PUBLIC POLICY BRIEF

The Cost of Raising State Income Taxes to Fund Education

LIBERTAS INSTITUTE

SUMMARY

Perpetual calls to increase funds for K-12 education generally fail to tackle the root causes of scarce funding and ignore the question of whether additional tax revenues are even needed. Often these appeals for greater funding center on increasing the state income tax.

Without a basic understanding of why Utah's state income tax rate is where it currently is, it can be easy to wrongly conclude that simply raising the rate by a small fraction would do no harm to Utah's economy.

Utah's competitive advantage in attracting businesses depends on maintaining favorable regulations and taxes. This includes the state income tax, which impacts the relocation decisions of businesses and their employees.

If the state is serious about increasing K-12 education funding, we must first consider alternative options within the $16 billion budget, rather than pursuing a fruitless state income tax increase that will most certainly hurt Utah's economy.

Proposals to raise Utah's income tax rate punish those who fuel the local economy while putting a mere band-aid on the problem of public education funding.

Recent discussions about raising the state income tax rate often appear completely disconnected from the history of the tax itself, rate changes over time, and the impact on public education revenue. Before discussing recent proposals and their problems, we should first explore the history and context of the state income tax.

Birth of the Income Tax

The concept of a state income tax in Utah is an offshoot from the controversial history of the federal income tax. When the U.S. Constitution was originally ratified, an income tax was out of the question, yet some presidents and politicians were still able to push through the establishment of an income tax several times prior to ratification of the 16th Amendment.

The first temporary personal income tax was established in 1861 during the Civil War. It was repealed rather quickly in 1862 after failing to bring in desired revenues.[1] After about 30 years, a peacetime income tax was passed and subsequently struck down by the U.S. Supreme Court in *Pollock v. Farmer's Loan & Trust Company*.[2]

Pollock was then overturned by the the 16th Amendment, which gave way to a permanent income tax in 1913. Utah was one of only four states to outright reject the amendment.

The Great Depression

Utah's individual income tax was instituted in 1931 after the Great Depression dried up most other sources of revenue.[3] Seventy-five percent of funds raised were to be used for public education. It was seen by proponents as a necessary step in order to avoid sky-high property tax rates and corporate taxes. By this time many other states had already implemented their own income taxes, and Utah legislators and bureaucrats worked together to develop a preferred state model. There was little opposition to the overall concept within the Legislature.

Utah's state income tax rate and the base of who paid the tax went through dozens of changes before reaching its peak of 7.75 percent for the top tax bracket in 1975. Beginning in 1987, there was a successful effort to lower the rate little by little until it reached a rate of 7 percent. It was at that point in 2003 that Governor Olene Walker called upon a commission to investigate lowering the rate by a significant margin, as well as issuing recommendations for broader tax reform.

The Huntsman Tax Cut

One of former governor Jon Huntsman, Jr.'s central campaign talking points in 2004 was to cut the state income tax. The federal government had also cut taxes in 2001, and it was viewed as a necessary step to remain competitive with other states.

Eleven different states have decreased their income tax rates since 2014, including "blue" states like Hawaii, Illinois, and Massachusetts.

Once elected, it took Huntsman two more years of work to hammer out a compromise that changed Utah's multi-tiered income tax rate into a flat tax at 5 percent. Eliminating the progressive nature of the tax along with some of the exemptions allowed for a broadening of the tax base at the same time the rate was lowered.

Huntsman's effort enjoyed a broad coalition of support with very little opposition for the final proposal—even from the education community that, under Utah's Constitution, receives 100 percent of the revenue generated by the income tax. Large surpluses had become the norm each year as the growth of government revenues outpaced the growth of the economy.

Senator Wayne Niederhauser was the chief sponsor of the bill that ended up passing unanimously and was signed into law by Governor Huntsman in 2007.[4] It was the largest tax cut in Utah history and was considered the beginning of further cuts, which included the sales tax on food and corporate income taxes.[5] These cuts were shelved when the economy entered into a recession the following year.

It is important to note that even with this tax cut, lawmakers were able to increase spending on education by a record amount, including a $2,500 across the board pay raise.[6] While the overall state budget was projected, at the time, to continue reaching record spending levels over subsequent years, the Great Recession altered those projections significantly.

As with many tax cut proposals, some Utahns expressed concern that only the wealthy would see a reduction in taxes. In reality, over 90 percent of Utahns saw a decrease in their state income taxes the following year, eliminating those concerns.

