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NOW WHAT?
A Citizen's Tax Reform Troubleshooting Guide

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INTRODUCTION

Utah policymakers spent 2019 with their gaze fixed on a wide-ranging tax overhaul, culminating in the passage of a reform package in a special session in December. However, inspired mainly by a backlash from grocers and citizens to increasing the sales tax rate on food, signatures rapidly piled up supporting a referendum to overturn the reform. In response, the Utah Legislature repealed the tax reform at the start of the 2020 regular session.

In the wake of this remarkable turn of events, the House speaker and the president of the Senate have appealed for advice on how to address the issues facing state budget crafters. These include the adequacy of general fund revenue; the competitiveness of income tax rates; and a large constitutional earmark.

To help citizens better participate in addressing those challenges, this report sets forth a number of possible options, though it does not in any way recommend for or against any of them. Neither does it provide comprehensive analysis of the options in terms of economic efficiency, economic neutrality or fairness. Rather, it lays out various choices – or, depending on your point of view, potential consequences – on the table following the reform effort's demise.

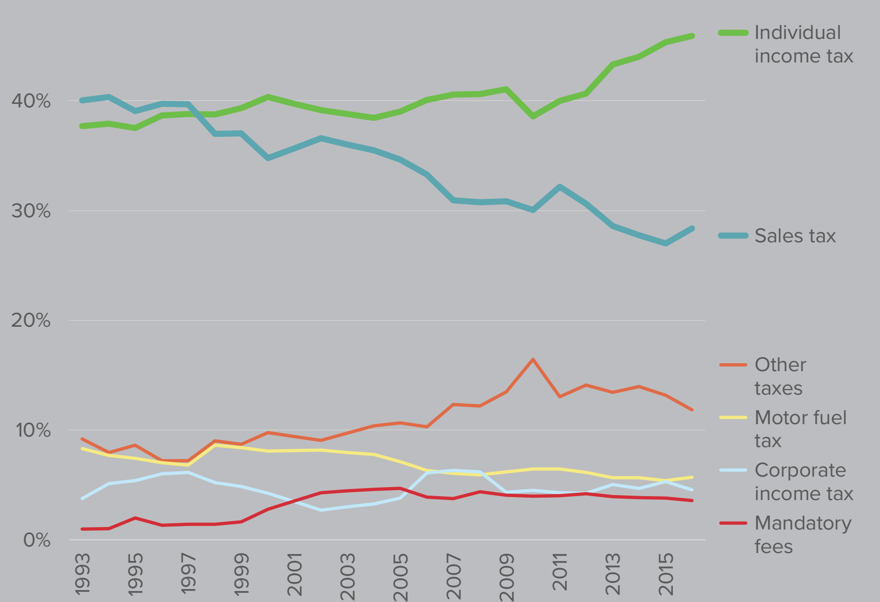
ISSUE 1: ADEQUACY OF GENERAL FUND REVENUE

Rising costs, particularly transportation and health care costs, and the shrinking role of key revenues for the General Fund have state policymakers worried about their ability to maintain funding levels for basic state spending categories in the coming years.

Specifically, the roles of motor vehicle fuel taxes (which are dedicated to transportation) and sales taxes (many of which are also dedicated to transportation) in overall state revenues have declined due primarily to greater fuel efficiency and a shift in overall consumer spending from taxable goods to untaxed services. In its 2018 report on sales taxes, Utah Foundation revealed that, over the course of 45

The role of income taxes in Utah's tax picture has risen as the roles of sales and motor fuel taxes have fallen.

Figure 1: Separate Tax Sources as a Share of Total Tax Burden, 1993-2016



years, Utah saw the nation's second biggest decline in taxable sales as a proportion of consumer expenditures.[1] Utah had essentially the same real per capita sales tax revenue in 1978 as in 2016 – meaning that, as costs climb, the state has lost purchasing power from this revenue source.

These issues are potentially complicated by a lack of flexibility in state spending due to a large constitutional earmark dedicating income taxes to K-12 and higher education. It should be noted that as long as the state spends General Fund revenues on higher education in addition to revenue from income taxes, the matter is somewhat hypothetical. However, some budget analysts argue that the day is fast approaching when those General Fund revenues will be inadequate even to cover non-education expenses.

