Is the Utah Tax System Obsolete?
by Dave Patton, PhD, CPPA Director

A clever shopper might visit a local electronics store looking for a new plasma television, find the make and model that suits them best, then go home and search the Internet for the same product at a better price. In addition to the wider market competition available on the Internet, this consumer might find a 6.8% discount by avoiding the Utah sales tax levied at the local store.[1] Today, virtually anything can be purchased over the Internet in direct competition with Main Street retailers who are required to collect sales tax at a decided disadvantage. In another case, a homeowner may want to do a little yard work but because of the antiquated sales tax laws you would be charged sales tax if you were to purchase a lawn mower or for the service to repair a lawn mower but you would not pay sales tax if you were to hire a lawn care service. There does not seem to be a clear rationale behind what services are or are not taxed in the state. Utah levies a sales tax on about one-third of potential services compared to some nearby states.[2]

New Tax Strategies for a Changing Economy

The Utah economy has changed significantly over the past several decades. In 1950, mining, manufacturing, transportation/communications/utilities and government made up 56 percent of the state economy (as measured by non-agricultural employment – see figure 1). By the turn of the century those same components had dropped to 36 percent. Mining has fallen below one percent of employment, manufacturing from 15 percent down to 12, transportation down from 11 to 6 percent and government is down from 23 to 17 percent of employment. The sectors that have grown significantly are services (up from 11.3 percent in 1950 to 25 percent in 2000) and finance/real estate employment. The rest of the country can say that the economy has shifted from manufacturing to services, in Utah this would be somewhat misleading; manufacturing has fallen by only three percentage points since 1950. The major employment decline has been in mining, transportation/communications, and government with a corresponding increase in employment in the service sector.[3]

Figure 1. Changes in Non-Agricultural Employment in Utah, 1950 – 2000

Non-agricultural employment, industry share of total employment, Utah Governor’s Office of Planning and Budget.

Although the state’s economy has transformed over the decades, its tax system is basically unchanged. The beginnings of the Utah tax system go back to 1878 when the property tax was...
first levied on real and personal property and was the principle revenue source for state and local government until the Great Depression. The economic downturn in the 1930s created a financial crisis for state and local governments and consequently the personal income tax and corporate franchise taxes were implemented in 1931 and the state sales tax in 1933. Twenty-six years later (1959) the sales tax was expanded to local governments. The financial crisis of the Great Depression demonstrated the need for a tax system that was designed to tax a broad base of economic activity at relatively low rates, not relying on a single source of revenue. Today’s economy looks much different, but the tax system design remains relatively unchanged. As a result, current taxes are not efficient at providing needed revenue, unfair to those who are paying taxes and possibly limit economic growth. [4]

Utah recently underwent major changes to its tax policy by enacting a flatter income tax system and reducing the sales tax on food, but two recent studies on taxation policies in the states indicate that Utah’s tax system may need additional revision of its tax policy. The Pew Center on the States has recently studied how state tax systems can adjust to the new economy. Their findings indicate that states need to develop tax systems that encourage economic vitality in order to be competitive not only between the states but in the world economy. The Pew study, like the recent CPPA study, An Evaluation of Utah’s Tax System, advocates a modern tax system that is simple, transparent and utilizes a broad base that provides a balanced revenue stream and spreads the tax burden fairly.[5] Most state tax systems, according to the Pew, study are now inefficient and act to “stifle economic vitality by creating an environment that’s inhospitable to business.” The study identifies several tax strategies that can help improve a state’s business climate.

Balance Tax Rates and Public Services

Many states, including Utah, have focused on reducing tax rates as a strategy to improve the competitive position of the state in the national and world economy. The Pew study acknowledges that lower tax rates may influence businesses to locate in a given state – if all other things are equal – but this is where the strategy is overly simplistic. More important to business location are an educated workforce, a well-developed transportation and communications infrastructure and public amenities. A study by the Information Technology and Innovation Foundation found that five of the weakest states on its business climate scale are among those with the lowest tax burdens.[6] Lower taxes can lead to service reductions including some areas that affect economic development. Many businesses and economic development specialists are coming to the conclusion that “ground zero for economic development is a high-value workforce.”[7] To maintain a vital economic environment, tax rates should be balanced by the need for key public services.