Income in Relation to Prosperity

One ongoing question in relation to income taxes is whether tax cuts of this variety strengthen the overall economy. What is absolutely clear is the inverse: high state income tax rates relative to the rest of the country hurt a state's overall economy.[7]

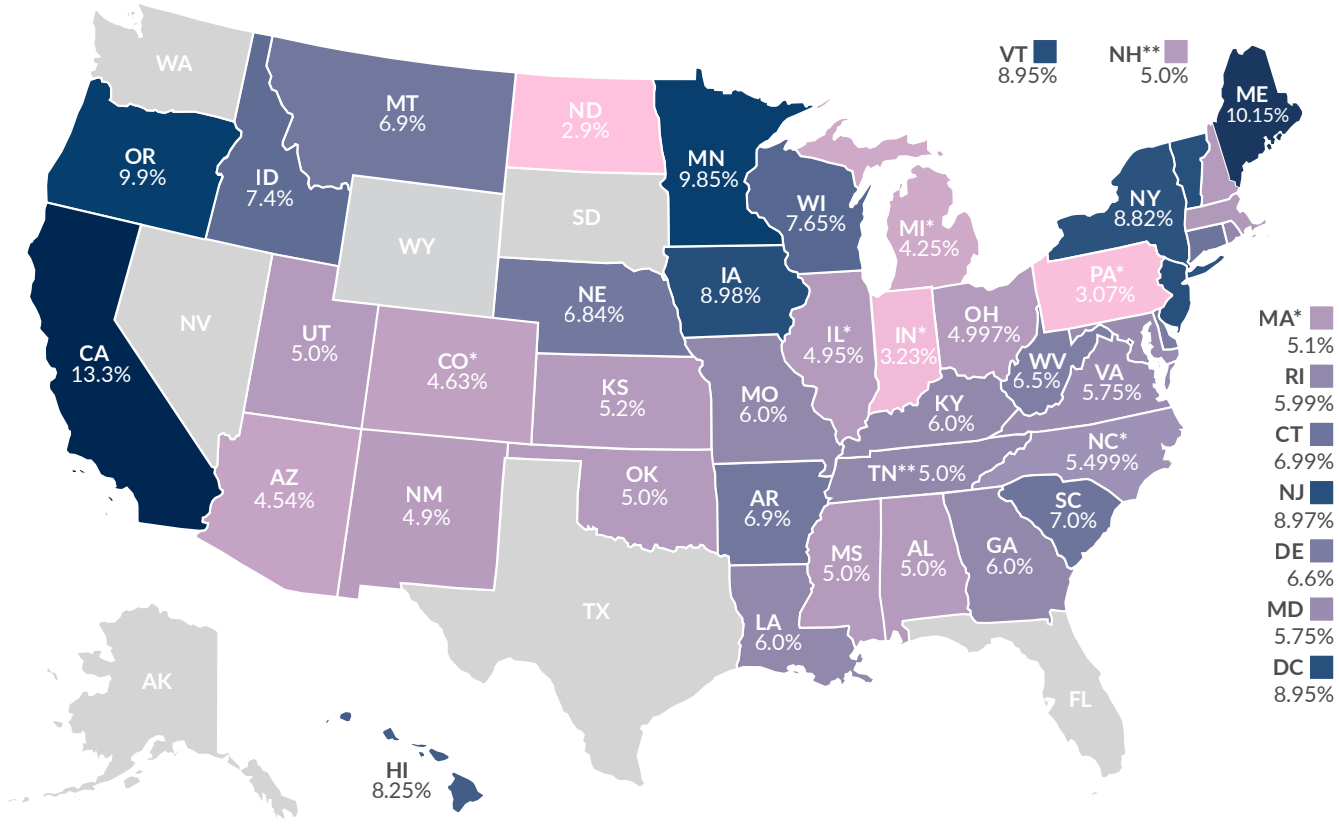
In the mid 1980s, the average top state income tax bracket was above 7 percent; Utah lawmakers worked to lower the rate to stay in the middle of the pack during the late 80s and early 90s. By 2006, the average state income tax bracket had fallen to 5.3 percent. It was at this point that the Huntsman tax cut was implemented to keep Utah competitive, hoping to improve the state's economy.

While there continues to be a debate as to what extent federal income tax cuts improve the economy,[8] it has become apparent that a high state income tax rate relative to most other states is damaging to that state's economy.[9]

Utah's income tax rate in the last 30 years has never been much lower than the average in comparison to other states. Indeed, whenever the Utah rate has been lowered, it was merely to keep up with competitive decreases enacted by other states.

How High Are Income Tax Rates in Your State?

