

A VISUAL GUIDE TO TAX MODERNIZATION IN UTAH

PART ONE: SALES AND USE TAXES

November 14, 2018



DAVID ECCLES SCHOOL OF BUSINESS

With grateful acknowledgment for data and input provided by the
Utah Governor's Office of Management and Budget, Utah Office
of Legislative Research and General Counsel, and
Utah Office of the Legislative Fiscal Analyst

*“You can fight change and lose.
You can accept change and survive.
Or you can lead change and prosper.”*

- Ray Noorda, former President and CEO of Novell

Utahns share a common interest in a state and local tax system that provides for our needs, keeps the economy strong, and remains viable over the long term. This visual guide to tax modernization presents economic and demographic realities impacting Utah’s current sales and use tax system*.

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* For the remainder of this guide the term “sales tax” refers generically to the entire sales and use tax system.

November 2018

Dear Policymaker:

Utah Gov. Gary Herbert and the Utah Legislature took steps to modernize Utah's tax structure in the 2018 General and Special Legislative Sessions. Among other changes, Utah policymakers lowered the income tax rate and froze the property tax rate for education. These changes have the potential to create greater revenue stability and economic efficiency, while continuing to fund important needs. Congratulations on a job well done!

Tax modernization like this is hard work. As Utah's population and economy continue to evolve, more tax changes will be necessary. Nowhere is this more evident than with Utah's sales tax. An aging population, changes in consumer preferences, and technological advancements are carving away Utah's sales tax base. If left unaddressed, this imbalance will eventually compromise state and local governments' ability to meet public needs.

This visual guide to tax modernization focuses on Utah's sales tax and presents the challenge, explanation, and opportunity, along with potential solutions.

Modernizing sales taxes isn't for the faint of heart. Utah policymakers can leave it to someone else, but each year the problem will become more difficult to solve. The Gardner Policy Institute stands ready to help. We offer INFORMED RESEARCH, that guides INFORMED DISCUSSIONS, and leads to INFORMED DECISIONS™.

Thank you for your public service,



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The Challenge:

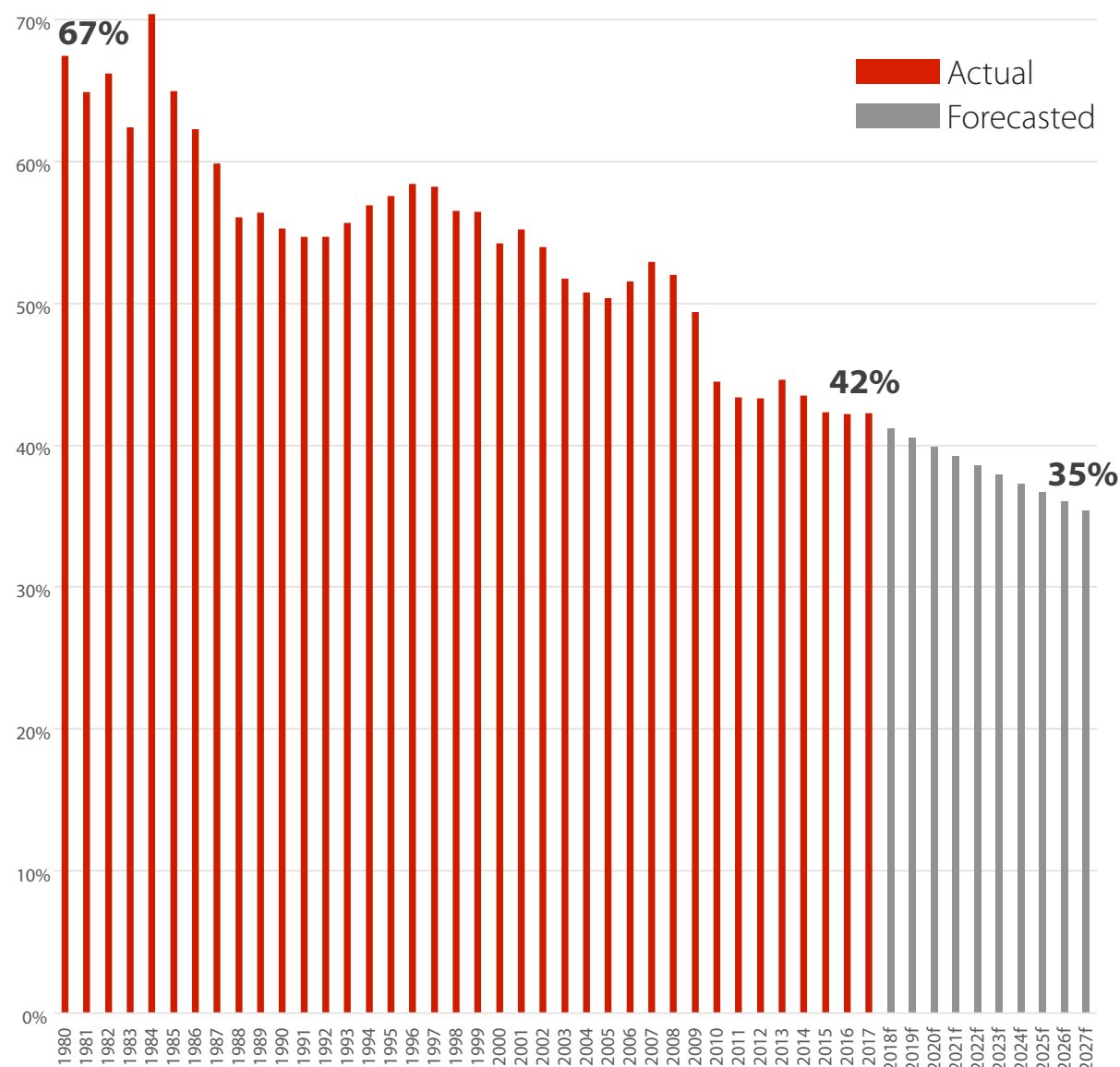
State government faces a structural sales tax challenge.

