

Insights and Caveats From Recent Tax Reform in Utah

by *Olene Walker, Gary Cornia, Pam Hendrickson, Bruce Johnson, Leo Memmott, Gayle McKeachnie, Ray Nelson, Val Oveson, Keith Prescott, and Lynne Ward*

Olene Walker is a former governor of Utah, a former lieutenant governor of Utah, and a former member of the Utah Legislature. She is now engaged in a variety of community projects dealing with improving K-12 education in Utah. Gary Cornia is a professor in the Marriott School of Management at Brigham Young University. Pam Hendrickson is chair of the Utah State Tax Commission. She is the former president of the Federation of Tax Administrators. Bruce Johnson is a commissioner of the Utah State Tax Commission. He is a past chair of the Multistate Tax Commission and was a partner and practicing attorney with Holme Roberts and Owen LLC. He was the cochair of the Streamlined Sales Tax Project study group. Leo Memmott is the past director of the Office of Fiscal Analysis for the Utah State Legislature. He was director of the State Olympic Office for the 2004 Winter Olympics. He has held a number of executive committee positions with the National Conference of State Legislatures. Gayle McKeachnie is a former lieutenant governor of Utah. He is a past member of the Utah Senate and chair of the Utah State Constitutional Commission. He currently practices law in Utah. Ray Nelson is a professor in the Marriott School of Management at Brigham Young University. Val Oveson is a former lieutenant governor in Utah, a former Utah state auditor, former chair of the Utah State Tax Commission, and former national taxpayer advocate with the IRS. He now is a practicing CPA. Keith Prescott is a CPA and a partner with Wisian Smith Racker & Prescott, a regional accounting firm. He is also the chair of the Governor's Tax Reform Commission in Utah. Lynne Ward is a CPA and currently the executive director of the Utah College Savings Program. He is a past state budget director for the state of Utah and a past president of the National Association of State Budget Officers.

Introduction

National and subnational tax reform initiatives occur with predictable regularity. As an example of those reform efforts, consider the comprehensive recommendation of the President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-

Growth: Proposals to Fix America's Tax System." Such labors seem to be part of a continuous tax reform cycle, a process that often leaves some government officials and especially tax experts frustrated by the snail's pace of the progress toward improved taxation. The occasional breakthroughs, however, encourage those who care about good tax policy, giving them optimism about future progress.

This article recounts the tax reform effort conducted during the term of Utah Gov. Olene Walker. It is written by Walker and the majority of the members of the ad hoc advisory team she assembled. We write as participant observers of state tax reform. We realize that as such, a measure of objectivity is lost, but we believe that this story may contribute to others' attempts to reform state tax systems. In the end, the Utah reform efforts resulted in substantial success, but as we will note, there were areas of little or no success, and the actual positive outcome followed an unexpected route. This report generalizes our successes and failures and enumerates recommendations from our collective experience. We make an attempt to jump-start future reform efforts by sharing some of the lessons learned through this process.

The motivation for state tax reform has roots in many arenas. For example, issues about the size and weight of tax burdens cause the public to question the appropriateness of their contributions to government financing. Elected government officials respond to those concerns, but they also face the additional challenge of achieving adequate financing to deliver the public goods that the same public demands. The desire for a tax system that will contribute to economic development is an additional reason states consider tax reform. A common concern is that the current system deters economic development. There may also be concerns that the provision of public services is inadequate. In Utah, for example, a substantial contributor to the feeling that tax reform was needed was the expected growth in demand for K-12 education because of significant

demographic changes predicted in Utah. Some public officials were concerned that the existing system of funding K-12 was inadequate. Regardless of the causes, when the perceived faults and inadequacies of the tax system generate sufficient dissatisfaction, officials initiate the reform process in an attempt to fix the system.

Traditional state tax reform consists of several steps. After the decision to consider tax reform is made, the next step is to identify individuals to serve on committees that will help filter and shape the suggestions for reform. Those individuals are usually business, community, and government leaders, and academic tax experts. Most members of those committees serve without compensation. They accomplish their task with the aid of research staff employed by state legislatures and various public agencies such as revenue departments. It is also common to contract with policy analysts associated with universities, think tanks, or national accounting firms to conduct the studies. The next step is for the advisory group to settle on a set of comprehensive recommendations, a process that requires substantial time, meetings, and briefings. After the recommendations are developed, they are released to the public, the press, and elected government representatives. The most important public officials to receive the recommendations are the members of the state legislature.

In the next phase of reform, considerations of the proposals' political feasibility dominate the reform process. Legislators project the effects of reform proposals and, not surprisingly, take positions to shield their constituencies from increased burdens. Also, special interest groups lobby to gain or retain benefits. During that phase, the leaders and experts who initially recommended the reforms view the political process with some dismay as they observe the dilution of their policy recommendations. Often, only a subset of the proposals is considered. Frequently, enthusiasm for change dissipates as politicians assess the political costs of thanklessly attempting to reform taxes.

Chronology of Reform Efforts in Utah

At the outset of her Utah tax reform initiative in 2003, Walker followed the traditional process and drafted a group of tax and budget specialists to assist in the design of the reform measures. Walker informed the group — the authors of this article — that we were not to limit our examinations and that every option for tax reform was on the table. She also told us to check our proposals against defensible tax principles. In a nutshell, reform did happen, but the pathway to reform was anything but straight. The report, "Governor Olene S. Walker's Recommendations on a Tax Structure for Utah's Future," was issued in November 2004. After three additional years of analysis and debate over myriad proposals,

counterproposals, and amendments, Gov. Jon Huntsman (R) and the Utah Legislature enacted significant personal income tax reform in 2007. There are many factors that extended the length of time to move reform through the process, one of the most important being the legislative cycles, including the election cycles.

History Preceding the Reform Initiative

When Walker decided to initiate comprehensive tax reform, she reentered a sequence that had been periodically initiated by preceding executives in Utah, including Govs. Scott Matheson and Norman Bangerter, and her immediate predecessor, Gov. Michael Leavitt. None of the previous attempts at reform had been entirely satisfactory. Previous reforms had used blue-ribbon committees that consisted of a range of representatives from the community, including appointed and elected government officials, business community representatives, lobbyists, and so forth. The results were general plans that reflected compromises among the diverse membership, but few suggestions found their way into the tax code.

Walker became Utah's chief after Leavitt was appointed to head the federal Environmental Protection Agency. Walker, who had served as Leavitt's lieutenant governor for 10 years, assumed office with a little more than a year until the state gubernatorial elections, and about 18 months left in her appointed term. Almost immediately after assuming office, she concluded that she wanted to begin tax reform. She was fully aware of the challenges of attempting tax reform, recognizing that the process does not garner much political credit: It offers few political benefits but significant risks. Some of her policy advisers also pointed out that her regular duties as governor would consume her schedule, and they counseled that she might not want to spend her abbreviated time pursuing tax reform.

