

# Utah Public Education at Risk

Summary: A Wakeup Call to Public Education .....	2
Revenue Issue #1 -- The Legislature has Siphoned Off Up to \$600 Million from the Education Fund .....	3
Revenue Issue #2 -- Basic Minimum Program Property Tax Rate Cut Almost \$400 million in the Past Twelve Years .....	6
Revenue Issue #3 -- Utah's New Income Tax Reform Means Lower Education Revenues Now and in the Future .....	8
Revenue Issue #4 -- Large Centrally Assessed Companies' Declining Share of the Property Tax Results in Fewer Education Dollars .....	10
Revenue Issue #5 -- Corporate Tax Under Assault .....	13
Expenditure Issue #1 -- Status Quo Budgets .....	15
Expenditure Issue #2 -- "Hollow Funding" .....	16

## **A Wakeup Call to Public Education – Your Funding is Being Siphoned Off to Other Programs**

Despite fairly generous increases over the past two fiscal years, Utah’s spending on Public Education still lags the rest of the country. An October 2007 Utah Foundation report noted Utah’s revenue “effort” on Public Education fell from a fairly high 12<sup>th</sup> place in the nation to 34<sup>th</sup> place in 2005.<sup>1</sup> On the flipside of the fiscal coin, revenue “capacity” to fund Public Education fell from 11<sup>th</sup> place in 1996 to only 22<sup>nd</sup> place in 2005.

This Utah for Public Schools report highlights the reasons why Utah’s Public Education spending has fallen off. In addition, it is a warning that if these trends persist, they will significantly limit funding to Public Education in the future. The Utah Foundation report in its final summary laments that:

To rise from the last place in the rankings would be fiscally daunting. To be just one rank higher in 2005 Utah would have had to spend about \$500 million more to be ahead of Arizona, which spent \$1,004 per pupil more than Utah. To rise to the middle of the states, ranking 25<sup>th</sup> nationally would have take more than \$1.4 billion in additional funding in 2005, or a 55% increase.<sup>2</sup>

While this appears to be “fiscally daunting”, this reports finds that systemic, if not systematic, changes have occurred in the past decade, that, if reversed, would bring in more than a \$1 billion in revenue **back** into Public Education. With the right combination of determination and grit, a reversal of fortune could be realized. **Utahns for Public Schools recommends that the Legislature reconsider its actions of the last decade and once again conclude that Public Education should be its top long-term economic development priority.**

<b>Revenue Issues</b>	<b>Fiscal Impact on Public Education</b>
1. Appropriations to Higher Education from the Education Fund Growing Fast and Leaped in FY2008	- \$250 million to - \$600 million
2. Cost to Public Education of Reducing Basic Minimum Rate	- \$381 million
3. Cost to Education Fund from Income Tax Reform	- \$220 to - \$245 million
4. Reform Centrally Assessed Practices that limit Property Taxes paid by Centrally Assessed Properties	- \$90 million
5. Cost to Education Fund from Reducing Corporate Franchise Tax to Exporters	- \$60 million
<b>Grand Total</b>	<b>- \$1.011 billion to - \$1.376 billion</b>

<sup>1</sup> Utah Foundation, “Utah’s Education Funding Effort”, August 2007, p. 2

<sup>2</sup> Ibid. p. 4.

## **Revenue Issue #1 – The Legislature has Siphoned Off Up to \$600 Million from the Education Fund, At First to Fund Higher Education and in FY 2008 to Fund Transportation Projects (Cost to Public Education -- \$250 to \$600 million per year)**

***Abstract.** Significantly altering the way the State's three major funds have been distributed has not only weakened General Fund programs, but also, indirectly the Education Fund. In fiscal year 2007-08 more than \$302 million will be diverted from deserving General Fund programs to fund transportation projects. Due to a constitutional change made in the 1990s, \$761 million will be diverted in fiscal year 2007-08 from the Education Fund to Higher Education. Opening up "arteries" of funding has allowed the Legislature to fund its pet projects first, forgetting that long-term economic development starts with an excellent school system, which produces a high-quality workforce.*

A ten-year effort by transportation fund proponents finally won out a few years ago with the passage House Bills 314 and 383 in the 2007 Session. These bills created a large artery of funding from the state sales tax into the Transportation Fund. In the current fiscal year, \$302 million<sup>3</sup> will flow from sales taxes into the Centennial Highway, Critical Needs and other Special Transportation Fund projects. With this one stroke of fiscal footwork the Legislature achieved two important policy wins:

- 1) "Starve the Health, Human Services and Public Employees Beast!" -- Denying the General Fund its claim to 7% to 11% increases over the past three years meant limiting funds for Medicaid, Health Services and higher public employee raises, which could have offset no raises during recession years.
- 2) "We Don't Need a Gas Tax Hike!" -- The motor fuel taxes on gasoline and diesel are particularly well suited to funding both transportation construction and maintenance needs. They are well suited because they are based on the "benefits" principle of taxation – those that drive the roads, pay for the roads. But because it is based on gallons consumed without a price component, it does not cover inflationary needs for salaries or for construction cost hikes from asphalt, concrete and steel. Therefore, periodic increases in the tax rate are necessary to cover inflationary driven cost increases.