Broaden the Tax Base

The second strategy is to modernize the state tax system by broadening the sales tax to include taxing services. Although expanding sales taxes to the service sector would help to fulfill the basic axiom of tax policy, “broaden the base and lower the rate,” there is considerable push-back from service providers. A study by the Federation of Tax Administrators[8] describes the shift in the economy toward services and catalogs state practices in the taxation of 168 service-related transactions. States have increased the number of service-related transactions taxed since 1992, but efforts in two states to enact broad-based expansion of sales tax levied on services met significant resistance and both were later repealed. Most of the increases have been in the business services and personal service categories. Of the 168 service areas studied, six states tax more than 100 services: Hawaii (160), Washington (157), New Mexico (156), South Dakota (146), Connecticut (143), and West Virginia (110).

Recent legislation may have changed the numbers of the FTA survey modestly, but as of 2004, Utah taxed 57 service transactions and was relatively low in business services such as
advertising and consulting (taxing 6 of 34 potential services), personal services such as barber shops and carpet cleaning (8 of 20), utilities including electricity and water (7 of 16) and computer services such as internet providers or software (0 of 8). Utah was near the top when it comes to taxing repair services (15 of 19). Only a very few states tax professional services such as attorneys, engineers and physicians.

States could improve the fairness of its tax system by broadening the sales tax base to services and work with other states and the federal government to capture sales transactions made online that often avoid paying sales tax.

**Developing a Fair, Flexible, Accountable, and Stable Tax Policy**

The Pew study recommends several other strategies that can help a state improve its business climate, including the following:

- Capture shifted corporate taxes. Corporations operating in several states sometimes report their profits in states that do not levy corporate income taxes. Some states now impose "combined reporting" which allows states to tax the percentage of corporate profits that can be attributed to the corporation’s (and its subsidies) operations in the state.[9]

- Treat telecommunications companies equally. Telecommunication companies are no longer the telephone monopolies of bygone years. Intense competition between communication companies in a variety of media can be unfairly influenced by state tax policies that affect one company differently than others.[10]

- Allow local governments the flexibility to support economic development. Local governments are restrained by state law and tax and expenditure limitations on the amount of revenue they can raise. This restricted own-source capacity can harm the ability of local governments to provide needed services and adjust to unexpected economic circumstances. Greater flexibility with appropriate state control can complement the state’s economic development efforts.[11]

- Improve monitoring and accountability for tax incentives and exemptions. Tax incentives and exemptions often fail the basic test for investments: is there a clearly identifiable return on investment? The Pew report found that every state that offers tax incentives monitors by verifying how the company receiving the incentive has or will produce a level of investment or job creation in the state. Eighty percent of states impose a penalty for non-performance on
incentive obligations. Most states publicly disclose tax incentive information, and eighty percent of states have tax expenditure budgets providing data on the fiscal impact of tax incentives (including lost revenue and potential returns). Utah is ranked by the study as one of five states needing improvement in this area.[12]

· Keep the tax system stable by reducing change and volatility. Businesses accept taxes as a cost of business, but they want to rely on a system that is not continually changing the rules. Volatility in tax revenues negatively affects governments who need to establish reliable budgets to accomplish the mandates they are required to perform. Diversified tax portfolios can reduce volatility by relying on several different taxes and broad bases for each tax so fluctuations in the economy will not have a concentrated impact on a single tax. Utah now has one of the lowest volatility rates in the country.[13]

· Plug the leaks in the tax system. States have employed five methods to simplify tax collections and improve compliance. One means to improve compliance is to conduct audits electronically and let companies know exactly what is needed for the audit. A common method to improve collection is e-collection including e-filing for sales and business taxes. A well-publicized and fair appeal process that is independent of the tax authority can also help improve compliance.[14]

Utah has recently undergone a dramatic change in its income and sales tax policies and property taxes are now under the microscope with changes suggested by the State Legislature. Although tax reform is an ongoing process, there are advantages to a relatively stable, unchanging tax system so businesses, individuals and governments can anticipate their tax obligations. However, as the economy changes, it is important to continuously review tax policy to make sure the system remains fair and efficient. The reforms suggested by the Pew study include one final recommendation – that states establish a mechanism for ongoing review of their tax systems in light of the changing economic environment. Utah has been successful in fulfilling this recommendation by creating and listening to a Tax Reform Commission composed of legislators and other experts on tax policy. The recent Pew report will provide Utah policy makers with further considerations for review.

[9] Barrett and Greene, p. 25
[10] Barrett and Greene, p. 26