Center for the Study of Economic Liberty
at Arizona State University

Policy Report

No. 2015-01 May 12, 2015

PATHS TO REFORM

A Policy Roadmap to Elimination of the Arizona Income Tax

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EXECUTIVE SUMMARY

RESTRUCTURING THE STATE'S REVENUE SYSTEM to rely more on consumption taxes (i.e., the transaction privilege tax, commonly known as the "sales tax") and eliminating the personal income tax can be beneficial from both an economic perspective and a public policy perspective. In the following study, I explain how the reform can be accomplished while still maintaining budget balance over six to eight years.

The case for consumption taxes rests on the fact that, in comparison to income taxes, consumption taxes are less harmful to investment and job-creation. That's largely because consumption taxes are "neutral" with respect to investment decisions over time and between industries. They also tend to be more stable as a revenue source over time, and further reliance on them could reduce the volatility of state general fund revenue.

The policy case for reforming the tax system in Arizona recognizes that our state is competing for capital and workers. Low tax burdens will not be enough. We must be more competitive, particularly with states that have no income tax and with states that are taking greater strides than Arizona at reforming their tax codes.

Over the past few years, lawmakers have helped to stay Arizona competitive by lowering corporate taxes and commercial property taxes. However, state policymakers have done little

Published by the Center for the Study of Economic Liberty at Arizona State University
Tempe, Arizona 85287 | (480) 965-1131 | economiclibertyasu.com

over the past decade to reform personal income taxes or review the revenue system as a whole and determine whether it's one that works best for the Arizona economy. This is particularly important with regard to the personal income tax because it is, in ways that many do not notice, a business tax too: "pass-through entities" like S-corps, LLCs, sole proprietorships, and joint partnerships pay their business taxes through the personal income tax code. Since these types of businesses account for over 97 percent of all employers in the state, ignoring the importance of income tax reform more broadly leaves behind the single-largest share of business types.

There are at least five main policy paths available to state policymakers pursuing tax reform. This study outlines each of these options for the purposes of serving as a "tool kit" for policymakers. Each scenario assumes a critical factor: spending discipline in the state general fund budget, which should be an important factor in any long-term plan for tax reform. Tax reform can also be envisioned within the context of revenue growth of the type exhibited over the past 15 years and that economists suspect will continue in the near future.

If policy makers desire revenue neutrality, tax reform can point the way toward more reliance on the sales tax by expanding the sales tax base to some services that are not currently included as a means to "buy-down" the income tax rate to zero over time. This is a reform that can be made in a way that shields the poor and also diminishes the distortions in the economy while stabilizing the revenue stream. Yet it should only be considered as a means to phase down the income tax. Any action that increases the tax burden would be counterproductive and jeopardize our relatively good standing in terms of overall state tax burden.

There are at least five main policy paths available to state policymakers pursuing tax reform. This study outlines each.

Other options for revenue neutrality exist, such as increasing user fees associated with automobile registration or capping the homeowner property-tax rebate. Yet another option would be to avoid being too doctrinaire about revenue neutrality on the tax collections side and instead make room in the budget through spending reforms to allow a commitment to an ultimate goal of phasing out the income tax as quickly as possible. The best option would be to make reforms to spending programs that would reduce state spending obligations and use the savings to "buy down" the income tax rate. An example of that would be reforming the urban revenue sharing program that is anchored to the current personal income tax.

Arizona policymakers have a unique opportunity to consider such important reforms now that state government has reached a semblance of structural budget balance for the first time in years and the state prepares to face a new era of economic growth. This study can serve as a roadmap for such a policy discussion.

INTRODUCTION

Governor Doug Ducey has promised a goal of giving people tax relief each year he is in office. He also has stated that he believes that the state is due for tax reform and that phasing out the personal income tax should be put on the table as a realistic reform option.[1] In addition, a joint legislative task force in 2013 also considered some of the technical aspects of income tax reform, indicating a receptiveness among the leadership and members of the legislature to consider big-picture reforms to the state's tax system.[2]

As we'll see, a substantial amount of peer-reviewed literature in tax policy analysis suggests that elimination of the state income tax would greatly benefit any state that undertakes reforms to do this. This study makes an economic and policy case for such a reform and outlines a number of different scenarios that could make such a tax reform a reality.

My goal in this study is to provide other researchers and policymakers with a realistic picture of different reform options. Each option presents different challenges to lawmakers, but each is also based on an important starting point in discussing reform: tax reform throughout my discussion doesn't need to deprive the state general fund of revenue needed for necessary functions. "Revenue-neutral" tax reform is possible and can, in fact, still be beneficial to economic growth. However, defining success as collecting just as much revenue as before to carry out the same functions of government is not the only path. Savings from reform to spending programs could "pay for" tax reform and simultaneously put Arizona state government on even firmer budgetary footing.

