

November 28, 2007

An Evaluation of Utah's Tax System and a Comparison of Eight Intermountain Western States

Executive Summary

by Janis Dubno, MBA and Levi Pace, MBA, CPPA Research Associates

Introduction

State tax policy must take many factors into consideration. State legislatures grapple with the task of raising revenue to fund state budgets and the desire to minimize taxes for its citizens. What constitutes good tax policy can be subjective and the interests of different taxpayers conflicting. The differences between state and local tax policy can also present various dilemmas, such as the desire for uniformity versus the need for local autonomy. Inevitably, discussions about the size and role of government come into play, intermingling politics and philosophy with public finance. All of these issues necessitate a comprehensive, thorough and unbiased analysis of the impact of different tax policies on the ability to fund state government and the impact of these policies on the economic lives of its taxpayers. Through an understanding of the effects of different tax policy structures, state and local governments can better craft state and local tax policy to achieve the desired results.

This study evaluates Utah's tax policy with respect to three sources of tax revenues - the state income tax, state and local general sales tax, and property taxes, and compares these policies to those of seven Intermountain Western states, including Arizona, Colorado, Idaho, Montana, New Mexico, Nevada and Wyoming. Policy principles chosen as criteria for evaluation include simplicity, transparency, neutrality and efficiency, stability, sufficiency and adequacy, balance, equity and competitiveness. Simplicity and transparency address the process of filing taxes, how easy they are to understand and whether taxpayers are aware of their exact tax burden. Neutrality and efficiency assess the impact of the tax systems on the economic decision making processes of individuals as to where to live, how much to work, how much and what they should consume and where to locate businesses. It focuses on whether the tax systems treat different family types and different levels of income equally. Stability, sufficiency and adequacy evaluate the viability of the income, sales, and property taxes as well as the total state and local tax revenue system as funding sources for state government expenditures. Balance examines the diversification of revenue sources with respect to the three taxes included in the study and between state and local government. The principle of equity addresses fairness, how taxes are distributed across the income spectrum and among different family types, with respect to both effective tax rates and who pays the majority of the taxes collected. Equity is evaluated in the Tax Incidence Analysis. Finally, competitiveness compares the attractiveness of the different tax systems from the point of view of the taxpayer. Competitiveness, by nature a comparative analysis, will be evaluated in the comparison of the eight Intermountain Western states.

Evaluation of Utah's Tax System

The tax reform passed by the Legislature in 2006 and 2007 improves Utah's income and sales tax. In evaluating simplicity and transparency, the Single Rate income tax that will go into effect in 2008 is the most simple and transparent of the three taxes, while the property tax is also transparent. By establishing a single statewide rate on food for home consumption, the tax reform simplifies the sales tax.

In terms of neutrality and efficiency, while no tax is completely economically neutral, the Single Rate income tax system expands the tax base from 63% to 73% (aggregate taxable

income/aggregate federal adjusted gross income) and lowers the top tax rate to 5% from 6.98%, both crucial elements to a relatively neutral income tax. This tax reform also improves the neutrality of the sales tax system by establishing a uniform rate on food for home consumption. Yet, neutrality is undermined with respect to the sales tax base. Utah taxed only 57 out of 168 services in 2004, just 34%. With 67 sales tax exemptions, totaling over \$650 million for state and local taxes, the impact on neutrality is significant. In 2006 gross taxable sales were 45.83% of state GDP, that is to say that less than half of Utah's GDP is included in the sales tax base. The property tax, like the sales tax, does not meet all the requirements for economic neutrality. Assessment ratios vary for residential and non-residential property and the range of property tax rates from locality to locality is significant.

Sales and property tax revenues are more stable than income tax revenues under either income tax system. The coefficient of variation of sales tax revenue from 2000 to 2006 was 5.30%, while the coefficient of variation of income tax revenues under the current Income Bracket, Graduated Rate system was 9.57% and 9.23% under the Single Rate system. While we were not able to calculate a coefficient of variation for the property tax, the Beta of the property tax is .4. Beta, in this context, measures the change in tax revenue relative to the change in non-agricultural wages. A Beta of less than 1 indicates that the tax revenue changes less than the change in non-agricultural wages. The income tax has a Beta of 1.4, and the sales tax, 1.1.

The income and state sales taxes were sufficient sources of tax revenue and financing for the Education Fund and the General Fund over this time period. The income and sales taxes contribute over 75% of state tax revenue. The property tax is the most important local tax revenue source, averaging 68.42% of local tax revenue from 2000 to 2006. The local general sales tax averaged only 20.08%.

