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TAX SYSTEM DESIGN

What is the Goal of a Tax System?
Utah's Tax Portfolio Highlights Tradeoffs Among Different Tax Choices

Taxes generate revenue to pay for public services demanded by citizens. These services, such as transportation, public safety, corrections, courts, health care, water, air quality, parks, and education provide economic and societal benefits.

These benefits come at a cost. Revenues from taxes, fees, intragovernmental transfers, and other sources cover the service spending levels policymakers select. This paper focuses on the tax portion of these revenue sources.

Tradeoffs Among Tax Ideals

Tax policy addresses tradeoffs among competing ideals. Because tradeoffs frequently arise, setting tax policy involves value judgments as to which ideal takes precedence. The following major policy ideals drive common tax tradeoffs:

- Revenue Sufficient
- Efficient
- Fair
- Easy to Administer and Comply
- Accountable

> *"There are no solutions, only tradeoffs."*
>
> – Thomas Sowell –

Each individual tax in an overall revenue portfolio may fare better or worse on each ideal, depending on that tax's underlying economic base and specific system design features. Informed crafting of tax policy assesses tradeoffs among different tax ideals to achieve the desired system-wide balance, including offsetting where possible any shortcomings of one tax with strengths of another.

The following explains aspects of each major tax ideal in more detail.

Revenue Sufficient – An ideal tax system consistently generates sufficient revenue to plan for and meet the core public service needs of citizens. Taxes fundamentally exist to fund core services demanded by citizens at levels selected by policymakers. Unlike many private sector businesses which see both demand and revenue fall during economic downturns, governments often face higher demands for services just as revenues decrease. This countercyclical demand for some government services

requires thoughtful budget implementation to maintain fiscal sustainability when downside revenue volatility occurs. A reliable tax system for taxpayers and service recipients sustainably raises sufficient revenue to deliver core public services over the business cycle; facilitates budget balance by allowing revenue estimation with reasonable accuracy; responds to inflation, population, and economic changes; provides taxpayers sufficient ability to anticipate the tax consequences of economic decisions; and ameliorates unanticipated impacts of tax system changes, including through transition measures.

Efficient – An ideal tax system minimizes market distortions. Policymakers must balance the economic and societal benefits of public services against their economic and societal costs. An economically efficient and neutral tax system minimizes adverse effects on household and business decisions by imposing low tax rates across a broad tax base; treats similar transactions similarly; allows free markets to drive economic decisions by broadly focusing on widely-applicable tax provisions rather than narrow tax provisions only for certain taxpayers; fosters a positive overall climate for economic growth; avoids using the tax system to incent desired behavior that would occur absent any incentive; clearly articulates the justification for preferential tax treatment (if any) and regularly scrutinizes special treatment (if any) for promised outcomes; prevents tax-driven zero-sum behaviors among local jurisdictions or taxpayers; and cultivates economic competitiveness with other states and nations.

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Fair – In an ideal tax system, taxpayers perceive the system to be equitable. Fairness takes into account a broad array of issues impacting taxpayer perceptions. These issues include the amount of tax paid by taxpayers individually and in aggregate; taxpayer ability to pay considering the impact on differently-situated taxpayers, including vulnerable populations such as low-income households (vertical equity) and the impact on similarly-situated taxpayers, such as those at similar income levels (horizontal equity); and the benefits principle, where those who use or otherwise benefit pay for the costs of services (particularly services other than social welfare and non-rival and non-excludable goods, termed "public goods").

Easy to Administer and Comply – An ideal tax system minimizes burdens of compliance and administration. It clearly specifies how to determine the tax amount and related tax procedures; balances the cost-benefit ratio for collection, administration, and enforcement; minimizes where possible the costs borne by businesses and households to comply with tax laws (including both explicit out-of-pocket compliance costs, as well as implicit costs such as time); and ensures efficient filing and reporting requirements.

Accountable – An ideal tax system achieves accountability, transparency, and simplicity, which engender confidence in the tax system. It allows taxpayers to easily know how much tax they should pay, to which entity they pay the tax, and how the taxing entity uses tax funds; protects personal and proprietary information; minimizes tax pyramiding; minimizes noncompliance and evasion; continually monitors the impact and effectiveness of tax policies (including regular scrutiny for preferential tax treatment); clearly notifies taxpayers when tax changes occur; and minimizes tax-created economic distortions.

