UTAH TAX REVIEW COMMISSION

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Senator Stuart Adams, Senate Chair
Representative Todd E. Kiser, House Chair
Revenue and Taxation Interim Committee
Utah State Capitol Complex
Salt Lake City, Utah 84114

Gentlemen:

Earlier this year, Sen. Niederhauser and Rep. Kiser asked the Utah Tax Review Commission (TRC) to respond to several questions regarding the sales and use tax on food and food ingredients. This letter contains our response to the questions that were asked.

Background

As you are aware, in the 2006 and 2007 General Sessions, the Legislature reduced state and local sales and use taxes on food and food ingredients ("sales tax on food")[1].

During the 2006 General Session, H.B. 109 *Sales and Use Tax - Food and Food Ingredients* (Newbold) reduced the state sales tax rate on food from 4.75% to 2.75%, effective January 1, 2007. At the time, the Office of the Legislative Fiscal Analyst (LFA) estimated that the changes would reduce General Fund revenues by $35 million in FY 2007 (½ year) and by $70 million in FY 2008 (full year).

During the 2007 General Session, S.B. 223 *Tax Amendments* (Niederhauser) further reduced the state sales and use tax rate on food from 2.75% to 1.75%. In addition, the bill removed food from the tax base for certain local option sales taxes (local 1.00% and county 0.25% rates continue to be imposed). For some local option sales and use taxes, offsetting rate adjustments were made. At the time, LFA estimated that these changes would reduce General Fund revenues by approximately $19 million in FY 2008 (half year) and $40 million in FY 2009 (full year).

In a bill introduced during the 2009 General Session (H.B. 403 *Sales and Use and Income Tax Amendments*, McIff), LFA estimated that restoration of the full state sales

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[1] Excludes bundled transactions and prepared food

and use tax rate would generate approximately $145 million in General Fund revenues and approximately $16 million in restricted fund revenues in FY 2010, resulting in a net revenue increase of approximately $160 million.

How have recently enacted sales tax on food reductions affected General Fund revenues, both in terms of revenue amounts and revenue stability over the economic cycle?

Because of the differentiated tax rate, sellers separately report food and food ingredient data on their sales tax returns filed with the Utah State Tax Commission ("Tax Commission"). This sales tax return data collected by the Tax Commission indicates that total food and food ingredient taxable sales were $4.47 billion in FY 2008 and $4.51 billion in FY 2009. This represents a year-over increase of a little less than 1%. During the same period, the remaining sales tax base excluding food and food ingredients declined by nearly 10%. That is, in a time of declining taxable sales overall, food sales served as a stabilizing factor in the sales tax base. However, we note that the state did not receive this full stabilizing impact in state sales tax revenues because of the reduced rate. Charts 1 and 2 below show the year-over percent change in selected sectors of the sales tax base.

Chart 1
Year-Over Percent Change in Selected Sectors of Sales Tax Base
Annual FY 2008 to FY 2009

