Analysis of a Three-Part Proposal to Reform Utah's Sales Tax

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Introduction

A proposal that will be discussed during the 2013 General Session would return Utah's state sales tax on groceries to the general sales tax rate, while offering two kinds of tax credits to mitigate the negative impacts on vulnerable households. A detailed economic analysis from the Institute on Taxation and Economic Policy (ITEP), a non-partisan research organization, demonstrates that the negative impact of restoring the full tax rate on groceries can be mitigated, provided the tax credits are large enough and that eligible households know how to apply for the credits.[1]

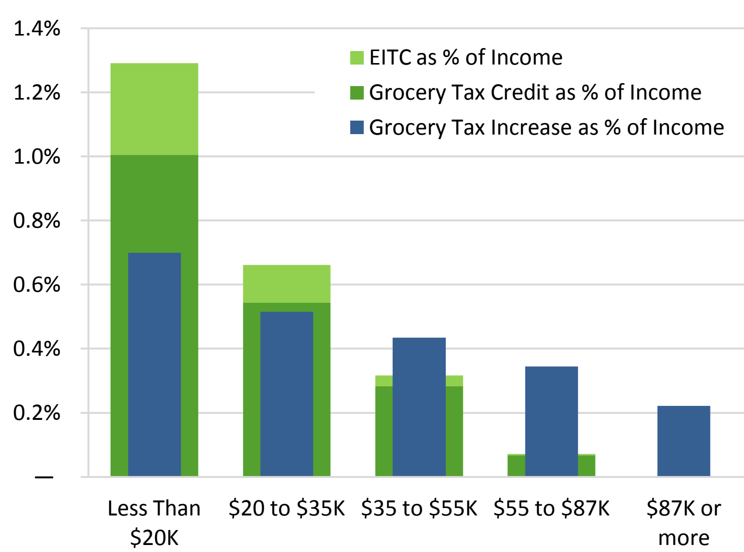
In other words, Utah can actually *improve the fairness* of its tax system through adoption of a revenue-neutral, three-part proposal that would restore the grocery tax to the general sales tax rate, establish a grocery tax credit and shore up the earnings of low-income working families. The ITEP study shows that two-thirds of Utah households would be eligible for a grocery tax credit to help offset the sales tax paid over the course of a year. It shows how much a refundable state earned income tax credit (EITC) would further benefit low-income working families who qualify for the federal EITC.[2]

Overall impact

The combined result of the grocery tax increase, the grocery tax credit, and a refundable state EITC is a fairer, less regressive state sales tax system. Fully two-thirds of Utah households would be eligible to receive a grocery tax credit of either $80 or $40 annually for each dependent. This includes every Utah resident whose annual household income is below $60,000 (Figure 1). The EITC would further boost the incomes of about 15% of Utahns who work in particularly low-wages jobs. The next sections consider each element of the three-part proposal in turn.

Figure 1. Credits where Credits Do More

Impact of proposal on quintiles of Utah households

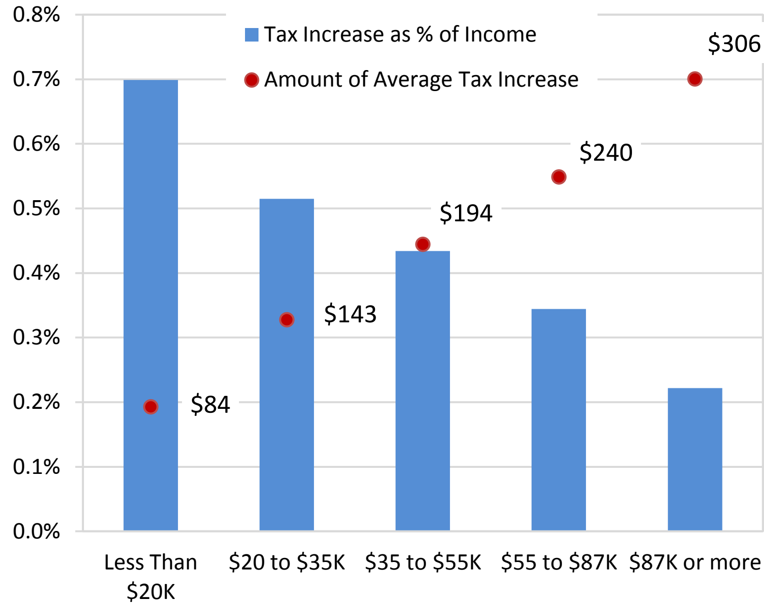


Derived by Voices for Utah Children from analysis by ITEP, December, 2012 .

Impact of restoring the full rate on groceries

The sales tax is regressive, that is, it costs low-income households a larger share of their income than higher-earning households pay. The results of the ITEP model illustrate regressivity very clearly in the case of the sales tax on groceries (Figure 2). In the absence of offsetting credits, Utah's average low-income family would face a small but measurable increase in the tax it pays, equal to about 0.7% of its household income. In contrast, the average tax increase for the wealthiest families barely registers, at 0.2% of annual income. Put another way, the tax increase for the lowest income families, which averages $84, presents a greater burden than the average $306 that families in the top quintile would pay.

