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WHO GETS THE BILL?

Water Finance and Fairness in Utah

THE PAYING FOR WATER SERIES
PART III - SEPTEMBER 2019

WHO GETS THE BILL?

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INTRODUCTION

Utah ranks among both the nation's driest and fastest growing states. Water governance approaches that ensure sufficiency of affordable, quality water into the future is a major concern. Utah Foundation's series of water reports seeks to fully explore the issue of how we pay for that water.

Historically, property taxes, impact fees and water rates have played strong roles in funding the development and delivery of water. But there is a robust debate over the how much property tax revenues should be used (if at all) in Utah's funding model.

Parts 1 and 2 of Utah Foundation's series on paying for water addressed Utah's water landscape, how residents tend to pay for water delivery and infrastructure, and how the balance between water rates and property taxes can affect water conservation. Part 3 specifically looks at fairness issues pertaining to the use of property tax revenues and water rates.

WHO PAYS THE BILLS?

Issues of water fairness primarily revolve around the fact that revenues generated from property taxes and revenues generated from water rates rely on two different groups. One group includes all those who pay property taxes, and the other includes all those who use water from the public community system.

The property tax group includes owners of property within defined geographical regions of service. However, different groups have different levels of property tax liability, as follows:

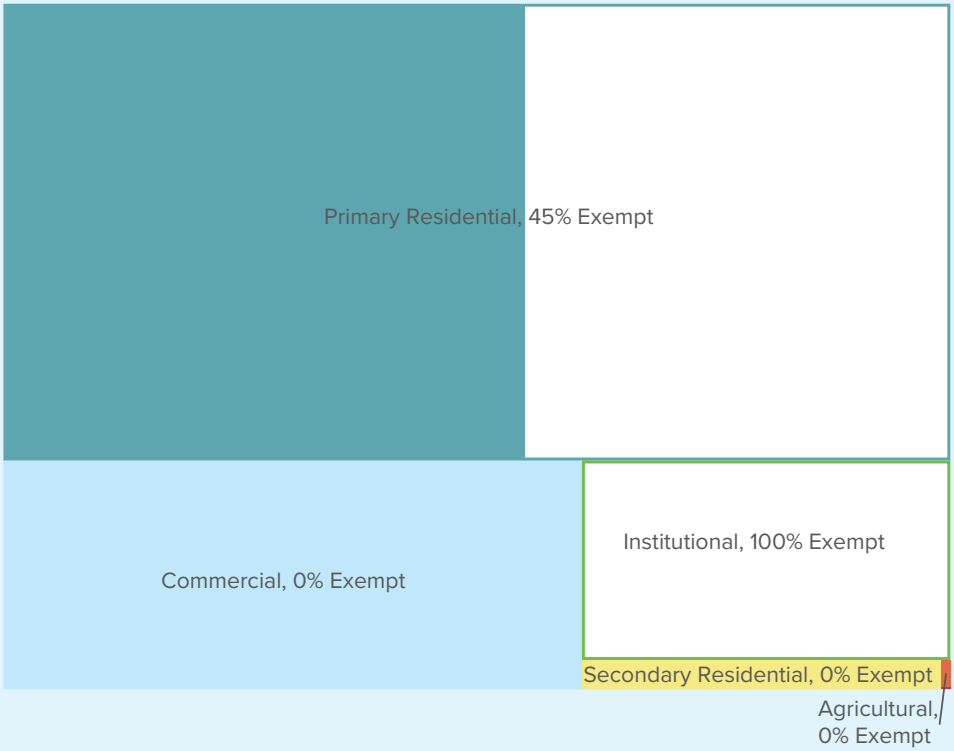
- Most homeowners pay a property tax rate based upon 55% of their properties' total assessed value (through a 45% exemption).
- Owners of secondary residences, undeveloped land and commercial properties all pay property tax rates based on 100% of their properties' total assessed value.