How Do Economists Classify Goods?

Economists often classify goods into four types (private goods, public goods, common resources, and club goods) based on characteristics of rivalry and excludability. Rivalry means one person's use of a good or service infringes on or impedes someone else's use. Excludability means people can be excluded from using a good or service (often tied to payment).

Table 1: Types of Economic Goods

	Rival	Non-rival
Excludable	Private good *(food, clothing, congested toll road)*	Club good *(satellite TV, digital music, uncongested toll road)*
Non-excludable	Common resource *(fish in the ocean, timber in a forest, congested non-toll road)*	Public good *(national defense, lighthouse, uncongested non-toll road)*

Source: Greg Mankiw, *Principles of Economics,* Kem C. Gardner Policy Institute

Data's Role in Tax Policy

Designing a tax system represents an adaptive rather than purely technical challenge. Unlike a technical challenge with a clear problem and solution, adaptive challenges require learning and stakeholder involvement to carefully specify the challenge and craft mutually agreeable solutions. Tax policy requires those involved to answer important value questions that address underlying tax policy tradeoffs.

Good data can help inform the process. For example, data can shape understanding of the tax burden distribution under different tax portfolio combinations, but it cannot answer the normative question of what the tax burden distribution should be. Similarly, data can provide insight into the historical volatility of existing revenue streams, but it cannot assume the role of determining appropriate funding levels, which citizens and policymakers jointly address as they navigate the tradeoffs between public service levels and taxation.

In short, data can inform decision-making, but setting tax policy involves judgment as to which tax ideal takes precedence.

"The universal truth about taxation is that people want government without paying for it. The history of taxation is the story of a struggle among individuals and groups intent upon achieving that goal for themselves or for their groups."

– Glenn W. Fisher –

Tradeoff Example 1:

Weighing Revenue Sufficiency Against Fairness

A tradeoff may occur between revenue sufficiency over the business cycle and the fairness of the tax burden distribution. For example, income tax overall exhibits more volatility than other major revenue streams, such as sales tax and property tax. But not all income sources within the individual income tax base drive this volatility. Wages and retirement income such as Social Security, pensions, and individual retirement accounts (IRAs) tend to experience mostly steady growth, resulting in substantial revenue reliability.

Conversely, other income sources such as interest and dividends, capital gains, and business income demonstrate much higher volatility, driving much of the overall income tax volatility.

High-income households receive a much larger share of their income from these volatile income sources (Figure 2). One policy design choice to increase revenue reliability would be to only tax wage and retirement income and exclude from the tax base more volatile capital gains, interest and dividends, and business income. However, the associated tradeoff would be to shift the tax burden downward to low- and middle-income households. The highest-income households on average generate about 80% of their income from these volatile revenue sources, while the low- and middle-income households on average generate 10% or less of their income from these more volatile income sources.

Figure 1: Major Utah Individual Income Source Nominal Year-Over Growth Rates, 2000–2022

Source: Utah State Tax Commission
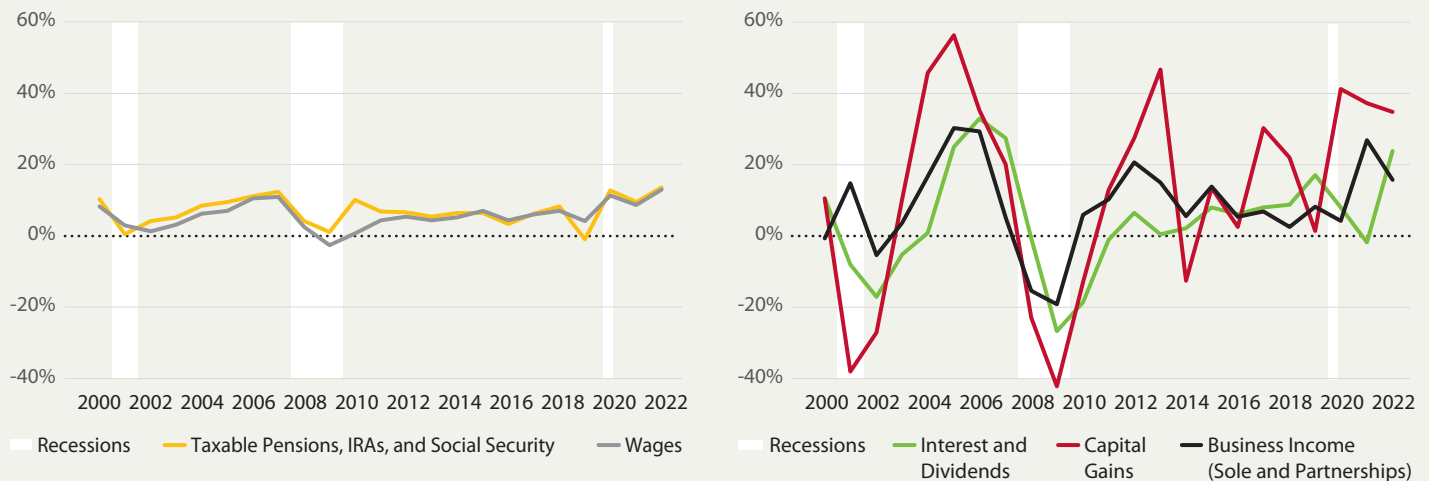
Figure 2: Utah Individual Income Source Composition by Income Level, 2022