In addition, continuous pressure from business groups has led to an increasing number of exemptions for business inputs. Currently, there are 68 specific exemptions,<sup>4</sup> compared to only 11 exemptions 17 years ago in 1981.<sup>5</sup> Furthermore well-meaning efforts to tax Internet sales have practicably failed and led to more complicated tax forms, and more discouragingly, tax loopholes for special retailers (e.g., Cabela's) for their Internet and

---

<sup>3</sup> Governor Jon Huntsman, Budget Recommendations, Fiscal Year 2009, p. 17

<sup>4</sup> Utah Code, Section 59-12-104, 2007 Supplement

<sup>5</sup> Utah Superseded Code, 1981, Section 59-15-6

catalogue sales. These were exactly the types of sales that the Internet thrust was supposed to bring into the tax net.

At first glance the \$302 million fiscal artery from the General Fund to the Transportation Fund might not appear to impact Public Education (Chart 1). But it has hurt the General Fund's ability to provide for its critical needs, one of which is Higher Education. If the needs for Higher Education cannot be met by funds from the General Fund, then the Education Fund will have to step up.

**Another disturbing trend was illustrated by the significant, one-year \$250 million increase in funding to Higher Education from the Education Fund. In fiscal year 2007, \$511 million was expended by Higher Education from Education Funds. The FY2008 appropriation allows Higher Education to spend up to \$761 million.<sup>6</sup>**

**At the same time, General Fund spending on Transportation capital projects leaped \$349 million between FY 2007 and FY 2008.<sup>7</sup> Most likely the bulk of this money came from sales taxes now dedicated to fund transportation construction projects. But first, the \$250 million appropriation increase in Education Funds, instead of the General Fund, used to fund Higher Education, allowed the Legislature to make the \$302 million increase in Transportation funds possible.**

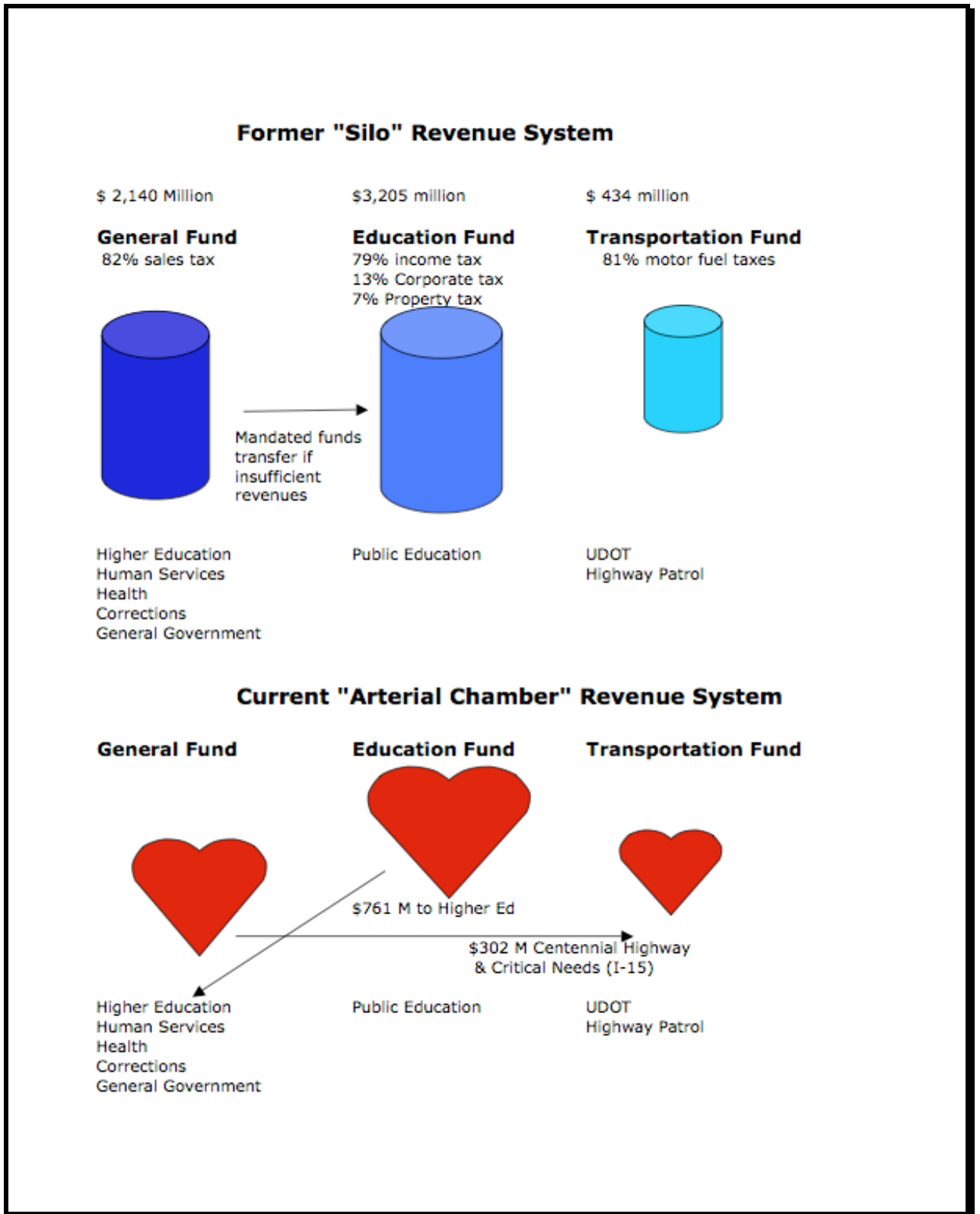
Chart 1 below highlights how the former, independent "Silo" system of state funding protected Education funding in the past. In the lower panel, under this new "Arterial Chamber" funding system, whatever program catches the Legislatures' current fancy can draw down funds. This year's fancy appears to be the widening I-15 in Utah County. This is not to say that widening I-15 is not a critical need. **But, if the backbone of Utah's thriving economy is its educated workforce, then, Utahns for Public Schools believes those demands need to be met first.**