Top State Marginal Individual Income Tax Rates as of July 1, 2017



Note: (*) State has a flat income tax. (**) State only taxes interest and dividends income. Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.

Source: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.

In 2017, the median state income tax rate dipped to 5 percent, continuing a yearly decline. This raises an important question of whether a tax *decrease* is prudent in order to maintain competitiveness, rather than the increases that have been regularly proposed in recent years.

The Right to What One Produces

Utah businesses often struggle with attracting top talent to fill their high-end positions. Compensation rates for CEOs and other top-level management are highly affected by state income tax rates because the difference between 5 percent and 6 percent amounts to tens of thousands of dollars for most of these individuals.

Simply adding more money to the pot will not accomplish the end goal of increasing funding for K-12 education.

When these potential recruits choose not to come to Utah or a business chooses not to locate in Utah as a result, the state loses out on a large amount of state income tax revenue—to say nothing of the economic growth, workforce expansion, community investment, and other positive attributes that high taxes can hinder.

Of course, these arguments do not even begin to touch the larger picture of whether or not the income tax is good moral tax policy.[10] Human beings ought to be allowed to keep most of what they earn by the sweat of their own brow.

Utah should look at the tax policies of other states and make decisions relative to its overall competitiveness in the national marketplace, rather than myopically raising taxes in the dubious hope of generating additional revenue.

Income Tax Policy in Other States

Eleven different states have decreased their income tax rates since 2014, including "blue" states like Hawaii, Illinois, and Massachusetts. Only a single state—Minnesota—increased income taxes on one tax bracket during the same period.

Seven states have no income tax, and two more only tax interest and dividends. Every state surrounding Utah has a lower income tax rate or none at all, with Idaho being the exception.[11]

If Utah increases its income tax rate, it will move from its position in the middle of the pack to being one of the higher taxing states. This would be a complete reversal of the competitive economic policies that have been pursued over the last three decades. Those economic policies have brought incredible economic growth to the state—gains that are jeopardized if the trend is reversed.

If anything, Utah should be considering lowering its state income tax rate to keep up with other states and maintain its competitive advantage. In light of this data, why is there so much interest in raising taxes?

Recent Attempts to Raise

The idea of raising state income tax rates is not a new one. Democrats in the Utah State Senate have been attempting to do so in order to bring more funding to K-12 education.[12] Interest in raising the rate has continued to grow because of the oversimplification of the proposal, the perceived equity to taxpayers (as opposed to a steep property tax rate hike), and the belief that Utah schools are underfunded.

In 2016, this led to the formation of a group called Our Schools Now (OSN), comprised of members of Utah's business elite and assisted by a number of public education advocates.

Initially OSN proposed seeking action by the Utah Legislature, later shifting to a ballot initiative with the goal of instituting a straight income tax rate increase. Eventually, OSN settled on a push for both an income tax increase of about half a percent and a sales tax increase of about half a percent.[13]

While some of its chief supporters claimed that long-term economic viability was the goal, the OSN tax increase proposal would in fact hurt Utah's economic trajectory.[14] In addition, a tax hike like this disproportionately affects the poor, increasing their tax burden by 17 percent, as opposed to a 10 percent increase on the wealthy.

Proponents claimed that the initiative would generate $700 million in tax

revenues; however, their proposal to Utah voters did not take into account federal tax cuts announced after their measure was drafted, which would potentially increase the amount collected from taxpayers by their initiative to nearly $1 billion dollars. In addition, the proposal placed a 25% cap on raises for teacher salaries, limiting how many dollars could actually reach the classroom and benefit both teachers and their students.

What the proposal's proponents did not seem to understand is that very little new funding in the aggregate will reach K-12 education if the status quo is maintained in the structure of Utah's state budget.

Utah's Leaky Budget

In 1996, Utah's Constitution was amended to allow funds raised through the state income tax to be distributed to higher education by means of the education fund.[15] Prior to this, 100 percent of state income tax dollars were earmarked for K-12 education.

As a result, an average of $500 million is siphoned off to higher education each year instead of funding K-12 schools. According to Lane Beattie, president of the Utah Senate at the time and a sponsor of the OSN initiative, one of the principal reasons for the constitutional amendment "was based on the fact that economists and other people coming and telling us we were going to have a drop in the number of students in public education."[16] That estimate has obviously not come to fruition; as such, those K-12 education funds should be retained, rather than re-allocated to higher education institutions that cater to adults who can work.

Unfortunately this is only one example of how funds that were supposed to be appropriated to Utah schools end up being spent elsewhere.