KEY FINDINGS OF THIS REPORT

- Depending on their water providers' reliance on property taxes, nonprofit institutions and other exempt and partially exempt property owners may pay less than their share for the water they use.
- A shift away from property taxes could result in steep rate increases for some users – including school districts and universities. In some cases, those costs may end up being passed on to the public in other ways.
- Based on who uses the most water, a move to greater reliance on water rates would generally provide for a fairer distribution of the cost.
- Using property taxes ensures that a broader base of those who benefit from water systems share in the cost.
- There are ways to address certain fairness issues without changing the revenue mix, such as by charging differential rates based upon user type.
- To the extent that property taxes lower water rates, they can make water more affordable to lower income Utahns. However, there are ways to adjust water rates to address basic affordability without using property taxes.
- From a broad perspective, a mix of property taxes and water rates allows water providers a means of counterbalancing core fairness characteristics attributable to each funding source.

Most property in Salt Lake County is not taxed on its assessed value.

Figure 1: Estimated Share of Property Ownership and Assessed Value in Salt Lake County



Source: Utah State Tax Commission, Salt Lake County Assessor's Office.

- Religious institutions, nonprofits, schools and governments are exempt from paying property taxes on property they use for exempt purposes.
- Under Utah's Farmland Assessment Act, qualifying agricultural properties can be assessed based on their production value rather than market value, likely reducing their property tax liability.
- Commercial and residential renters do not directly pay property taxes. However, owners pass at least a portion of the burden of property taxes to their renters through rents.

To the degree that entities are exempt or taxed at a reduced value on their property, they benefit, but it may be at a higher cost for those that are not exempt. See Figure 1 for an example of exemptions in Salt Lake County.

The water user group consists of those who consume water from water providers. This includes the large majority of households, commercial properties, schools, government buildings, churches and others. Those not included in this group are those who provide their own water based on their water rights, those who rely on canal districts for their distribution of agricultural water, and property owners (typically of undeveloped land) that do not use any water.

HOW RELIANCE ON WATER RATES CAN INCREASE FAIRNESS

The argument for the fairness of water rates is straightforward: Those who primarily benefit from water development and maintenance – those who actually use the water – are the ones supporting the provision of water. To put it simply, the more water you use, the more you pay. The less water you use, the less you pay. Those who use no water pay nothing at all.

A reliance on property taxes means that exempt property owners or those who pay taxes on a reduced valuation are likely paying less than their share of the cost of water. Governments, nonprofits, churches and schools do not pay property taxes; consequently, if their water provider relies heavily on property taxes, they may pay only a fraction of the cost of the water they use. This can be of particular concern where such users maintain large green spaces as part of their property. Churches and religious institutions own hundreds of properties across the state, and a portion of these properties have large turf areas to support outdoor sports or recreational events. Schools have large grassy areas to support school activities. Municipal parks and golf courses use substantial amounts of water to support their green space. Universities also often support large grassy areas on their campuses.

Conversely, businesses, second-home owners and others that pay property taxes on the full assessed value of their property are likely paying more than their share of the cost of water. Ultimately, a heavy reliance on property taxes can mean that non-exempt property owners are lowering the cost of exempt property owners' water use.

As an example, the University of Utah is generally considered one of the highest water users in Salt Lake City, often listed among the top 10 users.[1] It also has $1.27 billion of property in northeastern part of Salt Lake City.[2] Of this property, $179 million is taxable, leaving $1.09 billion exempt. Because most of its property is exempt, it pays only $54,000 in property taxes to the Metropolitan Water District of Salt Lake and Sandy instead of the $384,000 it would otherwise pay. Similarly, the University of Utah only pays the Central Utah Water Conservancy District $72,000 in property taxes rather than $508,000. That means a total of $766,000 in water taxes are not paid because of its property tax exemption is covered by the other taxpayers.[3] This example is not used to single out the university; it is just one example among many across the state.