Since the 1980s, Utah's economy and population have changed dramatically, but Utah's sales tax system has not. While state tax revenue continues to increase in total, taxable sales as a percent of the economy are shrinking. The sales tax base has declined from 67 percent of personal income in 1980 to 42 percent today.

If this trend continues, analysts project the sales tax base will decline to 35 percent of the economy over the next decade.

State government faces a structural sales tax challenge.

Sales Tax Base as a Percent of Personal Income



Source: Governor's Office of Management and Budget and Kem C. Gardner Policy Institute

Three-legged stool?

The tax policy metaphor of the three-legged stool provides a useful way to think of the challenge facing state policymakers.

Utah's state budget sits atop three "legs." Many believe the system works best when the legs are balanced to create the right mix of stability, fairness, and responsiveness.



* Includes local property taxes supporting public education

** All state sales tax collections, including earmarks

The Explanation:

Powerful structural trends threaten the long-term viability of the sales tax.

Structural vs. Cyclical

A variety of **STRUCTURAL** trends contribute to Utah's sales tax revenue problem. Structural trends result from powerful forces such as disruptive technologies, demographic change, or changes in consumer behavior. These long-term and unyielding changes, all of which are occurring in Utah today, create a new paradigm.

In contrast, **CYCLICAL** trends follow the ups and downs of the business cycle. They are relatively short-lived and track consumer sentiment, saving and investment, and imbalances in the economy. Utah's budget reserve accounts, also called "rainy day funds," are designed to address cyclical downturns in the state budget.

Utah's sales tax base faces a structural problem that gets worse over time.

The leg of stability represents the **property tax**. It remains relatively steady during good and bad economic times.

The leg of fairness represents the **income tax**, also called ability to pay. It is a progressive tax (not because of the rate but because of tax credits), which means wealthy households pay a higher proportion of their income for the tax. While there is not agreement on the degree of what is and isn't fair, many believe taxes should be levied

according to how well a person can shoulder the burden.

The leg of responsiveness represents the **sales tax**. It increases or decreases with the ebb and flow of the business cycle. During periods of economic growth there is more revenue to pay for this growth. Many people have less money and therefore buy less and pay less in taxes. In this way, the sales tax responds to economic conditions.

Taken together, the three-legged stool represents a balance of stability, fairness and responsiveness that has served Utah well. Currently, Utah's three-legged tax stool is out of balance.

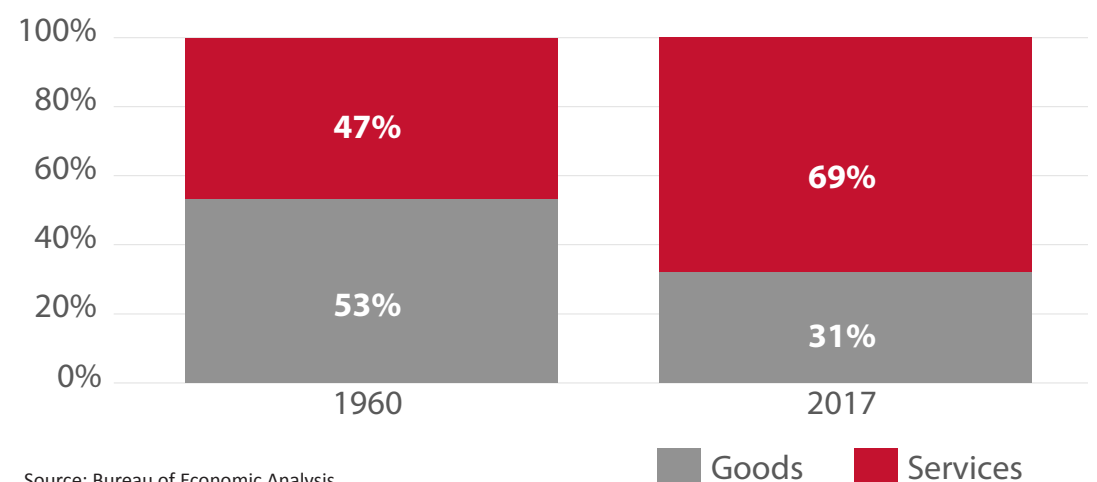
The Structural Trends:

Five structural trends, all of which relate to and reinforce one another, explain the decline in sales tax revenue relative to the economy.