Walker was not an amateur in the halls of government; she understood the push and pull of state government policymaking. Before serving as lieutenant governor, she had been an elected member of the Legislature and a member of legislative leadership. She was well acquainted with the budgeting process and she was aware of potential future budgetary challenges. Her interest in education caused her to view with alarm an anticipated influx of children into the public school system. She was worried that the vagaries of future business cycles could complicate education finance. Her concern for educating Utah's children caused her to pursue the politically risky tax reform process. She reasoned that because she might not be running for a second term, she could afford to take politically unpopular stands that might be needed to further tax reform and provide adequate financing of future government needs.

Selection of Tax Principles

As part of her ambitious one-year agenda, which she promoted as "Utah Works," Walker outlined a tax reform strategy for her advisory team. First, she identified seven principles and objectives to guide all reform efforts. In her press conference to launch tax reform, she challenged all involved to create a tax system that:

- is fair, just, and balanced;
- supports a business-friendly economic environment;
- focuses on funding critical needs;
- has structural balance;
- is the tax system for the 21st century, and
- balances state and local obligations and revenue sources.

Those principles followed standard public finance literature, which suggests that states need tax schemes that provide adequate revenue, minimize distortions, treat citizens fairly and equitably, facilitate economical administration, and achieve accountability.

Those objectives addressed the issues that were already percolating in the Legislature. For example, because all personal income tax revenue in Utah is earmarked for public education, one bipartisan group was proposing reducing the per-child exemptions for children to address the issue that large families with more children to educate were often paying lower taxes to finance schools because of the tax deductions those children generated on their parents' tax returns.

Walker and Her Tax Advisers

Walker gave us *carte blanche* regarding the issues and taxes we could consider. A critical strategic decision by Walker was to keep politics from limiting any discussion of potential tax policies. She declined to invite any members of the Legislature or representatives of any specific business or industry groups to serve among her advisers.

Despite a demanding schedule, Walker received regular reports from her advisers and kept us focused on achieving comprehensive tax reform. She quizzed us about tax details and guided our efforts. She often admonished us to be bolder, reminding us that the political feasibility of our proposals was not part of the criteria. For each alternative proposal, Walker encouraged us to let principles guide our efforts and policy analysis.

From the details of each individual tax, we began to generalize. We first accepted the axiom that sound tax policy is generally advanced by broadening tax bases and lowering rates. We also carefully considered the volatility of taxes over the business cycle in addition to the expected growth of revenue. The focus on volatility was likely precipitated by the then-recent experience of the 2001-2002 downturn in the national economy. Finally, we were anxious to

maintain and, if possible, enhance Utah's ability to attract new businesses and encourage growth in existing businesses.

During the reform efforts, we were able to use computational resources and statistical software to mine relevant insights from the Utah State Tax Commission's database of individual state tax returns, while carefully maintaining the confidentiality of individual taxpayers. We found we had diverse opinions that resulted in conflicting assessments of the proper path to tax reform. Because we had access to data mining techniques coupled with the income tax data base, we could recalculate in essentially real time what changes in tax policy would do to tax receipts. The ability to make those calculations allowed us to move beyond preconceptions about proposed changes in tax design, and facilitated developing proposals that were largely void of political considerations. The real-time data summaries and graphs produced substantial value. Our conjectures about the causes and effects of tax policy were refined as we became more aware of the capabilities of mining income tax returns. Although we had years of experience in tax administration, tax compliance, and tax policy, we frequently found that the data contradicted our initial intuitions.

Original Comprehensive Tax Reform Proposal

In November 2004, after a new governor had been elected, Walker released "Recommendations on a Tax Structure for Utah's Future." The significant recommendations in the plan were to:

- retain the relative share of sales, income, and property taxes;
- adopt a flat personal income tax;
- eliminate the state corporate tax;
- simplify and expand the sales tax exemption for almost all capitalized business inputs; and
- broaden the sales tax base by taxing services.

Other recommendations proposed changes for less prominent taxes, supported the national Streamlined Sales Tax Project, and made general, less radical suggestions.

Two of the proposals merit further discussion here because of their conflicting nature. We believed strongly that the sales tax base was too narrow and failed to incorporate many of the services that are an increasingly important part of the economy. (Indeed, that is Tax Reform 101, and we do not claim any particular insight here.) We also thought it was important to eliminate the sales tax on business inputs, thus avoiding pyramiding and enhancing the competitiveness of Utah-produced goods, both in the domestic and export markets. (Again, that is Tax Reform 101.)

What was surprising to us, however, was the extent to which these principles clashed. Utah already taxed telecommunications, hotel and restaurant services, car repairs, cleaning and laundry services, and admissions to places of amusement or entertainment. Most of the significant remaining services, such as advertising, legal services, accounting services, and data processing and information services, were used disproportionately by businesses. Thus, expanding the sales tax to include those services would enlarge the sales tax base, but would also increase pyramiding and reduce the competitiveness of Utah goods. In fact, the only really significant untaxed services that were used primarily by households rather than businesses were education and medical services. Walker took education off the table, viewing it more as investment than consumption. Thus, the only large increase in the sales tax base would come from taxing medical services.¹

Most of the significant untaxed services were used disproportionately by businesses. Thus, expanding the sales tax to include those services would enlarge the sales tax base, but would also increase pyramiding.

Before the formal release of the tax recommendations, Walker sought general input from legislators, the business community, and citizens. That was especially important because the gubernatorial campaign was forcing candidates to react to possible tax reform avenues. To increase the chances for the continuation of tax reform after Walker left office, we briefed the candidates from both political parties on the analysis, findings, and potential recommendations of the advisory committee.

We believed strongly that a pure flat tax based on federal adjusted gross income should be implemented. We worried that allowing some deductions would open a floodgate of requests for special considerations and that it would subvert the purpose of

¹We recognized, of course, that many legal, accounting, and other services are performed for households, and we recommended taxation of those services when provided for personal use. Estate planning, for example, might be taxable, whereas a business incorporation plan would not be. That dichotomy, however, produces its own unusual results. For example, in a landlord-tenant dispute, the landlord's legal fees would not be taxable (a business input), but the tenant's legal fees would be subject to tax (as personal consumption). Similarly, in a malpractice suit, the doctor's legal fees would not be subject to sales tax, while the patient's legal fees would be taxable.

broadening the base and lowering the income tax rate. We knew, of course, that there was a strong constituency in favor of retaining deductions for charitable contributions and mortgage interest. The potential for implementing a flat tax was decreased when religious and charitable organizations opposed the removal of charitable contribution deductions. As we feared, the representatives of real estate interests also strongly opposed any limitation on mortgage interest deductions. Soon, the anticipated cascading effect materialized as other interest groups lined up for special consideration.

Response to Initial Plan and Transitional Slippage

Even though Walker sought informal feedback from gubernatorial candidates and legislative leaders, the political dynamic of the comprehensive tax reform announcement created challenges. In the briefing for the legislative leadership before the announcement to the press and editorial boards, it became evident that the current leaders had strong opinions and that the new leaders were trying to establish themselves in their new positions. Walker had originally planned to announce her tax proposals before the election so they would be widely debated and discussed as part of the electoral process. She later decided to delay her recommendations so that the candidates wouldn't be pressured by special interest groups to promise away bits and pieces of the reform plan before it could be considered as a whole. To their credit, both candidates avoided using the plan against each other during their campaigns.