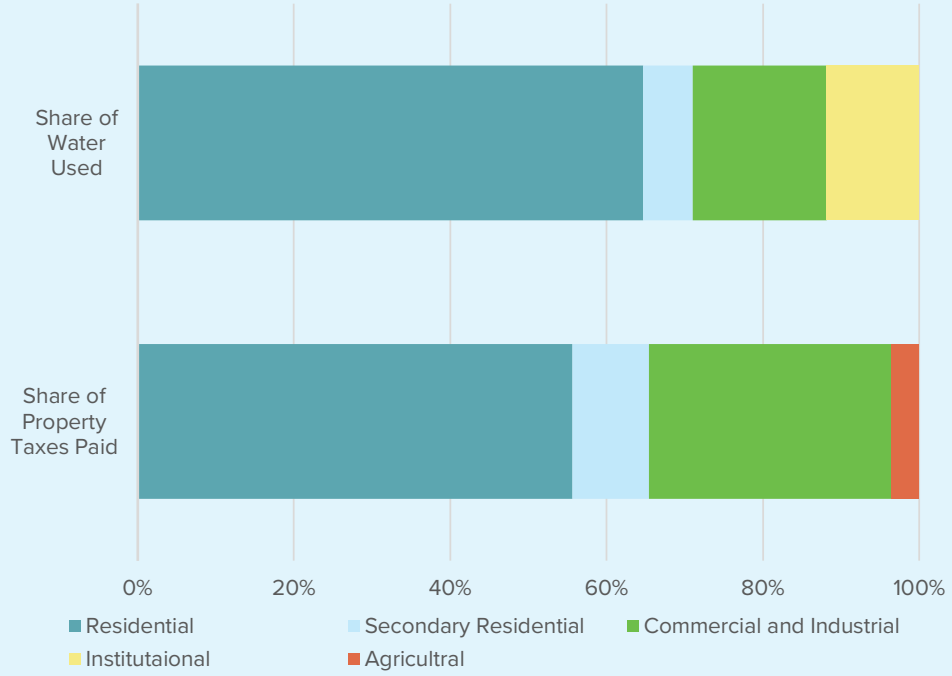
But it should be noted that, because large exempt property owners are often major water users, they do contribute significant sums to the upkeep of water systems through water rates. In some cases, this may allow them to "catch up" to some extent on the rate side of the equation. Nonetheless, the general principle is, the more water districts rely on property taxes, the less exempt users will pay, and the more non-exempt users will pay. By relying solely on water rates and impact fees, institutional users would pay a fairer portion in relation to the amount of water used.

Still, it should be noted that, to the extent the exempt entities are public institutions rather than, say, private nonprofits, the public could end up paying indirectly for their higher water costs. For instance, were a public school required to pay for water through rates alone, their operating costs would rise – costs that would ultimately be shouldered by taxpayers.

A heavy reliance on property taxes can mean that non-exempt property owners are lowering the cost of exempt property owners' water use.

Government and nonprofit institutions pay no property tax, but use 12% of the water in the public community system.

Figure 2: Sources of Property Tax Revenue Compared to Use by Type: Statewide Average



Source: Division of Water Resources, Utah State Tax Commission, Utah Foundation calculations.

A greater reliance on water rates would tend to be beneficial to owners of non-primary residences and commercial property owners. Commercial property owners pay 31% of property taxes, but use only 17% of water from the public community system, on average.

Similarly, non-primary residences pay 10% of the property taxes but only use 6% of water from the public community system. Because primary residences receive a property tax exemption, households generally pay less than the share of water they use. Owners of primary residences pay 56% of property taxes, but use 65% of water in the public community system. Greater reliance on water rates would reduce these imbalances.

Greater reliance on water rates would also be beneficial for undeveloped land holders. Under the status quo, they use no water, but they pay for it through property taxes. Like commercial properties, they pay taxes on the full-market value of their property. The greater the reliance on water rates to cover a water provider's costs, the lower the burden on these property owners.