#1 The rise of the service economy

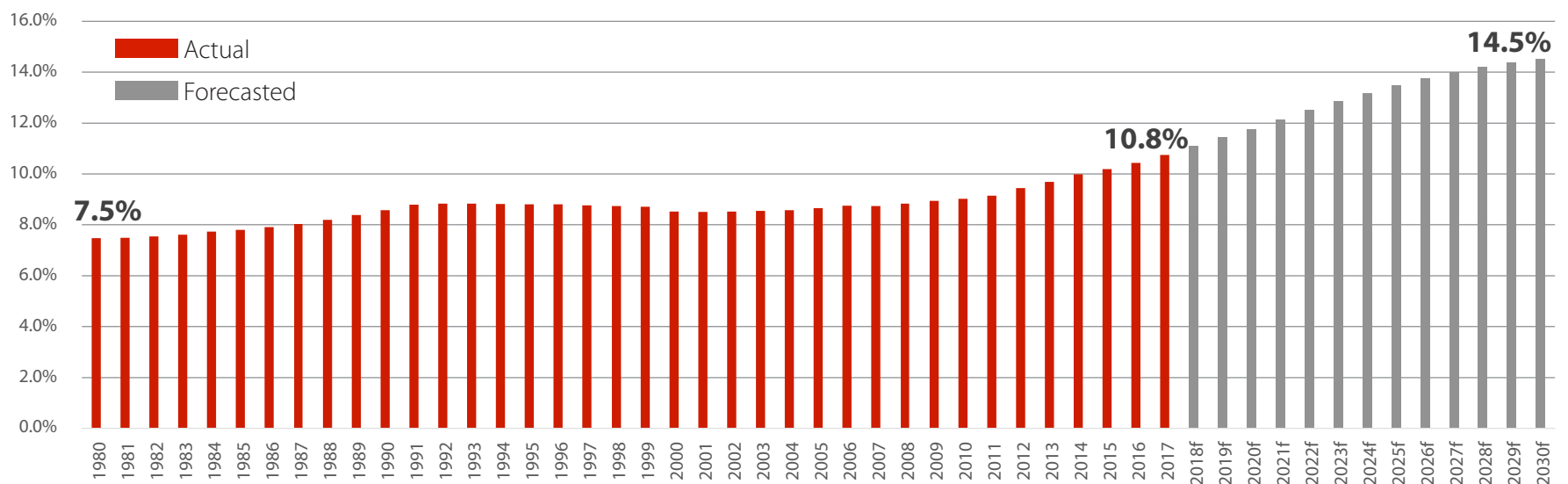
In Utah, we tax most goods and very few services. Services, which used to represent less than half of personal consumption expenditures, now comprise more than two-thirds of consumption expenditures. As consumer preferences continue to change, services will become an even larger share of expenditures.

Goods and Services in U.S. as a Share of Personal Consumption Expenditures



#2 and #3 The aging population and changing expenditure patterns

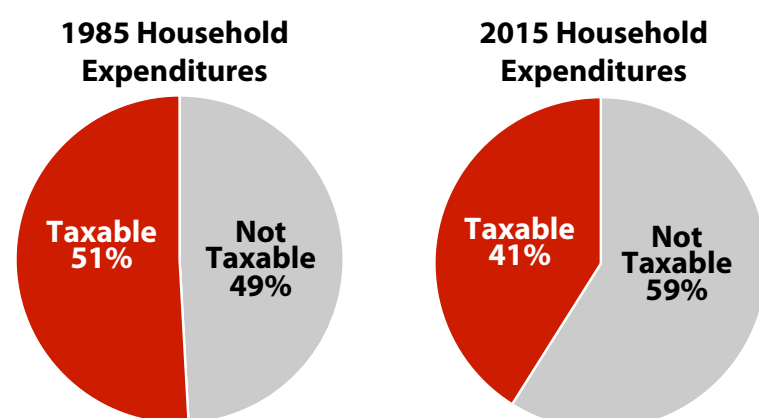
Utah Population 65 and Over, Percent of Total



Source: U.S. Census Bureau Decennial Census and Population Estimates and Kem C. Gardner Policy Institute

As people age, they change the way they spend money. Because of Utah's aging population, a much larger share of people's income now flows to health care expenditures, which are not taxed. The problem gets worse every year as the Baby Boom Generation continues to age.

If expenditure patterns in 2015 matched those of 1985, the Utah Legislature would have an estimated \$650 million in additional funds each year.

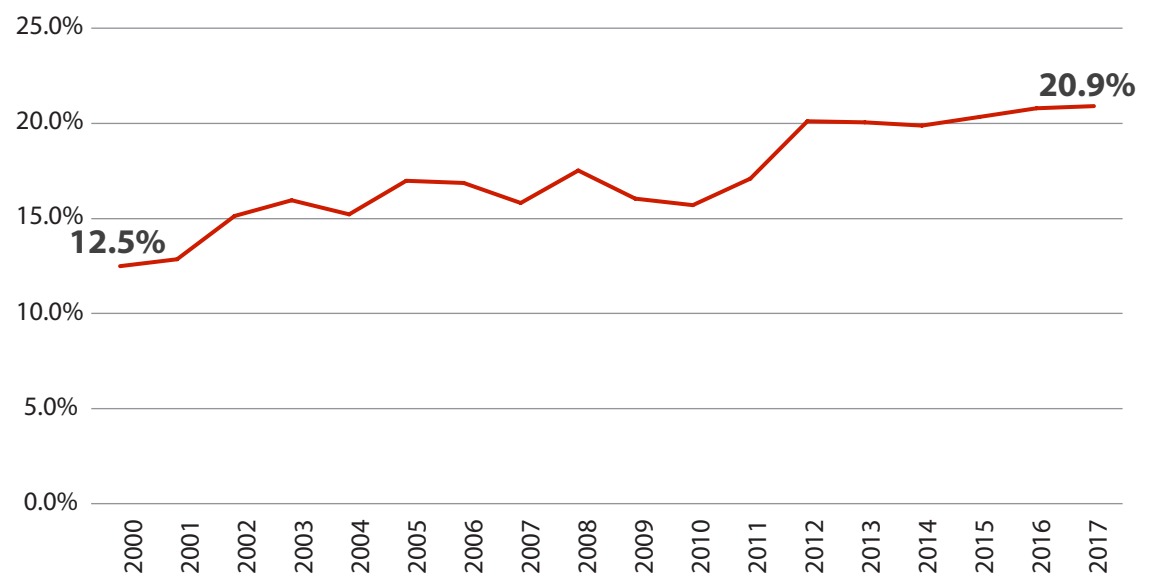


Source: U.S. Consumer Expenditure Survey and Kem C. Gardner Policy Institute

#4 Rising health care costs and consumption

Utah's sales and use taxes have also taken a hit from the expenditure side. Even without full Medicaid expansion, Medicaid expenditures as a percent of the state's General Fund have grown from 12.5 percent in 2000 to 20.9 percent today. This trend does not appear to be responsive to improving economic conditions.