Policymakers should be concerned about how the state tax system extracts revenue. The Arizona tax system has a number of attributes that distort the state economy and diminish the ability of the state to attract new investment and drive job creation. Among them is the current income tax. Since states are competing with each other on the dimension of tax policy, and other states have moved toward elimination of income taxes in favor of consumption taxes or had the pre-existing advantage of having no income tax, Arizona is losing out in the race to attract investors and jobs.

Since a fundamental reform of the state's tax system to reduce or eliminate the state income tax is a goal of the new governor, an examination of the various reform options is a worthwhile exercise to understand how we get from "here" to "there" and also to help stakeholders anticipate the possible consequences of reform.

The paper concludes with a list of possible reform options that would eliminate the personal income tax in Arizona. The most realistic ones are those that phase out the income tax over time starting in fiscal year 2017 (the general budget for which will be considered in the 2016 legislative session). Based on the analysis outlined in this paper, the income tax can indeed be phased-out over a six or seven year period if the state experiences average annual revenue growth rates typical of what the state has experienced over the past 15 years. It will require overall spending discipline that holds spending to a strict baseline, but tax reform could also include reform of a number of spending programs (including urban revenue sharing) or an expansion of the state sales tax base to some services as long as overall tax burdens do not increase.

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A CASE FOR TAX REFORM

The first question that needs to be addressed is why Arizona should embark upon such a tax reform. As we shall see throughout this study, there are a number of reasons to do so. Primary among the reasons is the reality of economic competition between states, as well as the goal of achieving higher economic growth. In addition to the economic benefits, tax reform could also make the state's general fund revenue more stable over time.

Across the states, much of the debate over tax reform is over tax burdens – how much taxpayers pay to the government in per capita terms each year. This is certainly an important concern as high tax burdens can inhibit economic growth.[3] However, in the case of Arizona, the concern about overall tax burdens as a reason for tax reform may not be as worrisome when compared to how other states fare. In terms of total per capita state and local tax burden, Arizona ranks 16th lowest in the nation. That's the exact opposite of where the state was in 1990, when it had the 16th highest state and local per capita tax burden in the nation.[4]

Arizona's tax cuts in the 1990s lowered the income tax burden. In 1995, Governor Fife Symington signed into law a substantial reduction of income tax rates, which brought the top rate from 7% to 5.6%. This tax cut alone was enough to bring Arizona to the national average in terms of tax burdens after a number of prior years far above the national average. Later, Governor Janet Napolitano (in 2006) signed into law further reductions to the income tax rates that eventually cut the top rate to its current level of 4.54%.[5]

Since 2006, the focus in Arizona has strayed away from reform of the income tax; instead, greater attention has been paid to creating new tax credits to encourage specific types of behavior in order to receive a tax cut. While Arizona lawmakers have been busy pondering tax credits, states like North Carolina and Oklahoma have pursued income tax reforms, catapulting them ahead of Arizona in terms of potential economic competitiveness.

This acknowledgment of past good tax policy decisions should not be read to suggest that Arizona policymakers can't or shouldn't continue to find savings in the state government budget and pass the savings on to taxpayers in the form of lower taxes. Lowering the cost of government could indeed translate to lower tax burdens for Arizona residents and businesses and that could generate some additional economic growth at the margin.

Tax reform that does not break the budget, however, can still create important economic growth potential through important changes to *how* we tax economic activity in Arizona. This type of approach to fundamental tax reform should be the next frontier. Low taxes are no longer enough. To chart the right path, policymakers should understand how the current system distorts business and economic decisions as well as what the current system does well and poorly.

ELIMINATING THE INCOME TAX CAN REDUCE DISTORTIONS IN THE ECONOMY

Income taxes, by their nature, create economic distortions. The distortions that come from income taxes aren't just a function of how policymakers carve out special exemptions and credits for particular industries or categories of activities, although those are clearly distortionary. Even an income tax free of politically motivated loopholes is non-neutral with respect to investment decisions over time. A truly neutral tax system should treat savings and consumption evenhandedly. In other words, it would have a neutral impact on a person's decision to save or consume an additional dollar.

This is far from an idle or merely academic concern. The microeconomic decisions made by every individual add up in the aggregate to large macroeconomic patterns. Nor are these decisions made in a vacuum. They are made contingent on assumptions and expectations about the future and a knowledge of alternative uses of their money. If a tax system penalizes saving and investing, there will be less of that activity – and, with it, fewer business starts, lower productivity, and lower job growth.

An example may be helpful in understanding how income taxes skew economic decisions. Table 1 depicts three different scenarios. The first depicts a world in which there are no taxes. The second scenario depicts a world with a 30 percent income tax. The third depicts a world with a 30 percent consumption tax.

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Assume that in each scenario a worker has just received an extra $2,000 in income. (The person in this example could just as easily be a businessperson looking to invest in his or her own business by buying new machinery or expanding a facility.) He has a decision to make: either spend the money or save the money. In each scenario, assume the person consumes half and saves half. Also, assume the rate of return on savings (i.e., the interest rate) is 10 percent.