---

<sup>6</sup> Governor Jon Huntsman, p. 96.

<sup>7</sup> Ibid. p. 155.

Chart 1. Revenue Distribution Funding Systems



## **Revenue Issue #2 -- Basic Minimum Program Property Tax Rate Cut Almost \$400 million in the Past Twelve Years (Cost to Public Education -- \$381 million per year)**

***Abstract.** Steady cuts to the basic minimum property tax over the past twelve years reduce funds to build a better education system. Significant class size reductions could have been funded, pre-school programs could have been expanded to all low-income children in the state, and significant salary increases could have made Utah teacher salaries more competitive. Instead, large cuts went to businesses and homeowners who already had property tax burdens well below average U.S. burdens.*

One of the key components of the Basic Minimum School Program is the equalization of the property tax contributions by each school district. In order to enjoy entry into the \$2.5 billion program each district must levy an equal rate on their taxable values. The property taxes based on the equal rate from each district are combined with income taxes (\$2.274 billion in FY2007-08) and then distributed back to each district on an equalized basis at \$2,514 for each weighted pupil unit (WPU).<sup>8</sup>

The Legislature has consistently cut the basic minimum rate over the past twelve years in order to grant token tax relief to businesses and homeowners. Over time, however, these rate cuts have become significant. Chart 2 below shows that in FY1995 the minimum basic (school) tax rate of 0.422% raised \$274 million for the basic program. Consistent rate cuts over time dropped the property tax infusion to the Basic Minimum School Program to \$232 million in FY2007 (on a rate of 0.1593%). Had the 0.422% rate been used in FY2007, the basic minimum rate would have raised \$613 million, \$381 million more than collected under the 0.1593% rate.

**This would have meant a near 19% revenue increase to the Minimum Basic Program, which could have been used in a multitude of productive ways. It could have brought teacher salaries ahead of national averages. It could have dropped the teacher/pupil ratio by 4 students per class. It could have been used to cut class size for 1<sup>st</sup> through 3<sup>rd</sup> grades by 12 students per class and provide pre-school classes for all the low-income students in the state who are not now covered by Head Start.**

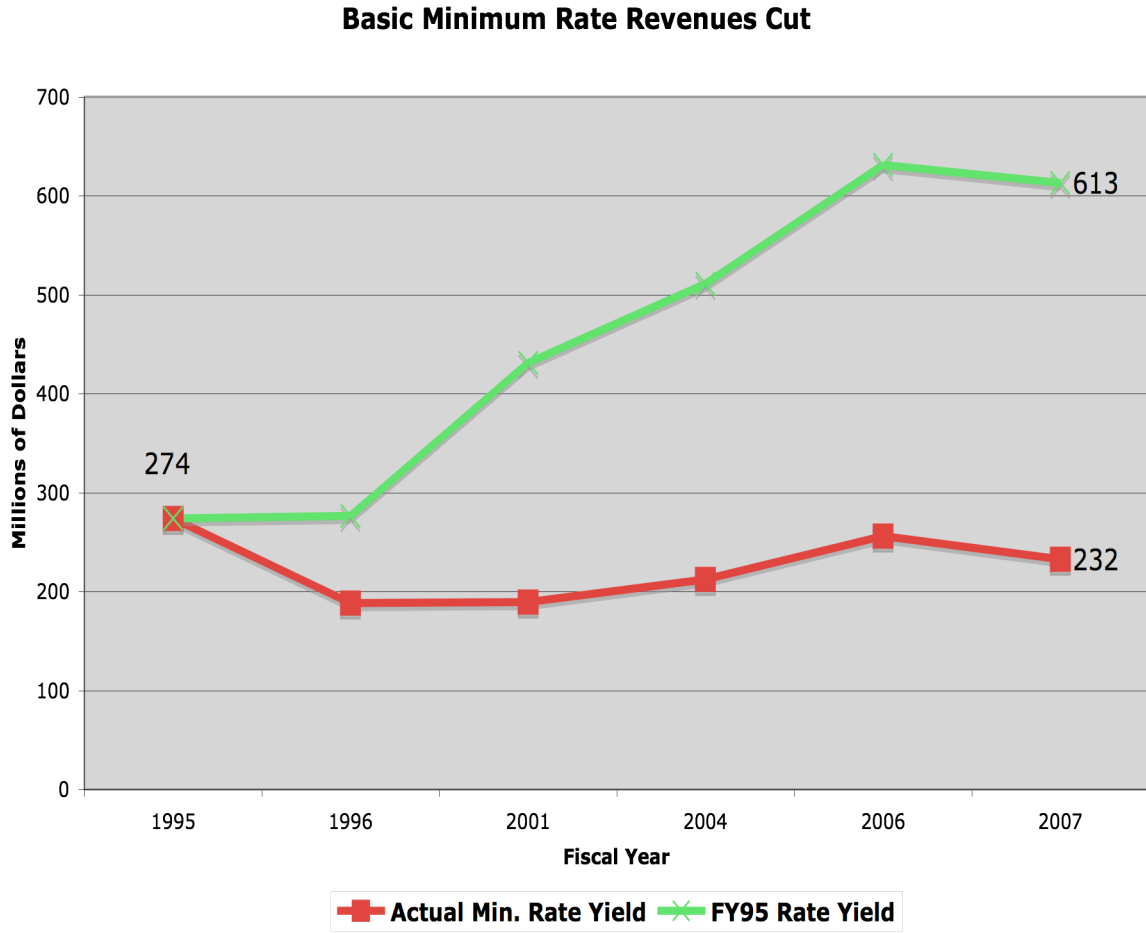
A chart in a recent Utah Foundation report identifies the cuts to the “Property Tax – Basic Levy” as one of the key reasons for the decline in Public Education spending “effort”.<sup>9</sup>

