

## Policy Perspectives

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Taxes / Revenue Forecast

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### CONTENTS

Sales Tax Reform

Income Tax Proposal

Income Tax Reform and 2nd Substitute SB 242

Punishment by Reality

Western States Primary Update

ASPA Luncheon - April 7th

## Sales Tax Reform

By Janice Houston, Senior Policy Analyst, CPPA

There was a lot of political capital spent on tax reform during this last legislative session. Members of the House, Senate and the Governor's Office all had different visions of what sound and fair tax policy meant. After a last minute deal between all three bodies, it looked like reform was going to happen to most of the tax system. In the final minutes of the session, though, income tax reform didn't make it through the House. This has prompted the Governor to call for a Special Session to resolve the issue. For the moment, the most significant reform to the tax system was a two percent decrease in the sales tax rate on food, to be implemented in 2007. This reduction was a compromise on the Governor's campaign promise to eliminate sales tax on food. His promise was in response to polling data that showed that the tax issue Utahns cared about the most was the food sales tax.

While the reduction is going to cost the state \$70 million in sales tax revenue, what are the impacts going to be on the average Utah resident? Is he or she even going to notice the difference? Who is going to benefit the most and by how much? Will the expenditure of political capital on this issue pay off at the ballot box in November? This article will attempt to address these issues.

First and foremost, how will this impact the average citizen? [Figure 1](#) breaks down before and after tax income, the average annual amount spent on groceries and the tax implications by income category. Disregarding the "income less than \$5,000" category because of its anomalies, these figures show that, on average, Utahns will keep about \$71 in their pockets each year. Assuming one trip to the grocery store every week, this is about \$1.37 per trip.

While the overall savings are small, the reduction in the sales tax on food does seem to help lower income residents to a greater degree than others. For those in the \$5,000 to \$9,999 income range, the burden of the food tax drops by the most significant degree, one-half of a percent, from 1.1 percent of after-tax income to 0.6 percent of after tax income. For those in the next category up, earning between \$10,000 and \$14,999, the burden is reduced by two-fifths of a percent, from 0.9 percent of after-tax income to 0.5 percent of after-tax income. It is important to note that "after-tax" income for the purposes of this data set only refer to federal income taxes. Comparing these figures to the savings offered to low-income families through the tax credit proposal favored by the Utah Senate shows that for a married couple with two children and an income under \$30,000, the credit would have been a better deal. This couple would have netted an average savings of \$75 per person (or a total savings of \$300) with the grocery tax credit as opposed to approximately \$57 total with the sales tax reduction.

Income is not the only factor that should be considered when reviewing these data. As Utahns tend to have larger families, which in turn spend more on food as well as eat at home more, it is important to examine the impacts based on family size. [Figure 2](#) provides this information. As it shows, families with five or more members do see the largest return, in percentage terms, with sales tax on food as a percent of after-tax income dropping from 0.4 percent to 0.2 percent. However, the percentage of after-tax income spent on groceries is proportionately larger than that return. On average, families of five or more spend 8.4 percent of their income on groceries, whereas for all other family sizes that percentage is between 6.0 and 6.6.

The final iteration of these data is the impacts by age category. Elderly residents are more likely to be living on modest fixed incomes. Additionally, as mobility declines with age, they are also more likely to eat at home. [Figure 3](#) highlights the impacts by the age of the head of household. Here, one can see that those age 75 and over receive the greatest benefit from the sales tax reduction.

Since this issue was one of great concern among Utahns, why wasn't the impact greater? Even if the sales tax on food were eliminated completely, the largest return would only be \$245 a year to a family of five or more, as shown in [Figure 2](#). Again, assuming one trip to the grocery store a week, this is about \$4.71 per trip.

Part of the answer lies in our eating habits. As [Figure 4](#) shows, anywhere from 30 to 56 percent of the average food budget is spent on meals outside the home. Even among low-income residents, a significant portion of food expenditures are on dining out. Were the individual impacts

of this tax reform larger, one might expect to see more people choosing to eat at home rather than dine out. This substitute effect might positively impact health outcomes, especially among low-income residents. However, since the money saved in individual food budgets is so small, the convenience of fast-food and restaurant meals will still probably outweigh any monetary savings at the grocery store.