In Scenario 1 – the world without taxes – the price ratio of current consumption to future return on savings

TABLE 1: How Income Taxes Distort Investment Between Time Periods

	Scenario 1 No Taxes		Scenario 2 30% Income Tax		Scenario 3 30% Consumption Tax	
	Current Consumption	Current Saving	Current Consumption	Current Saving	Current Consumption	Current Saving
A. Current Pre-tax Earnings	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
B. Current Tax	$0	$0	$300	$300	$300	$0
C. Current After-tax Consumption	$1,000	$0	$700	$0	$700	$0
D. Current After-tax Savings	$0	$1,000	$0	$700	$0	$1,000
E. Future Pre-tax Annual Return	$0	$100	$0	$70	$0	$100
F. Annual Tax on Return	$0	$0	$0	$21	$0	$30
G. Future After-tax Return	$0	$100	$0	$49	$0	$70
Price Ratio: Future After-tax Return (G) & Current After-tax Consumption	**$1.00**	**$0.10**	**$1.00**	**$0.07**	**$1.00**	**$0.10**

Source: Michael Schuyler, Consumption Taxes: Promises and Problems. *Institute for Research on the Economics of Taxation, 1984.*

is $1.00 to 10 cents. In other words, the return on every dollar of foregone present consumption (i.e., savings) will be 10 percent.

In Scenario 2, the worker is taxed on his current income and also on the income he earns through savings. This is a form of double taxation because the money is taxed when it is earned as income, and the interest on the savings (the rate of return) is also taxed because it is understood to be income regardless of whether that return on investment will be re-invested somewhere. Therefore, the price ratio of current consumption to future return on savings is $1.00 to 7 cents. The tax code in this scenario disadvantages saving and investing and thereby gives a differential preference to consumption. To put it another way, the income tax as constructed here – which mimics the current federal and Arizona income tax – creates an economic distortion by encouraging consumption at the expense of saving by reducing the rate of return of saving.

In Scenario 3, the price ratio between present and future consumption is identical to that in the no-tax scenario. That is because consumption taxes eliminate the double taxation of saving. Thus, the consumption tax is truly neutral because it does not bias the decision of a taxpayer to save or consume. This does not mean that taxes don't inhibit the *amount* of economic activity in an economy. Higher taxes will always translate to having less money for the private sector to consume or invest. What the example does indicate, however, is that the decision to do one or the other will be far less influenced by the tax code in a state that relied on taxes based on consumption, not taxation of the mere act of earning income.

In fact, this is just the tip of the iceberg when it comes to biases against productive activity inherent in the nature of income taxes. For instance, creating a workable definition of income – whether it should include interest income or not, for instance – is actually much harder to do than defining consumption. Even by this basic analysis, taxing consumption instead of income eliminates the penalty on saving and investing and thereby creates a more neutral tax system. In essence, it is the only possible system that is as non-distortionary as a world in which there are no taxes at all.

An economy less distorted by a sub-optimal tax system would be expected to perform better economically than others. Indeed, the empirical analysis of the real-world evidence shows that states with lower taxes, better tax structures, or the lack of an income tax in particular do see higher levels of economic growth.[6] Perhaps not surprisingly, people making decisions on where to move also favor states with better tax environments probably largely as a result of the healthier economies they find there. Large increases in net migration into states with no income taxes have been ongoing for the past couple of decades.

TAX REFORM CAN MAKE THE BUSINESS CLIMATE MORE FRIENDLY

States are in competition for business investment, be it homegrown or relocating from other states. If the tax climate of a state is, on average, hostile to capital formation or a state maintains a punitive tax burden on businesses and the investments they make, it will lose out to other states that offer better tax treatment. There is substantial evidence that a business tax climate, when properly measured, has an impact on economic growth.[7]

In Arizona, the focus of business tax reform has tended to be on the property tax and the corporate income tax. There are good reasons to focus on these: property taxes can, indeed, be a large expense for businesses and can severely handicap a business's ability to grow. This is especially true in Arizona, which has some of the harshest urban property tax burdens in the country for commercial and industrial property[8] There has been some movement toward remedying this: in 2011, the state legislature passed, and Governor Jan

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Brewer signed, a tax package that will lower the "assessment ratio" of commercial property – the percentage of value used to calculate a company's taxable property base – from 20% (starting in 2013) to 18% by 2016. There were also changes made to allow more generous depreciation write-offs and raised exemption levels for property that is taxed under the business personal property tax.[9]

Corporate income taxes tend to be levied on a specific type of large company (C-corporations), but they are often mitigated by various credits (which, on average, create economic distortions themselves). Yet, lowering corporate income tax burdens in a general way is important because corporate taxes are a form of "invisible" taxation that is ultimately passed down to consumers, shareholders, and workers of the taxed company.[10]

In the sense that corporate income taxes create adverse economic effects, lowering corporate tax rates is indeed a way to make a tax system less distortionary. To that end, Arizona has made some good strides: the state corporate income tax rate is scheduled to fall from 6.5% (the rate for 2014) to 4.9% by 2017. In addition, various provisions to carry-forward net operating losses have been made more generous to make Arizona more comparable to states that already allow such carry-forwards.[11] These tax phase-downs must continue.