Source: Utah State Tax Commission
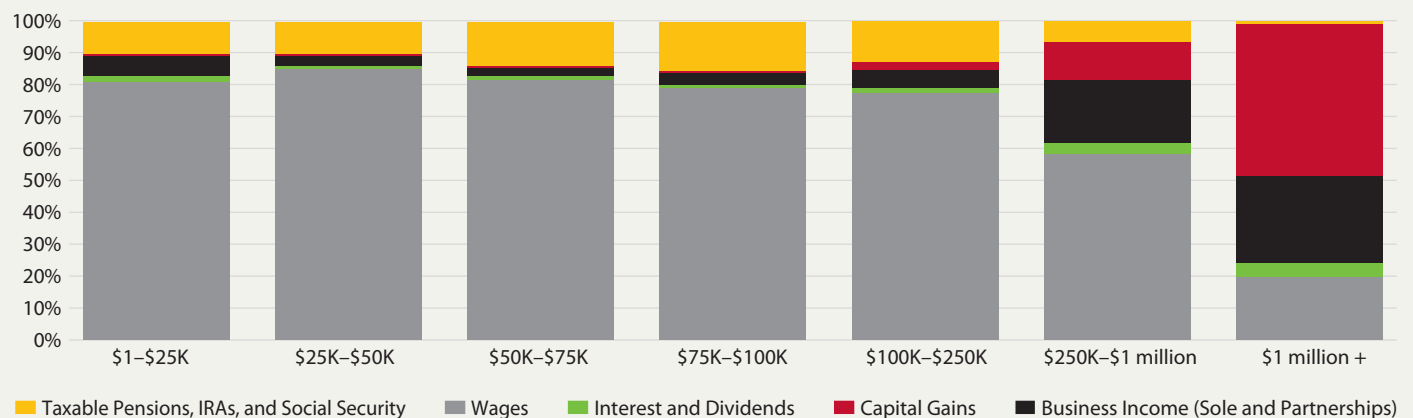
"Don't tax you. Don't tax me. Tax that fellow behind the tree."

– Sen. Russell Long –

Tradeoff Example 2:

Weighing Efficiency Against Fairness

Another tradeoff may occur between economic efficiency and perceptions of fair tax burden distribution.

Taxes create economic drag, or inefficiency, when they distort market price signals away from the economic optimum. That is, when taxes cause resource misallocation, they shrink the size of the economy from what it would otherwise be. The demand for and supply of some types of goods and services respond little to price changes, while others respond substantially. The greater the market response to tax-induced price changes, the greater the economic drag. A tax policy designed only to minimize market distortions would more heavily tax items that respond the least to price changes.

For example, as a necessity, taxing the broad category of food purchases results in very minimal economic drag since everyone must eat. Research indicates individual types of grocery food consumption also demonstrate low price elasticity—meaning food purchases exhibit lower price sensitivity than many other types of goods that respond more to price changes. Even when the price of grocery food (including the tax) rises, consumption remains relatively steady compared to other categories of consumption, including food away from home (primarily restaurant food).