Medicaid Expenditures as a Percent of General Fund, Utah

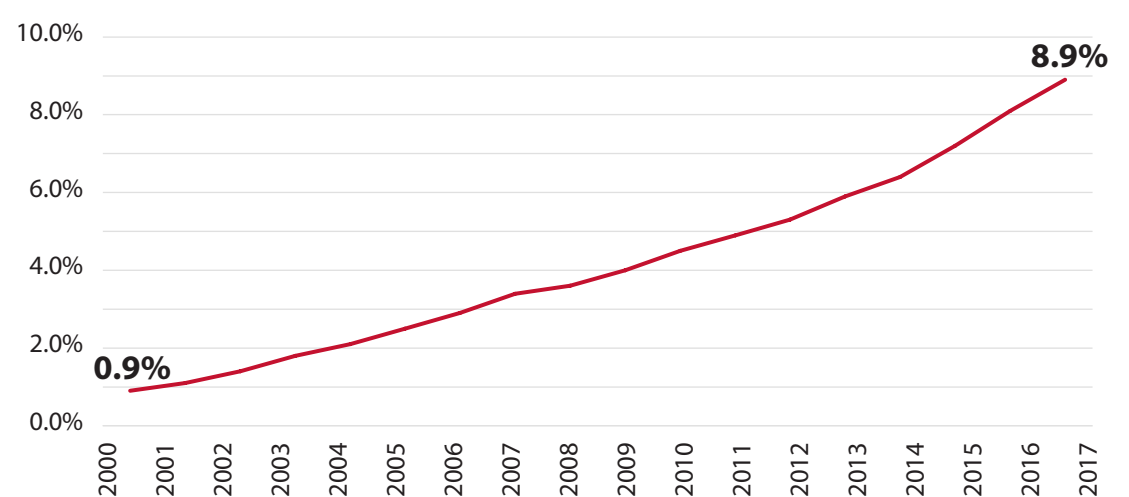


Note: Includes sales tax earmarks
Source: Governor's Office of Management and Budget

#5 The relentless growth in E-commerce

The persistent growth in E-commerce also impacts sales tax revenue. A recent ruling by the U.S. Supreme Court will alleviate much of this problem and provides a good example of how public policies can change to reflect current realities.

Remote Sales as a Percent of Total Sales, U.S.



Source: U.S. Census Bureau, Quarterly Retail E-commerce Sales

Why is a declining sales tax base a challenge?

1 When government revenues are mis-aligned with economic and population growth, elected officials continuously “rob Peter to pay Paul” or use duct tape and quick fixes to balance the budget and meet critical state needs like funding roads

and education. Over time, this maze of funding can create unneeded complexity, inefficiencies, unfairness, and conflict. It's hard to plan, invest, spend, cut, and save wisely with such a complicated fiscal situation.

The Opportunity...

Timely action will advantage Utah over the long term.

The Utah economy continues to prosper. Job growth is high, unemployment is low, wages are rising, and net migration is positive. The current expansion is the second longest on record and appears to be holding strong.

Many policymakers are asking the right questions:

1. Can we use this prosperous time to address the structural problem in Utah's sales tax?
2. If we act now, can we avoid making even more difficult decisions during hard economic times?

The answer to both questions is "yes," but it will require a long-term view and a willingness to make tough decisions and act.

Informed Decisions in the Past

Throughout Utah's history, governors, legislators, and local elected officials have made tax and expenditure decisions with an eye to the future. Great examples include the following:

1980s

Investment in Public Education. A significant and lasting surge in school-age population and a major recession loomed large in Utah. Utah's two largest employers – Kennecott Copper and Geneva Steel – shut down. State policymakers took action to address increasing needs in public education and declining revenue, making the difficult decision to raise sales and income taxes.

1990s

Critical Infrastructure Investments and Tax Cuts. Utah's governor and Legislature leveraged revenue surpluses from a booming economy into substantial investments in water, highway, and public transportation infrastructure. These investments helped to secure the state's 2002 Olympic bid. The state even advanced funding, which was eventually repaid, for Olympic venues before winning the bid. Policymakers also funded the preservation of the State Capitol and expanded the capitol complex. In addition to funding large capital projects, policymakers cut the state sales tax rate twice.

2000s

More Tax Cuts and Infrastructure, Pension Reform, and Weathering the Great Recession. Utah's economy soared following a moderate recession in the early part of the decade, again generating revenue surpluses. Utah's Legislature and governor made sizable sales, personal income, and corporate income tax cuts and reduced the sales tax rate on food while significantly expanding the personal income tax base. They allocated funds to major transportation projects like the I-15 expansion and Legacy Parkway. When state revenue dropped severely as the Great Recession took hold in 2008, lawmakers were able to mitigate impacts to education and health and human service programs on account of previous decisions to reform public pensions and limit liability, set aside surplus funds for public education, and cash-fund infrastructure to preserve debt capacity.

2010 and beyond

Encouraging Economic Growth and Addressing Revenue Volatility. The \$3.6 billion rebuild and expansion of the Salt Lake City International Airport currently underway is the largest public works project in Utah history. Salt Lake City saved money for decades in anticipation of the rebuild and will complete the project without using any tax funds on account of these savings, and airline gate fees, rental car royalties, and Federal Aviation Administration grants. The relocation of Utah's state prison will free up hundreds of acres of developable land in the hub of Utah's growing innovation economy at the intersection of Salt Lake and Utah counties while bringing water, transportation, and utility infrastructure and opportunity for economic growth to Salt Lake City's northwest quadrant. State rainy day funds have more than doubled since 2011, with lawmakers typically tying deposit requirements to revenue volatility criteria.

Source: Compiled by Kem C. Gardner Policy Institute

...and Solutions

Fiscal problems always have a revenue and expenditure side.

Policymakers have three options to address these problems:

- 1) Reduce or limit expenditures,
- 2) Change sales tax rates, or
- 3) Broaden the sales tax base.

