

State Tax Reform: Lessons from the Beehive State



Commissioner Pam Hendrickson
Commissioner Bruce Johnson

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The Marriage of Policy and Politics

- Since 2003, Utah has studied Tax Reform.
- Through 5 years of tinkering, the original proposal, developed by tax experts, and the final product, developed in the political world, look vastly different.
- Reason: Politics and Tax Policy make strange bedfellows...

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A Brief History of Tax Reform in the Beehive State 2003 - 2008 Genesis

- Lt. Governor Olene Walker became Governor.
- With tax revenues supporting education inconsistent and unpredictable, Walker quickly takes on Tax Reform as a priority for her administration.



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Structure of Gov. Walker's Tax Review Commission

- Gov. Walker gathers small group of "advisors":
 - 2 Tax Commissioners
 - 2 Former Commissioners
 - 1 CPA / Tax Preparer
 - 1 Professor of Economics
- "Advisor" title exempted the group from Open Meetings Act, enabling much more productive dialogue.

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Governor Walker's Six Principles

1. Be Fair, Just, and Balanced
2. Support a Business-Friendly Economic Environment
3. Focus on Funding Critical Needs – Primarily Education
4. Have a Structural Balance
5. 21st Century Tax System
6. Balance State & Local Obligations & Revenue Sources

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Rude Awakening

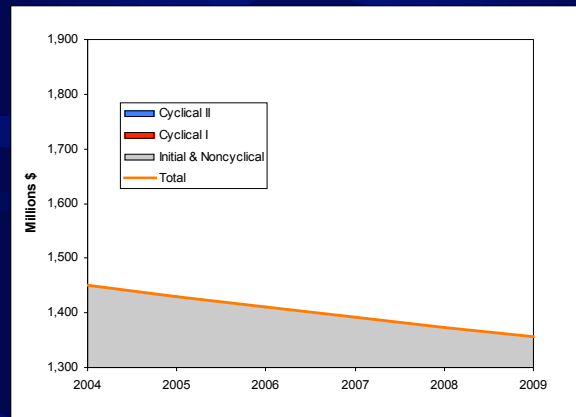
- In 2003, Utah's core base of most taxes was declining.
- Substantial volatility in Sales, Income, and Corporate Taxes.
 - Income Tax and Corporate Tax in Utah are dedicated completely to funding education.

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Sales and Use Tax



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Sales Tax Portfolio Contribution

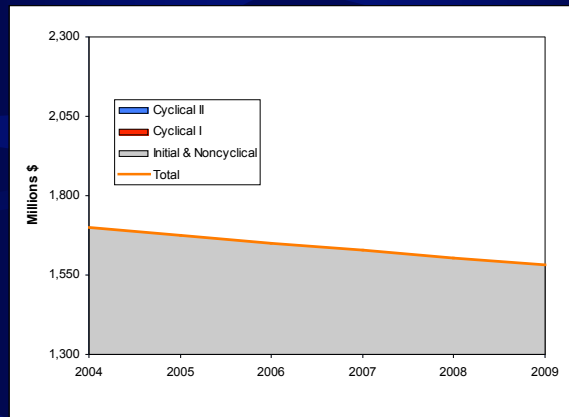
- Non-cyclical component declines
- Moderate growth potential
- Somewhat stable revenue source
- Base is shrinking as services and internet become more prominent parts of the gross state product.

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Individual Income Tax



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Individual Income Portfolio Contribution

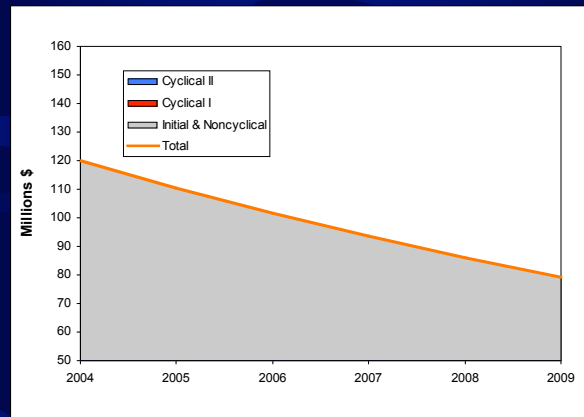
- Non-cyclical component declines.
- Attractive growth potential because of high beta.
- Risky revenue source for education.
- Because of linkage with federal, little potential exists for changing the base.