However, the corporate income tax generates a small overall share of state revenue – only about 7% in 2014, for instance. Since it's such a small part of Arizona's revenue stream, changing the economic growth trajectory through innovative corporate tax reform seems unlikely. In addition, a tremendous amount of economic activity is generated by small businesses, even though big corporations are higher-profile businesses that capture media attention. Small businesses, like S-corporations, LLCs, and partnerships make up over 97% of all employers in the state and amount to over 40% of the private workforce.[12] Also, many small businesses are entrepreneurs who are self-employed and don't have any employees. But unlike their C-corp counterparts, all of these types of small businesses – called "pass-through" entities because, for tax purposes, their profits are passed through to the shareholders and owners – are taxed as individuals through the personal income tax and haven't had much relief thanks to the prolonged focus on corporate taxation. As such, it may be worth thinking of the personal income tax as not being merely a tax that individuals pay but one that is also paid by the single largest share of employer-types in the state.

It's important, therefore, to consider how investment is treated by the state income tax within this context. A better tax system would be one that introduces the least number of distortions in behavior, and an optimal tax system (as we've already seen) would be one that has a neutral stance toward investment decisions.

One of the distortions in the current tax system is the treatment of depreciation of assets. When a business owner decides to make a capital investment in his business – think of a restaurant owner considering whether to expand the kitchen by buying a new oven or a small manufacturer eager to invest in a 3D printer – one of the questions they have to answer is whether the investment will yield a return over time. Tax rules usually allow only a small portion of the initial cost of investment to be deducted in the first year and a declining amount each year to take into account the decreased value of the machine, also known as "depreciation." But this system by its very nature requires an understatement of the cost of doing business in the first year and then, when you take into account even nominal inflation, may mean a business cannot fully recoup its investment. The optimal depreciation schedule, on the other hand, would remain neutral with respect to the timing of an investment and would, as a result, allow the business to write off the full cost of the investment in the year it's made.[13]

Policymakers at the federal level came to understand the problems with the depreciation system and the federal government did offer what is called "instant expensing" for a large category of capital goods (software and used vehicles, for instance) starting in 2001, subject to a cap. The cap eventually rose to $500,000 in investment per company by 2014. Tax law changes at the federal level over the past decade and a half also allowed a 50% "bonus depreciation" of other heavy machinery categories to speed up the write-off schedule and thereby encourage more investment than would have occurred under the old system.

States, however, may not have been automatically following the federal tax code on this matter. Some actively opted to conform their state tax codes with the federal tax code on these specific provisions while others opted not to. Thirty-three states eventually opted to conform to the federal rules on expensing and bonus depreciation, leaving those that didn't at a competitive disadvantage. Arizona did conform for one year (2013) to the instant expensing provision but when that year was over, Governor Brewer vetoed a bill to make that expensing provision permanent. (As for bonus depreciation, Arizona still only allows 10% of the federal bonus making it one of 28 states not to fully conform to those federal rules.)

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Conditions have improved somewhat on this score in Arizona as of April 2015. Governor Ducey signed into law an extension of the conformity on the instant expensing provisions and its accompanying $500,000 limit. However, this still depends on annual federal renewal. The sort of expensing provision that would best fit a consumption-tax based regime would be a permanent one.

However, in a state without an income tax, these policy concerns would be moot. Far from being an arcane provision in the tax code, depreciation and expensing provisions are a critical element to redefining the tax base to take the current income tax penalty off of investment and transition to a general consumption base. It also eliminates a key distortion created by the income tax and keeping such a distortion in a state tax code makes that state instantly less competitive.

The treatment of capital gains taxes is also crucial. Taxation of capital gains for stocks and business investment also impedes crucial investment because it lowers the after-tax rate of return and consequently stifles the supply of new capital. Entrepreneurial activity has been shown to be sensitive to tax treatment of capital gains: states that allowed more generous exemptions of capital gains from taxation have seen increases in venture capital funding to the businesses in their state.[14] Overall employment growth suffers in states with higher effective capital gains tax rates.[15] During the last economic growth period (2000-2007), the eight states that apply capital gains taxes at a lower rate had, on average, a 35% higher net job creation rate than the states that fully tax capital gains as normal income.[16]

Arizona has made some strides in capital gains tax reform. In 2012, the legislature and governor reduced the tax rate on long-term capital gains on assets purchased after 2011 and held longer than one year. This was accomplished by allowing an exemption of 15% of capital gains in 2013 from income taxation. That exemption grew to 25% by 2015, where it will stay unless state policymakers change it.