Table 2 shows estimated elasticities of food and beverage categories. Higher elasticities exhibit more responsiveness to price changes (more price elastic), whereas elasticities closer to 0 demonstrate less responsiveness (less price elastic). Taxing the lower elasticity items will result in less economic drag than taxing the higher elasticity items.

Table 2: U.S. Price Elasticity Estimates by Category, 1938-2007

Food and Beverage Category	Estimated Absolute Value of Mean Price Elasticity of Demand
Food away from home	0.81
Poultry	0.68
Cereals	0.60
Milk	0.59
Vegetables	0.58
Eggs	0.27

Source: Andreyeva, T., Long, M.W., & Brownell, K.D. The Impact of Food Prices on Consumption: A Systematic Review of Research on the Price Elasticity of Demand for Food American Journal of Public Health, 100, 216-222, https://doi.org/10.2105/AJPH.2008.151415

While economically efficient because of its price insensitivity, taxing food creates a greater burden relative to income on low- and middle-income households who spend a larger share of their income on grocery food (Figure 3). While some of these purchases, particularly for those at the lowest income levels, receive tax exemptions through programs like SNAP, WIC, or private food pantries, taxing food will impose a greater burden as a share of income on low- and middle-income households than on high-income households.

That is, when considering both grocery and restaurant food taxation, policymakers face a tradeoff between economic efficiency and tax burden distribution.

Figure 3: Estimated Average Sales Tax on Food by Income Decile, 2023

Legend (left chart):
- Annual State Sales Tax on Food
- Annual State Sales Tax on Food (SNAP-Adjusted)
- Average Household Income (Right Axis)

Legend (right chart):
- Annual State Sales Tax on Food as Share of Household Income
- Annual State Sales Tax on Food as Share of Household Income (SNAP-Adjusted)
- Average Household Income (Right Axis)
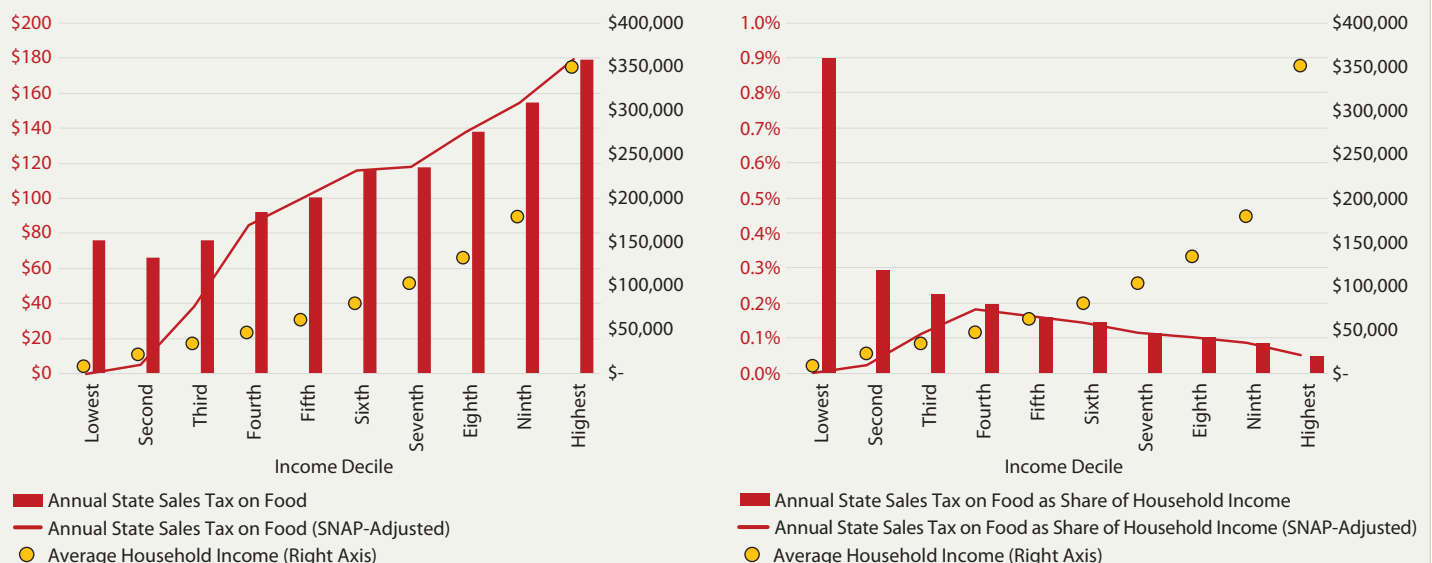
Source: Kem C. Gardner Policy Institute analysis of U.S. Bureau of Labor Statistics and Utah Department of Workforce Services data