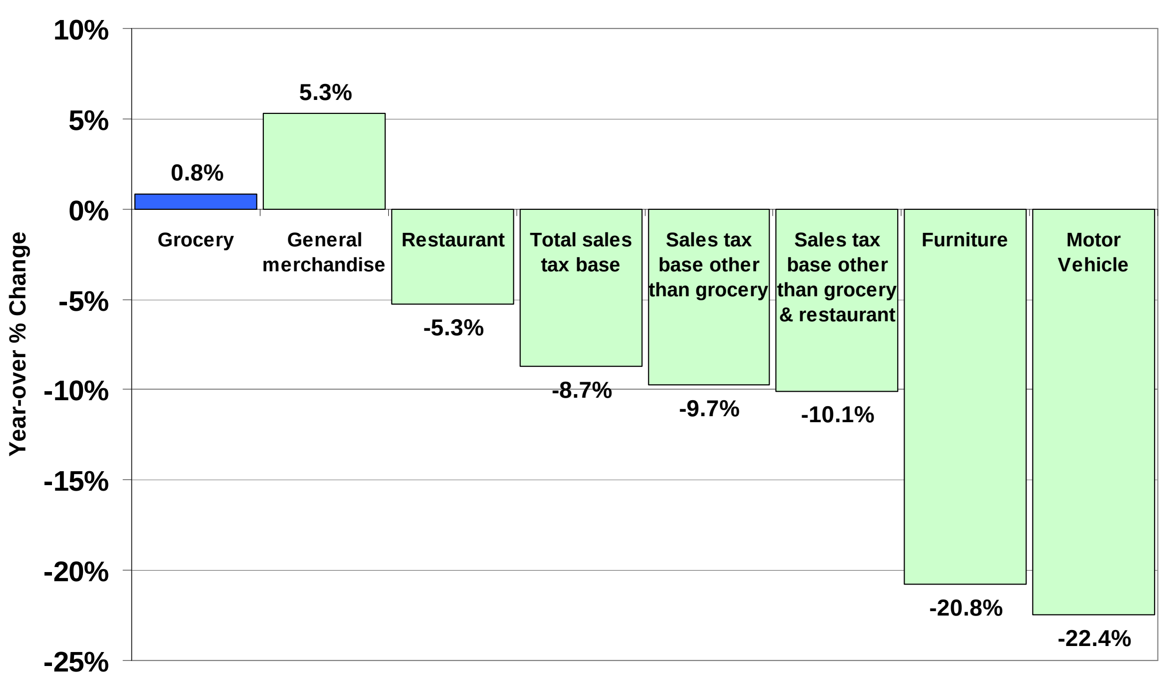

Chart 2
Year-Over Percent Change in Selected Sectors of Sales Tax Base
Quarterly 2008Q1 to 2009Q2

Multiplying the state food tax rate by the food tax base provides a ballpark estimate of gross total generated revenues.[2] Multiplying the difference between the state food sales and use tax rate and the state general sales and use tax rate[3] provides a ballpark estimate of total amount of foregone revenues from the rate reduction. In FY 2009, this amount of foregone revenue was approximately $130 million, as illustrated in Chart 3.

Based on this historical revenue estimate of about $130 million in FY 2009, LFA's $160 million fiscal note estimate for FY 2010, and initial estimates in the range of $110-120 million, it appears that the sales tax on food rate reductions have reduced state General Fund revenues more than originally estimated.

We only have limited actual data on which to draw conclusions about long-term impacts (10 quarters, many of which have occurred in the midst of significant economic turmoil). Accordingly, we cannot specifically state the exact long-term revenue impacts over the economic cycle. However, both theory, anecdote, and the data collected to date suggest that the sales tax on food generally has a stabilizing impact on the sales tax.

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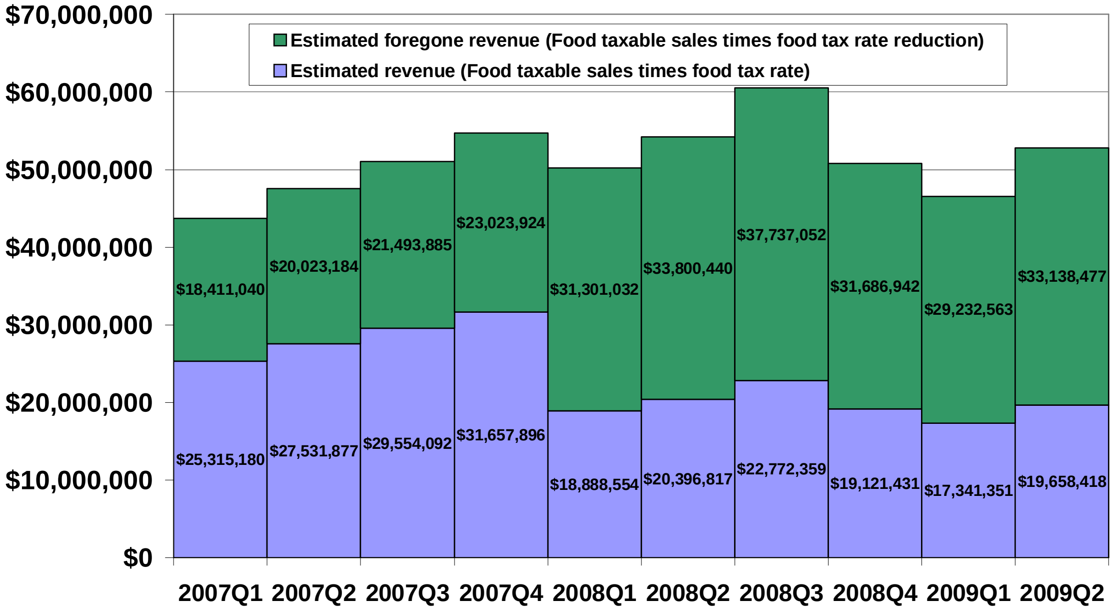
[2] This gross estimate provides an estimate of total (not just General Fund) revenues due before adjustments, and would vary from a General Fund revenue estimate due to earmarked funds, seller discounts, failure to collect taxes owed, etc.