The statewide average would vary based on local circumstances. Water providers rely on property taxes (directly or indirectly) to different degrees. However, specific studies carried out by or commissioned by water providers that collect property taxes largely confirm the statewide average. Both the Washington County Water Conservancy

Some institutional entities might see the amount they pay for water more than double. For some of these entities, those costs could be hard to absorb, and they might seek to pass the new costs on to others.

District and the Metropolitan Water District of Salt Lake and Sandy commissioned analyses of the impact of eliminating property taxes on end water users.[4] Jordan Valley Water Conservancy District, which covers much of the Salt Lake Valley outside of Salt Lake and Sandy, performed its own analysis on the impact to end users.[5] Estimates varied based on their methodology and the geography analyzed. Some water providers rely more on property taxes than others. For example, Salt Lake City provides a majority of water itself, and purchases water from the Metropolitan Water District of Salt Lake and Sandy only to cover summer peak use. By contrast, some entities served by Jordan Valley Water Conservancy District receive all of their water from the district. Water providers that rely less on property taxes would expect to see smaller changes in net price.

Based on these three studies, institutional users were projected to see a 17% to 138% net increase in their water costs. Households could see anywhere from 2% to 102% net increase on their net cost of water if property taxes were eliminated. Commercial entries in Salt Lake would pay 5% to 59% less on net, with some exceptions for entities that use relatively more water but have a relatively lower property value, such as restaurants. Commercial entities in Washington County saw a broad range, from a 71% net decrease to an 81% net increase; overall, more types of commercial entities were estimated to have higher net water costs.

Undeveloped landowners and landowners that fall within the jurisdictions of a water provider collecting property taxes, but that are not a user of the public community system, were not specifically addressed in the Salt Lake County studies. However, these property owners, as highlighted by the Washington County study, would expect to see their costs to the public community system removed.

Based on who uses the most water alone, a move to greater reliance on water rates generally provides fairer distribution of the cost.

While it might be fairer from a certain perspective, any major transition away from a property taxes toward water rates would have significant impacts as outlined above. Some institutional entities might see the amount they pay for water more than double. For some of these entities, those costs could be hard to absorb, and they might seek to pass the new costs on to others. For instance, if post-secondary institutions had to pay more for water, they could seek to pass the costs on to students in the form of higher tuition or fees.

With that said, many providers across the U.S. – and in Utah – rely solely on water rates to pay for their infrastructure, operations and maintenance costs. In these cases, exempt property owners are already paying full freight for their water use. This creates winners and losers among different water providers. Among some providers, exempt property owners enjoy a discount on their water. In others, they do not.

There might be ways to increase fairness without changing the revenue mix. Water providers could charge differential rates to different classes of users. Commercial properties could be charged with a set of lower rates because of their higher contribution through the property tax. Households could have a slightly higher set of rates as they are partially exempt from the property tax. And institutional users could have an in-

FAIRNESS AND IMPACT FEES

While this report focuses primarily on the fairness of property taxes, there are also concerns about fairness regarding impact fees. Impact fees can be a substantial source of income for water providers, particularly in quickly growing areas. Impact fees are levied on new development to account for the cost of connecting to the water system and essentially "buy in" to the system that existing users have paid to build. This seems fair in that the users of the new development are paying the costs of their connection and purchasing equity in the water system.

However, this assumes the those purchasing in the new development are new to the community. If current local residents are purchasing in the new development while newcomers primarily purchase older houses, then the existing residents who already paid for the water system are buying equity in a system in which they contributed in previous years, while newcomers gain the benefit of the equity the previous owners paid into the water system.