Tax System as a Portfolio

Public finance researchers often compare different tax revenue streams to investments held in a personal financial portfolio, such as a 401(k). Each tax portfolio component generates tradeoffs associated with its characteristics, including distinguishing features such as reliability, distribution of the tax burden, compliance and administrative costs, accountability, transparency, simplicity, and impacts on the economy.

Policymakers balance each tax's tradeoffs as they choose how to weight different aspects of their revenue portfolio.

For example, one tax revenue stream may function like a fund with stocks of startup tech companies, with high growth potential but major downside risk. Another revenue stream may function more like a fund with long-standing utility company stocks, with slower but more predictable growth.

Figure 4: Example Investment Fund Options by Risk/Reward and Annual Return
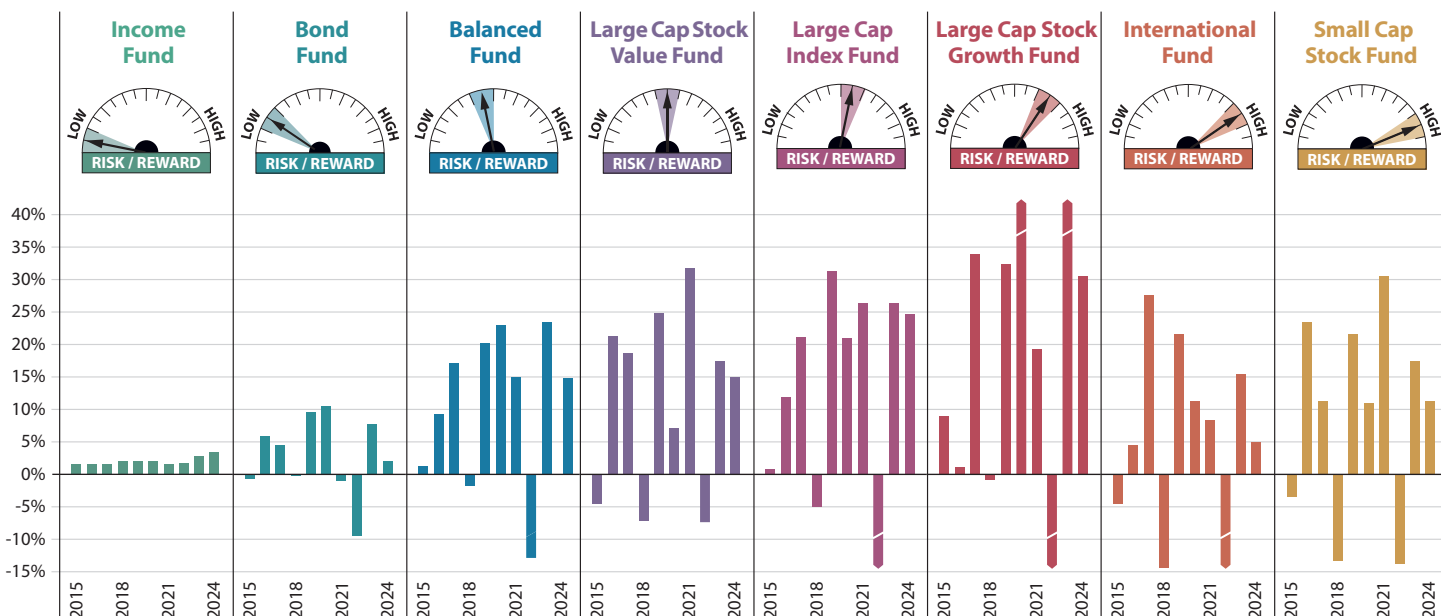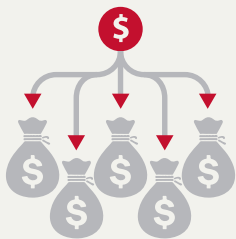
Source: Utah Retirement Systems

Utah's Three-Legged Stool

Analysts sometimes refer to Utah's current tax portfolio as a three-legged stool because three major tax types comprise over 90% of Utah's state and local tax portfolio. These consist of (1) individual and corporate income taxes ($7.1 billion), (2) state and local sales and use taxes ($7.1 billion), and (3) property taxes ($5.2 billion) as of FY 2024.