A combination of the three may make the most sense.

#1 Reduce or limit expenditures

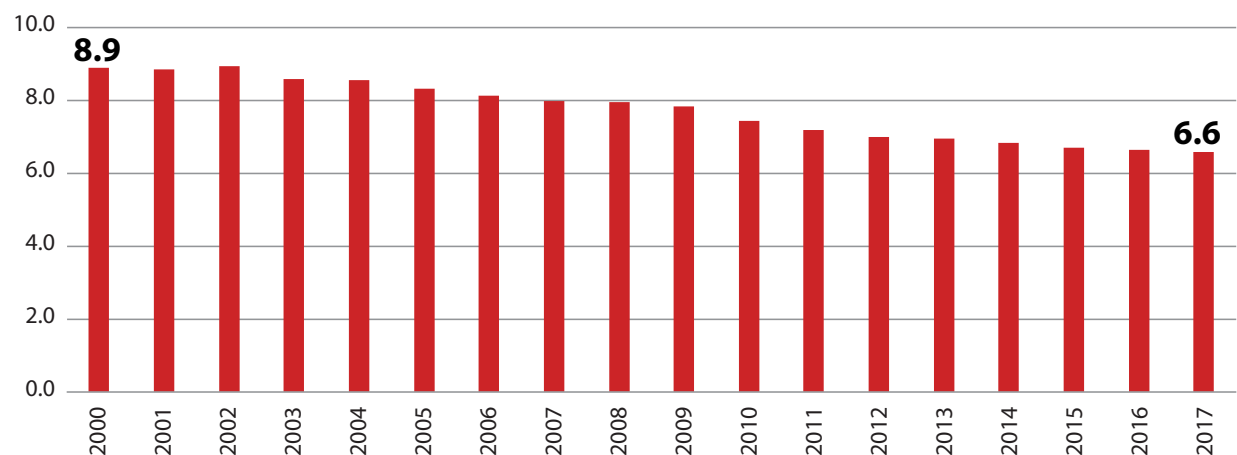
Many believe government should do less and seek to reduce or limit expenditures. Still others believe government does the right things, but can improve efficiency.

Decisions about the role and size of government belong to elected officials.

Government can ALWAYS do better, but Utah already does quite well in a variety of efficiency measures.

For example, state government employment per capita (excluding higher education) has fallen from 8.9 per 1,000 population in 2000 to 6.6 per 1,000 population in 2017.

State Government Employment per 1,000 Population



Source: Utah Governor's Office of Management and Budget, Utah Department of Administrative Services, and Kem C. Gardner Policy Institute

Gov. Herbert's SUCCESS Initiative provides another example of increased efficiency. The Utah Governor's Office of Management and Budget and Office of the Legislative Fiscal Analyst have also identified these potential areas for increased efficiency:

- Enhance higher education building utilization
- Optimize local water pricing and use decisions
- Replace service-based contracting with outcome-based contracting
- Develop and invest in strategies that result in lasting successful outcomes for state social service recipients
- Change government business processes to increase efficiency and improve outcomes
- Continue to promote and adhere to prudent budgetary practices

Governor Herbert's SUCCESS Initiative

Gov. Herbert has made efficiency a hallmark of his administration. Through the Governor's Office of Management and Budget SUCCESS initiative, 110 distinct government systems across 24 state agencies achieved a combined 27 percent

improvement in average performance from 2013 to 2016. Results of these improvements include decreased waiting times for customers of various state services, productivity gains in critical state functions such as those performed by the Utah State

Laboratory and Utah Office for Victims of Crimes, and quality improvements in the accuracy and/or reliability of state services delivered, among numerous other successful outcomes.

For more information visit gomb.utah.gov

The Opportunity and Solutions

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Timely action will advantage Utah over the long term.

#2 Change sales tax rates

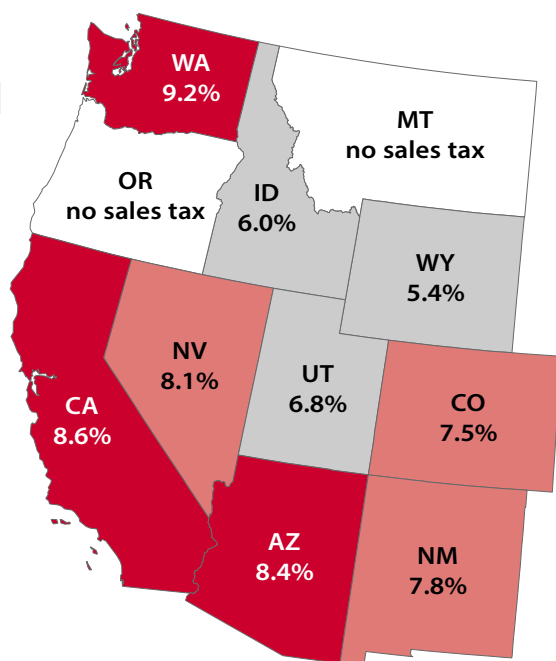
The Legislature could raise sales tax rates. Over the past two decades, sales and use tax rates at the state level have increased twice and have decreased four times. Increases at the local level have held steady at the maximum of 1% but earmarked local taxes have increased significantly.

Currently, every locality eligible to impose the 1% local options sales and use tax has done so. The county option of 0.25% was implemented in 1998. As of 2008, all counties have imposed the maximum 0.25%.