On the expenditure side, rapid population growth is putting continued pressure on transportation spending.[2] Meanwhile, rising Medicaid costs have been consuming an increasing portion of state budgets nationwide. From fiscal 2017 through fiscal 2019, Utah saw an estimated 20% increase in state spending on Medicaid.[3] This challenge will be compounded by the decision to extend Medicaid eligibility to Utah adults whose annual income is up to 138% of the federal poverty level. Up to 120,000 Utah adults may be eligible for the expansion program.[4] (Although the federal government is expected to cover 90% of those new costs.)

Possible Responses

Broaden the Sales Tax Base. Broadening the sales tax base was at the core of the 2019 tax reform effort. There are two basic ways to broaden the base: (1) include a wider universe of goods and services in the taxable base and (2) eliminate exemptions. To realize the potential for broadening the base, consider this: In 2018, Utah Foundation determined that if Utah expanded the sales tax base to include all personal consumption transactions, the state could have dropped the effective rate to 2.1% (from 6.2%) and still generated the same amount of revenue.[5] Utah Foundation also found that this state was fairly average in the range of goods and services it taxed compared to other states, suggesting there may be room for expansion.[6] However, expanding sales taxes to capture services can face intense pushback from industries to be affected and from citizens who fear the change will result in net tax increases.

Eliminate Earmarks. Another way of looking at the funding problem is not that there is a lack of funding – indeed, overall state revenues, especially from income taxes, are growing at a steady clip – but that the Legislature lacks the budgetary flexibility to address its needs appropriately. When the state's largest revenue source, the income tax, is constitutionally pledged to education, budgetary flexibility is reduced. For that reason, large constitutional earmarks are often considered poor public policy. The same is true of lengthy catalogues of small earmarks. And, to be sure, there are currently constraints even on sales taxes. In fiscal 2020, more than 27% of the state's sales tax revenues are earmarked[7] – meaning the expenditures lack standard annual legislative oversight, and the government's flexibility to meet changing needs is constrained.

It should be noted, however, that the flexibility of funding higher education from either the Education Fund or General Fund allows for a degree of fungibility that has made the earmark of the state's income tax somewhat symbolic in recent decades.

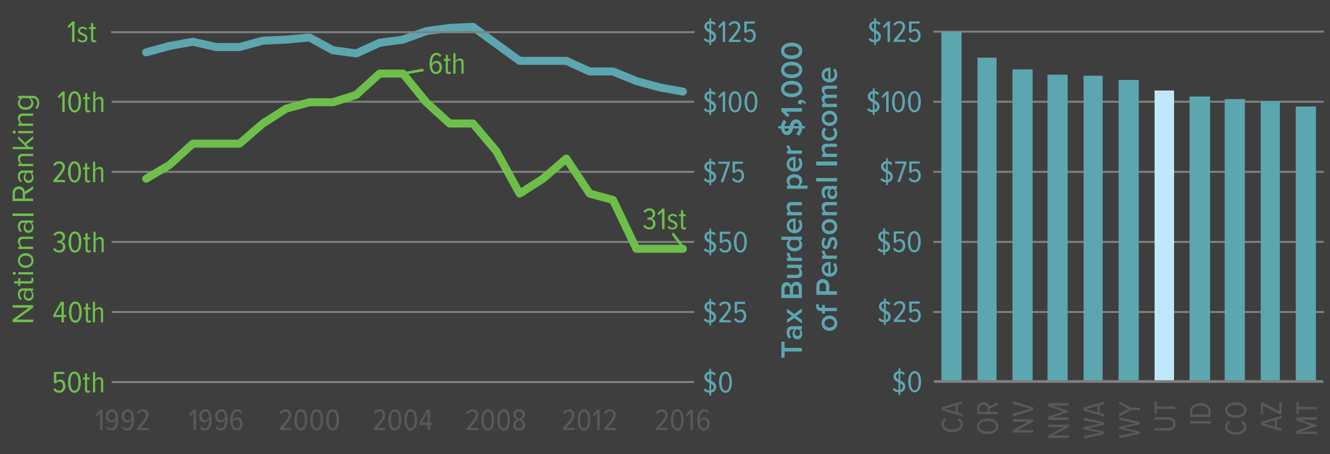
Raise Gasoline Taxes. In the longer term, transportation funding may benefit from an entirely new funding approach, based heavily upon vehicle miles traveled (VMT) fees, rather than gasoline taxes – a topic Utah Foundation will cover in a forthcoming report. With VMT still in its infancy, an alternative in the meantime would be to increase gasoline taxes to cover a greater proportion of transportation spending. Raising motor vehicle fuel taxes would mean transportation costs depend less on the General Fund, freeing up General Fund revenues