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Corporate Franchise



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Corporate Franchise Portfolio Contribution

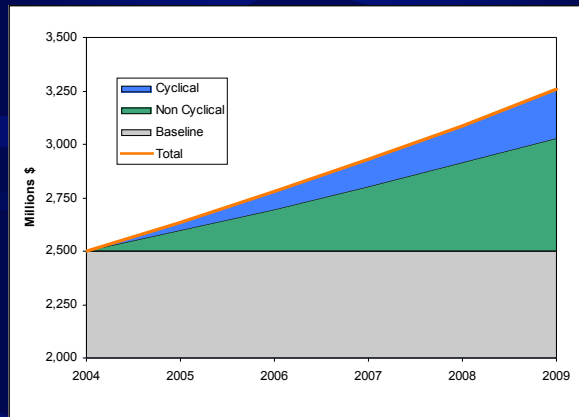
- Non-Cyclical growth is negative.
- Extremely volatile.
- Very prominent amount of nonsystematic risk.
- Very risky as revenue source for education.

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Property Tax



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Property Tax Portfolio Evaluation

- Stable over the business cycle.
- Steady non-cyclical growth.
- Great portfolio anchor.
- Potentially beneficial attributes for the state portfolio.

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2004 – Election Impacts – Timing

- Release originally scheduled to allow debate by candidates for Governor, hoping to set the stage for public debate.
- Decision revised to avoid undue pressure by outside interest groups and potential horse-trading that would compromise the comprehensiveness and fairness of the proposed reform.

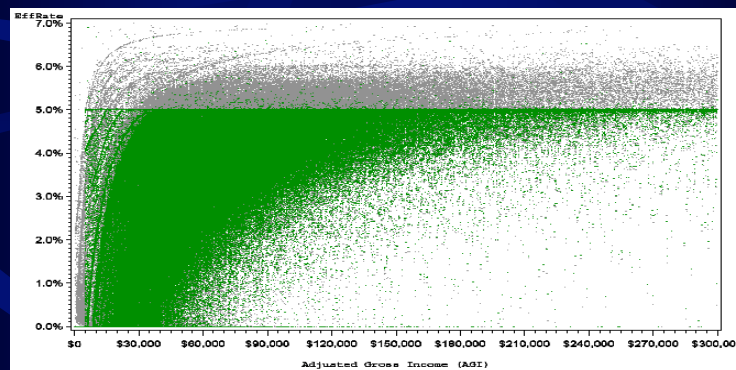
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Data Mining and Prediction Models

- With help from staff, tax records were used to simulate results of possible tax changes on every measurable social group: age, marital status, number of children, etc.,



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Tax Plan Released – November 2004

- Retain the relative share of sales, income, and property taxes.
- Adopt a flat personal income tax.
- Eliminate the state corporate tax.
- Simplify and expand the sales tax exemption for virtually all capitalized business inputs.
- Broaden the sales tax base by taxing services.

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The Legislative Process: Making Lemons out of Lemonade

- A new, legislative task force was assigned to review the Walker Tax Plan.
- Legislators sought to limit “Losers”.
- Huge surplus meant limiting losers was very plausible, actually inhibiting reform.
- Limiting losers for an idealistic plan inevitably means re-tooling.
- Re-tooling means unbalancing in the world of legislative politics...

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Response to Initial Plan and Transitional Slippage

- Tax plan principles were abandoned to craft a political solution.
 - Made more difficult by media: “Whose ox is getting gored?”
 - Interest Groups: Special considerations “just for us” ...

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Losing Focus, Shifting Rhetoric

- Flat Tax debate becomes very volatile.
- Broadening of the income tax base in a flat tax results in tax relief at the top, greater tax liability for low – middle income earners.
- Legislators and Governor abandon Flat Tax, discuss “flatter, fairer tax”.

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Casualties of Political Reality...

- Tax Reform is new Governor's "#1 Priority".
 - But not the Walker Reform Plan
- Removal of Sales Tax on Food tops new Governor's list, which narrows tax base.
- Corporate Tax Removal
 - As revenues grew with surplus, appetite for abolishment is lost.
- Taxing Services
 - Education and healthcare, two most heavily used services, seen as sacrosanct and politically untouchable...