---

<sup>8</sup> Utah Code, Section 53A-17a-103

<sup>9</sup> Utah Foundation, “Utah’s Education Funding Report”, August 2007, p. 1

Chart 2. Fiscal Impact of Basic Minimum Program Property Taxes, FY95 to FY07



### **Revenue Issue #3 -- Utah's New Income Tax Reform Means Lower Education Revenues Now and in the Future (Cost to Public Education - \$220 million to \$245 million per year)**

***Abstract.** The lower effective rate and the abolishment of the multiple-rate bracket rate will reduce the long-run elasticity of future individual income tax revenues. Over the years this small elasticity compounds. Had the new system been in place from FY98 to FY07 the Education Fund would have received \$235 million less than it actually did.*

Despite the fact that recent income tax reform was highly touted as a means to protect the state's long-term economic viability, those responsible for this concept did not produce any empirical findings to support the notion. In fact, Utah's leading employment growth rate in the nation flew in the face of those complaining about its then 7% top-marginal income tax rate detracting from the Beehive's state' economic viability. It is true that the new income tax reform will slightly decrease the income tax's volatility, but volatility, if rationally budgeted and appropriated for, especially in good economic times, served as a boon to revenues. In fact, the ultimate, all-consuming goal of reformists was to lower the top marginal rate from 7% to 5%.

While most economists typically feel that, all things being equal, lower rates are better than higher rates, all things did not turn out to be equal. For example, most economists and accountants for high-income taxpayers will tell you that they look at the "effective marginal rates" to determine the true rate of tax. Because the old system included a substantial deduction for 50% of federal taxes, the former bracket system's effective rate was 5.76%,<sup>10</sup> not the "high, non-competitive" 7% as complained about by its critics. The new tax reform will experience lower revenues from the following changes:

1. For high-income taxpayers with large capital gains who will pay the new 5% marginal rate instead of the old system's 5.76% effective rate (the old 6.98% top rate adjusted for 50% deduction for federal taxes), revenues will decrease by about \$15 million per year.
2. Eliminating the 5 brackets, which ranged from 2% to 7%, will lower revenues to Utah's schools by about \$10 million per year.
3. The Legislative Fiscal Analyst's estimated revenue loss from income tax reform was \$220 million per year including all provisions.

A secondary analysis on long-term elasticity (new system response to growth in taxable income) revealed that the long-term elasticity from income tax may drop from 1.109% to about 1% due to reform. This means that when personal income rises 10%, the former system revenue system would increase on average 11.09%,<sup>11</sup> but, under the current reform revenues may increase only 10%. The Chart 3 below illustrates that, during the