While a good step, Arizona still remains less competitive than other states on this score. Current law amounts to a top effective Arizona tax rate of 3.3% on capital gains income. New Mexico, on the other hand, has a top effective capital gains tax rate of 2.85%. And states that have no income tax, of course, do not have to worry about onerous taxation of capital gains income. Finding a way to exempt capital gains income from taxation altogether would be an important goal for any tax reform looking to erase the tax penalty on investment, and elimination of the income tax is one sure way to do so.

Plenty of data indicate that tax factors matter in overall business growth and economic potential for a state. Empirical studies indicate that reforming a state's tax codes to remove the tax barrier to capital creation would, by definition, remove barriers to the creation of new businesses.[17] This has ramifications for job-seekers: creation of new firms and the expansion of existing ones can, by extension, drive further job growth in a state.

It's also no wonder that states which undertake fundamental tax reform that creates more opportunities for investment are also deemed to have a better national reputation as being business-friendly and seen as having a more favorable business climate. For instance, when North Carolina started the process of flattening their income tax structure and began to transition to a sales-tax based revenue system over a decade during which the state income tax will be phased-out – a reform that is very similar to the one suggested later in this study – their ranking in the Tax Foundation's State Business Tax Climate Index jumped to 16th place from its original perch at 44th place. By contrast, Arizona – despite its movement on property tax reforms and corporate income tax cuts – has remained at the middle of the pack at around 23rd.[18]

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TAX REFORM CAN DECREASE REVENUE VOLATILITY

Eliminating the income tax also would decrease the volatility of state general fund revenue and smooth out the swings over the business cycle. Volatility is measured as the growth rate of revenue relative to the growth of the tax base.[19] Since revenue volatility is a ratio, when the ratio is much greater than 1, the tax revenue is said to be more volatile than the tax base. When the result is closer than 1, the revenue is considered less volatile (i.e., more stable). To put it in straightforward terms: volatility scores are like golf – you usually want a lower score.

Income taxes are notorious for being more volatile than sales taxes. A 2008 Federal Reserve Bank of Kansas study reported volatility scores for the three major types of statewide taxes from 1965 to 2007. The personal income tax received a score of 2.58. The corporate income tax received a score of 2.61. Meanwhile, sales tax clocked in at the least volatile, with a score of 1.24.

Within the income tax, there are varying rates of volatility for particular sorts of income. It's not surprising, for instance, that corporate income taxes are more volatile because they are dependent upon the business cycle and corporate profitability. They grow the fastest in economic booms but fall the fastest and the furthest in economic downturns. Capital gains income is also volatile and, as a result, capital gains tax revenues are volatile as well.[20]

Historically, it was believed that the structure and the health of a state's economy – the industry mix and the performance of industries within a state – were a big factor. However, a Rutgers University study in 2011 concluded that when tax structure is taken into account, revenue volatility was more strongly associated with tax provisions (such as what is being taxed, what is exempt, and the rates at which they are taxed).[21] It also stands to reason that tax systems that are based on consumption taxes will tend to have a more stable revenue flow because consumption is less likely to fluctuate wildly the way income and profits do.

Arizona has been typical in this respect. As the Joint Legislative Budget Committee has reported, the sales tax has been the least volatile revenue source over the past ten years, tracking Arizona personal income quite closely. The personal income tax, however, has been very "elastic" and more volatile than the sales tax. The corporate income tax has been the least stable revenue stream.[22] Thus, eliminating the income tax could have more than just an economic benefit: it could have the benefit of making the state's revenue stream more predictable over the business cycle.

THE ARIZONA SALES TAX

State policymakers may want to include new revenue sources to replace the income tax when it disappears. It's worth noting that the single best way to make room in the general fund budget for any tax reform is spending reform and a commitment to discipline in general fund budget growth, particularly if it includes a reappraisal of what government does well or poorly and making changes to the budget accordingly. Or, to put it another way, being realistic about what the proper role of government should be is an important step in all of this.

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As a practical matter, creating new sources of government revenue runs the risk of increasing the tax burden and rendering income tax reform less economically powerful. That said, the best option available for revenue enhancement is through the sales tax system, particularly since the sales tax is a consumption tax and the best sales tax systems, when constructed correctly, can embody many of the attributes of good tax policy outlined in this study. Therefore, a policy discussion of this sort requires a look at the current sales tax system to see how it compares to other states. After all, any changes made to the sales tax system should be considered only in the context of increasing, not decreasing, Arizona's competitiveness.

The first consideration is the tax rate. As we can see in Table 2, the sales tax rate for the state is currently 5.6 percent, which includes the 0.6 percent Proposition 301 tax to fund education programs. That puts the state's sales tax rate above most states in the region but below California. Also included in the table are the rates for the states that have no income tax and rely largely on sales taxes for much of their revenue. Arizona's rate is below five of the seven states in this chart that do not have an income tax.

The rate is only part of the full story. Where much of the differences between states exist is the sales tax "base" – the goods and services to which the rate applies. States that have a "narrow" sales tax base – meaning they tax a smaller list of goods – need to have a higher sales tax rate to generate the same amount of revenue that a state with an average or low sales tax rate applied to a broader and less narrow base has.