Other taxes such as the mid-sized motor and special fuel excise taxes ($0.7 billion) and smaller tax revenue sources such as beer, cigarette, and tobacco excise taxes, severance taxes, and insurance premium taxes make up the remainder. In addition to taxes, the State of Utah and its local governments impose fees and receive revenue from other levels of government.

Notably, even with sizable income tax cuts in recent years, the income tax leg of the three-legged stool remains as large as the state and local sales tax leg. As of 2024, property taxes (imposed exclusively by local governments) generate nearly $2 billion less than income and sales taxes, so the three-legged state and local revenue stool currently lacks complete balance.

Diversification

də-,vər-sə-fə-ˈkā-shən

Owning a wide variety of investments with different characteristics to reduce volatility

Source: Investopedia

Individual and Corporate Income Taxes
($7.1 billion)

State and Local Sales and Use Taxes
($7.1 billion)

Property Taxes
($5.2 billion)
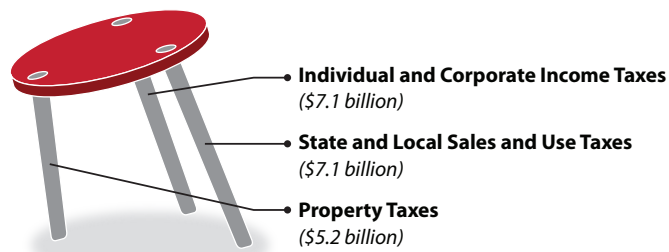
Figure 5: Utah's Combined State and Local Tax Portfolio Composition, FY 1920-2024

Legend: Property, Individual and Corporate Income, Sales and Use, Motor Vehicle and Fuel, Excise (Non-fuel)
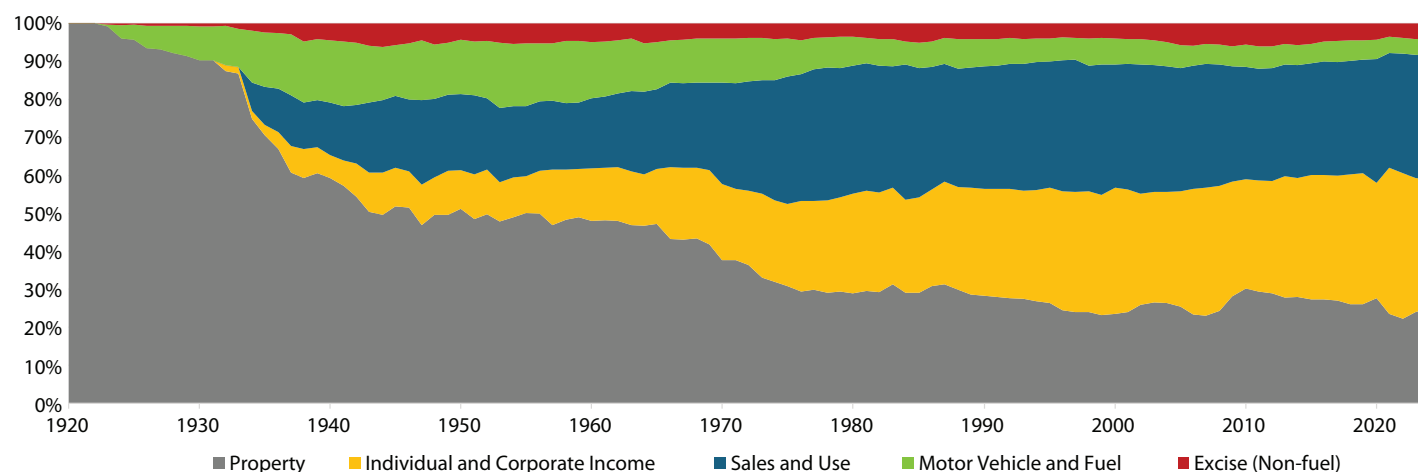
Source: Utah State Tax Commission