How these fees are used can also provoke other fairness concerns. If impact fee revenues are used for future users (not directly for the users moving in) it could work against intergenerational fairness considerations.

creased rate that is more reflective of the full cost of water as they do not pay property taxes. Salt Lake City currently charges differential rates to water users outside city boundaries based on a similar justification.[6] A Utah law passed in 2019 that becomes effective in 2021 defines "a situation in which ... retail customers in one classification ... contributed ... to build or maintain a system differently than retail customers in another classification," as a "reasonable basis for charging different rates."[7] North Logan is another jurisdiction that charges differential rates to commercial and institutional users, although they do not appear to be related to their property tax contributions.[8]

At the same time, Utah and all other states have determined that governments, churches, nonprofits and similar entities are a special class that merit an exemption to the property tax on property used for enumerated purposes.[9] So while these institutions also rely on local transportation infrastructure, for instance, they do not contribute to its upkeep, meaning that other property owners are fully subsidizing them. The services these entities provide are judged to be beneficial enough to be partly or completely exempt them from taxation. It might seem presumptuous to some to charge differential rates when Utah's constitution has designated that they merit a special tax-exempt status.

HOW RELIANCE ON PROPERTY TAXES CAN INCREASE FAIRNESS

Undeveloped landowners do not use water, and therefore they do not pay water rates. However, they may pay property taxes to support local water systems. One can argue that this is fair because, while they do not directly benefit by using water, there are other ways they benefit from their local water systems.

To begin with, when water infrastructure is in place to support development, the value of their land increases. During the process of development, landowners are generally responsible for much of the cost of bringing infrastructure onto their property, but they benefit from the fact that there is a larger water delivery system to which they can connect. If water providers relied solely on rates, then owners of undeveloped land would not contribute to a public asset from which their property may ultimately benefit through increased property values and future access to the water system.

While more indirect, a similar argument could be made for water users that provide their own water. Though they are not a part of the public community system, they likely derive benefits from having a public community system nearby. If a commercial entity

is providing its own water, it still benefits from a public community system supporting the existence of local consumers and employees. Residences in a similar position benefit similarly from a public community system nearby to support economic growth, allowing residents to purchase necessary commodities locally. This situation, however, may be of less concern as water users that supply their own water may do so because they fall outside the service area of a water provider and are not affected by property taxes to support a water provider.

Looking at fairness more broadly, it is important to keep in mind that some water providers can focus on more than just providing water to households, businesses and institutions. Traditional water delivery services capture, treat, purify, convey, pump, store and distribute water to residents. When these are the services provided, it may be more fair to rely exclusively on rates. However, water providers (especially many conservancy districts) also support services such as fire flows, hydroelectric power, watershed management, endangered species protection, groundwater protection, water storage, flood control, water quality protection, long-term planning, land right-of-way acquisition, emergency planning, various types of conservation programs and recreational amenities. It is clear that the general public directly benefits from the activities beyond providing water, and it can be argued that it would not be fair or logical for water users alone to bear the burden of certain public services.

One specific example to illustrate this issue is Central Iron County Water Conservancy District. This area relies primarily on groundwater as its water source. Studies provided by the conservancy district and Utah's State Engineer indicate that the district's underlying aquifer can support an annual withdrawal of 21,000 acre-feet of water.[10] The area actually withdraws 28,000 acre-feet annually. Further, there are water rights claims for this aquifer for 50,000 acre-feet.[11] The conservancy district is active in working with Utah's State Engineer to resolve unused water claims and find a way to reduce water use to supportable levels. In 2017, the district finished building an aquifer recharge plant and plans on building a water treatment plant to clean up sewer-effluent water to be used to recharge the aquifer.[12] These efforts benefit all area residents and property owners. For that reason, one might argue that it would be unfair to put all of the costs associated with the area's groundwater and watershed management on the monthly water bills of the subset of county households that receive their water directly or indirectly from the conservancy district.

One potential way to address these concerns is through the broader use of enterprise accounts. Cities may provide water services, but they also might provide library, police, fire, economic development, housing assistance, streetlighting and other services. They often separate business-like services (such as utilities) from their general-government services through the use of enterprise accounts. Generally, the revenue earned from those services and the cost of providing those services is linked solely to those accounts. If special districts have branched into providing general -government services, they can separate the two into different accounts. Then the general population can support general services while water users can exclusively fund water delivery and services. Some conservancy districts that provide hydroelectric power have already done this with hydroelectric revenues and expenses.