There are a number of commonalities with respect to sales tax bases. The main one is that most sales tax systems do not tax food. Of the states in Table 2, the exceptions are Tennessee, which taxes food at a rate of 5.5 percent (less than its normal state rate of 7 percent), and South Dakota.

The big differences in the tax bases come in the number of services that are taxed by the sales tax. The Federation of Tax Administrators (FTA) compiles a list of what services are taxed in each state and groups them by category. This allows comparisons of sales tax bases between states and helps determine which states have narrower tax bases.

Table 3 lists the number of services (out of a total of 168 in the FTA master list) that each state taxes. It indicates that Arizona has a tax base that is broader than Colorado, Nevada, and California. The base, however, is narrower than Texas. With the exception of Nevada, states that do not have income taxes tend to tax a larger number of services. (Nevada is an anomaly since much of their sales tax revenue comes from a particular set of taxed services paid for primarily by tourists. Hence, they can get away with a narrower tax base in a way that other states, except tourist destinations like Florida, cannot.)

Note that the states without an income tax and the broadest bases are South Dakota and Washington. New Mexico also has a very broad sales tax base and a lower sales tax rate, but it also has an income tax and a slightly lower state sales tax rate than Arizona. Washington taxes many services through its "business and occupations tax" which is functionally a business-based form of sales taxation. Finally, it's worth noting that Florida and Texas have broader sales tax bases than Arizona, and yet their sales tax rate is not much higher than the Arizona's 5.6 percent rate.

TABLE 2
2014 State Sales Tax Rates: Arizona and Its Competitor States

State	Sales Tax Rate
California	7.5%
Tennessee	7.0%
Nevada	6.85%
Washington	6.50%
Texas	6.25%
Florida	6.00%
Utah	5.95%
Arizona	5.60%
New Mexico	5.13%
South Dakota	4.00%
Wyoming	4.00%
Colorado	2.90%

Source: Federation of Tax Administrators

TABLE 3
Number of Services Taxed by the State Sales Tax

State	No. of Services Taxed
Colorado	15
Nevada	18
California	21
Arizona	55
Utah	58
Wyoming	58
Florida	63
Tennessee	67
Texas	83
South Dakota	146
Washington	158
New Mexico	158

Source: Federation of Tax Administrators

Contrasting Arizona and states without an income tax, particularly Texas, Washington, South Dakota, and Wyoming, yields some useful comparisons, particularly when it comes to services taxed. Table 4 outlines those differences by category.

States on this side of the country that do not have income taxes tend to tax more services than Arizona does – in particular, personal services, business services, and repair services. Each of the other states is able to maintain a sales tax rate of 6.5 percent or lower while avoiding the need to institute an income tax. Personal services are usually things like salon and cleaning services. Business services are things like design, copy, or car services. Taxation of professional services – like legal, engineering, and accounting services, for instance – tend to be more controversial and not frequently taxed. However, they are, indeed, taxed in South Dakota and Washington. In the latter state they are taxed at a lower rate (1.5 percent) than other services.

Besides Arizona, Wyoming is the only state in this comparison that has a relatively narrow sales tax base. They are, however, a unique state: close to 40 percent of their revenue comes from severance taxes and royalties on mineral, gas, and oil extraction, roughly equal to the amount they raise in the sales tax.[23] Unlike Texas, which generates only around 11 percent of their revenue from comparable sorts of severance taxes including those on oil and natural gas, Wyoming can operate with such a narrow sales tax base and the absence of an income tax.[24]

The picture that emerges when comparing state sales tax bases and the rates that are assessed on them indicates that tax policy textbooks are generally correct: states that have a broad sales tax base can raise sufficient revenue to finance state government without an income tax. A potential problem with taxing some professional and business services, however, is that of "tax pyramiding," which is a form of double taxation. This creates double taxation because the taxes on the input costs (the services a business may purchase while they are making their own product)

TABLE 4
Taxable Services (by Category)

	Arizona	Texas	South Dakota	Washington	Wyoming
Agricultural services	1	2	4	5	0
Industrial and mining services	2	2	4	4	0
Construction	4	3	4	4	0
Utilities	12	12	14	16	10
Transportation	5	3	5	7	3
Storage	6	2	6	6	0
Finance, insurance, and real estate	0	2	7	8	0
Personal services	2	10	19	20	6
Business services	7	14	28	33	6
Computer services	0	8	8	8	2
Automotive services	1	1	5	5	4
Admissions and amusements	9	12	13	13	6
Professional services	0	1	5	9	0
Leases	3	1	4	4	4
Fabrication, repair and installation	2	10	18	16	16
Miscellaneous	1	0	2	0	1
Total number of taxable services	55	83	146	158	58

are collapsed into the price of the final retail good, which is itself taxed. Any reform that broadens the sales tax base also needs to address this problem in some way.