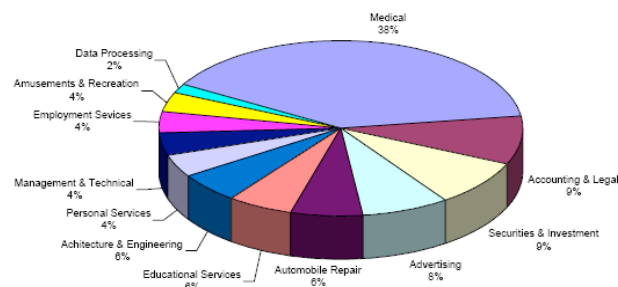
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Tax on Services

Service Economy (2003)



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Business Share of Purchases of Services, 2003

From Cline, Mikesell, Neubig & Phillips,
Sales Taxation of Business Inputs (COST, January 25, 2005)

Industry	Business Share of Purchases of Services	Total Purchases of Services (\$billions)
<i>Principally Business</i>		
Advertising	98%	175.3
Architecture & Engineering	96%	125.2
Employment Services	94%	88.6
Management & Technical	88%	89.8
Data Processing	84%	38.4
Accounting & Legal	71%	196.1
Securities & Investment	66%	194.9
<i>Principally Household</i>		
Automobile Repairs	26%	145.6
Personal Services	11%	96.5
Education Services	7%	131.4
Amusements & Recreation	5%	81.0
Medical Services	1%	889.5
		2,252.3

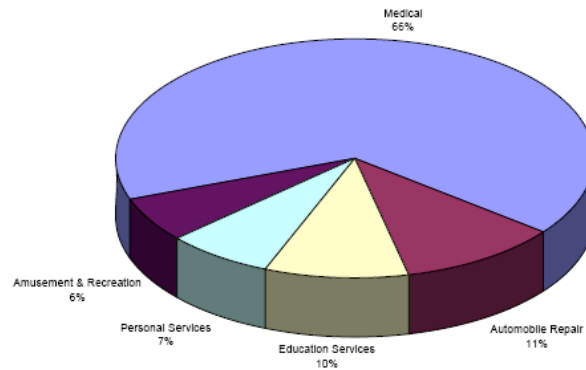
Note: Calculated by E&Y from U.S. Bureau of Economic Analysis, U.S. Benchmark Input-Output Matrix, adjusted to 2003 levels. Business percent equals business purchases divided by total supply of the service.

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Purchases of Services Used Primarily by Households (2003)



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Transitioning to Reform - What NOT to do...

The slide displays a portion of a tax form with several lines of text and numerical input fields. Overlaid on the form are several annotations:

- A large red stamp that reads "Better call the Tax Commission to let them know how mad I am!"
- Yellow text that says "The Tax Commission sets tax rates, right?"
- Blue text that says "Is this how I pay my taxes next year?!!!"
- A large red stamp that reads "Huh? What? Why?"
- Three blue arrows pointing from the text "Why?" to lines 12, 13, and 14 of the form.

The form lines visible include:

- 6. Modified federal adjusted gross income (subtract line 5 from line 4) (page 8)
- 9a. Standard or itemized deduction (page 8)
- 9b. One-half of the federal tax (page 8)
- 9c. Retirement exemption/deduction - use TC-40B (page 8)
- 10. Utah income tax (subtract line 9 from line 8). If less than zero, enter zero.
- 11. Enter "X" if you are a qualified exempt taxpayer (page 10)
- 12. TRADITIONAL TAX CALCULATION: Calculate tax on page 21
- 13. SINGLE RATE TAX CALCULATION: Multiply line 6 by .0535 (see pg 11 if taking UESP credit)
- 14. Utah Income Tax (enter the lesser of line 12 or line 13)

At the bottom of the slide, the date "8/21/08", the text "FTA June 2008", and the number "25" are visible.

The End Result: Tax Reform Lite

- Tax Reform went from an aggressive, multi-faceted effort, to simple income tax reform revolving around the popular idea of a tax cut.
- Recent efforts have partially removed the state's portion of sales tax from food, further narrowing the tax base.
- Some limitations on pyramiding.
- Itemized deductions and personal exemptions were successfully eliminated for high income individuals.

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