[3] Rate decreased from 4.75% to 4.65% on January 1, 2008 and then increased to 4.70% on January 1, 2009.

Chart 3
Estimated Historical Sales Tax on Food Revenue Impacts
Quarterly 2007Q1 to 2009Q2



During slow economic times, households undoubtedly adjust their food buying habits somewhat. But in the end, they still buy food. As we've seen in this economic downturn, purchases of other types of goods and services (especially durable goods such as cars, furniture, and home improvements), can be, and often are, postponed. However, because of the necessity of food and the difficulty in stockpiling large amounts of the food households typically consume, taxation of food can provide a comparatively stable source of funding, even during slow economic times.

Because households with less income tend to spend a higher portion of their annual income on food, one argument raised in support of sales tax on food reductions relates to tax equity. If the state were to tax food at the general sales and use tax rate, what options exist to mitigate the regressivity of the sales tax on food?

A regressive tax is one in which higher-income households pay less in tax *as a percentage of income* than lower-income households. Chart 4 provides data from the federal Consumer Expenditure Survey's "Food at Home" category. As the chart shows, the average annual dollar amount spent on food for home consumption is substantially greater at higher income levels than at lower income levels (roughly $6,000 compared to roughly $2,000). However, the percentage increase in food consumption is smaller than the percentage increase in income. As a result, food consumption as a percentage of income declines, as shown in the red line.

Chart 4
Food at Home Expenditures by Income Class

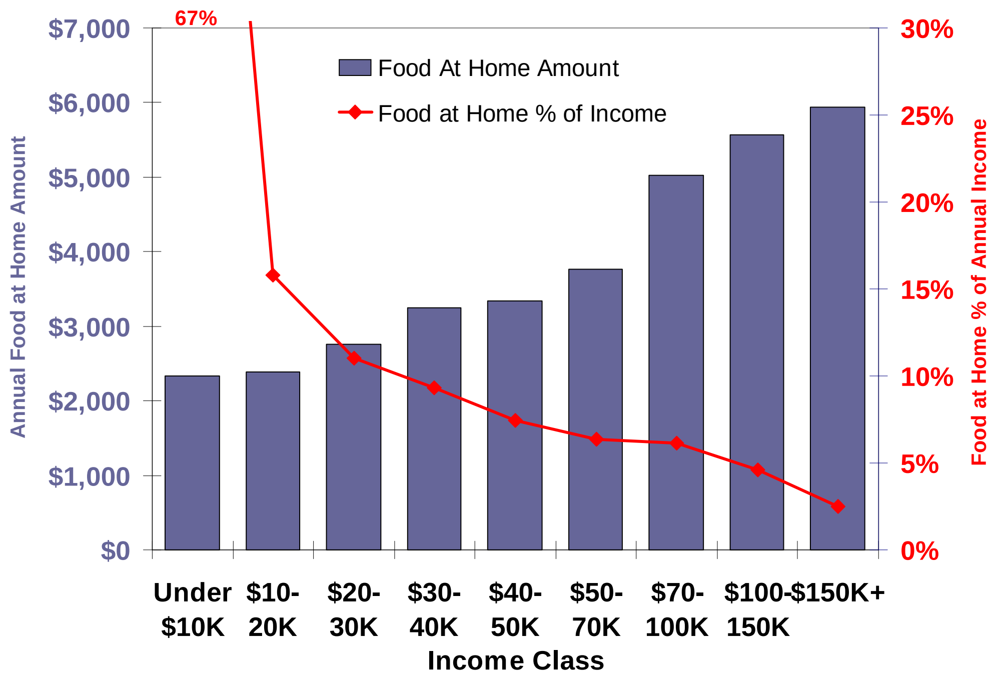


Table 1 below estimates sales tax on food amounts by income and household size at a 6.75% rate, based on federal consumer expenditure survey data.

Table 1
Estimated Sales Tax on Groceries, by Income and Household Size
6.75% State and Local Rate

	Household Size				
Income Class	1	2	3	4	5+
$0-10K	$100	$190	$230	$240	$290
$10-20K	$110	$190	$210	$240	$280
$20-30K	$120	$200	$240	$260	$280
$30-40K	$140	$210	$250	$310	$310
$40-50K	$140	$210	$270	$280	$360
$50-70K	$150	$240	$280	$310	$360
$70K+	$180	$290	$350	$400	$470

Assuming that Utah and national food consumption patterns are generally similar, to the extent a tax is imposed on these purchases, the tax will be regressive with respect to annual income. Understanding that low income households may purchase food using various sources of income, we also note that some food purchases, such as those made with food stamps or WIC vouchers, are exempt from sales tax.