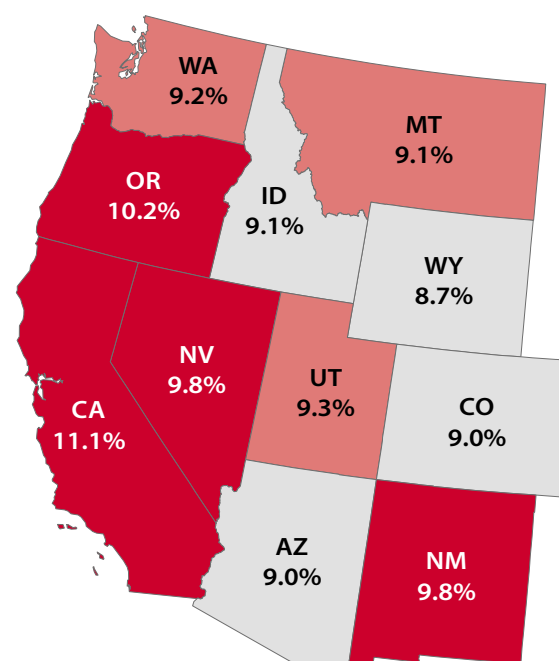
Raising rates creates at least three problems:

- First, while Utah's average combined state and local sales tax rate is in the bottom third of western states, our total tax burden is already relatively high compared to our most of our neighbors.
- Second, spreading the rate upon a diminishing base will mean policymakers need to keep increasing rates to maintain the same level of revenue. This will make revenue more volatile.
- Third, higher rates impact the economy by making it less efficient.

Combined State & Local Sales Tax Rates, 2018



Tax Burden: All State and Local Taxes as a Percent of Personal Income, 2015



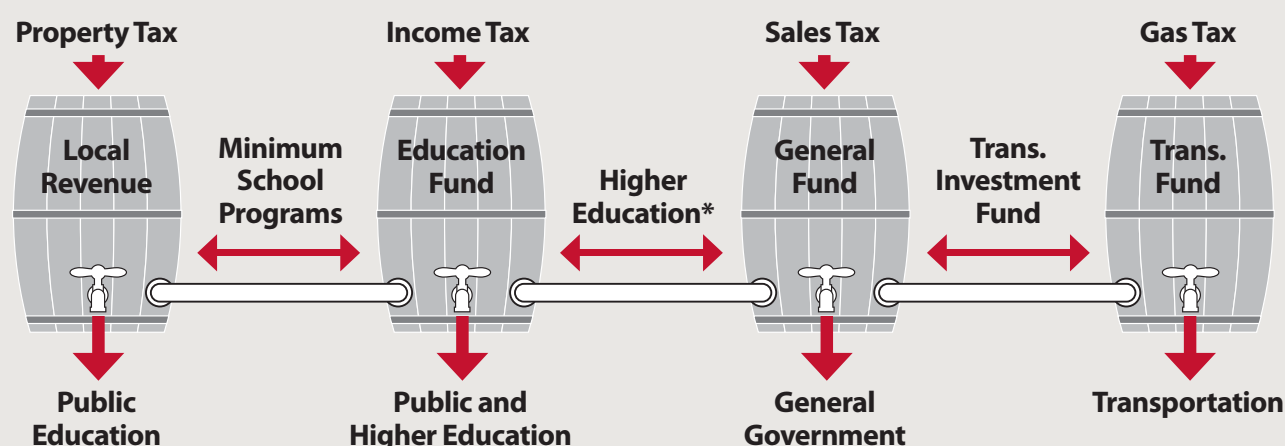
Note: Severance tax collections are excluded from tax burden analysis.

Sources: Tax Foundation and Kem C. Gardner Policy Institute analysis of U.S. Census Bureau Survey of State and Local Finances data and U.S. Bureau of Economic Analysis data

Why is a declining sales tax base a challenge?

2 Utah currently has an integrated budget and tax system. Sales tax moves throughout the system, mitigating volatility in other sources of revenue. As sales tax decays, flexibility and policymakers' ability to manage uncertainty both diminish.

The co-mingling of funds



* The Utah Constitution earmarks all income tax revenue to public and higher education. Currently, higher education is paid for by both the Education Fund (income tax) and General Fund (mostly sales tax), creating a link between the two funds.
Source: Utah Office of the Legislative Fiscal Analyst

#3 Broaden the base

Sales tax applies selectively to most goods and some services. In “tax speak” the sales tax applies to the following:

- Retails sales of goods,
- Meals,
- Admissions to places of amusement,
- Intrastate communication and passenger service,
- Commercial electric, gas and heat utility service,
- Hotel and motel accommodations, and
- Certain other services.

Major areas of the economy that are excluded from the sales tax base include the following:*

- Prescription drugs and medical equipment/devices,
- Health care services,
- Legal services,
- Accounting services,
- Construction and real estate services,
- Personal care services (haircuts, massage, tanning, etc.),
- Property services (landscaping, cleaning, repair, etc.), and
- Transportation services.

Broadening the base has two positive features:

1. **Fair** – It creates a more even playing field for all commodities (goods and services).
2. **Efficient** – It allows policymakers to lower rates and create the same amount of revenue. Lower tax rates create less distortions in the market, leading to a more efficient tax system.

Broadening the base can also create negative consequences if it impairs economic competitiveness.

* In addition, food is taxed at a lower rate

Golden rule of tax policy

Many economists call a policy of broadening the base and lowering the rates the Golden Rule of Tax Policy. That’s because by doing so policymakers can achieve a more efficient, fair, and economically competitive tax system.

If you want to <u>lower</u>	Then consider...
Sales tax rates	<ul style="list-style-type: none"> ■ Fully taxing residential energy and food – Are there better ways to target those in need? ■ Expanding the base to include select consumable services, such as transportation services and personal services. ■ Taxing motor vehicle use for the full cost of building and maintaining roads. ■ Reviewing and repealing select exemptions. ■ Implementing additional state government efficiencies.