Total state tax revenue, on average, comprised 64.01% of state own source revenue and 52.57% of state direct expenditures under the Income Bracket, Graduated Rate system. Under the Single Rate system, the percentages would have been 63.62% and 51.65%, respectively, only a slight decline. Local tax revenue accounted for 60% of local own source revenue and 29.72% of local direct expenditures, reflecting the importance of non-tax revenue and state government transfers at the local level. State and local combined tax revenue averaged 62.57% of combined own source revenue and 41.44% of combined direct expenditures under the Income Bracket system (62.31% and 40.97%, respectively under the Single Rate system).

While the income, state sales and property taxes are sufficient sources of state and local tax revenue, tax revenue overall funds 50% or less of direct government expenditures. Federal government revenue accounted for \$2.9 billion in 2005, approximately 28% of general revenue. General revenue from own sources was 71% of general revenue in the same years. Total state tax revenue in 2005 was \$4.9 billion. Clearly, federal government revenue and other sources of revenue play an important role in the financing of state government in Utah.

Overall, Utah's tax system performs well under evaluation according to sound tax policy principles described above. Improvements such as expanding the sales tax base and instituting a uniform sales tax rate would improve the neutrality of the sales tax system. Similarly, simplifying the property tax system and improving the uniformity of property tax rates would also enhance neutrality. However, the issue of local autonomy comes into play here and the ability of local governments to levy taxes according to their specific needs and preferences

Comparison of Eight Western States

No one state performed the best under every policy principle. The tables below summarize the top performers, in order, for each principle evaluated.

Overall, Idaho is consistently one of the top performers with respect to the sales and property

taxes evaluated under the principles of simplicity, transparency, neutrality, and competitiveness. Idaho also performs well with respect to the sufficiency of the property tax and state and local combined revenue. Idaho also does well in achieving balance between the income and state sales tax and all three taxes combined.

In examining income taxes, Utah's Single Rate income tax system (UT 08) is one of the top performers with respect to the principles of simplicity, neutrality, stability, sufficiency, and balance. Colorado's income tax system also ranks among the top performers for simplicity, neutrality, stability, and sufficiency. Arizona and New Mexico's income tax systems are most competitive on a per capita basis, but only New Mexico is included as a top performer with regard to simplicity and stability.

In looking at state taxes, Utah performs well with regard to the neutrality of the sales and property taxes, sufficiency of the state sales tax, and balance between the income and state sales taxes and all three taxes combined. Colorado's decentralized sales tax system results in it being a top performer with respect to the sufficiency of local sales tax revenue and local tax revenue.

With respect to competitiveness, Utah did not rank among the top performers. Arizona and New Mexico are the most competitive with respect to the income tax. Idaho and Colorado have the most competitive sale tax systems. Idaho, Wyoming and Colorado are the top performers with respect to the competitiveness of their property tax systems.

Summary of Top Performers

	Income tax	Sales Tax	Property Tax
Simplicity	UT 08, NM, CO	ID	ID
Transparency	All (MT, ID, UT 08)	None (ID best)	All
Neutrality	UT 08, CO, MT	ID, UT, NM (tax base)	ID, UT
Stability	NM, CO, UT 08	CO, UT	n/a
Competitiveness	AZ, NM	ID (combined), CO (state)	ID, WY, CO

Summary of Top Performers Sufficiency

Income Tax	CO, UT 06, UT 08
State Sales Tax	NV, UT
Local Sales Tax	NM, CO
Property Tax	CO, AZ, ID,
State Tax Revenue	NV, ID, AZ
Local Tax Revenue	CO, AZ, MT
State and Local Combined Tax Revenue	AZ, ID, NV

Summary of Top Performers Balance

Income and State Sales Tax	ID, UT 08
Local Sales and Property Tax	NM
Income, State and Local Sales, and Property Taxes Combined	ID, UT 06, CO

Tax Incidence Analysis (Equity)

The Tax Incidence Analysis evaluates the tax systems of each state according to the policy principle of tax equity. The analysis separates the impact of demographics on tax incidence from tax policies by overlaying the different tax policies onto the same household profiles. In this way, it evaluates how the different tax policies would impact these household profiles with respect to the principle of tax equity. Thus, it is not an analysis of actual tax incidence in each state, but of how the tax systems of the each state would impact representative Utah households according to income level and family type.