When considering tax regressivity, we note an insight from the economic literature that income and consumption are not typically constant over a lifetime. Rather, both income and consumption tend to vary from year to year for a variety of reasons - some following relatively predictable lifetime patterns and some based on unique individual circumstances. Households may take these fluctuations into account and make consumption decisions based on time periods other than a year. Consequently, when considered over the long term, extreme years on either end tend to cancel each other out, and regressive taxes such as a sales tax may be less regressive when considered over a lifetime (and similarly, progressive taxes less progressive over a lifetime).[4]

For example, a young household may spend a significant portion of its income on food in the early years when parents are in school or just beginning a career. As the household's income increases over time or children grow up and leave home, the portion of income spent on food may decrease. When the parents retire and income drops somewhat, the portion spent on food may increase again. When considered over a lifetime, the tax incidence likely differs from the picture in any one year.

In addition, we point out that even though the sales tax on food is regressive with respect to annual income, households across the income spectrum receive substantial benefit from sales tax on food reductions - not just low income households. The consumer expenditure survey data summarized in Chart 4 indicates households with over $150,000 in income spend nearly 3 times as much on food as lower income households. So even though lower income households may receive a greater percentage benefit from a tax reduction, much of the dollar amount of the benefit accrues to those with higher incomes. In fact, we received estimates suggesting that between 1/3 to 1/2 of the benefit of recent reductions may have gone to households with annual incomes over $75,000.

To the extent the Legislature wishes to address sales tax on food regressivity through other means, several design options exist. We will provide additional options and information on ways to mitigate the regressive impact at a later date. Various income

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[4] Davies, James, France St-Hilaire, John Whalley. "Some Calculations of Lifetime Tax Incidence." *American Economic Review* 74 (September 1984): 633-49.

Fullerton, Don and Diane Lim Rogers. *Who Bears the Lifetime Tax Burden?* Washington, D.C.: The Brookings Institution, 1993.

Poterba, James M. "Lifetime Incidence and the Distributional Burden of Excise Taxes." *American Economic Review* 79 (May 1989): 325-30.

guidelines that the Legislature could consider in designing a credit are found in Appendix A.

If the state were to tax food at the general sales and use tax rate and enact any of the regressivity mitigation options requested above, what offsetting reduction in the sales and use tax rate would result in a revenue-neutral proposal?

Based on FY 2009 historical data, it appears that if the Legislature reinstated the full state sales tax rate on food and desired a revenue-neutral rate reduction, the general state sales tax rate could be reduced to between 4.35% and 4.40% (a 0.30% to 0.35% reduction from the existing 4.70% state rate).

Rates for local option sales and use taxes for which food was removed from the base vary across the state. Assuming a statewide average of 0.70% for these rates, a revenue-neutral reduction in local rates would be roughly 0.05%. However, this would vary by location.

To the extent the Legislature desires to enact a credit or program to mitigate sales tax regressivity, this would reduce the amount of the rate reduction. Table 2 shows the estimated state rate reduction at various levels of regressivity mitigation through a method such as a tax credit.

Table 2
Estimated Revenue-Neutral State Sales Tax Rates

Cost of Regressivity Mitigation	Estimated State Rate Reduction (Percentage Points)
$0	0.30% to 0.35%
$25 million	0.25% to 0.30%
$50 million	0.20% to 0.25%
$75 million	0.15% to 0.20%

We also note that because overall sales tax revenues have been declining, these estimates based on historical data may differ from estimates for future years. We understand that LFA will soon be updating their revenue estimates and can then provide you a more precise estimate of revenue-neutral rates for future years.

What tax policy considerations should the Legislature bear in mind in examining the sales tax on food?

At our February 18, 2009 meeting, the TRC adopted a motion stating that we believe good sales tax policy consists of taxing all final consumption uniformly, while excluding business inputs. We reiterate that statement. We invite the Legislature to consider what we believe are some good tax policy principles outlined below.

Economic Neutrality. In a properly functioning competitive market economy, price serves as the mechanism regulating consumption and production decisions. When tax policy unequally alters prices by taxing different types of consumption differently, it distorts economic decisions by favoring certain types of consumption and production over other types. We highlight that under the state's current sales tax system, most goods are taxed at one rate (within any particular jurisdiction), prepared food is generally taxed at a higher rate than the general rate, unprepared food is taxed at a lower rate than the general rate, and some types of consumption (such as many services) are not taxed at all. Among other things, this arrangement distorts market prices, thereby distorting market consumption and production decisions. A tax that taxes all consumption equally (i.e., has a broad base) and has a low rate improves economic neutrality.