After the election, the issue of tax reform passed to the new governor. Fortunately, the governor-elect, Jon Huntsman Jr., had made tax reform a significant part of his campaign. Many of his ideas coincided with Walker's, but he also had strong views of his own.

Tax reform inevitably creates winners and losers because the tax liabilities of various individuals increase and decrease. Winner and loser calculations started immediately following Walker's press conference. The winners-versus-losers calculation was especially important for the flat tax proposal. It quickly became apparent that the lower rate and broader base of the flat tax would achieve the desired outcome of a more business-friendly environment. Advocates for low- and middle-income taxpayers, however, reacted strongly to the burden shift toward the income groups they championed. The tradeoffs between economic efficiency and fairness became an important part of the debate.

As would be expected, tax reform momentum was lost as Walker prepared to leave office. Fortunately, as Huntsman formed his transition team, he selected one of the members of our committee to serve on that team. Huntsman identified tax reform as his

number one priority. He had also campaigned for removing the sales tax on food. Although fully aware of the importance of broadening the base and lowering the rate, Huntsman believed strongly that broader public policy should trump economic theory on that point. Many legislative leaders, particularly in the House of Representatives, agreed with the governor. Other differences in values and goals arose as interested parties were able to study and understand the initial proposals. Those conflicts, however, are an essential part of the tax reform process; they ensure that the ultimate product is as free as possible from errors and miscalculations and that it has the broad support necessary to be implemented.

First Legislative Session

With a new governor and Legislature, tax reform efforts shifted from a comprehensive reform based primarily on theory to a more political approach based on feasibility. (That was the process that Walker had envisioned. As noted, we were admonished to come up with sound proposals regardless of political considerations. Those proposals would then be debated and amended in light of public input.)

The tradeoffs between economic efficiency and fairness became an important part of the debate.

An early casualty in the reform process was the goal of broadening the sales tax base. As noted, Huntsman strongly supported removing the sales tax from groceries, thereby significantly narrowing the base. Also as noted, the most significant untaxed services used primarily by households were education and healthcare. There was arguably no sound policy reason to tax the first and no political constituency to tax either.²

Although the business-friendly aspect of removing the corporate income tax initially resonated with gubernatorial candidates, little by little, lack of interest after the election doomed the proposal's legislative potential: There was no serious support for removing the state corporate income tax.³ Atten-

tion ceased when it became apparent that the tax was generating significant amounts of revenue that made additional funding for education possible. The package deal for tax reform quickly narrowed in focus to consideration of reforming the income tax and removing the sales tax on food.

Key legislators said they would not accept any tax reform that produced losers. The focus on giving everyone a tax cut so obscured other information in the potential reform debate that it retarded achievement of a fairer tax burden distribution.

The phrase "simpler and fairer" came to characterize Utah's income tax reform efforts. The fairness issue of the flat tax continued to cause concern. Figure 1(a) (next page) shows that higher income percentiles pay the majority of income taxes. Figure 1(b) (p. 927), however, shows that a flat tax unequivocally shifts the tax burden from high-income citizens to middle- or low-income taxpayers. And Figure 1(c) (p. 928) shows the shift in the tax burden under a proposed flat tax. The increase in the relative tax burden borne by the lower and middle adjusted gross income percentiles gave many legislators pause. To provide tax relief to that group and exempt low-income citizens entirely from any tax burden, lawmakers proposed a phased-out credit based on filing status and number of exemptions.

Determining the size of the tax credit and the phaseout range required intensive data mining by legislators and analysts. Although many public finance experts suggest maintaining focus on the overall equity of tax systems, the public inevitably becomes preoccupied with tabulating losers and winners. That in turn affects the political feasibility of proposed changes. By changing the calculated tax credit values, it was possible to change the composition of the losers and winners, as shown in Figure 2-a (see, p. 929). That diagram reflects the number of tax returns in each AGI percentile that would experience an increase, decrease, or no change in tax liability.

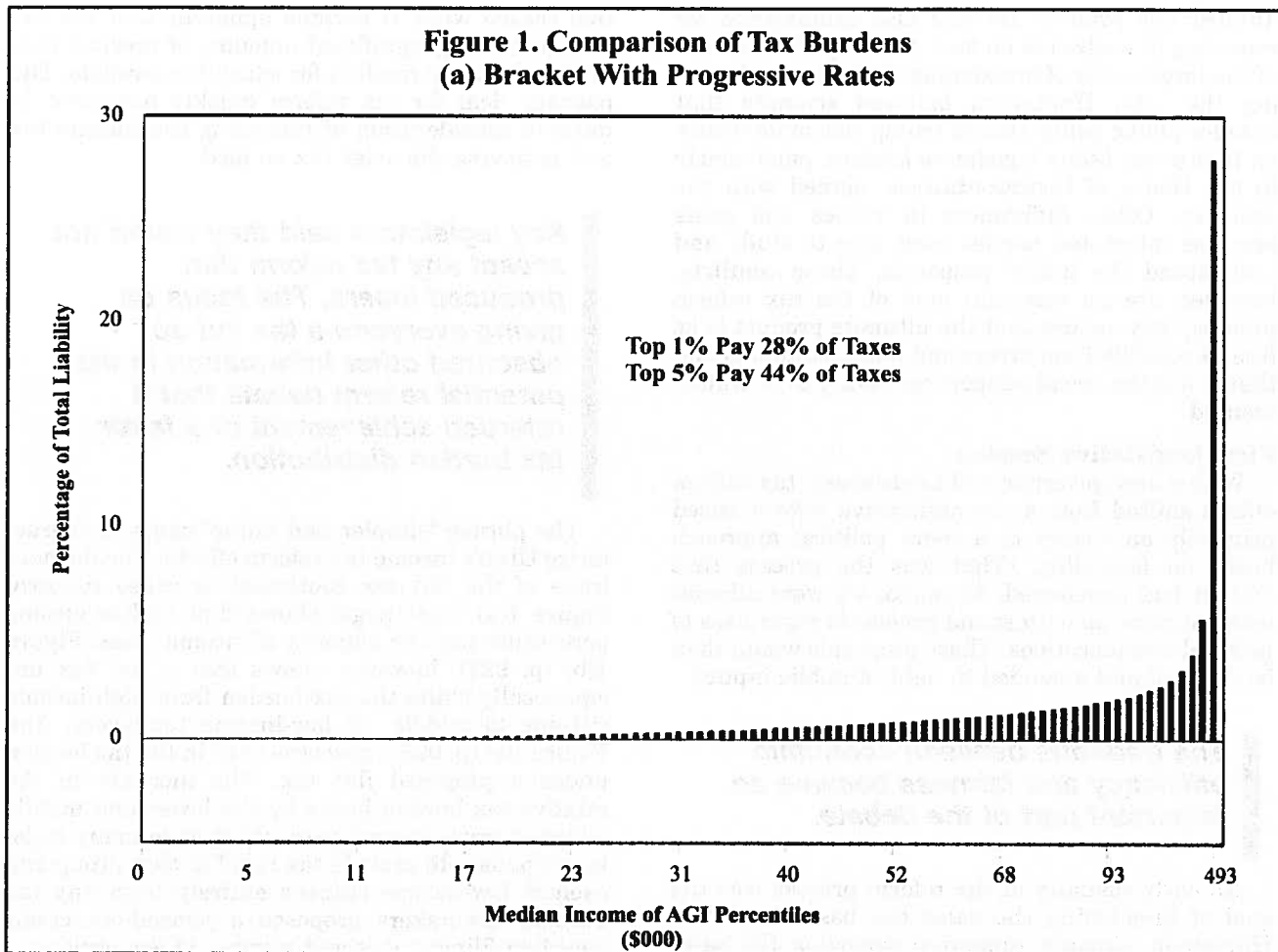
The computational power of data mining techniques was especially helpful in the overall process because it allowed interested legislators to assess

require every county assessor in Utah to become a business appraisal specialist and would create unmanageable complexity and volatility in the most stable and predictable of Utah's major taxes. Moreover, the ease with which much intangible property could be moved out of state would make any such tax difficult, if not impossible, to administer fairly.