Source: 2017 Legislative Policy Summit

The Opportunity and Solutions

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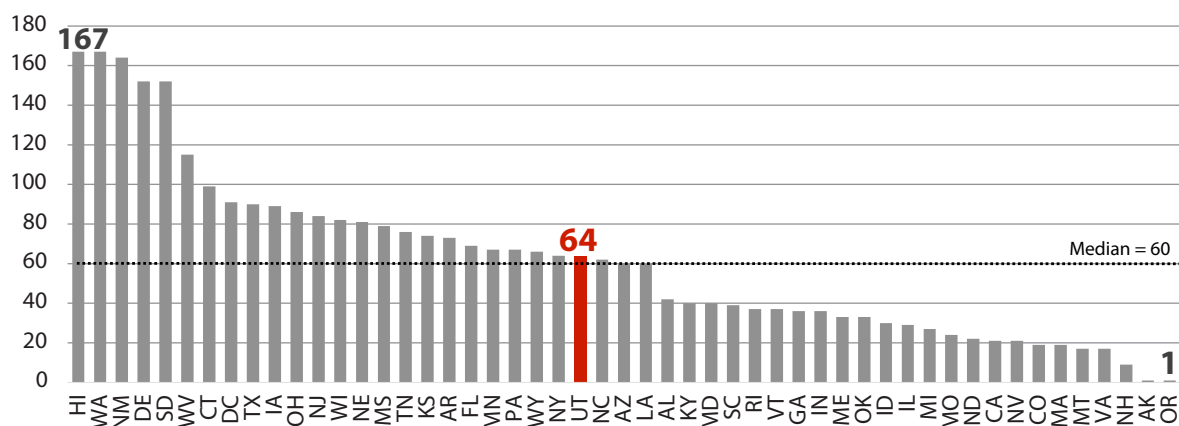
Timely action will advantage Utah over the long term.

Taxing Services

As the rise of the service economy continues to grow (47 percent of personal consumption expenditures in 1960; 69 percent in 2017), elected officials at the state and local level may want to consider taxing services.

Utah taxes a little over a third, 64, of the 176 major services tracked by the Federal Tax Administrators. Twenty-two states tax more of these services, 27 states tax less. The number of services Utah taxes is at or above the median for most service categories; Utah taxes less than the median number of services in utilities, business services, and computer services.

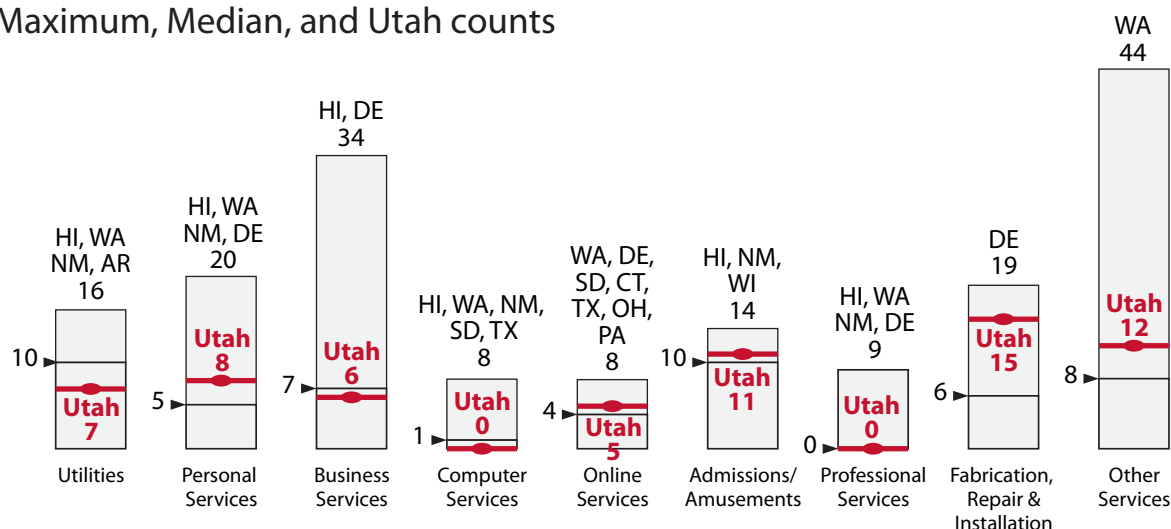
Number of services subject to state sales and use taxes, by state



Note: 176 total services; The most recent counts for AZ, LA, MD, MA, NM, and OK are from 2007; all other counts are from 2017. Source: Federation of Tax Administrators Sales Taxation of Services Survey; Medians calculated by Kem C. Gardner Policy Institute