A final consideration Utahns should make when reviewing the benefits of the sales tax reduction are the indirect costs. The Legislature set aside \$6 million to be allocated to the Utah State Tax Commission. These funds are to be used to assist businesses in converting their cash registers and scanning systems to calculate the new tax rates. The Legislature was very clear in the bill language that they do not anticipate this \$6 million will be adequate to meet all the needs of Utah's businesses. As the statute reads:

*"This bill appropriates \$6,000,000 from the General Fund for fiscal year 2006-07 only to the State Tax Commission for distribution to **certain** sellers to reimburse **some** of their costs in complying with the reduced sales and use tax rate imposed on food and food ingredients."* (Enrolled Copy H.B. 109 "Sales and Use Tax-Food and Food Ingredients," italics and emphasis added)

The statute provides monies to businesses with between \$15,000 and \$500,000 in tax remittances for computer upgrades. These businesses will receive either \$10,000 toward the costs of those upgrades or 50 percent of the amount they spent on those upgrades, whichever was lower. Additionally, these businesses will be eligible for reimbursement of the full cost of any computer upgrades done to account for sales taxes that might not have been remitted during the transition to the lower rate. For businesses with over \$500,000 in sales tax remittances, the bill provides monies only for accounting of lost sales tax and only at 50 percent of the cost of the computer upgrades. For this reason, small businesses may receive more assistance than larger ones, in getting their scanners and cash registers ready for the change. However, if there are more claims than the \$6,000,000 allocated, the pool is pro-rated and all businesses will get less.

So what does this mean to the grocery consumer? If business costs related to the sales tax reduction exceed the assistance offered by the Tax Commission, how is that lost revenue going to be made up? Businesses have the option of either absorbing these costs or passing them on to the consumer in the form of higher prices. Since the costs associated with this change are a one-time event, it is hoped that businesses would just absorb them, perhaps piggy-backing them onto other related costs, such as a planned upgrade to their cash register system. However, the grocery business is one of razor-thin profit margins. In all likelihood then, the costs of changing the tax systems will be passed along to the consumer. If these costs are high enough, Utahns may find their tax savings eroded by higher grocery bills.

All of this leads to the final question posed above, will the expenditure of political capital on this issue pay off for those facing re-election in November. Given that the new policy is not enacted until January 1, 2007 and most people are more interested in the fact that there was some type of tax cut, regardless of how much money they actually see in return, it is most likely that the reduction in sales tax on food will have a larger political benefit to politicians than financial benefits to Utah households.

## Income Tax Proposal

By Governor's Office of Planning and Budget

### Introduction

Tax reform has been a top issue to Utah lawmakers for several years. In November of 2004, Governor Olene Walker issued a report that made 16 recommendations to address Utah's declining tax base. When Governor Huntsman was elected, he made tax reform a central priority of his administration. In October of 2005, Governor Huntsman proposed a personal income tax reform package as part of the Legislature's Tax Reform Task Force that was based on the recommendations of the Walker Tax Advisors. The proposal meets the goals of the task force to create a simple, stable, broad-based, and responsive tax system for the state.

The proposal is based on a flat tax of about 5% on federal adjusted gross income (AGI), and includes a tax payer credit, and credits for charitable contributions and mortgage interest expenses. The proposed income tax will position the state for the 21<sup>st</sup> century by broadening the tax base, lowering the rate, and providing a simplified income tax system.

### Broaden the Base

Utah's current individual income tax uses federal taxable income (FTI) as the basis on which income taxes are imposed. Federal taxable income is also the tax base used by the federal government to calculate income tax liability. FTI is computed by subtracting federal deductions and exemptions from AGI. The tax reform plan will broaden the income tax base to adjusted gross income. AGI consists of gross income from taxable sources minus certain items, such as payments to a qualified Individual Retirement Account (IRA), or an employer-sponsored 401(k) account. These are often called "pre-tax" contributions because they are not part of the AGI calculation.

If Utah were to maintain its current income tax system and simply move from FTI to AGI, the change would increase revenue collections to the state. By broadening the base, lawmakers have the ability to reduce the tax rate. The plan also incorporates a \$70 million tax cut in the income tax system.

In addition to broadening the tax base, basing the income tax system on AGI has other positive effects. First, it will largely decouple the state from the federal tax system. It would make little sense to do away with many of the destabilizing federal deductions in exchange for three simple credits, and then use FTI as the tax base. This would allow for the deductions to creep back into Utah's tax system. Many states already use AGI in order to broaden and simplify their tax base. Of the 41 states that impose an income tax, two-thirds use AGI as the base.