²The ethical, practical, economic, and distributional aspects of a sales tax on healthcare are intriguing, to say the least, but well beyond the scope of this article.

³The general lack of enthusiasm for removing the corporate income tax initially surprised us. It later became clear that some members of the business community thought the elimination of the corporate income tax was a backdoor attempt to increase property tax on business. The Utah Constitution exempts intangible property from the property tax if the income from the intangible property is subject to tax (Art. XIII, sec. [2][5]). However, we never contemplated a property tax on intangibles. Taxation of intangibles would

(Footnote continued in next column.)

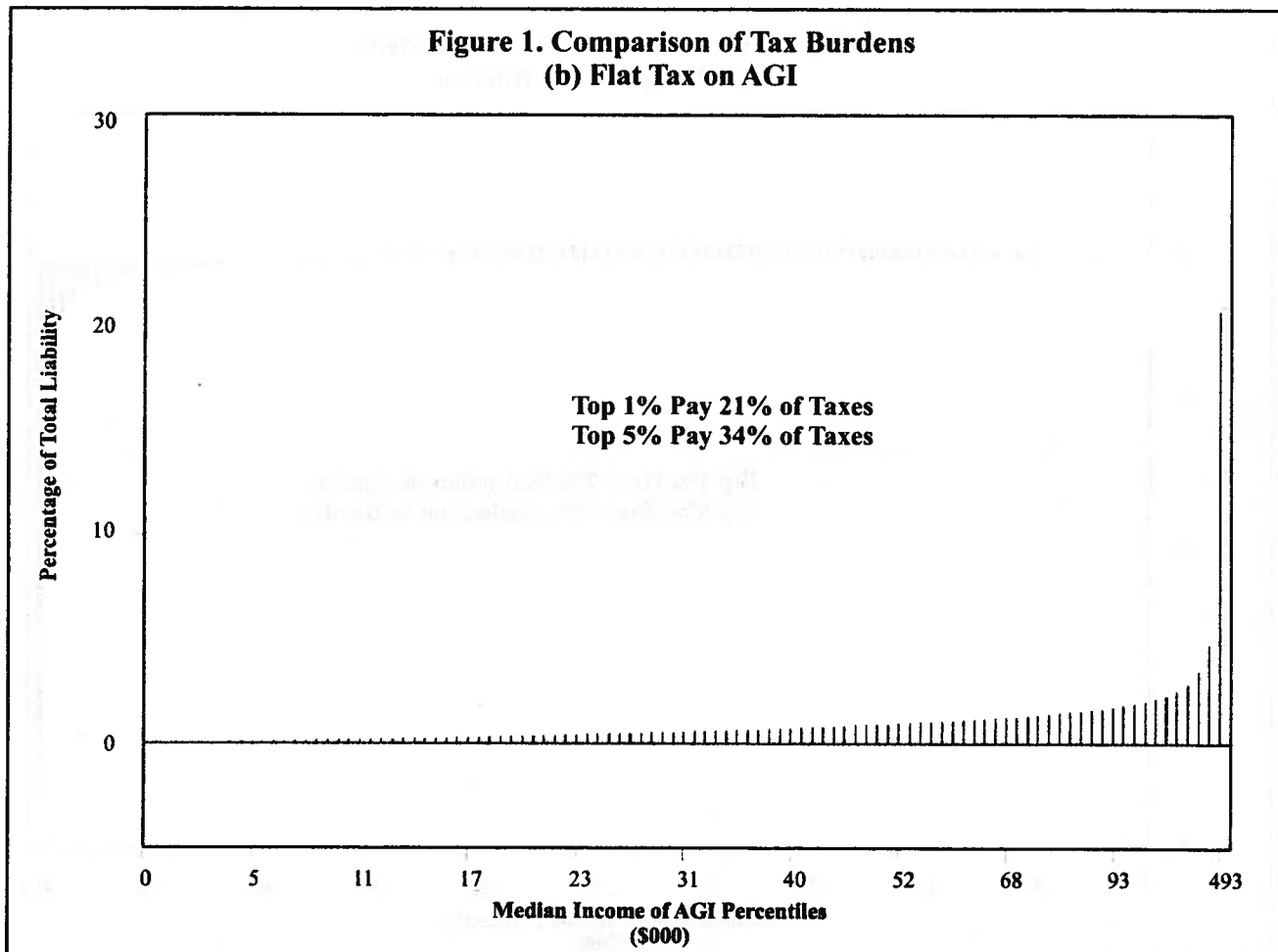


within seconds the effect of tax credit proposals. The ability to allow elected officials to see the implications of different tax proposals in real time prevented some bad ideas from going forward. In fact, the ability to analyze proposals in real time caused the Legislature to pass bills that gave legislative analysts access to sanitized data that would allow them to check their own proposals and cross-check executive branch analysis.

One commonly used graph identified the winners and losers by their income (see Figure 2(a)). Those graphs gave legislators the ability to immediately recognize winners and losers and to manipulate tax reform to benefit their constituencies. Once the legislators focused on winners and losers, that criterion took on a life of its own. It became difficult to distract them from winner and loser calculations to get them to consider the relative sizes of tax cuts as shown in Figure 2(b) (see, p. 931). Key legislators said they would not accept any tax reform that produced losers. The existence of a significant state surplus after years of belt-tightening contributed to the problem. It was politically impossible to raise

anyone's taxes during a year when the surplus was being widely announced. Consequently, it was impossible to get legislators or their constituents to ask whether the current tax burden was equitable in the first place. The focus on giving everyone a tax cut so obscured other information in the potential reform debate that it retarded achievement of a fairer tax burden distribution.

By the end of the first legislative session, no part of the initial Walker plan had been adopted. The ability to identify winners and losers in the proposed tax reform clearly revealed specific losers. For example, it was clear from the models that the loss of the retirement deduction would cause retirees to pay more income taxes. The same level of detail was available for religious groups and other charitable entities. They expressed strong opposition to changes to the existing deductions, as did the residential real estate lobby. Because of that opposition, it was clear that more political work was needed before any significant income tax reform could be implemented. And despite campaign promises by the governor and legislators, food



remained part of the sales tax base.⁴ Double taxation of business inputs continued, the sales tax base wasn't broadened to include services, and corporations continued to face income tax liabilities.