---

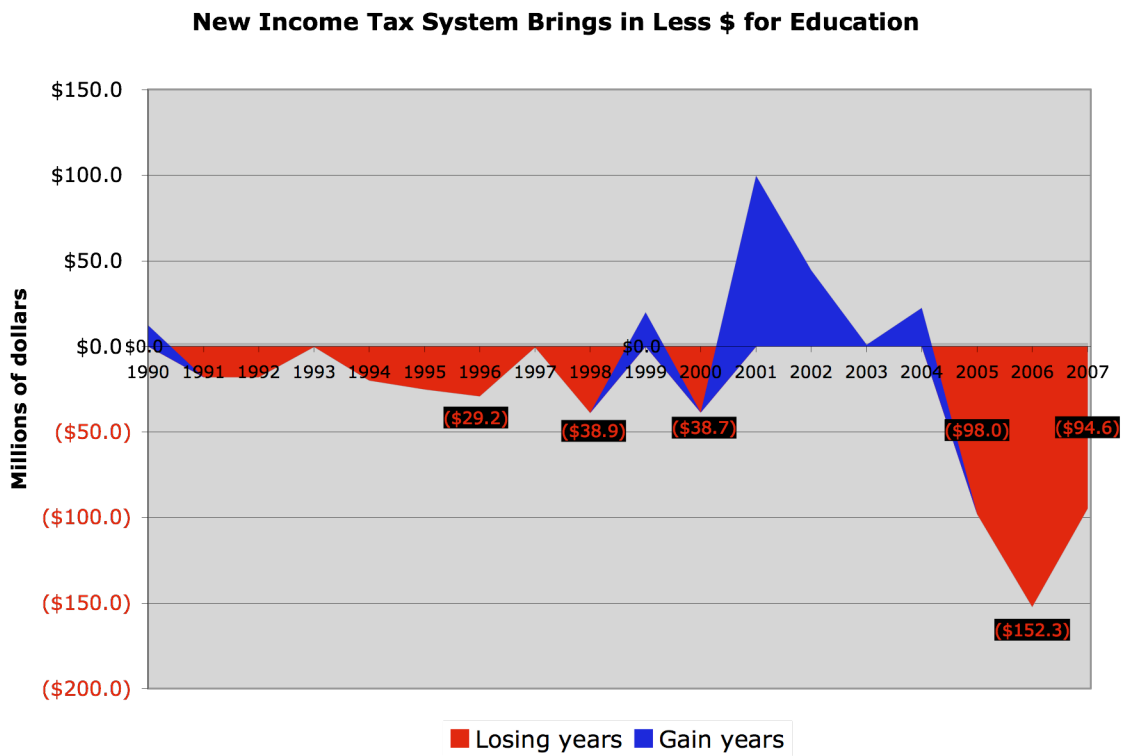
<sup>10</sup> Utah's former effective rate in 2007 was equal to:  $.0698 \text{ (top rate)} \times (1 - (.50 \times .35 \text{ top federal tax rate})) = .057585 = .0576$

<sup>11</sup> For the period between fiscal years 1988-89 to fiscal year 2006-07

past 10 years, had the new 5% single-rate income tax system been in place, the Education Fund would have received \$235 million less in revenues, compared to the former graduated 6-rate bracketed system.

Importantly, significantly less revenue would have accrued in the last three fiscal years. In fact, during fiscal year 2007, the income tax yield would have been \$94.6 million lower under the new single- and lower-rate system. In the 18 years simulated, significantly lower (more than \$10 million) revenues would have occurred in 10 of the 18 years. Significantly higher revenue would have accrued in 5 of the 18 years.

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



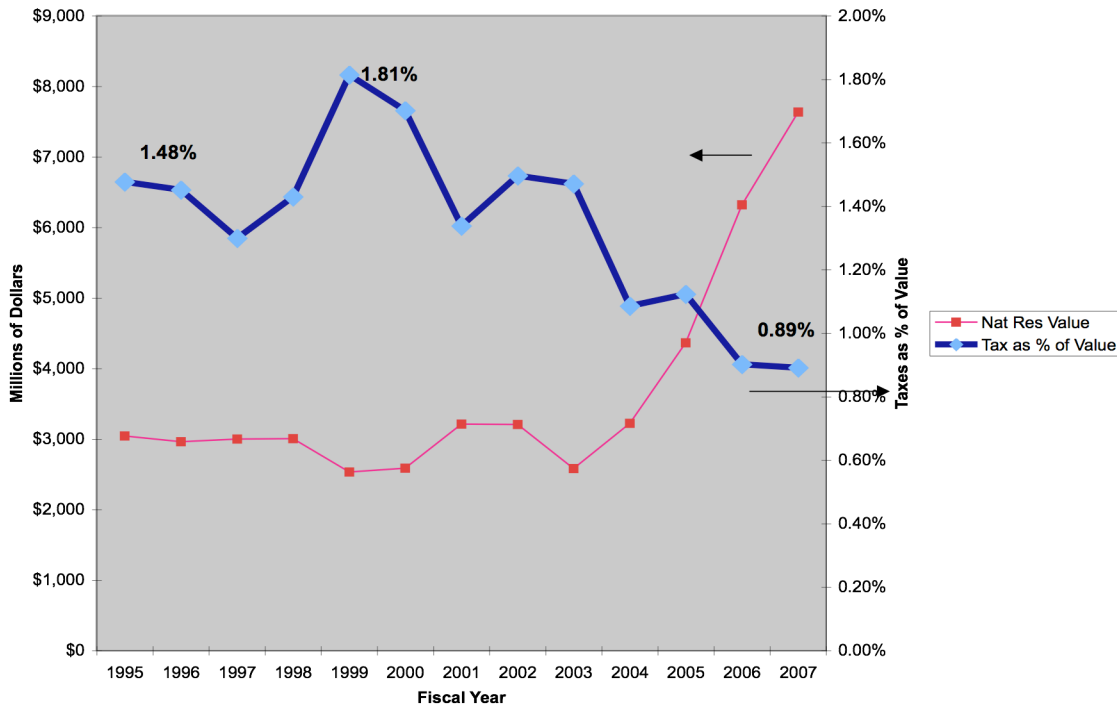
## Revenue Issue #4 – Large Centrally Assessed Companies’ Declining Share of the Property Tax Results in Fewer Education Dollars or Higher Tax Burdens to All Other Taxpayers (Cost to Public Education - \$90 million per year)

**Abstract.** A cursory analysis shows that property taxes paid by Centrally Assessed properties are either declining (utilities) or are not growing as fast as their values of production (natural resource companies). While to some extent this may be due to other factors, the assessment process appears to be tilted in favor of these big businesses.