Second, it will stabilize future revenue flow. The economic surge in the late 1990s was followed by the dramatic downturn of the early 21<sup>st</sup> century. This caused major fiscal impacts for both the states and the federal government. Although Utah fared well compared to many other states, elected officials were still forced to make many difficult fiscal decisions when revenues did not meet expectations. By tying the income tax to AGI, Utah's income tax will provide a more stable revenue stream. Government growth will be slower in good times, and the downside risk will be smaller in bad times.

## **Lower the Rate**

There are many problems with the current income tax system. On paper it is a system with progressive rates, but in practice it is a flat-rate system with a number of detrimental loopholes. Utah needs a tax system that fosters growth and innovation and that recognizes the economic realities of the 21<sup>st</sup> century. Utah's current top marginal income tax rate is not only one of the highest in the West, but also in the nation. The personal income tax is an important factor in many business owners' and private citizens' decisions to relocate to a new state; it is vitally important that Utah has a competitive income tax system.

Currently, Utah's personal income tax system consists of six brackets, with top rate of 7% imposed at an income level at or above \$8,600 per year. The tax reform proposal will remove the brackets from the tax system, creating a marginal tax rate that is flat for all taxpayers. The proposal will also lower the tax rate from 7% to about 5% for all Utahns.

The current top rate of 7% ranks Utah fourth highest among western states levying personal income taxes. By lowering the tax rate to a flat 5%, Utah's top marginal rate will become the second lowest in the West. The state will also go from having the 14<sup>th</sup> highest rate in the nation, to having the 14<sup>th</sup> lowest rate in the nation. Lowering the income tax rate will make Utah more competitive, both in the West and in the nation.

## **Simplify the Tax System**

Due to a lack of specific planning or design, Utah's personal income tax has become burdened by numerous deductions and special credits. These deductions have the effect of increasing volatility and complexity in Utah's tax system. In addition to having its own complexities, Utah's tax system stands on the shoulders of Federal law, which provides loopholes for non-compliance and aggressive shelters. By removing special credits and deductions, the income tax will no longer give favor to special interests, and Utah will have a fairer tax system.

The proposed plan would remove many of the volatile "piggyback" federal deductions in favor of three tax credits: a tax payer credit, a homeowner credit, and a charitable contribution credit. The tax payer credit will replace the current standard deduction and personal exemptions. This credit ensures that low and middle income Utahns don't receive large tax increases, thereby offsetting the regressivity of a pure flat tax. A portion of this credit phases out as income increases, however, and everyone will still receive a per person credit. Also, in order to encourage charitable giving and home ownership, the proposal includes tax credits based on charitable contributions and mortgage interest.

Not only will this plan simplify the income tax, it will also provide benefits to Utah's taxpayers. Although there will be fewer credits and deductions, it will be simpler for taxpayers to benefit from them. Under the current system, only those who itemize deductions on their federal income taxes, about 40% of tax filers, are able to receive a deduction from their income for charitable contributions. Under the proposed plan, it will be simpler for tax payers to receive this benefit.

## **Conclusion**

The individual income tax reform plan proposed by Governor Huntsman and advanced by members of the Utah State Legislature is the culmination of years of analysis and debate. The tax plan will make Utah more competitive regionally, and it will enable the state to better position itself for the 21<sup>st</sup> century.

## **Income Tax Reform and 2nd Substitute SB 242**

*Things we would like to know...*

By Sandy Peck, Executive Director, League of Women Voters

The League of Women Voters has followed tax policy for many years. We also have supported adequate funding for quality education. Since all income tax revenue goes to education, we have been especially interested in Governor Olene Walker's study group recommendation in 2004 to broaden the income tax base and lower rates to provide stability and flexibility for future needs, needs that are growing rapidly due to a burgeoning school age population.

### **Tax rates, tax bases, economic development and education**

The Walker group expressed a particular concern that the income tax base is decreasing by 1.4% a year. This was puzzling, so we'd like to know...

*If the population and the economy are growing, why is the income tax base going down 1.4% a year?*

The Walker group, Governor Huntsman, and some legislators on the Tax Reform Task Force have said the income tax base is decreasing because our top income tax rate of 7% is too high. It discourages new businesses who would broaden the tax base from coming to Utah. So we would like to know...