Second and Special Legislative Sessions

Despite adjourning the first legislative session without completing any tax reform, Huntsman and leading legislators remained committed to the process. With the support of the governor, legislators formed a committee to study tax issues and make reform recommendations.

The legislative committee included representatives and senators from diverse backgrounds and philosophies. Lawmakers had not been directly in-

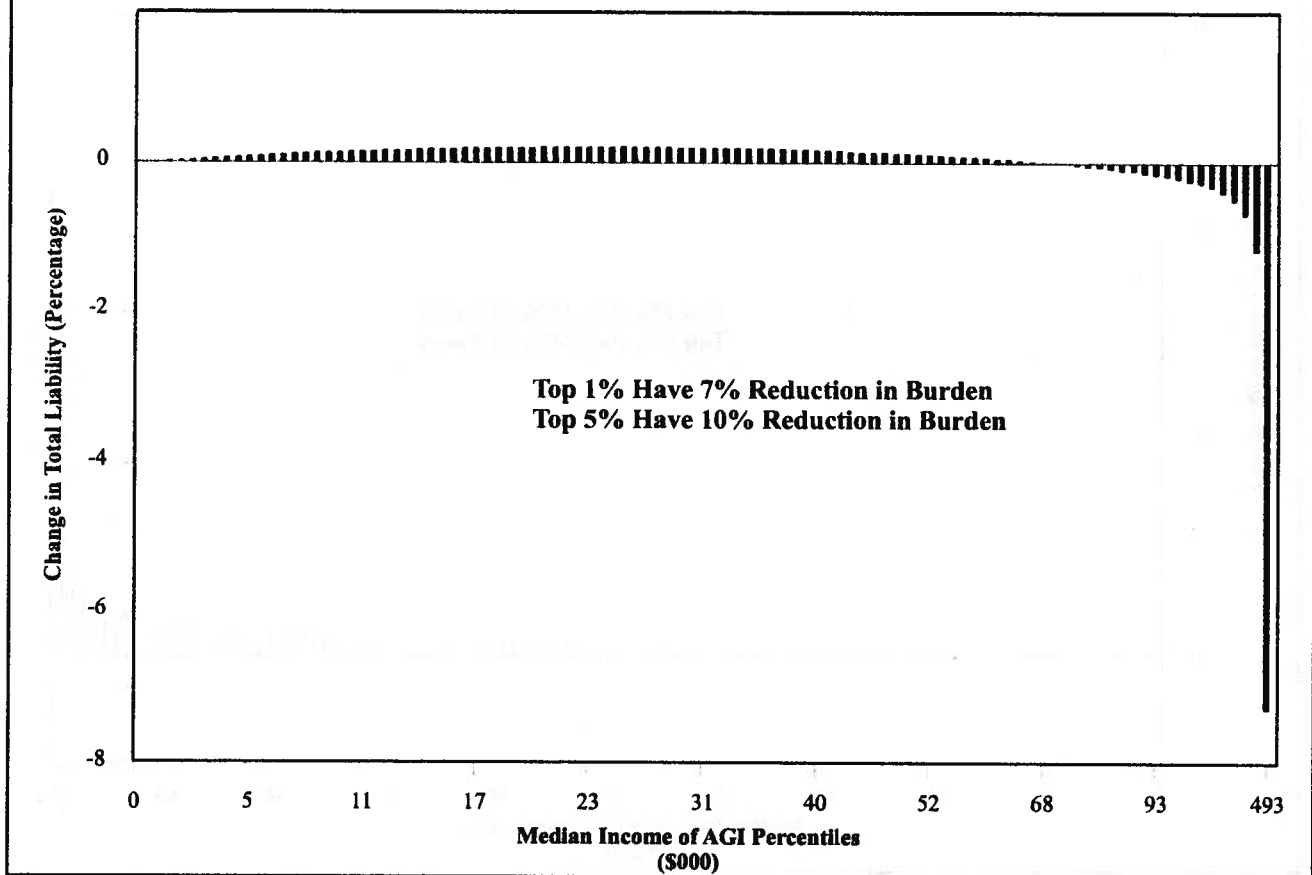
involved in formulating the original Walker proposals, but they now took center stage in considering tax reform.

Debate during the second legislative session focused on income tax and sales taxes on food. Once again, as the adjournment deadline approached, and despite heavy lobbying by Huntsman's staff, the only significant changes in the tax code occurred at the last minute as the sales tax rate on food was reduced. Huntsman promised that if the Legislature didn't pass income tax reform, he would call a special session to continue the debate.

Later in the year, Huntsman fulfilled his promise and called a special session to consider income tax reform. Because Utah's economy was growing robustly and was generating surplus income tax revenue, lawmakers once again insisted that any income tax reform must have no losers. To accomplish that, Huntsman and legislators devised a dual tax system. That system allowed citizens to choose between paying income taxes under the old system of

⁴Local governments also impose sales tax in Utah; that is a significant part of many local budgets. The removal of tax on food was complicated greatly by the fiscal impact on many small towns whose only major retailer was a grocery store.

**Figure 1. Comparison of Tax Burdens
(c) Change in Tax Burden**



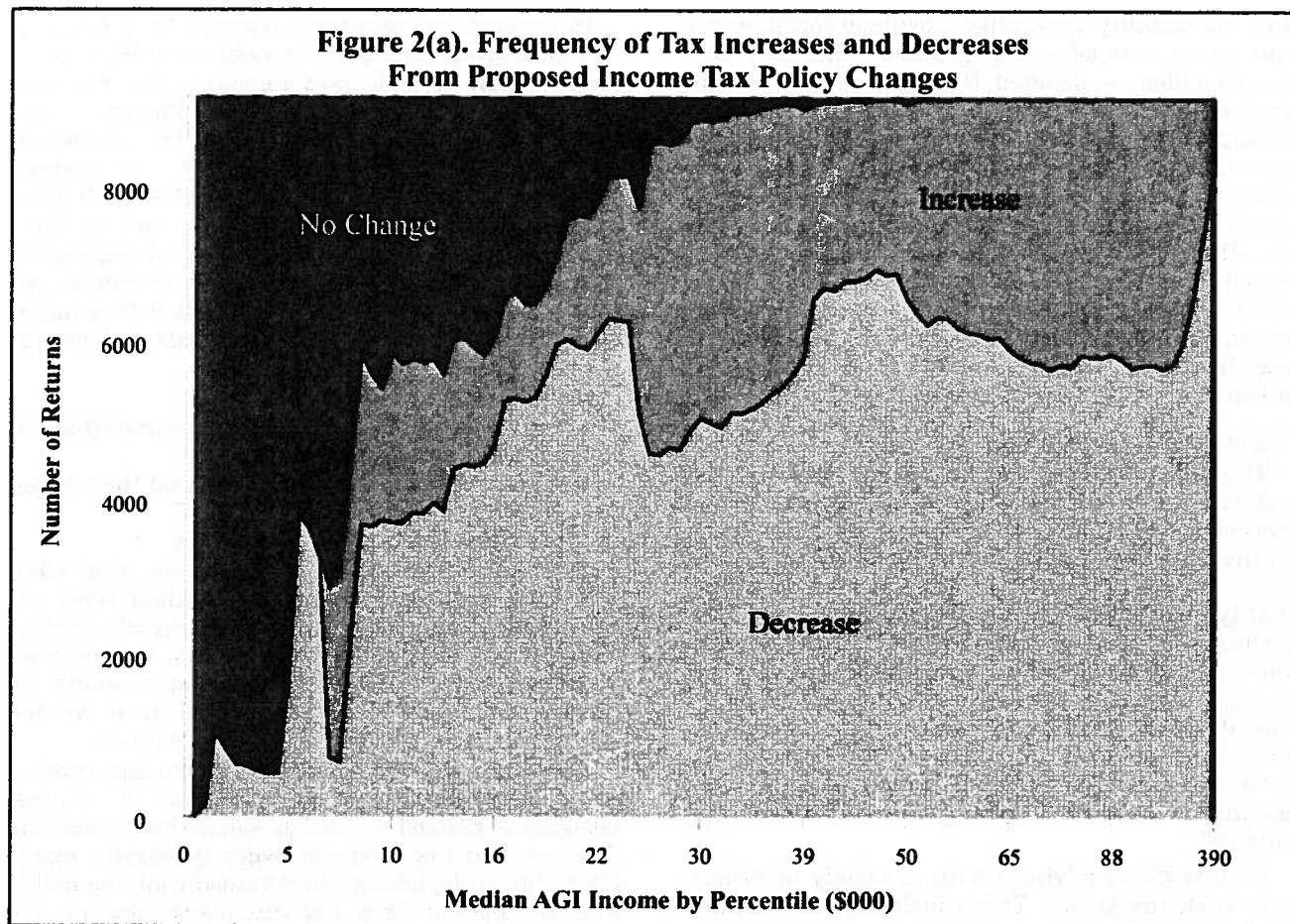
graduated rates with deductions and exemptions or a new alternative flat tax system that was based on federal AGI but with no deductions or exemptions. Any taxpayer who did not benefit from the new flat tax could elect to file under the old method. Although many criticized the complexity of a dual system, it was passed without significant opposition.