It is important to keep in mind that some water providers can focus on more than just providing water. It is clear that the general public directly benefits from the activities beyond providing water, and it can be argued that it would not be fair or logical for water users alone to bear the burden of certain public services.

Bonds can be used to create inter-generational fairness regardless of whether or not water providers have access to property tax revenues.

However, enterprise accounts alone might not be enough. Some expenses could have both general government and business-like purposes. One example might be maintaining a reservoir, which serves both as a water source and also has more general government uses such as flood control, water storage and recreational amenities. The difficulty in classifying some expenses might limit the impact of enterprise accounts in differentiating between business-like services and general-government services.

INTERGENERATIONAL FAIRNESS

Utah's population is expected to increase by nearly two million residents by 2065.[13] Areas experiencing high levels of growth often need to plan ahead to ensure they have enough water to support expected growth. Many of the districts serving these areas develop plans to bring in water from other sources or additional treatment, storage or pumping facilities to meet their future needs. These water development projects can be expensive and take decades to build. As a result, water projects often need to be under construction before those who will use the water arrive.

Most of the state's population growth is a result of Utahns having children and Utahns living longer. Not only is the entire community responsible for population growth, but it also benefits from the economic growth that water permits. Some argue that it would not be fair to place the whole burden of growth on those that pay water rates when the entire community is responsible for the population growth and benefits from economic growth.[14] More to the point, there is the question of intergenerational equity: Are costs appropriately distributed across time to ensure that beneficiaries both today and tomorrow share appropriately in the cost?

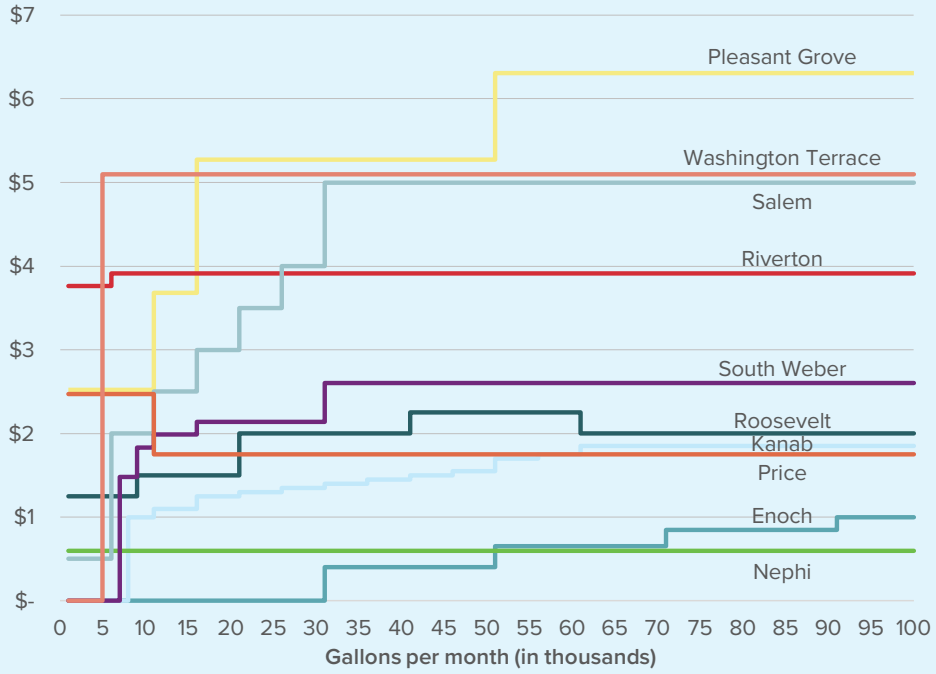
The most common way of addressing the equity between current and future users is with bonds. Bond proceeds can be used at the present time to build projects that will benefit the future users. The bond repayment structure ensures that at least a portion of future users will directly share in its costs as the bonds are paid off over time through taxes or water rates. Bonds can be used to create inter-generational fairness regardless of whether or not water providers have access to property tax revenues. The impact of removing property tax collections for general use on the finances of water providers and their ability to obtain affordable financing is further discussed in Part 4 of this series.