*Do we have data to tell us how many new businesses would choose to locate in Utah and how much the tax base would be increased by lowering the top rate from 7% to 5% or 4.95%? Would the growth make up for the education revenue lost using the lower rate?*

We have several reasons for asking. Our current 7% rate seems fairly competitive with those in other states (Arizona, 5.04, California 9.3, Idaho 7.8, Montana 6.9, and Oregon 9.0). Nevada and Wyoming have no income tax. Colorado's rate of 4.63 is apparently not financially sound.

We also wonder how important the 4.95% rate would be to CEO decision-making. Last July, the Utah Education Association invited Richard G. Sims, President of the Sierra Institute on Applied Economics, to speak to the Revenue and Taxation Interim Committee. He pointed out that 48% of total business costs go to labor and only 0.27% to business taxes. This indicates that a well educated and well trained labor force is likely to weigh more heavily in business location decisions.

When the League studied education and economic development 18 years ago, we found important factors in economic development were an educated labor force, employee training and retraining capabilities, university research and development, technology transfer, and good elementary and secondary schools for employees' children. We expect these factors are still important and know that state policy makers are aware of them. The question is. . .

*What are the relative effects of marginal tax rates vs. the quality of our public education system on economic growth?*

### **Revenue stability**

The Walker group endorsed the lower marginal tax rate not only to attract business but to create a more stable revenue flow that would not vary more than the ups and downs of the economy. This stability would make budget management easier. However, as Rep. James Ferrin asked during the March 1 House debate of SB 242, do we want stability in a growing economy? He pointed out that the Uniform School Fund would grow more slowly, collecting less money for education. Our questions are...

*Couldn't we use tools for stability we already have such as Rainy Day funds and judicious use of general obligation bonds instead of lowering the tax rate? Isn't increasing revenue for education as quickly as possible a major goal of income tax reform?*

### **Expanding the base by eliminating exemptions**

During the March 1 House floor debate (which I highly recommend listening to at [le.utah.org](http://le.utah.org)) it was very clear that a major obstacle to passing SB 242 is the proposed elimination of virtually all current tax exemptions except credits for charitable deductions and home ownership. Legislators said they wanted to keep exemptions for retirement income (claimed on 81,000 returns) higher education savings accounts, medical expenses, adoption expenses, special needs adoptions, motor fuel used by agriculture, half of federal tax paid (claimed on 605,000 returns), and check-offs for contributions to political parties, the homeless and others. Altogether there are at least 20 tax breaks in current law, but their loss was not discussed much in task force meetings, perhaps in hopes of avoiding controversy. Our question is. . .

*Should some exemptions be preserved for their social policy value and what would the tradeoffs be in terms of a higher top rate and administrative efficiency?*

### **Tax fairness**

Since SB 242 is considered not "flat" but "flatter" we believe it has some progressive elements. We would like to know...

*Is subsistence income protected for low-income taxpayers by a floor and indexing?*

*What would the tax burden be for households at various income levels, expressed as the percent of income spent on all state taxes? Is it at least proportional, even if not progressive?*

### **Revenue neutrality**

The original intent of tax reformers was revenue neutrality. But SB 242 would provide a \$65 million tax cut in the first full fiscal year after it took effect. It would seem more productive to spend that amount on education initiatives such as smaller class size and full-day voluntary kindergarten. We would like to know...

*Why did lawmakers decide to incorporate tax cuts instead of keeping reforms revenue neutral?*

Maybe this question should be multiple choice: a) revenue surpluses (b) its an election year c) make-up for loss of treasured exemptions or (d) all of the above.

We look forward to a better understanding of tax reform before the special session convenes.

## **Punishment by Reality**

By Ken Embley, CPPA

My colleague, Janice Houston, points out that a number of well-intended people made great efforts to realize the promise of sales tax ideals. What is the reward for their valiant efforts—punishment by reality.

The topic of this article is—**public sector incentive programs**. How many times have we experienced well-intended and valiant efforts to devise an incentive program for public employees where the reward for doing so is—punishment by reality? Do recent changes in the State of Utah sick leave policy or proposed changes to the Jordan School District retirement policy come to mind? Well, if the topic of public sector incentives is of interest to you, you may be interested in what the grandpas of the world have to say about incentives.

When I am out visiting public agencies, I hear employees complain about the lack of incentives and I hear well-intended managers discuss valiant efforts to provide incentives. On one occasion, a particular manager boasted of the monies set aside for incentives and in the same breath, complained about ungrateful employees—ah, the valiant effort of a well-intended person whose reward is—punishment by reality.