Twelve years ago, in fiscal year 1995, natural resource companies and utilities paid 17% of Utah’s property tax burden. In fiscal year 2007 these same companies only paid 8.7%, about half as much.<sup>12</sup> To a certain extent this shift may be due to the large numbers and higher values of new homes and commercial businesses constructed since 1995.

However, a simple comparison of natural resource production values to their property taxes indicates a significant tax gap may exist. Chart 4 compares the rise in values of natural resource companies with the property taxes they paid from fiscal year 1996 (\$3.1 billion) to fiscal year 2007 (\$7.6 billion). Even though values went up 158% in this period, property taxes only rose 58%. The effective property tax rate (taxes as a percent of value) fell from 1.48% in fiscal year 1995 to 0.89% in fiscal year 2007.

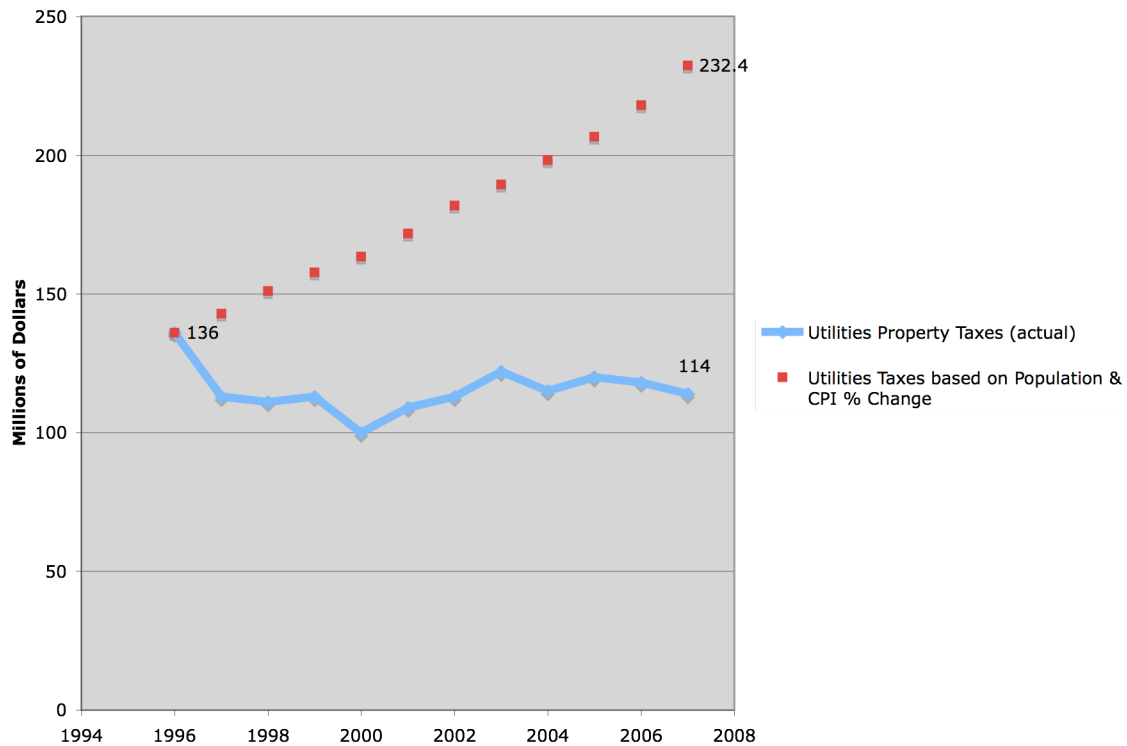
Chart 4. Natural Resource Company Production Values vs. Effective Property Taxes



<sup>12</sup> Annual Reports of the Utah State Tax Commission, fiscal years 1995 -2007, <http://tax.utah.gov/research/reports.html>

A more significant property tax gap can be found in the growth of utility property taxes. Under normal circumstances one would expect utility property taxes to grow with (U.S.) inflation and Utah population. But between fiscal year 1996 and 2007 utility property taxes fell 1%, while the sum of population and inflation in Utah rose 62%.<sup>13</sup> Chart 5 compares actual natural resource company property taxes with an estimate based on inflation and population. Had utility property taxes grown with inflation and Utah population, they would have risen to \$245 million in fiscal year 2007, instead of the \$112 million in actual property taxes charged.

Chart 5. Utility Property Taxes vs. Taxes Growing with Inflation and Population



What are the causes for these disturbing trends? To be sure our estimates are somewhat simplistic, but they still point to a potentially serious long-run revenue problem. There are many reasons why natural resource and utility properties (mines, oil drilling and pipelines, airplanes, trucking, railroads and electrical and natural gas utilities, also known as Centrally Assessed Property) may be undervalued. The following are our conjectures of part of the problem:

- 1) Centrally assessed taxpayers have the legal and financial resources to appeal their taxes on a regular basis.
- 2) Companies can spend more money on expert witnesses.
- 3) Tax Commission staff are probably insufficient in numbers, salary and sometimes in expertise. In some cases, staff does not feel supported by the Commission.