For example, schools bond for new funds every year, but often these bonds are for lavish buildings and facilities. Billions of property tax dollars go to the creation of magnificent structures while neglecting the education that takes place inside of them.

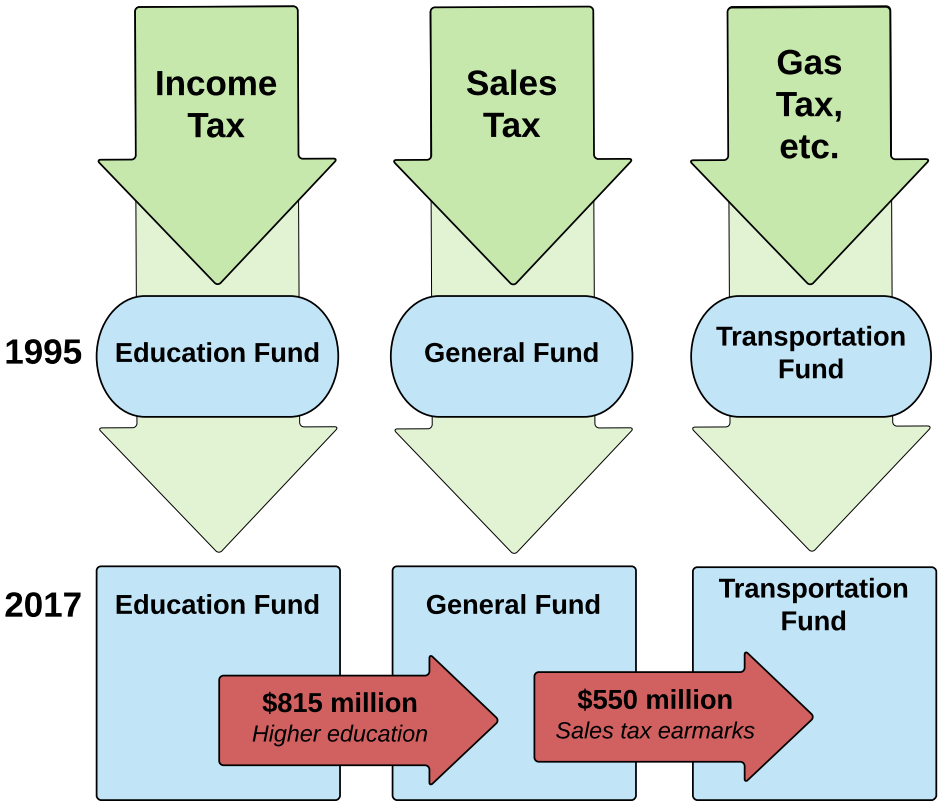
Local school boards vote to give away future property tax funding each year to dubious economic development projects that often involve retail developers looking for their next tax break.

New stadiums and arenas, after obtaining initial funding and property tax breaks, return in future years to have their property tax valuations slashed, thereby avoiding paying back taxes that would go to local schools.

Utah's water rates are subsidized by local property taxes that should be going to public K-12 schools instead of building wasteful billion-dollar water projects that Utahns do not actually need.

Utah's budget is filled with a number of other tax credits, exemptions, pet projects, and funding misappropriations that could instead be going to K-12 education.[17]

Previously Separate "Buckets" of Funding, Now Connected



Source: "Getting By with Less: Two Decades of K-12 Education Revenue and Spending," Utah Foundation, Report Number 743, November 2016, 10.

Case in point, hundreds of millions of dollars from sales tax revenue are earmarked for transportation every year.[18] Instead of coming to a long-term solution on funding roads through some type of user fee to replace the gas tax, Utah's budget is thrown out of sync with these enormous earmarks.

Utah's porous budget demonstrates why simply adding more money to the pot will not accomplish the end goal of increasing funding for K-12 education. The funding mechanisms within the budget must instead be fixed, and loopholes closed, before a tax increase can be seriously considered.

More Tax Revenue or Better Prioritization?

Due to a constitutionally dedicated school fund, the number one priority of the Utah state budget is K-12 education. If current prioritizations do not reflect this, how will adding additional tax revenue change the outcome?

In short, it won't. Until spending is cut in other areas of Utah's $16 billion budget and existing priorities are re-evaluated, the funding generated by a state income tax increase will only offset the ever-increasing divergence of other funding from K-12 education.

Even once the money gets to K-12 education, the funds are often mismanaged.[19] Only in the past few years has the Utah State Board of Education pushed to adopt basic accounting principles to keep track of budget line items and overall spending.

