

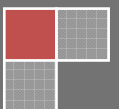
2010

School Funding and Tax Policy Series—Report IV

Income tax breaks to the wealthy

COST TO PUBLIC EDUCATION \$220 to \$245 MILLION PER
YEAR

The lower effective rate and the abolishment of the multiple-rate bracket system will reduce the long-run elasticity of future individual income tax revenues. Over the years, this smaller elasticity compounds. The cost to public education is \$220 million to \$245 million per year.



Income Tax Breaks Benefit the Wealthy**COST TO PUBLIC EDUCATION—\$220 MILLION TO \$245 MILLION PER YEAR**

Abstract—The lower effective rate and the abolishment of the multiple-rate bracket system will reduce the long-run elasticity of future individual income tax revenues. Over the years, this smaller elasticity compounds. The cost to public education is \$220 million to \$245 million per year.

Background

The individual income tax changes enacted during the 2007 General Legislative Session establish a single-rate one track system, effective in tax year 2008. For tax year 2007, the state had a dual track system, with a choice between the traditional multiple-rate bracket system and a 5.35 percent flat tax based on federal adjusted gross income (AGI). The new system effective in tax year 2008 applied a single tax rate of 5.0 percent after making certain additions to and subtractions from AGI.ⁱ

Changes

The tax system implemented as of 2008 moves from a deduction-based system to a credit-based system. Rather than claiming deductions to arrive at taxable income and then applying various tax rates to different brackets of income, the new tax system allows certain tax credits which reduce tax liability. Allowable credits provide a benefit for the federal standard deduction or itemized deductions (such as charitable contributions, mortgage interest, certain medical expenses, and certain state and local taxes), personal exemptions, and retiree status.ⁱⁱ The new system lowered the top rate from 6.98 to 5.0 percent, but because the credits phase out for those above the median income, the effective rate is higher than 5.0 percent.

The primary benefactors from the 5 percent single rate system are taxpayers with incomes more than \$2 million.

