fleming
Jessica Stago

ACES School
Joseph Austin

Dineh Chamber of Commerce
Derrick Watchman
Kim Kanuho
Anthony Martinez

To read the full analysis,
please visit:
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