<sup>13</sup> Economic Report to the Governor 2008, p. 41 and 109.

- 4) Rulings by the Commission tend to split the difference between staff recommendations and company valuations, lowering values.
- 5) Fiscal notes on property tax legislation often do not include the total impact due to lack of time and resources to complete the note and sometimes interference from political pressure.<sup>14</sup>
- 6) The Utah Office of Education, unlike the Utah Association of Counties, does not play a role in the appeal process and protect its tax base.
- 7) The Tax Commission can interpret a statute more broadly and by doing so can create a new sales or property tax exemption.<sup>15</sup>

Utahns for Public Schools estimates that reversals of these two areas would increase property taxes by \$163 million per year, and if rates were not lowered would bring in about \$90 million to Public Education.<sup>16</sup>

---

<sup>14</sup> Deseret News, "Fiscal abuse costs 'real money'", December 8, 2006, p. A20.

<sup>15</sup> Daily Utah Chronicle, "State makes college textbooks tax-free", March 6, 2008

<sup>16</sup> Salt Lake Tribune, "Counties Sue, say Verizon undertaxed", March 1, 2008

## **Revenue Issue #5 -- Corporate Tax Under Assault (Cost to Public Education -- \$60 million per year)**

***Abstract.** Over the past three years, bills in the Legislature have called for the complete elimination of or material reductions to the corporate franchise tax. Corporate Franchise taxes are projected to raise \$330 million in fiscal year 2008-09. Currently, Second Substitute SB28 proposes to reduce corporate taxes for companies who export most of their products to a level below what an average family pays in income tax. By 2013 the annual cost of this bill will probably reduce corporate franchise taxes by more than \$60 million per year, an 18% cut.*

Some economists and businessmen like to expound that “Corporations do not pay taxes, only people do.” But who are these people? Mostly, they are wealthy shareholders from the East Coast, from California, from Europe and from the oil-rich, middle-eastern countries. Over the past three years, Utah’s corporate franchise tax has been under assault by taxpayer groups, their legislators and even the Governor, who called for its repeal in the 2006 legislative session. The latest attack (SB 28 Apportionment of Business Income) intends to decrease the corporate tax burdens for some of Utah’s richest corporations from millions of dollars down to a level below what the average Utah family pays in income tax (Table 1).

Utah’s 5% corporate franchise tax was designed to, as fairly as possible, have each corporation pay a tax on its Utah taxable income expressly “for the privilege of exercising its corporate franchise or for the privilege of doing business in the state.”<sup>17</sup> The State of Utah directly or indirectly provides the following valuable resources to businesses so they can effectively compete and prosper:

- 1) The State provides services to educate a high-quality work force at relatively low wages.
- 2) The State provides an adequate transportation system to transport employees, goods and services to its corporations.
- 3) The State provides a legal system of commerce and taxation laws that protect land and property.
- 4) The State regulates its utilities to insure lowest possible electricity and natural gas prices for manufacturers and mining companies.
- 5) The State provides law enforcement and incarceration facilities to minimize the effects of personal and corporate crimes and other services to enhance the quality of life for the corporation and its employees.

---

<sup>17</sup> Utah Code, Subsection 59-7-104 (1)

For all these and more, the State requires a 5% tax<sup>18</sup> on net apportioned taxable income, which is expressly dedicated to fund and improve Utah public and higher education systems. Corporations may not be people in the human being sense, but they are legal entities, and have legal rights and legal standing in our courts just like individuals.

Table 1 below illustrates how a corporation, which exports almost all of its production, will fare under the proposed Second Substitute SB 28. The highly regarded 3-factor formula, which was used to fairly apportion national company profits to Utah for the past 30 years, used equal shares of Utah's property, payroll and sales into Utah to apportion profits to Utah. This formula was mutated in 2006 to double-weight the sales factor, granting exporters a 25% reduction in their tax for tax years 2006 through 2008 (see second column in Table 1).

When (and if) it fully phases-in during fiscal year 2012-13 Second Substitute SB28 could drop corporate taxes for Utah's major exporting companies close to the minimum tax of \$100. This would strike a blow to fairness and equity, both with respect to corporations who have significant portions of their sales into Utah and to Utah families whose median income tax burden was \$1,810 in 2005.<sup>19</sup>