Another priority that needs to be pursued is education reform. Funding for K-12 education has increased at an astronomical rate in the U.S. over the last 50 years while test scores have stayed flat. Study after study shows that more spending does not lead to improved student outcomes.[20]

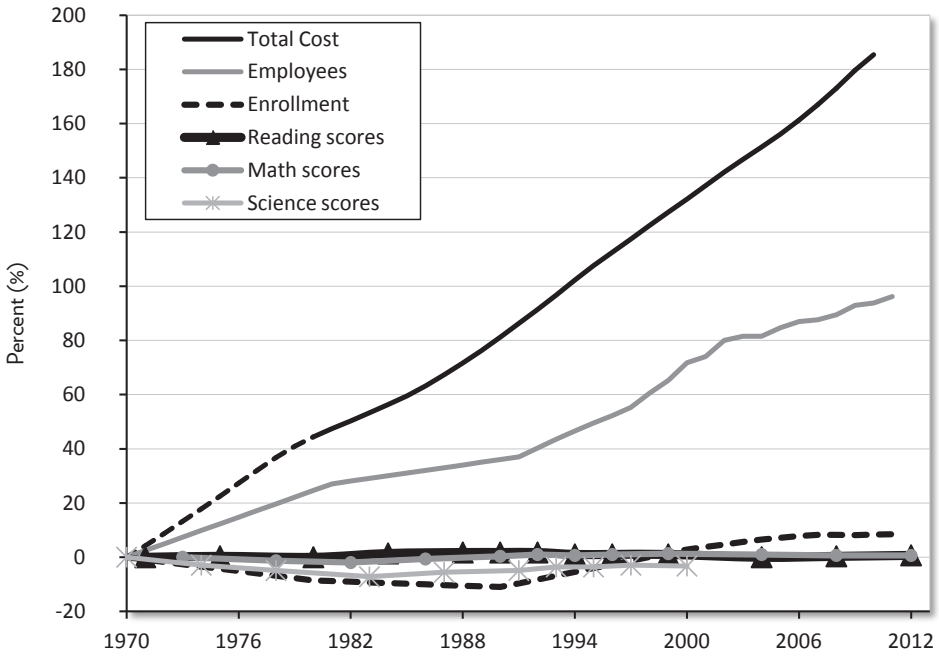
A study done by the Utah Legislative Fiscal Analysts shows that the correlation between funding and student performance is so weak that for Utah to make even the smallest marginal improvement on the NAEP (National Assessment of Educational Progress) it would have to spend nearly $1 billion more annually.[21] This would still leave Utah in its current position of above average test scores.

Utah's K-12 classrooms have an average size of 22 students. This means that for every classroom, there is nearly $200,000 available. Since the average teacher makes nearly $80,000 in salary and benefits, where does the rest of the funding go? Surely infrastructure and administration costs can be better managed so that more funds reach the actual classroom to benefit teachers and students.

Additionally, Utah has some unique challenges that make budget and education reform imperative. Utah has more children per wage earner than any other state. Also, over two-thirds of Utah land is owned by the federal government and is generating little to no tax revenue to help fund public schools.

Even with those challenges, Utah often ranks relatively well, for example in science, dual language immersion, and administrative efficiency. As demonstrated above, Utah already has the tax revenue needed to offer an excellent education to each child. A state income tax increase will do very little to change this trend, while inevitably hurting the overall economy.

Trends in American Public Schooling Since 1970



Courtesy of the CATO Institute, using the "Digest of Education Statistics" from the U.S. Department of Education and "Long Term Trends, 17-Year-Olds" from NAEP tests.

Note: "Total Cost" is the full, inflation-adjusted amount spent on the K-12 education of a student graduating in the given year. In 1970, it was $56,903; in 2010, it was $164,426.

PROPOSAL A: LET K-12 EDUCATION KEEP INTENDED REVENUE

We propose that Utah put its fiscal house in order by no longer subsidizing the cost of higher education for adults out of the K-12 education fund. All budget earmarks should be eliminated, providing legislators the flexibility they need each year to prioritize funding. Ideally, the Legislature should implement a zero-based budgeting model that would allow the most important budget line items to be funded first, rather than with whatever is left over.

PROPOSAL B: LOWER TAX RATE, DECREASE EXEMPTIONS

We propose that Utah lower its current state income tax rate from 5 percent to 4 percent in order to maintain Utah's competitive economic environment and keep up with the example of other states. Reducing the number of exemptions currently provided in law can help offset the reduction in revenue from a rate decrease. This may include a reduction in the overall per child tax exemption for taxpayers if their child attends public schools.

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