FAIRNESS AND ACCESS TO WATER

Most Utahns interact with water in the public community system. However, once in the public community system, water largely acts as a private good for most Utahns. As such, it is excludable (meaning the water provider can limit access if a household does not pay) and rivalrous (meaning each gallon a household puts on its lawn is one its neighbors cannot use on theirs). In general, it is widely accepted that free markets provide the best distribution for private goods. Market distribution can largely be characterized as follows: those willing to pay the most for a good get the most of that good. For those who subscribe to market optimization, a strong reliance of water rates best meets those goals.

Selected tiered water rates demonstrate the variability among water providers' rate structures.

Figure 3: Tiered Water Rates for Select Water Retailers



Source: Governor's Office of Management and Budget.

However, water is also considered a basic community resource. Utah's state constitution and statues classify the state as the owner of the water within the state. It recognizes claims via water rights only if it can be shown that its use has a useful or beneficial purpose.[15] There are also protections to prevent the monopolization of or speculation on water, or to prevent other uses that would work against the public welfare.[16]

If water is a basic community resource, necessary to survival, civilization and economic growth, it can be argued that all taxpayers, not just users, have a responsibility to ensure its provision – and at a rate that is affordable to all. From this point of view, property tax revenues appear desirable, because they lower water rates and thereby make quality water more affordable to those residents with the least resources to pay water rates. In addition, because property value offers an index of the owner's wealth, it can be argued that the property tax (particularly with a 45% discount for primary residences, whether owned or rented) has some progressive aspects that help further lower the burden on those less able to pay.

However, even without property taxes for general use, there are ways to ensure that water is broadly affordable. There is a certain amount of water necessary to maintain a healthy, hygienic life. Nearly everyone agrees that access to this minimum level of water should be affordable. Often, this necessary amount of water is sold below the actual cost of distribution. The amount lost by the water provider is made up by charging higher rates to water users who consume at higher levels. This is considered fair, not only because it allows a necessary amount of water to be available to all, but also because the additional demand created by those who use water at higher levels is more expensive to satisfy. While nearly everyone agrees in principle, there are varying perspectives as to how much water should be considered basic, and how much lower it should be relative to higher use rates as displayed in Figure 3.

If water providers wanted to take further actions to ensure a basic amount of water was affordable for all users, they could use water budgets. Water budgets are

individualized tiers based on factors like the number of occupants and lot size and would allow water to remain affordable at basic levels.[17] Water budgets could possibly even include income information, providing a discount for low-income households. Based on individualized information, water budgets can then be used to create increasing tiered rates oriented around basic, normal, above average and wasteful amounts of water used. Tailored tiers and rates could be used to ensure water is distributed according to community preferences and make basic amounts of water very affordable.

FAIRNESS AND TAXATION PRINCIPLES

There are several principles that are widely held as essential to good tax policy. These include basic principles such as simplicity, reliability, fairness, accountability and transparency. In addition, when it comes to water revenues, taxation principles such as the "ability-to-pay" and "benefits principle" are commonly discussed.

One advantage of the property tax is that it provides some indication of a payer's ability to pay. Those who have the most property at the highest values can ostensibly afford to contribute the most to society.

Water rates, by contrast, reflect the "benefits principle," which is also known as a user fee. Those who are benefiting from the availability of water (those who are using it) are those who are paying to make sure it is available. One good example is the way Utah funds its transportation development. The primary source of funds is from the motor fuel tax. Those who use the state's transportation infrastructure tend to purchase more fuel than those who do not, and thus tend to contribute at a higher level to its development and maintenance.[18] Additional funds are provided through the portion of the sales tax as generated by the purchase of vehicles, as well as vehicle registration fees.[19] Similarly, relying on water rates provides a strong link between those who benefit from the service to those who pay for the service.