Any sales tax reform should also acknowledge the challenge that city-specific tax rates introduce to the competitiveness of the state. Some jurisdictions have sales tax rate add-ons that can catapult the current sales tax rate of their residents to higher than 10%. Any proposals to expand the sales tax base should be sensitive to this and seek to keep the rate not only regionally competitive but as low as possible.

TAX REFORM SCENARIOS

What follows is a description of five policy scenarios that could be enacted to eliminate the personal income tax in Arizona based on the priorities and tax policy principles outlined previously in this study. Each scenario rests on a couple of important assumptions:

- Revenue growth over the next decade that, on average, would be the roughly the same as the state experienced over the last two business cycles.
- A disciplined annual general fund spending growth rate of 2.3%.
- A policy goal of phasing down the income tax as quickly as possible.

The assumption about maintaining spending discipline is vitally important. Indeed, it might be the single most important aspect of any approach to tax reform. Any large spending increase will either slow down long-term tax reform or necessitate large increases in other taxes that will counter and perhaps even overwhelm the beneficial aspects of getting rid of the income tax in the first place.

There are five policy scenarios that could be enacted to eliminate the personal income tax in Arizona.

<u>Scenario 1: Eliminating the personal income tax in one year.</u>

This is the quickest and cleanest way of eliminating the income tax. It's the one that would provide substantial tax relief to Arizona taxpayers. But it's also the one that will require very large spending adjustments to the state general fund since it is not revenue-neutral. Although the state personal income tax provides less than a quarter of total state revenue, it provided nearly \$3.5 billion in general fund revenue for fiscal 2014. This might necessitate spending cuts of up to somewhere between 30% and 36% of the general fund spending baseline.

The trade-off would be that more economic growth would occur as a result of a tax cut of this magnitude. Doing this would instantly make Arizona much more competitive against most states, particularly those that do not have an income tax. The revenue "feedback" that could occur as a result of the increased economic activity would eventually increase state general fund revenue collections relative to the new, lower baseline that no longer includes personal income tax revenue. It would not, however, eliminate all of the \$3.5 billion difference in revenue.

Also note that the \$3.5 billion estimate assumes that the amount of revenue sharing that the state currently provides to cities and counties would remain at current-law levels. The amount of budget cuts that are needed could go down by roughly \$600 million if urban revenue sharing was eliminated at the same time as the income tax in the first year. (In subsequent years without a change in current law, revenue sharing that is based upon personal income tax revenues would equal zero because the income tax upon which it is based would no longer exist.)

It's also worth noting that this scenario does not include an elimination of the corporate income tax. Doing that would add about \$400 million to the overall decline in baseline revenue and would require a commensurate cut in spending.

Scenario 2: Phase-out the personal income tax over time as revenues permit.

This option would allow a "buy down" of the income tax rates progressively, as revenues permit, over a long period of time. This scenario doesn't require supplementing current revenue sources or spending cuts. It does, however, require strict spending discipline of the kind described previously and at least normal revenue growth.

The idea here is to hold spending to a baseline of no more than a 2.3% growth rate each year – approximately the average rate of growth that is estimated through fiscal 2018 in the governor's January budget proposal.[25] Once spending is under control, step two in this scenario is to use the resulting surplus—each and every year—to reduce income tax rates across the board until they reach zero.

Of all the scenarios discussed in this paper, this phase-out will take the longest to achieve. Using conservative assumptions of revenue growth based on the historical pattern of the last 15 years, eliminating the personal income tax gradually could take more than a decade. It would take longer than that if the corporate income tax is included in the phase-out. During that time, it is probable that at least one recession will occur, which could derail the buy-down of the income tax rate until after the recession. There are also higher risks of political pressure leading to an increase in the income tax rate again to a previous level to balance the budget. Additionally, these gradual and relatively small rate cuts are not likely to spur much new economic growth, especially if there isn't a firm political commitment to maintain the income tax rate reduction until the rate reaches zero.

On the other hand, a more aggressive scenario to ensure spending discipline and a buy-down of the income tax rates could entail reform of the urban revenue sharing system (see Scenario 4 for details) and spending cuts or freezes.

Scenario 3: Eliminate the personal and corporate income tax in one year and make the reform revenue-neutral by reforming the state sales tax.

This scenario would allow the elimination of all income taxes in one year in a revenue-neutral fashion by either raising the sales tax rate on the existing sales tax base or increasing sales tax revenue by broadening the sales tax base.

In order to make up the revenue from eliminating the income tax in the expedited timeframe of one year without broadening the sales tax base, the sales tax rate would need to rise to around 9.6% (a base rate of around 9% plus the 0.6% rate for education funding per Proposition 301). When coupled with county and city sales tax rates, the higher sales tax rate could put the average Arizona tax rate to over 11% (and, in some locations, over 13%), making it the highest sales tax rate in the nation by a large margin and nearly twice as high as many of our competitor states. For instance, it would put our average state and local sales tax rate higher than Texas, twice the sales tax rate of Utah, and even higher than California.[26]

Maintaining spending discipline might be the single most important aspect of any approach to tax reform.