UTAHNS' TAX BURDEN FROM 2007 TO 2016

Utahns saw a notable decrease in their tax burden from 2007 to 2016, falling from $126.71 per $1,000 of revenue earned to $103.56. Correspondingly, the ranking of Utahns' tax burden fell from 13th highest in the nation to 31st highest over the same time period. With the exception of property taxes, the share of Utahns' income paid in taxes has decreased among all tax types – sales, income, motor vehicle, other taxes, even mandatory fees. Utah Foundation found that most of the decline in the overall tax burden has been a result of a growing population and increasing incomes. In other words, not only are Utahns' incomes increasing, leaving them with more dollars in their pocketbooks, but a lower tax burden means they also end up with a greater share of their dollars. For a full discussion, see Utah Foundation's October 2019 report, *A Lighter Load: Utah's Changing Tax Burden.*

Utahns' tax burden has steadily decreased in recent years.

Figure 2: Utahns' Total Tax Burden 1993-2016 and Compared to Western States in 2016



for other purposes. This change would hit lower-income households with cars disproportionately, as gasoline taxes consume a greater proportion of their income. It would also place an increased burden on industries that depend on motor transport, from trucking to ridesharing. That said, Utah's motor fuel tax burden has eroded since 1998 due to inflation and improved fuel efficiency. In fact, Utah has seen one of the nation's largest drops in fuel tax burden, although legislation passed in 2015 and 2017 to increase fuel taxes and index it to alleviate some of the erosion might alter this trend.[8]

Raise Sales Taxes. A failure of the state sales tax base to keep pace with growth will tend to put upward pressure on rates. While this is a problem among many states, Utah seems to be feeling it more acutely. In a 2019 report, Utah Foundation discovered Utah's sales tax burden had fallen the most out of any state from 1993 to 2016.[9] Still, over the past year, Utah's national ranking jumped from the 26th to the 20th highest combined state and average local sales tax rate, at 7.18%. Tennessee remained at the top, at 9.53%, with Louisiana just behind at 9.52%.[10] Of course, higher sales taxes on groceries alone were enough to spur much of the recent citizen backlash to reform. A significant tax increase on all purchases might meet with similar resistance. It would also intensify the regressive impact of the tax.

Impose a State Property Tax. Utah used to impose a significant state-level property tax. In 1950, state-levied property taxes in Utah accounted for 14% of the state's own source (non-federal) revenue. By 1970, that had fallen to 5%. During that time period, the state levy varied between .97% and .71%. In 1973, legislation ended a state property tax levy for schools (which had consumed more than 90% of the total state property tax revenues collected). In short, as the income tax became a more significant revenue source, the state wound down its property tax.[11] Imposing a significant new state property tax would introduce a highly stable funding source for state government. However, it would intrude upon the property taxing capacity of local government entities, such as cities, counties, special districts and school districts.

Curb State Services and Infrastructure Investments. If lawmakers take no course of action, they will by default be required to find ways to slow or reduce state spending. This could come in the form of offering fewer services or deferring infrastructure investments. However, reductions in such investments could yield setbacks in economic development and quality of life. For instance, a failure to keep up with transportation needs would probably lead to greater traffic congestion – already a key concern of Utahns.[12]

ISSUE 2: COMPETITIVE INCOME TAX RATES

By reducing the income tax rate in 2018 and at the end of 2019 (though the latter change was immediately repealed at the beginning of 2020), Utah's Legislative leadership signaled a commitment to reducing income taxes to keep Utah economically competitive. The state made a significant rate cut in the 2000s, and its single-rate individual and corporate income tax rates dropped from 5% to 4.95% in 2018, moving Utah's individual income tax rate ranking from 30th to 34th nationally. The scuttled reform would have further reduced the individual and corporate rates to 4.66% beginning this year.