Third Legislative Session

The dual tax law was supposed to create an orderly transition to a flat tax system. Unfortunately, most taxpayers still found it advantageous to calculate their tax liability using the old tax code. There was political pressure to amend the flat tax component of the dual system to entice more people to switch. To encourage more taxpayers to participate in the flat tax side of the dual tax system, Huntsman and the Legislature agreed to pursue a hybrid flat tax. That allowed lower- and middle-income taxpayers to claim a phased-out credit based on federal standard and itemized deductions. A credit was also allowed for retired citizens to avoid a significant tax increase for that group.

As former members of Walker's tax advisory group, we publicly testified that the dual tax system was a step backward from the simplicity that we had originally envisioned. Some legislators also worried that with time, the flat tax system would become more and more complex, with a wide variety of reductions and deductions. That would eventually result in two coexisting and complex means of calculating income tax, something similar to the federal alternative minimum tax.

Further complicating the reform discussions was the perceived political necessity of passing a tax cut. Because of record revenue generated by a booming economy and despite a general desire among voters to dedicate surplus revenue to improved education financing, legislators felt compelled to limit the growth of government spending by cutting taxes. Legislators wisely let discussions of revenue adequacy temper some of their tax-cutting zeal. They considered the volatility of personal income tax, because many remembered that business cycles also contain downturns. Some legislators reminded others that stable education financing was critical.



The idea of earmarking volatile revenue for education financing also entered into the discussion because of concern for discretionary spending.

The political process was further complicated as additional efforts were expended to eliminate the sales tax on food. In this third effort at tax reform, legislators took ownership in the process. Finally, an omnibus tax bill at the end of the legislative session mandated a modified flat tax (that is, a single-rate tax with phased-out credits) and further reduced the state sales tax rate on food.⁵ In an outcome that surprised almost everyone — especially those fatigued by three years of tax reform — that bill passed unanimously in both the Senate and House of Representatives.

Lessons Learned From Four Years of Tax Reform

In retrospect, judging the success of tax reform is difficult and leaves a bittersweet feeling from les-

sons learned and partially fulfilled expectations. There were high hopes at the outset of the process of Walker's tax reform efforts. That an omnibus tax reform bill eventually passed unanimously gives us a general sense of achievement. That the omnibus reform bill was not more sweeping and comprehensive in scope, however, causes disappointment. The whole process gives us hope that future efforts might validate our findings and recommendations. The following points generalize the insights into the reform process that we gained during four years of effort.

Role of Tax Principles

The principles of good tax policy must guide deliberations at critical junctures in the reform process. Maintaining focus is critical to all tax reform efforts. Throughout the policy study and formulation process, we often returned to the foundation of basic tax principles to refocus our efforts. Walker encouraged us to let principles guide the reform efforts and policy analysis. For example, discussions about a flat income tax benefited from the principle of a broader base contributing stability for adequate government financing. The trade-off

⁵Cities and towns were allowed to retain their sales tax on food.

between stability and equity consumed considerable time as we — as advisers, legislators, and executive branch aides — debated the relative merits and trade-offs for each proposal. Similarly, tax policy principles framed discussions about broadening the sales tax base to include services; removing taxes on business inputs would affect adequacy and efficiency. The use of graphs and real-time data analysis allowed us to educate policymakers in both branches of state government, business leaders, policy wonks, and those in the print and electronic media about tax reform. The best example of that was the importance that stability in revenue played in the analysis of every proposal.

Organization and Politics

The organization of the reform process is critical and presents a perplexing trade-off to state executives charged with initiating the process. The trade-off involves the appropriate involvement of politics in the reform process. Political expediency and feasibility don't always generate the best tax policy. Ultimately, however, the political process determines tax laws. Therefore, in organizing the reform process, executives must decide who should be included. What are the appropriate roles for legislators, lobbyists, and executive staff? How do you balance the political with the technical and encourage involvement from the Legislature and the community?

Walker chose advisers with a variety of experience with tax issues. Those included tax commissioners, lawyers, former executives, legislative executives, accountants, and academics. Although we had significant political experience as a group, it is clear she selected us primarily for our legal and technical expertise. The small size of the working group helped discussion flow without distraction, and because Walker purposely insulated us from the political process, analysis and recommendations had to come from outside the political process. Walker attentively encouraged us to think creatively, yet realistically. She often minimized constraints by making sure we understood that every reasonable reform possibility was on the table for consideration.

Walker's initial choice of a small number of advisers, however, caused future challenges. Previous reform efforts had included a much larger group, with representation from a broad range of business, government, and political interests. A larger number of individuals participating in the reform process generates more ideas and perspectives, although it sometimes results in only general recommendations so that all members can agree. A second problem with a small group is the necessary exclusion of many capable individuals with significant tax experience. Ownership in, and support for, our initial proposals may have benefited from broader representation.