Figure 2. The Picture of Regressivity: Sales Tax on Groceries



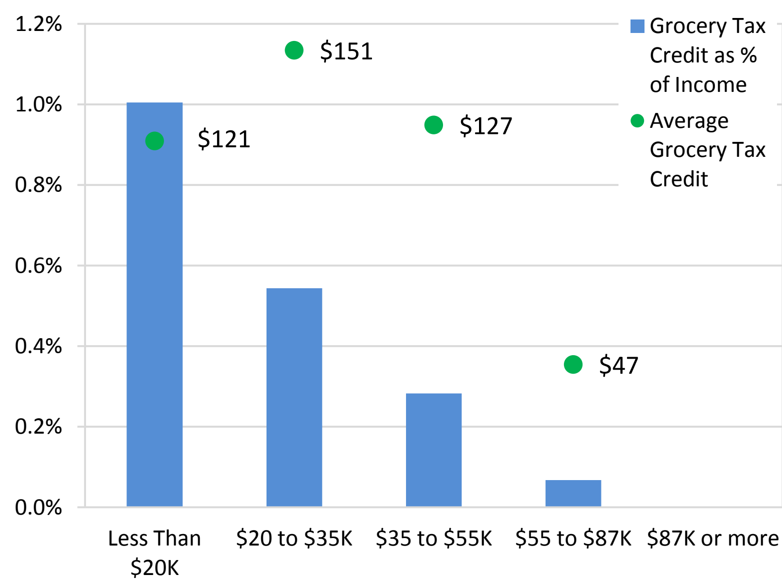
Derived by Voices for Utah Children from analysis by ITEP.

Impact of the grocery tax credit

The second component of the three-part proposal is a grocery tax credit aimed specifically at Utah's most vulnerable families. Two-thirds of Utah households would be eligible for this credit, and the total credit amount is based on the number of members of a household. Households that earn less than $20,000 per year would see an average credit equal to 1.0% of their incomes, around $121. Those earning between $20,000 and $35,000 would receive even more, about $151 per year.[3] The credit begins to phase out for households in the next two income quintiles (Figure 3).

Figure 3. Efficiently Targeted Credits

Impact of grocery tax credit on quintiles of Utah households



Derived by Voices for Utah Children from analysis by ITEP.

Impact of the EITC

The third component of the three-part proposal offers an additional credit to Utah's low-income working families through the adoption of a refundable state EITC. Any family that qualifies for the federal EITC would automatically receive a 5% "bonus" from the state on that federal amount. The benefits of the EITC, which would reach about 15% of Utah's households, are concentrated in the lowest three income quintiles.[4]

In all of the three eligible quintiles, the tangible impact of an EITC for low-income working families would be substantial. Because nearly all families who receive the EITC have children, the benefits would be especially important for lifting Utah kids out of poverty.

Figure 4. Bonus for low-income workers

Average EITC amount by quintiles of Utah households

Derived by Voices for Utah Children from analysis by ITEP.

The importance of outreach

As the three-part proposal is currently formulated, no vulnerable Utahn would be excluded from eligibility for the grocery tax credit. However, a credit is only useful if a family receives it. To do so, those who may qualify would need to file a state income tax return. This is the most cost-effective way for the state to ensure that only eligible families with proven economic dependents receive the credit.

For most households, the credit would be granted upon filing their state income tax returns. To help ensure that those households that would not otherwise file Utah income tax do claim their credits, the three-part proposal must include funding for outreach to households that have little earned income. This group includes retirees, and heads of households that rely on disability payments, were unemployed and those who were homeless for substantial portions of the previous year.

Conclusion

The proposal to reinstate the full sales tax on groceries is critically important to low-income Utahns. Increasing this rate would present a challenge for Utahns with modest household budgets, but this can be mitigated by adopting a three-part proposal that provides a grocery tax credit for these households. Negative impacts for low-income working families would be further mitigated by the establishment of a new state EITC. As demonstrated by the ITEP analysis, these two types of credits would more than offset the impact that reinstating the sales tax on food would have on the lowest-income taxpayers. However, to ensure that all households which are eligible for the grocery credit and the EITC do receive them, the three-part proposal needs to incorporate funding for outreach to these families.

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[1] This kind of analysis is known as a state tax microsimulation. ITEP's model is comparable to those used by the US Treasury, the Congressional Budget Office, and a very small number of other research organizations. In addition, ITEP is able to perform incidence analyses of state-level tax changes that even these agencies do not do.

[2] The specific figures used in this ITEP analysis are drawn from a draft of the three-part proposal presented by Senator John Valentine, and are subject to change during the legislative process. Still, the basic patterns of regressivity would remain broadly consistent unless major changes are introduced to the proposal.

[3] The dollar amount is slightly greater for households in the second quintile than for lower-earning households because family sizes in the former tend to be larger. Household sizes in the lowest quintile consist mostly of seniors and young, single people. However, larger families who experience sudden economic dislocation, such as that caused by unemployment or divorce, could also be found in this group in any given year.

[4] Again, larger average family sizes is one reason that EITC amounts are greater in the second quintile than in the first. In addition, the federal EITC is designed to reward additional earnings up to a certain level. The Internal Revenue Service establishes the income thresholds for the Federal EITC. In 2012, the maximum eligible income for the largest families was $50,270.