Figure 6: State of Utah Tax Portfolio Composition, FY 1920-2024

Legend: Property, Individual and Corporate Income, Sales and Use, Motor Vehicle and Fuel, Excise (Non-fuel)
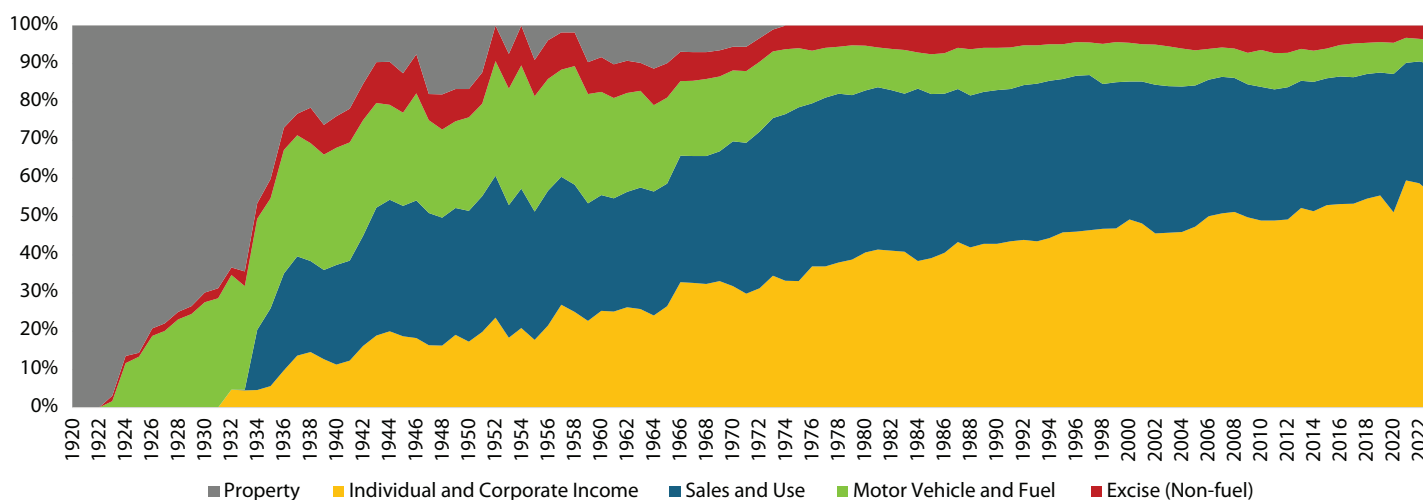
Source: Utah State Tax Commission

Figure 7: Utah Local Government Tax Portfolio Composition, FY 1920-2024

Legend: Property, Sales and Use, Motor Vehicle and Fuel, Excise (Non-fuel)
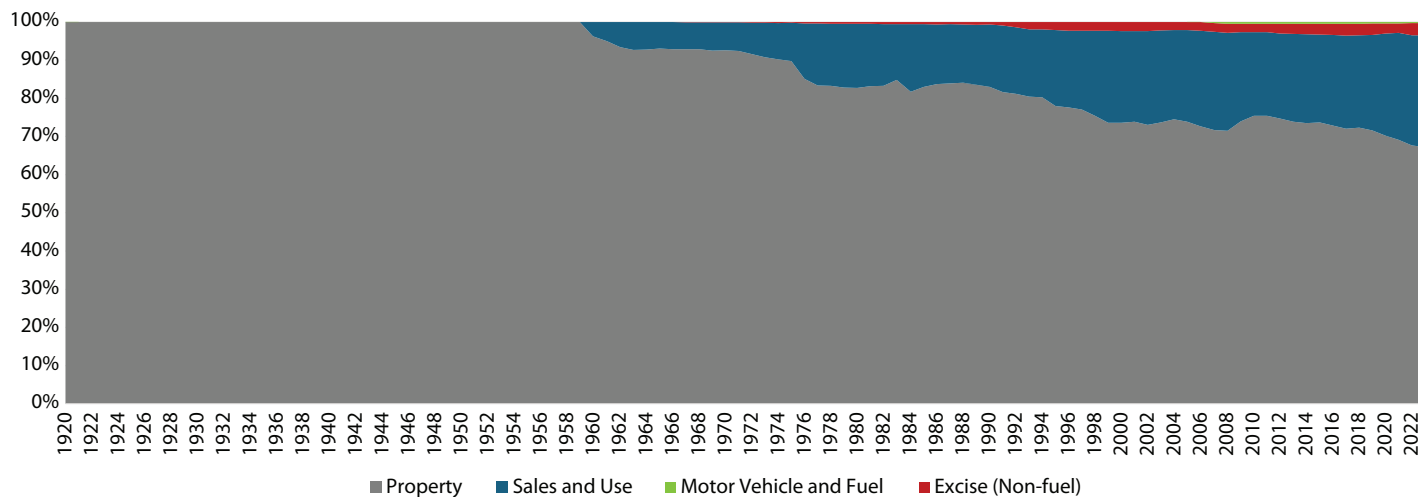
Source: Utah State Tax Commission