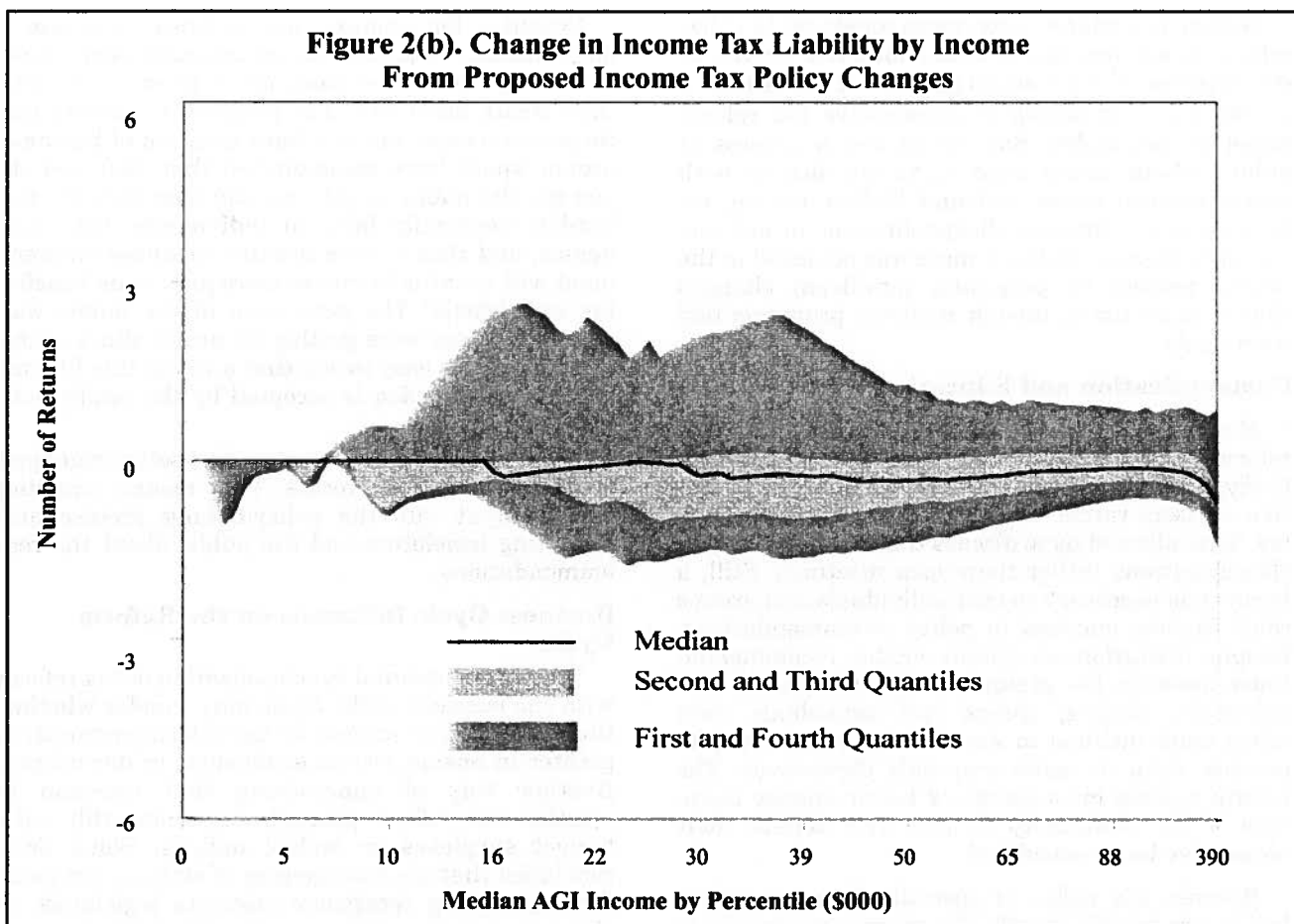
In general, tax reform is negative for politicians — a thankless task. For the public's welfare, however, it must be addressed regularly. The tax code needs a thorough, periodic cleaning. Therefore, seasoned legislators must step up to the challenge. Legislative leaders are needed who will sponsor unpopular legislation because it contributes to good tax policy and improves public welfare. In hindsight, Walker wished that she had involved legislators more extensively throughout the reform process. An advisory group could have been formed that might have included the following individuals and groups:

- the speaker of the House;
- the president of the Senate;
- the chairs of revenue and tax committees in both houses of the Legislature;
- representatives of the counties and the League of Cities; and
- the Utah Chamber of Commerce.

Periodic meetings with the governor, that advisory group, and her tax advisers might have advanced the tax reform agenda more rapidly. During different phases of the reform process, the governor and Legislature alternately took responsibility for tax reform. A joint meeting might have created synergistic executive and legislative support.

As would be expected, political friction complicated the evolution toward enactment of reforms. Legislators reacted to some proposals by insinuating that we, the tax advisers, were politically naïve. Even though legislators understood that the public was not looking for a tax cut, many conservative legislators believed cuts were appropriate. Many liberal legislators, however, fought hard for their constituencies. At the same time, religious and other charitable organizations exerted significant influence to maintain their tax advantage; realtors, who are widely represented in the Legislature, fought for the mortgage interest deduction; and retired citizens continued to represent a particularly cohesive, politically motivated group. In Utah those factors remain important political forces in any tax reform debate.

In summary, Walker's direct involvement with us gave us direction, and courage to propose major changes to Utah's tax code. She was pleased that we were able to innovate without political pressure and lobbying efforts unduly constraining the scope of our considerations. The unveiling of the final reform proposals might have been more successful, however, if key political and business leaders had been cultivated as champions for the reform proposals by allowing them to share insights and make recommendations early in the process. For example, legislative leadership at the time included attorneys and CPAs with tax experience and knowledge; those individuals could have been consulted without disrupting policy analysis. Earlier inclusion of business leaders might also have aided consensus building



earlier in the reform process. Cultivating proponents of the reform proposals might have helped the reform to proceed much more rapidly. However, it is not clear that the reform process would have moved further with that involvement. The reforms may have been passed sooner, but there is no reason to believe they would have been more sweeping.

Reform Scope

Another major decision in tax reform was whether to proceed with tax reform incrementally or with a comprehensive, sweeping initiative. Walker chose to package everything together into the bold recommendation described previously. Because true tax reform undoubtedly creates winners and losers, allowing individual interests to nitpick issues defuses enthusiasm for reform. The process becomes fragmented, and each proposal dies separately as opponents selectively attack individually unappealing changes. Walker thought that attempting reform one proposal at a time would allow legislators to do the easiest things first. A comprehensive package makes it more difficult for special interests to adopt

a divide-and-conquer strategy, and helps legislators retain their focus on passing comprehensive tax changes.

As an example of how tax reform can be short-circuited as individuals express concern over individual implications, consider the income tax. As mentioned, we suggested a base of AGI with a reduced and flat rate. That was possible only if no deductions or exemptions were taken from AGI. But the cascading effect of requests to retain deductions for charitable contributions and mortgage interest, along with provisions for retirement exemptions, quickly defeated attempts to base income taxes on AGI.

Packages of legislation that are amalgamated into single reform bills have significantly greater potential for passage. For example, in the final omnibus tax bill passed unanimously in the 2007 Utah session, proponents of income tax reform and sales tax reform compromised. Neither achieved exactly what they desired, but both concluded that the combination was worthwhile.