Utah's top marginal personal income tax rate currently stands higher than that of any neighboring state except Idaho (6.925%). (Nevada and Wyoming do not im-

Utah's top marginal personal income tax rate currently stands higher than that of any neighboring state except Idaho. Nevada and Wyoming do not impose personal income taxes at all.

pose personal income taxes at all.) However, nationally, only 14 states now have lower top-end rates than Utah.[13]

Furthermore, the state sought to make the burden easier on middle class families with children, which took a hit on state taxes as collateral damage from the federal reform that took effect in 2018. (See Utah Foundation's March 2018 report, *The Education Tax: Income Taxation in Utah.)* For a family of four earning $65,000, the 2019 sales and income tax changes would have saved them around $300 annually. The increased tax credits for children went down with the rest of the reform at the start of 2020, although the Legislature will consider a bill to address dependent tax credits during the 2020 legislative session.[14]

Possible Responses

Broaden the Sales Tax Base. Broadening the sales tax base, as discussed above, would create greater flexibility for cuts in the income tax rate and potentially allow for greater higher education spending from the General Fund. This, of course, was the very two-step that reformers sought to dance forward in the recently repealed tax overhaul. Given the resistance displayed by grocers and many of their customers at increasing the sales tax rate on groceries, one might assume that any action to broaden the base in the near future would not repeat that particular component.

Continue Incremental Cuts as Revenues Rise. While a large income tax cut cannot be easily accomplished without finding new replacement revenue from another source (such as by broadening the sales tax base), the Legislature could seek to hold revenues somewhat steady as time passes, allowing for a series of minor cuts to the income tax rate that could have a significant impact over time. However, those seeking increased funding for education would likely prefer to harvest new income tax revenues by keeping the rate steady – which leads to the next issue.

ISSUE 3: A LARGE CONSTITUTIONAL EARMARK

As part of the scuttled tax reform effort, plans to seek to amend the Utah Constitution to lift the constitutional earmark for education also appear to have fallen away. Under the Utah Constitution, all income tax revenues "shall be used to support the systems of public education and higher education."[15] However, as noted earlier, such large funding constraints are often considered bad public policy.

Furthermore, some have argued that, by relying heavily on a guaranteed revenue stream, particularly from a somewhat volatile source like income taxes, there is less predictability than there would be if the focus was on steady funding.

This issue may be particularly contentious given that Utah spends less per pupil on K-12 education than any other state, although Utah Foundation's own research on the connection between spending and outcomes demonstrates the relationship is somewhat tenuous.[16] Furthermore, it should be noted that many regard the principal issue with regard to education funding as one of adequacy, not stability. However, as discussed further in this report, funding adequacy for education does not suffer from a particular structural impediment. On the contrary, the largest and fastest-growing major funding component in Utah is the income tax, which is already dedicated to education.

Possible Responses

Replace the Tax Dedication with a Funding Guarantee. The Utah School Board Association recently floated the idea of replacing the current constitutional income tax earmark with language that would guarantee that the amount appropriated for public education is not less than the prior fiscal year, adjusted for inflation, plus an upward adjustment for enrollment growth. Under this scenario, funding for education would not only keep stable – it would always grow. This might also allow greater flexibility in funding the other needs of government, depending on the overall revenue picture.

Boost Reserves. Under state statute, the Legislature is required each year to transfer 25% of the Education Fund revenue surplus to the Education Fund Budget Reserve Account.[17] The account at the end of fiscal 2019 stood at $471.9 million, just below 10% of the total income tax revenues dedicated to the Education Fund that year.[18] If policymakers consider this reserve level inadequate, they might consider loosening the statutory provision prohibiting the reserve account from exceeding 11% of Education Fund appropriations for the fiscal year in which the Education Fund revenue surplus occurred.[19] This would not only promote funding stability under the status quo, it would also provide protection should the earmark be removed.

Increase Reliance on Local Property Taxes. Utah school districts rely particularly heavily on state funding,[20] and state income tax revenues are more volatile than the local property tax revenues for schools. Shifting a greater burden onto local districts (perhaps with statutory changes allowing districts greater flexibility to raise property taxes) would bring greater stability to districts' revenue mix and allow state revenues to be used elsewhere. This approach, however, could have ripple effects across other local-level government services by exhausting voters' tolerance for tax increases and absorbing local taxing capacity. It might also have negative effects on funding equity among school districts.

IS IT REALLY BROKEN?

From certain viewpoints, it could be argued that the status quo has merit.

Education currently has a solid and growing source of funding. Those wanting the best possible dedicated source of revenue for education seem already to have the right horse in the race: Income taxes, which once yielded roughly the same amount of revenue to the state as sales taxes, have already far surpassed sales taxes as the state's number one revenue generator. True, the contributions to education from the General Fund are likely to dwindle as competition for those dollars heats up, but at least education will continue to take the lion's share of state funding. And,

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yes, income tax revenues are subject to downward swings in economic downturns, but individual income and corporate franchise taxes have of late been growing far faster than any other major state revenue source. Individual income taxes alone now bring in more state revenue than all other revenue sources combined. With a healthy reserve fund, education funding advocates can take comfort in claiming the state's most formidable, if not the most stable, funding source.