Income, Consumption, and Wealth

Income (Inflow)
- Wages
- Dividends
- Interest
- Capital Gains

Consumption (Outflow)
- Housing
- Groceries
- Utilities
- Health Care
- Transportation

Assets (Stocks of Wealth)
- Cash
- Bonds
- Business Stocks
- Real Estate
- Cars

Source: Kem C. Gardner Policy Institute

PORTFOLIO TRADEOFFS

The degree of portfolio balance between revenue sources represents a policy choice, not a fundamental constitutional requirement. A balanced portfolio brings various tradeoffs, as do other tax portfolio choices.

Historically, property tax made up an essentially one-legged stool in Utah's original tax portfolio before Utah initially imposed income and sales taxes. But state and local property tax collections faced a downfall during the Great Depression as widespread property tax defaults occurred at a time of great public need. This breakdown resulted in the state broadening its tax portfolio during the Great Depression era to include income and sales taxes. Even though property tax remained the predominant tax for decades afterward, this began the shift to Utah's current three-legged stool tax portfolio.

In contrast to Utah's original one-legged tax system with property tax, the current somewhat-balanced three-legged tax portfolio provides the advantage of diversification. That is, the current system spreads the tax burden across different parts of the economy which counterbalance each other, including taxes on certain types of asset wealth (property tax), current income (individual and corporate income taxes), and consumption of most goods and selected services along with some production (sales and excise taxes) rather than imposing higher tax rates on one segment of the economy.

In turn, because the current portfolio taxes multiple elements of the economy, it may sacrifice potential economic growth or revenue growth relative to another portfolio approach, or face questions about the fairness of who pays taxes and who doesn't.

Figure 8: Utah's State and Local Tax Portfolio, FY 2024

- 32.7% State and Local Sales and Use
- 24.9% Property
- 4.4% Motor Vehicle and Fuel
- 4.0% Excise (non-fuel)
- 33.9% Income (Individual and Corporate)
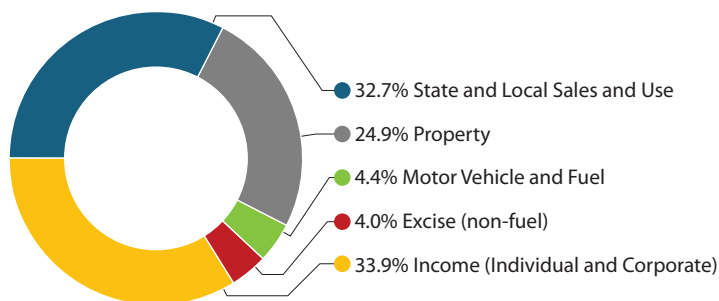
Source: Utah State Tax Commission

For example, the portfolio diversification in the current system allows offsetting attributes to counterbalance each other but grows more slowly than a portfolio constituted solely of income taxes. A portfolio constituted solely of income taxes would generally grow faster than Utah's current three-legged stool, but in turn expose budgets to greater volatility risk.

SUMMARY

Policymakers face a complex set of choices as they navigate fiscal policy, balancing citizen service demands with how to pay for services selected for funding. Consequently, tax policy involves a wide array of tradeoffs. Tradeoffs emerge between ideals such as revenue sufficiency, economic efficiency, fairness, ease of compliance and administration, and accountability.

Good data informs tax policy decisions, but policymakers must apply judgment to balance competing ideals and address tradeoffs as they design a tax system of choice.