Walker's legislative experience convinced her that reform by bits and pieces would not work. Driven by the intuition that she would get more if she asked for it, she urged sweeping comprehensive tax reform based on principles. She envisioned a process of public debate rather than backroom dealing with special interest issues. Although Walker and we, her tax advisers, expressed disappointment in not seeing more change, we think more was achieved in the reform process by proposing significant changes than if more timid, though realistic, proposals had been made.

Communication and Education

Managing the flow of information throughout the reform process was critical. To allow us to innovate freely, Walker decided to classify our group as executive advisers rather than as a blue-ribbon committee. That allowed us to discuss the reform process in closed sessions rather than open meetings. Still, a forum was necessary so that individuals and groups could become engaged in policy recommendations. Despite invitations to submit written recommendations, however, few groups submitted ideas for consideration. Rather, groups and individuals were much more inclined to wait for the opportunity to criticize than to make proposals themselves. The reform process must somehow better engage members of the community so that they believe their ideas have been considered.

Because tax policy is specialized and complex, legislators benefit greatly if resources are available to help them understand the implications of specific reform proposals. Utah has a Tax Review Commission, composed of legislative and other governmental appointees. It is staffed by legislative analysts. During the past session in which reform was successfully passed, that group devoted significant effort to educating legislators about tax policy. A sincere desire to understand policy exists among legislators, especially those new to the process. Those legislators with tax experience often accrue significant influence with their peers. In the future, the Tax Review Commission intends to run a pre-session tax boot camp for interested legislators.

Communicating reform proposals to the public is an even bigger challenge. The complexity of tax issues often excludes many citizens from the public forum. After a proposal has been made, the natural reaction of each citizen is to ask, "How does this affect my individual tax liability?" For this reason, after almost every reform proposal, the popular press and legislators immediately focused on who would benefit from a tax decrease and who would be saddled with a tax increase, while longer-term implications were often ignored. Tax policy has been relegated to sound bites that don't advance significant understanding of tax issues.

Consider, for example, our proposal to create a more business-friendly tax environment that would eventually cause the economy to grow faster and thus create more jobs. The proposal to remove the corporate income tax and limit taxation of business inputs would have accomplished that. But how do you get the public to get past the idea that the tax burden eventually falls on individuals, not businesses, and that a more friendly business environment will eventually create more jobs, thus benefiting individuals? The perception of the public was that businesses were getting an unfair share of the tax break. It is easy to say that a rising tide lifts all boats, but that idea is accepted by the public only with difficulty.

Like Walker, we wish that we had better managed the communication process. That means receiving earlier input into the policymaking process and educating legislators and the public about the recommendations.

Business Cycle Influence on the Reform Cycle

There is no optimal synchronization of tax reform with the business cycle. Some may wonder whether the probability of success for tax reform proposals is greater in business cycle expansions or downturns. Another way of approaching that question is whether tax reform proceeds more smoothly with budget surpluses or budget deficits. Some have concluded that the emergencies of state government funding during recessions motivate legislators to change tax codes. Others argue that an economic expansion would smooth the legislative adoption of reform proposals because extra funds would allow for compensating losers.

There is no optimal synchronization of tax reform with the business cycle. Pressing forward with reform is always risky, but waiting for the perfect time is unrealistic and unacceptable.

In the case of tax reform in Utah, budget surpluses complicated income tax reform. Even though the public was not clamoring for a tax cut, some legislators were aggressively looking for a means to limit the growth of state government. Also, because legislators perceived significant political liability from raising anyone's taxes during a time when the economy was growing so fast, they were cautious about passing any laws that would increase individual tax liability. In most sweeping tax reform proposals, some citizens undoubtedly experience advantageous outcomes at the expense of others. All of

us conclude that there is no optimal phase in the business cycle for tax reform to occur. All the stars will never align for optimal reform conditions. Pressing forward with reform is always risky, but waiting for the perfect time is unrealistic and unacceptable.

Research and Analysis

During tax reform in Utah, empirical findings and especially graphics strongly influenced the legislative process at times. In the first year of reform, legislators were so fixated on the political ramifications of winners and losers that they were distracted from assessing trade-offs among all the characteristics of a good tax. During the second round, they focused on volatility to the extent that revenue sufficiency became a dominating influence in the legislative process. That caused additional challenges as politicians and lobbyists selectively grabbed information and issues that sometimes diminished the value of the information that could have clarified issues. Because we were allowed access to tax return data, we were able to repeatedly test hypotheses about taxpayer tendencies, which helped us avoid creating unintentional outcomes.

Previous Reform Efforts

Because of the perpetual fluctuations in the state tax reform cycle, new initiatives can piggyback on those of previous efforts. Of course there are dangers in becoming too dependent on previous efforts. Sometimes previous analysis can cloud a fresh look into ongoing challenges that come with new and innovative approaches to tax reform. Nor should the failure of previous reform attempts preclude the reintroduction of good tax policy. Political conditions can change significantly, and with proper shepherding through the political process, previously rejected but nonetheless good ideas might become part of the state's tax code. Reform efforts in all states can certainly use "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System" as a prototype for the report they anticipate releasing at the conclusion of their efforts. Future attempts at tax reform, in Utah and other states, will hopefully benefit by reviewing the report issued by Walker and our committee of tax advisers.⁶

Summary Recommendations and Caveats

In conclusion, what do we wish we had known at the outset of the tax reform adventure we embarked on over four years ago? We extend the following

recommendations that might help others who attempt future tax reform journeys.

1. Manage the politics from the outset.

A governor can play a unique role in the tax reform process. A governor must manage the combination of the technical expertise of tax professions with the political reality and legislative leadership.

2. Make sweeping and comprehensive tax reform proposals.

Tax reform is more likely to be successful when it is a comprehensive effort packaged as an omnibus bill. Governors who petition legislators for aggressive reform will likely achieve much more than those who incrementally advance more timid proposals.

3. Use data-mined insights to test conventional wisdom.

Because exposure to the ideas of tax professionals and experts often is limited, commonly held preconceptions about taxpayers may not always be accurate. The results of mining insights from personal income tax return databases may often contradict conventional wisdom and taxpayer stereotypes. With the computational capabilities available from innovative data mining techniques and software, analysis can enlighten reform debates without compromising taxpayer privacy.

4. Find a champion and a leader.

Tax reform needs a political leader who understands fiscal issues but also understands the importance of the political process.

5. Exploit relationships with the media.

Much of the reason that tax reform finally occurred in Utah is because the media — especially the print media — took the time to understand the implications of the proposed reform. Did the media always get it right? No. Sometimes the media was wrong, but most of the time the media made the case for tax reform.

6. Use trained professional staff in the state.

The quality of the staff work provided by the executive and legislative branches of government was essential to reform. The staff coming from masters of public administration and policy programs are adequately trained to perform significant analysis. ☆

⁶Zodrow (1999) identifies Tannenwald (1990) on Massachusetts, Ebel (1990) on Nevada, Dearborn and Ladin (1990) on Maryland, McGuire (1989) on Arizona, Wasylenk and Yinger (1988) on Nebraska, and Coe, Coleman, and Bradford (1988) on New Jersey as helpful in his efforts to consider tax reform in Texas.