By the same token, advocates of smaller government may relish the opportunity to place increasing pressure on General Fund revenues. Education may occasionally receive windfalls from income taxes, but that could have the effect of putting downward pressure on income tax rates. Meanwhile, the remainder of government needs might have to duke it out for increasingly scarce resources. Proponents of a less expansive state government could take comfort that the constitutional earmark for education would put the squeeze on the rest of government. And with Utah's education spending per pupil still the lowest in the nation, it would take some time before excessive spending on education relative to other states might be a matter of concern.

Of course, this point of view does not account for the potential negative impacts of cutting into core services like transportation or the likelihood that a shrinking General Fund will put upward pressure on sales and motor vehicle fuel taxes, as it has in the past. As noted earlier, Utah can pay for rising transportation and Medicaid costs by raising the taxes that currently pay for them. In the longer term, it can create new revenue sources, such as VMT charges.

CONCLUSION

Utah offers a case study in the controversies that can arise as a result of large tax dedications and a changing tax base. To be sure, Utah may have considered broadening its sales tax base regardless of whether the income tax was tied up, simply in response to the trend showing sales tax losing ground as a major revenue source. But it seems unlikely that tax reform would have taken on the urgency it has without the constitutional earmark for education locking down the lion's share of the tax base.

In essence, the concerns about the flexibility of the income tax and the adequacy of other revenues amount to the same question: Are state revenues sources up to the job of funding the future priorities of Utah policymakers?

ENDNOTES

1 Utah Foundation, *The Everyday Tax: Sales Taxation in Utah*, June 2018.

2 As of last May, there were 169 construction projects statewide currently in progress or scheduled to start, with a combined value of $2.1 billion. "Mountain View Corridor Extension to S.R. 201 Leads UDOT's Top 10 Projects in 2019," Utah Department of Transportation, May 1, 2019.

3 2019 State Expenditure Report, Fiscal Years 2017-2019, NASBO, 2019, p. 54.

4 "Medicaid Expansion, Program History," Utah Department of Health, https://medicaid.utah.gov/expansion/.

5 Utah Foundation, *The Everyday Tax*, op. cit.

6 Ibid, p. 13.

7 Utah Office of the Legislative Fiscal Analyst, "Budget of the state of Utah and related appropriations: 2019-2020."

8 In 2016, Utah's motor fuel tax was at $3.35 per $1,000 of personal income, placing the state 21st in the nation and sixth among the 11 Western states. Utah Foundation, *A Lighter Load: Utah's Changing Tax Burden*, October 2019, p. 8. See also Utah Foundation, *Fueling Our Future, 2013-2040: Policy Options to Address Utah's Future Transportation Needs*, October 2013.

9 Utah Foundation, *A Lighter Load*, op. cit.

10 Cammenga, Janelle, *State and Local Sales Tax Rates, 2020*, Tax Foundation, Fiscal Fact Sheet No. 686, January 2020.

11 Utah Foundation's Statistical Reviews of Government in Utah, editions 1974-1981; HB1, first special session, 1973.

12 For a discussion of traffic concerns, see Utah Foundation, *Utah Foundation Quality of Life Survey: Measuring Utahns' Perceptions of their Communities, Personal Lives*, September 2018.

13 Loughstead, Katherine, *State Individual Income Tax Rates and Brackets for 2020*, Tax Foundation, February 2020, p. 5ff.

14 See HB 260, Dependent Tax Exemption Amendments, https://le.utah.gov/~2020/bills/static/HB0260.html.

15 Utah Const., Art. XIII, Sec. 5(5).

16 Utah Foundation, *Making the Grade? K-12 Outcomes and Spending in Utah*, August 2019.

17 Utah Code, 63J-1-313.

18 "State of Utah Financial Highlights, Fiscal Year Ended June 30, 2019," Department of Administrative Services, Division of Finance, November 2019.

19 Utah Code, 63J-1-313(3)(a)(ii).

20 See the Lincoln Land Institute, *The Future of U.S. Public School Revenue from the Property Tax*, July 2017, which puts local funding (primarily property tax) at 45% and state funding at 46.2%. In Utah, according to the Utah State Board of Education (https://www.schools.utah.gov/financialoperations/propertytax), state funds account for 63.99% of school districts' General Fund revenue, while local funding accounts for 24.15%.

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