Number of services, by category, subject to state sales and use taxes

Maximum, Median, and Utah counts

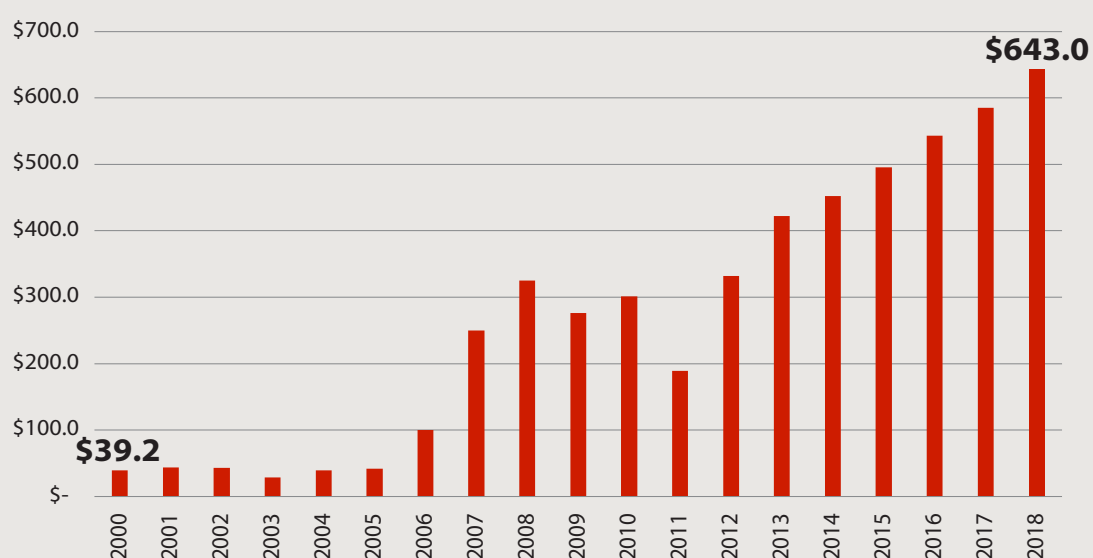


Note: Total services equal to maximum taxed in all categories but Admissions/Amusements (15 services) and Other Services (47 services); the most recent counts for AZ, LA, MD, MA, NM, and OK are from 2007; all other counts are from 2017. Source: Federation of Tax Administrators Sales Taxation of Services Survey; Medians calculated by Kem C. Gardner Policy Institute

Why is a declining sales tax base a challenge?

3 The growth in earmarked sales and use taxes provides another example of complicated budget fixes as state policymakers struggle to find needed funding for transportation and water infrastructure. These and other budget realities reaffirm that state government has a sales tax challenge that worsens every year.

Growth in earmarked sales and use tax (in millions)



Source: Utah State Tax Commission and Utah Governor's Office of Management and Budget

What Next?

Lead change and prosper

There is an old saying that if you do not change directions, you may end up where you are heading. Right now, a variety of structural trends are eating away at Utah's sales tax base. If left unaddressed, policymakers will face a growing gap between available revenues and the needs of a growing population and economy. This challenge will intensify with the next economic downturn as well as over time.

Policymakers face a difficult challenge. They must levy taxes that are sufficient, but not excessive. Taxes interfere with the market and impact our state's competitiveness. At the same time, successful economies must invest wisely in education, infrastructure, public safety, and other public needs.

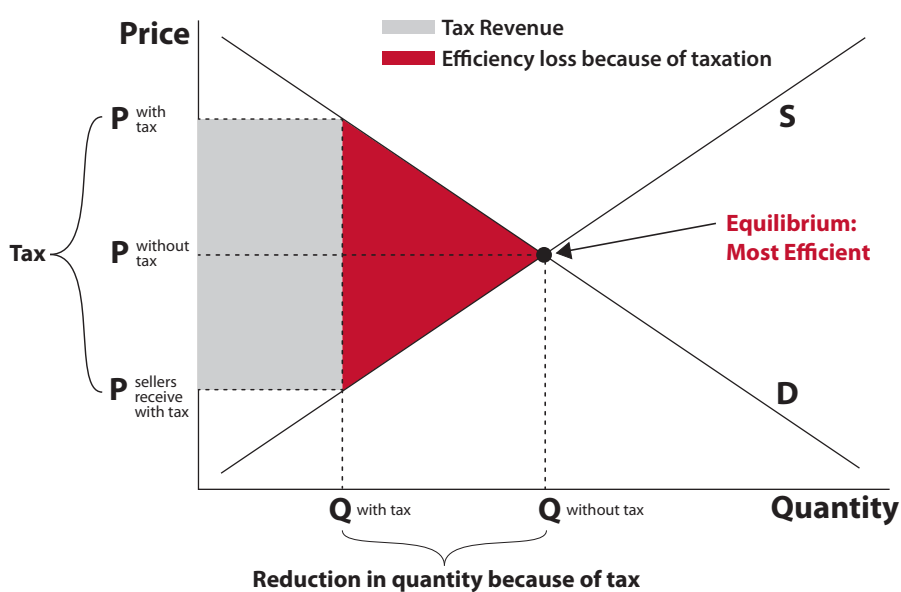
Many states make revenue and expenditure decisions over the short term...usually the next budget or election cycle. Utah is different. We think long-term and practice

fiscal responsibility. Our Legislature hosts a biennial planning conference, embraces long-term budgeting practices, conducts contingency planning, and performs budget stress tests. Our governor and Legislature balance the state budget, focus on efficiency, comply with constitutional and statutory borrowing limits, maintain a AAA bond rating, and benefit from a line-item veto.

Modernizing Utah's sales tax structure will require deft policymaking. Legislators and the governor can reduce or limit expenditures, change rates, broaden the base, or turn to other sources of revenue. As they do so they will be smart to remember the widely agreed upon characteristics of a great tax system. Most importantly, they'd do well to remember the mantra of one of Utah's technology pioneers, Ray Noorda. He said, "You can fight change and lose. You can accept change and survive. Or you can lead change and prosper."

Economic Tax Theory

Taxes cause inefficiencies because they prevent buyers and sellers from realizing some of the gains of trade.



What does this mean?

- 1 People respond to incentives.
- 2 Taxes change incentives.
- 3 Consumers purchase less.
- 4 Producers produce less.
- 5 Markets shrink below their optimum.

Characteristics of a Great Tax System

- 1 **Simple**
Make compliance and enforcement as easy as possible. The resources devoted to tax compliance are a form of deadweight loss.
- 2 **Efficient**
Tax system ought not interfere with the efficient allocation of resources.
- 3 **Equitable**
Taxes ought to be fair. Assessments about equity require normative judgments.
Benefits Principle—People should pay taxes based on the benefits they receive.
Ability to Pay Principle—Taxes should be levied according to how well that person can shoulder the burden.
Vertical equity—People with a greater ability to pay should pay greater amounts.
Horizontal equity—Taxpayers with similar abilities to pay should pay similar amounts.
- 4 **Flexibility/Revenue Sufficient**
Taxes ought to be adequate to fund the desired level of services, flexible to meet increasing or decreasing needs and stable to help with planning.
- 5 **Transparent/Political Responsibility**
The tax system should be transparent and accountable to taxpayers.

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