Can you provide your public employees with incentives—with expectations of reward that induces action or motivates effort (Dictionary.com/incentives)? The simple answer is yes! The realistic answer is maybe!

A fundamental problem with incentives is that, by definition, an incentive is an act of manipulation (expectations of reward that induces action or motivates effort). Alfie Kohn is the author of *Punished by Rewards / the Trouble with Gold Stars, A's, Praise, and other Bribes* In his book, Mr. Kohn makes the point that any person who manipulates another will eventually pay a heavy price for that manipulation.

Therefore, if you want incentives, the first thing you must do is ensure that a common understanding of the means and methods of manipulation is in place and that all involved respect and value the process. Here is where the grandpas of the world come into play. A long time ago the grandpas of the world learned to say, "I have some candy for the little ones who can give me the biggest and best hugs and kisses." In this case, the grandpas and grandkids both have a common understanding of the hugs and kiss game and both like the game. Collectively, they are manipulating the heck out of each other but both love it. The lesson, be like the grandpas of the world—**where everyone understands, and all involved respect and value the incentive process**

Now, if you want incentives, the second thing you must do is ensure that you have a reliable means to deliver the desired reward. There are actually two things that you must do. When I say, "a reliable means to deliver," it means having on-going resources to ensure delivery (usually

a budget) and when I say “a desired reward,” it means the recipient needs to value the reward. Always remember, management can offer new and exciting rewards, but management cannot take those same rewards away from recipients, Mr. Kohn predicts, without paying a heavy price for the manipulation. You see, grandpas have it easy. Grandpas have what seems to be a reliable source of candy that grandkids love. The lesson, be like the grandpas of the world—**have a reliable means to deliver a desired reward**

Finally, if you want incentives, recipients must see the measures of successful achievement as being fair and equitable. The question is—how will you determine who gets the reward and will those involved see your method of determination as being fair and equitable? Again, grandpas have this down pat. Grandpas know the difference between a good hug and a bad hug and they know what good kisses are, and they have lots of fun, and so do the kids, working together to achieve the measures of success. If you want incentives, you need to be like the grandpas in the world where everyone involved can recognize measures of success and everyone involved knows they can achieve the measures of success and together, all involved relish in the success of every member. The lesson, be like the grandpas of the world—**be sure the measures of successful achievement are fair and equitable**

Can your organization benefit by creating a public employees incentive program? The answer is yes—as long as you can be like the grandpas in this world.

However, incentive programs require that you address and solve each of the three issues. If you cannot do that, your well-intended and valiant efforts will likely be in vain. Even the grandpas of the world, who are well intended and make valiant efforts, have trouble over time. All it takes is for the grandkids to get a little older. When this happens, the ability to comply with the three issues becomes more and more difficult and even we grandpas begin to experience—punishment by reality.

## Western States Primary Update

The Utah Legislature passed SB 60, the Western States Primary bill, during the 2006 session. The bill permits the state to hold a presidential primary on the first Tuesday in February in presidential election years. Proponents of a Western States Primary believe that it will result in candidates spending more time in the West and becoming more familiar with issues important to the region, and it may increase voter turnout. Governor Huntsman signed the bill on March 21, 2006.

In early fall, the Western Policy Research Network, will host a symposium on the Western States Primary Election. The symposium will bring together public officials, party leaders, and academics to discuss:

- potential of a regional primary to highlight western issues
- political impact of a regional primary
- costs and benefits of holding a regional primary
- challenges of implementing a regional primary

For more information about the Western States Primary Election Symposium, please visit [www.westernpolicynetwork.org](http://www.westernpolicynetwork.org)

## ASPA Luncheon - April 7th

*The State of Tax Reform in Utah*

**The State of Tax Reform in Utah  
Where have we been? What should we expect in the Special Session?**

**The April 7th ASPA luncheon meeting will held at 12:00 noon  
in the Auditorium of the State Office Building**

**Keith Prescott, CPA**  
Member of Governor's Tax Reform Group

Due to limited space, please make your reservations early. The luncheon will be catered. Reservations or cancellations must be received no later than Tuesday, April 4th. **No shows will be billed**. Limited parking is available--please carpool where possible.

The cost of the luncheon is \$12.00 for ASPA members, students and Buzz Supporters and \$15.00 for nonmembers.

Please call the Center for Public Policy and Administration, University of Utah at 581-6493 or e-mail reservations by [clicking here](#).

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