Stability. Although not perfectly stable, as a necessity of life food consumption tends to be more stable than many other components of the sales tax base, some of which are much more dependent on economic conditions. As previously discussed, the sales tax on food tends to provide a stabilizing impact on the sales tax base.

Simplicity. A tax that is simple will generally be easier for taxpayers to pay and for tax collectors and enforcers to collect and administer. We note that a different sales tax rate on food increases the compliance burden for sellers by requiring them to differentiate between items taxed at different rates. In addition, the exact same food item may be taxed differently depending on the context of the sale.

Equity. As discussed earlier, the sales tax on food tends to be regressive when examined on an annual basis. We believe the Legislature should carefully consider options to offset this regressivity, as outlined above. We also note that most state sales tax on food revenues are deposited into the General Fund, which is the primary funding source for many programs targeted to low-income households.

Economic efficiency. Taxes on inelastic goods and services tend to create less economic inefficiency ("deadweight loss") than taxes on elastic goods and services. We note that food consumption is relatively inelastic and, by extension, likely generates less economic distortion than taxes on many other types of consumption.

Would the TRC recommend that the Legislature reconsider its action to reduce the state sales tax on food?

Yes. In addition to a general recommendation that the Legislature continuously examine its existing tax policies against principles of good tax policy, we specifically recommend that the Legislature restore the sales tax on food to the general state sales tax rate imposed on most other purchases provided that measures to mitigate the regressivity of such actions are also enacted. We also recommend that the Legislature restore food to the tax base of the various local option sales taxes from which it has been removed.

The TRC believes that this action to fully restore food to the sales tax base will improve the stability of the sales tax. As noted above, in a time of declining taxable sales overall, food sales have been a stabilizing factor in the sales tax base.

We believe that the revenue implications of this recommendation are best left to elected policymakers, as we believe the level of taxation is beyond our purview. The Legislature may choose to reduce the general state sales tax rate, reduce other tax rates to achieve a revenue-neutral outcome, or expend the revenue increases resulting from our recommendation.

In considering this tax policy change, we invite the Legislature to consider its intent in enacting sales tax on food reductions over the past several years.

To the extent the intent of the reduction was to benefit low income households, we suggest that there are better ways to target the desired population. The broad-based reduction enacted by the Legislature has proved to be an inefficient method to grant tax relief to those taxpayers who are most harmed by having to pay sales tax on food purchases. Indeed, estimates suggest that much of the tax relief has benefitted higher income households.

To the extent the intent of the previous reductions was to provide a broad-based sales tax reduction and continuation of that reduction is desired, we suggest a general sales tax rate cut as an alternative. When taxes are broadly based, the tax rate can be adjusted relatively easily to provide the desired amount of revenue. Estimates of revenue-neutral rate reductions are detailed earlier in the letter.

Conclusion
We hope that this information is helpful to you and other members of the Legislature as you deliberate on the state's tax policy related to sales tax on food.

Sincerely,

M. Keith Prescott

M. Keith Prescott, Chair
Utah Tax Review Commission

David J. Crapo

David Crapo, Vice Chair
Utah Tax Review Commission

Appendix A

Options for Income Eligibility Guidelines

Option 1. Link to Federal Poverty Guidelines

2009 Federal Poverty Guidelines

Family Size	75%	100%	125%	150%	175%
1	$8,123	$10,830	$13,538	$16,245	$18,953
2	$10,928	$14,570	$18,213	$21,855	$25,498
3	$13,733	$18,310	$22,888	$27,465	$32,043
4	$16,538	$22,050	$27,563	$33,075	$38,588
5	$19,343	$25,790	$32,238	$38,685	$45,133
6	$22,148	$29,530	$36,913	$44,295	$51,678
7	$24,953	$33,270	$41,588	$49,905	$58,223
8	$27,758	$37,010	$46,263	$55,515	$64,768

Option 2. Link to Income Eligibility Guidelines for Free and Reduced Price School Meals

Family Size	Reduced Price (185% of Federal Poverty Guideline)	Free (130% of Federal Poverty Guideline)
1	$20,036	$14,079
2	$26,955	$18,941
3	$33,874	$23,803
4	$40,793	$28,665
5	$47,712	$33,527
6	$54,631	$38,389
7	$61,550	$43,251
8	$68,469	$48,113