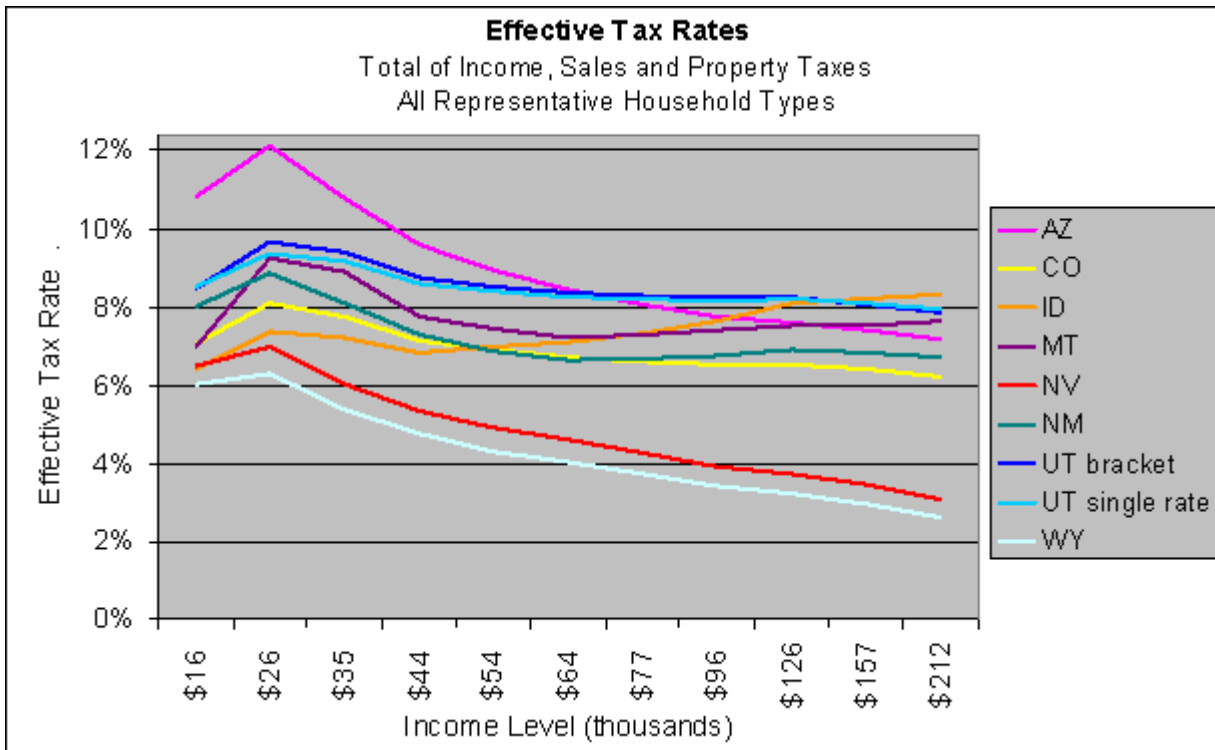
The examination of income tax structures showed that New Mexico, Idaho and Montana have the most progressive income tax systems in the study. Utah's Single Rate system ranks fourth within the study with respect to progressiveness. However, Utah's Bracket system (UT 06) and Colorado's income tax system are the least progressive.

The sales tax is regressive for all states. New Mexico and Arizona are the most regressive. Effective rates are highest in Arizona across the income spectrum. Nevada and Colorado have the least regressive sales tax policies. Effective rates are lowest in Wyoming and it has the lowest combined state and local rate in the study at 5.39%.

Excluding renters (families earning \$16,000 are assumed to rent rather than own a home), the property tax is also regressive in each state. Idaho has the least regressive system, primarily due to the limit on the homeowner's exemption. Idaho allows a 50% exemption, limited to a specific dollar amount (approximately \$101,000 projected in 2008). As a result, more expensive homes receive a smaller percentage exemption than lower valued homes. This creates a less regressive property tax structure. Property tax effective rates are highest in Arizona and Montana and the most regressive.

Combined income, sales and property tax (total tax) effective rate curves are determined by the effective rates of each tax and the percentage contribution of each tax at each income level. The following graph shows the effective rate curves for total taxes for each state. Except for Idaho, which has a proportional to slightly progressive combined income, sales and property tax system, total taxes are regressive for all states. Montana has the least regressive total tax structure, followed by Utah's Single Bracket system.