Fairness in terms of taxation principles can be argued both ways. Using a definition of fairness that focuses on use, water rates are fairer. If the definition of fairness focuses instead on an equal need and unequal resources to obtain that need, then property taxes tend to be fairer. Under the status quo, water providers that rely on both revenue sources indirectly balance user fees with the ability to pay through property taxes. Districts have some ability to adjust that ratio to reflect local needs and desires. Without property tax revenues, the state moves toward the benefits principle: a simple user-fee basis.

Fairness in terms of taxation principles can be argued both ways. Using a definition of fairness that focuses on use, water rates are fairer. If the definition of fairness focuses instead on an equal need and unequal resources to obtain that need, then property taxes tend to be fairer. Under the status quo, water providers that rely on both revenue sources indirectly balance user fees with the ability to pay through property taxes.

CONCLUSION

At first glance, water rates appear to be a fairer way to pay for water than property taxes. With water rates, those who directly benefit from water systems – the users – pay according to the amount of their use. Yet there are fairness arguments to be made on both sides.

Allowing property taxes as a use of revenue would be fairer in the following terms:

- Water is a necessary for basic human survival. Using property taxes ensures that the broader community is paying its share to fulfill a basic need of civilization. Water is an essential component of civilization and community growth, from which all property owners derive benefit – whether they use water or not.
- Property taxes provide a means by which those in the community with more resources can aid those in the community with fewer resources to meet one of life's most basic needs.
- When water providers offer services that benefit not just water users, but the entire community, (recreation, flood management, fire flows, etc.) it is fair that the entire community helps to pay for those services.

However, relying solely on water rates is fairer in the following terms:

- Those who use the most water must pay the most to support water systems.
- All households and entities will pay closer to the full cost of the water they use, rather than having high-property-tax-liability entities subsidize low-property-tax-liability and tax-exempt entities.

Regardless of the revenue mix, actions can be taken to make things fairer. If relying on property taxes, differential rates can be charged to those who pay different amounts in property taxes or based on use. If relying solely on rates, tiered rates (standard among most water providers) or water budgeting can allow high-water users to partially cover the costs among low-water users, ensuring that a basic level of water is affordable to all income levels.

In short, when it comes to property taxes versus water rates, fairness is often a matter of perspective – and the devil is in the details.

ENDNOTES

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14 Groesbeck, John D., "Economically efficient funding of special districts in Utah," *Meridian Consulting Group and Southern Utah University Department of Business,* Prepared for Washington County Water Conservancy District, (2000).

15 Utah Constitution, Article XVII, Section 1, Utah State Code Sec. 73-3-1.

16 Utah State Code Sec. 73-1-8.

17 Pacific Institute. "Water rates: Conservation and revenue stability," (2013).

18 Admittedly this is becoming less true as fuel-efficiency increases and electric vehicles become more popular. Many states are investigating a tax based on the miles traveled by vehicles to account for this systemic change.

19 Lyon Cotti, Morgan, Stephen Hershey Kroes, Shawn Teigen, and Michael Merrill, "Fueling our future, 2013-2040: Policy options to address Utah's future transportation needs," *Utah Foundation*, (2013) www.utahfoundation.org/uploads/rr713.pdf.

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Ogden City
Revere Health
Salt Lake Community College
Sandy City
South Jordan City
Snow College
Stoel Rives
Thanksgiving Point Institute
United Way of Salt Lake
Utah Farm Bureau Federation
Utah Hospital Association
Utah State University
Utah System of Technical Colleges
Utah Valley University
Vicki Tu'ua Insurance Agency
Visit Salt Lake
Webb Publishing
Weber State University
West Valley City
Westminster College

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