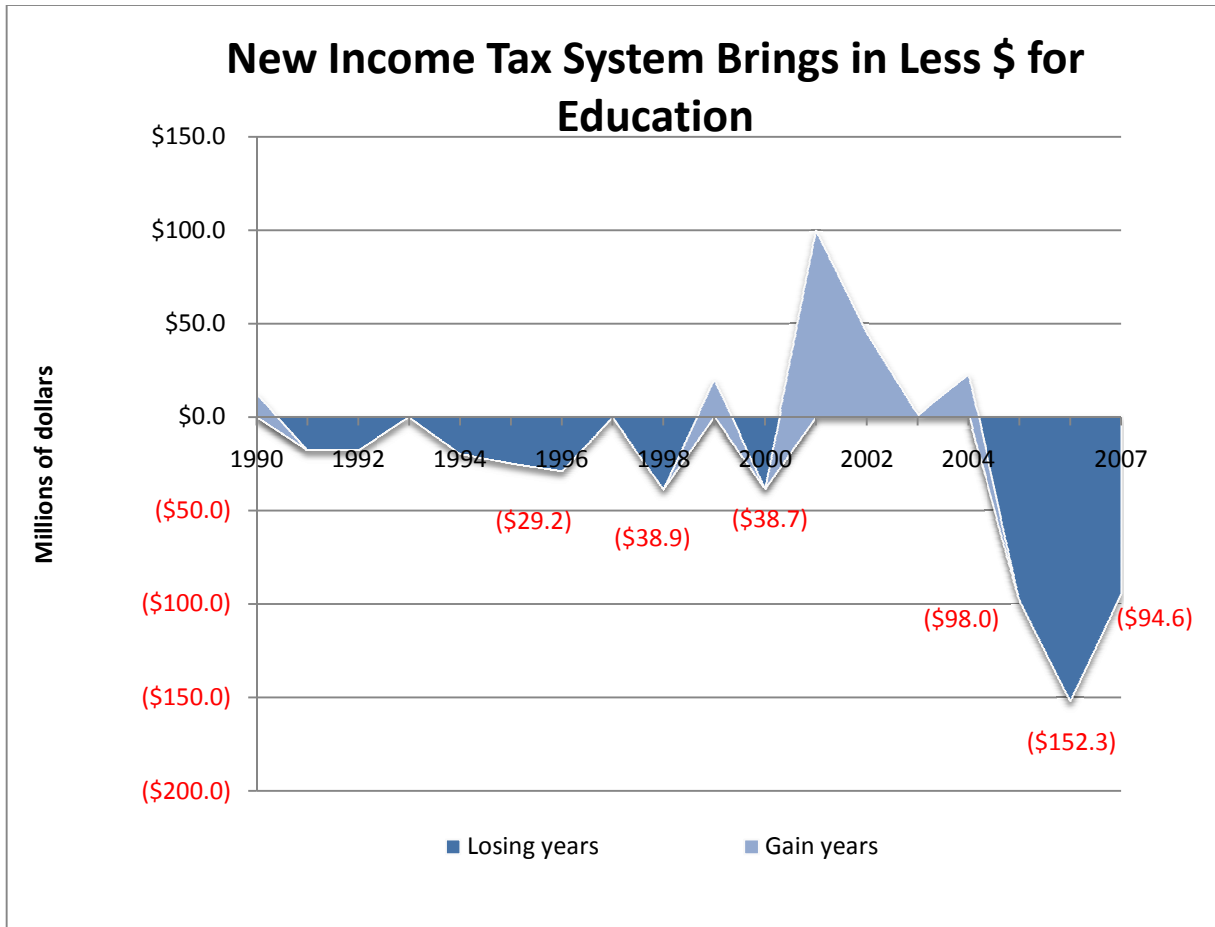
Effects

The Legislative Fiscal Analyst estimated revenue loss from income tax reform at \$220 million per year including all provisions. In addition, the new income tax system will grow more slowly over time. Eliminating the multiple-rate bracket system, which ranged from 2 to 7 percent, will lower revenues to Utah's schools by about \$10 million per year. Revenue from high-income taxpayers (more than \$500,000 per year) with large capital gains will decrease by about \$14 million per year. (This loss of revenue results from the difference between the old system's top effective rate of 5.76 percent and the new system's 5 percent marginal rate.)

A secondary analysis on long-term elasticity (new system response to growth in taxable income) revealed that the long-term elasticity from income tax will fall from 1.109 percent to about 1 percent due to reform. This means that when personal income rises 10 percent, the former system revenue would increase on average 11.09 percent,ⁱⁱⁱ but under the current reform, revenues will increase only 10 percent. Chart 3 illustrates that, during the past ten years, had the new 5 percent single-rate income tax system been in place, the Education Fund would have received \$240 million less in revenues, compared to the former multiple-rate bracket system.

Importantly, significantly less revenue would have accrued during the last three years of the multiple-rate bracket system —\$345 million. In fact, during fiscal year 2006-07, the income tax yield would have been \$95 million lower under the new single-and lower-rate system. For the eighteen years simulated, significantly lower (more than \$10 million) revenues under the new tax system would have occurred in ten of the eighteen years. Higher revenue would have accrued in only five of the eighteen years.

Chart 3. Impact of Lower Elasticity on Individual Income Taxes from New 5 Percent Tax Rate



Despite the fact that recent income tax reform was highly touted as a means to protect the state’s long-term economic viability, advocates for this concept did not produce any empirical findings to support the claim. In fact, Utah’s leading employment growth rate, one of the highest in the nation at that time, flew in the face of those complaining about its then 7 percent top-marginal income tax rate detracting from the Beehive state’s economic viability.

This report was commissioned by Utahns for Public Schools and researched by Econowest Associates Inc. Douglas A. Macdonald. Mr. Macdonald may be reached for comment at 801-550-3161 and Utahns for Public Schools at 801-971-9200. They may also be contacted by email at: douqmacdonald@mac.com and info@utahnsforpublicschools.org. For more information about Utahns for Public Schools, please visit our website: utahnsforpublicschools.org.

ⁱ Office of Legislative Research and General Counsel, “Tax Relief & Reform,” March 2007, p. 2

ⁱⁱ Id.

ⁱⁱⁱ For the period between fiscal years 1988-89 to fiscal year 2006-07