**Table 1. How Utah Exporters' Corporate Tax Will Decrease Exporters' under SB28**

<b>Hypothetical mining company, \$100 million in U.S. profits</b>	<b>CY 1976-2005 3-Factor (Equal Weights)</b>	<b>CY2006 - 08 Double-Weighted Sales Formula</b>	<b>SB 28 Single Factor Formula, fully phased in, 2013</b>
Utah's share of payroll to U.S.	20.00%	20.00%	
Utah's property share to U.S.	40.00%	40.00%	
Utah's share of sales to U.S.	0.01%	0.01%	0.01%
Total share	60.01%	60.01%	
Weight (divide by)	3	4	1
Utah apportionment factor	20.00%	15.00%	0.01%
<b>U.S. Profits</b>	<b>\$100,000,000</b>	<b>\$ 100,000,000</b>	<b>\$100,000,000</b>
Utah apportioned profits	\$ 20,000,000	\$ 15,000,000	\$ 10,000
Utah corporate tax rate	.05	.05	.05
<b>Utah corporate tax</b>	<b>\$1,000,000</b>	<b>\$750,000</b>	<b>\$500</b>
Percent change		- 25.0%	-99.95%

<sup>18</sup> Utah Code, Subsection 59-7-104 (2)

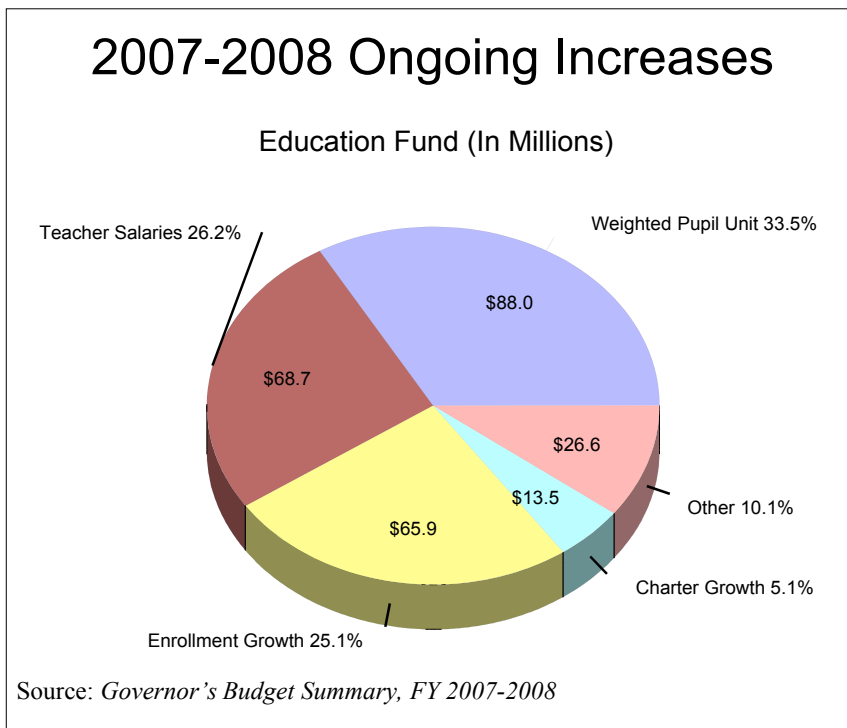
<sup>19</sup> <http://tax.utah.gov/esu/income/state05/rxfxline.PDF>

## Expenditure Issue #1 – Status Quo Budgets

Increases in the Public Education budget have been used primarily to pay for enrollment growth and inflation. Teacher salaries have also increased. But new funds to 1) lower class sizes, 2) handle greater English (as a) Second Language (ESL) populations, and 3) focus on math and science instruction, have not been forthcoming.

The Legislature increased ongoing school funding by \$265 million for the 2007-2008 school year. Much of that (\$235 million) went to maintaining existing levels of service.

Some important programs have not received needed increases.



1. A recent audit by the Legislative Auditor General reported that “Essentially, for the last six years CSR (Class Size Reduction) funds functioned as maintenance funding rather than providing for new class size reduction efforts.”<sup>20</sup>
2. The Local Discretionary Block Grant (\$21.8 million) has not been increased since its inception in 2001.
3. The Highly Impacted Schools Program, a program designed to bolster schools

<sup>20</sup> *A Performance Audit of Class-Size Reduction Funds*, December 2007, Utah Legislative Auditor General, pg. 17

facing the challenges of a high concentration of minorities, single heads of households, high poverty, and limited English proficiency, has seen few increases since it was started in the late 1990's.

4. Despite its overwhelming success and popularity, the K-3 Reading Readiness program has never received a funding increase.
5. Funding for school bus transportation has not keep pace with exploding fuel costs. Districts have been forced to take money out of classroom instruction to fill fuel tanks and heat buildings.

## **Expenditure Issue #2 – “Hollow Funding”**

Funding for some past reforms has been “hollow.” That is, ongoing programs have been started or ongoing needs have been funded with one-time funding. When the one-time funding runs out, the program or need remains but lacks the financial means to continue. Listed below are three examples:

1. The optional full-day kindergarten program was funded with a \$30 million one-time appropriation with direction that the funding should be spread out over the next four years. This means that in four years the money for this program evaporates leaving a hole that may or may not be filled.
2. House Bill 181, *Education Reform*, (2006 General Session) started two reform projects with one-time funding: 1) a basic skills competency test remediation program, and 2) a grade 4-6 math improvement program. Neither program was recommended nor endorsed by educators. But, both have experienced limited success. Eventually, the one-time funding will be spent leaving the shell of an ongoing program needing money.
3. Other ongoing needs funded with one-time money include \$50 million for technology; \$8 million for school transportation; and \$10 million for teacher supplies.