Combined tax effective rates are highest in Arizona and Utah's Bracket system, followed by Utah's Single rate system. For lower income families, property and sales taxes comprise the larger portion of total taxes. For upper income families, the income tax constitutes the greater portion.



The table below can be used to further understand the composition of total taxes that result in the effective rates displayed above. Based upon the estimates for the taxpayers in this study, the income tax, a progressive tax, accounts for 51.3% of total taxes in Idaho. Similarly, Montana's income tax is 52.9% of the combined total tax. The high proportion of the income tax in total taxes offsets the regressive sales and property taxes.

	% Income Tax	% Sales Tax	% Property tax
AZ	26.5	29.6	43.9
CO	43.5	25.0	31.5
ID	51.3	22.2	26.6
MT	52.9	0.0	47.1
NV	0.0	43.8	56.2
NM	33.2	26.0	40.8
UT Bracket	48.5	23.0	28.5
UT Single rate	48.3	23.1	28.6
WY	0.0	43.3	56.7

Source: Tax Incidence Analysis

Conclusion

The study concludes by identifying the best practices in tax policy as illustrated by the links between different policy structures and the performance of the different states according to the various policy principles. The following paragraphs summarize the best practices for the income, sales and property taxes, as well as state and local tax revenue systems.

Income Tax

Best practices with respect to the principles of simplicity, neutrality, stability and sufficiency of the income tax system include a broad base (fewer additions and subtractions) and a relatively uniform and lower tax rate across all income levels. A best practice with respect to equity is to shelter low-income households from a tax on income. Combining these practices can balance the performance of an income tax system with respect to neutrality, stability, sufficiency, and equity. Such an income tax system would include fewer additions and subtractions from FAGI (i.e., a broad tax base), low and relatively uniform tax rates, and a low-income tax credit which could be refundable or non-refundable, depending on the preferences of the citizens with respect to equity versus sufficiency.

Sales Tax

Best practices with respect to the sales tax include a broad base, low uniform rates, an exemption for food for home consumption and the inclusion of services in the tax base. Low uniform rates will enhance stability and neutrality. A broad base will promote neutrality and sufficiency. An exemption for food, the inclusion of services and a low rate will contribute to equity in the sales tax system. Balance between these principles will result in a sales tax system that may not be the best performer with respect to any one of these principles, but one that best achieves balance between them. Another point to consider is the stability and composition of the underlying economic base. A more stable economic base may allow more flexibility in achieving the desired balance.

Property Tax

As is the case with the income and sales tax systems, best practices include a broad tax base and low, uniform tax rates. Each state must strike a balance between sufficiency and competitiveness based on their particular demographic characteristics. We see in the case of Idaho, that neutrality, simplicity, and equity need not be in conflict. Tax relief for those with lower home values that is provided through a cap on the dollar amount of a homeowner's exemptions can create a more equitable system while maintaining a large base. Additional tax relief programs, such as the Circuit Breaker (that provides tax relief to the elderly, poor, and disabled), can protect those whose homes appreciate beyond their means to pay for the increases in property taxes. Best practices should also include a mechanism to protect homeowners from rapidly rising home values, such as Nevada's 3% cap on annual increases in assessed value. Limiting increases in assessment to the rate of inflation or using an average for assessment of a set number of prior years can protect homeowners whose increased home values are rising faster than income.

State and Local Tax Revenue

In evaluating whether or not a state or local tax system is sufficient, several questions arise. In the case of Utah, state tax revenue accounts for less than 50%, on average, of state direct expenditures, the lowest of the states in the study. Federal revenue in Utah is a significant source of funds. In Wyoming, other taxes (such as those on natural resource extraction) and federal government revenue play an important part in funding state government. In Nevada, selective sales taxes (which were not evaluated in this study) are significant, reflecting the importance of gambling as a source of state revenue. Thus, the sufficiency and adequacy of the tax systems depend on each state's other sources of revenue that can also generate revenue for state and local government. It is also important to assess the reliability of these alternative revenue sources over the long run.

For a hard copy of the full 250 page report, please email policy@cpga.utah.edu.

A PDF version of the full report will be available at the CPPA website

www.cppa.utah.edu soon.

Published by [Center for Public Policy & Administration](#).

Copyright © 2007 The University of Utah. All rights reserved.

The Center for Public Policy & Administration offers research, education and services to public and nonprofit organizations that will strengthen administration, leadership and public policy making.

Powered by [IMN](#)