The other option would be to broaden the sales tax base to some services. As explained earlier in this study, Arizona has a relatively narrow sales tax base when compared to some other states that currently have no income tax. Expanding the base to apply the sales tax to a number of professional, business and personal services could help make the elimination of the income tax revenue-neutral.[27]

However, it's important to make sure that the expansion of the sales tax base does not lead to taxing business inputs or lead to other forms of double taxation. This is especially important if policymakers look to eliminate the personal income tax but not the corporate income tax. The corporate tax, because it's based on profits that include sales receipts from items taxable by the sales tax, would effectively tax the same dollar or economic activity twice.

Exempting business inputs at the wholesale level is already done in Arizona. Each business uses their business tax ID number in business-to-business transactions and is not required to pay taxes on those transactions as a result. Taking the same approach for business services that are part of business-to-business transactions — legal services and accounting services, for example—would eliminate the hidden double taxation while expanding the sales tax to final-use, end-user services that are purchased by individuals.

It's important to make sure that the expansion of the sales tax base does not lead to taxing business inputs or lead to other forms of double taxation.

The reform option outlined here assumes that the state could expand the system currently in use for exempting wholesale purchases intended for resale to the taxation of services. In such a framework, business input transactions for services can be declared as exempt when the company remits sales tax receipts to the state.

With that in mind, the number of personal and business services that are taxed could be expanded in Arizona without becoming less competitive with other states and our regional neighbors, which would allow a less steep increase in the sales tax rate than would be required otherwise, but still higher than might be advisable for the purposes of regional competiveness or relative to the average sales tax rate of states without an income tax. Expanding the sales tax base in this way might only require a state sales tax rate of around 6.6% which, when coupled with the Proposition 301 add-on rate, would require a total state sales tax rate of 7.2% to make a one-year elimination of the personal income tax revenue neutral.[28] The rate would go down, however, if the sales tax base were expanded further than is proposed here.

<u>Scenario 4: Institute a flat income tax in the first year, then phase-out the personal and corporate income tax over six years and achieve revenue-neutrality through reforms to the sales tax and/or other revenue generating options.</u>

This scenario combines a gradual approach of phasing out all income taxes, while simultaneously enacting a number of beneficial reforms to the state tax code that can maximize economic growth while the income tax sunsets. To do so would require two components: 1) Replacing the current five-tier personal income tax with a flat-rate income tax in the first year that makes most taxpayers no worse off and includes permanent instant expensing allowances for small- and medium-sized businesses; 2) Begin a transition to a greater general fund reliance on sales tax revenue and require the sales tax base of cities to be made consistent with the new state base.

The spending discipline and paired with a transition to a broader-based sales tax would allow a "buy down" of the personal and corporate income tax rate each year until it reaches zero. The buy down of the income tax rates would occur at a speed contingent upon revenue growth during the fiscal year (assuming a firm commitment to budget discipline that holds general fund spending to around 2.3%). Estimates based on observed fiscal history and conservative assumptions about future economic and revenue trends indicate that the personal and corporate income taxes could be phased-out in this manner within five years.

Component 1: A flat-rate income tax to take the place of the current income tax that would eventually be phased out. The first step of this scenario is to collapse the current five-tier income tax structure into a single rate "flat" tax. However, unlike some versions of the flat tax, this one will not eliminate all exemptions or deductions or tax credits. (For a discussion of what to do about tax credits, see Appendix B.) It will keep the existing deductions and exemptions, including mortgage interest deduction, the charitable contribution deduction, and the medical expenses deduction. It also would keep the existing tax credits.

Instead, this one-rate income tax plan would increase the "zero bracket" below which income is exempt from taxation. It could do so by creating a single per-person exemption at the same dollar amount per person in a household. The per-person amount that creates the zero bracket could actually be broader than the current one and be based on the poverty line in Arizona.

For instance, the current income tax system relies on a standard deduction ($4,945 for a single filer and $9,883 for joint filers) and a personal exemption ($2,300 per child dependent and $6,300 per married couple). So, the current "zero bracket" for a family of four in this example is $20,783. In the flat tax proposed here, the bracket would be based on the poverty line in Arizona (currently at $23,850 for a family of four) and would essentially be a per person exemption of $5,962. Therefore, a family of four would be start with a "zero bracket" of $23,848.[29] This bracket would apply to the income of all families. Anyone with taxable income in Arizona would not be hit with the income tax until its income exceeded the zero bracket.

The personal income tax rate could then be determined based on the needs of the general fund in the short-term while also acknowledging a desire to make sure that everyone is no worse off under the new system and, in the best case scenario, might even see a small tax cut. The rate that balances each of these concerns is around 4.1%. This would ensure that almost everyone pays no more taxes than they did before. Those at the lower end of the income spectrum would receive a tax cut due to the generosity of the new zero bracket. Those in the middle- to upper-end of the income spectrum would receive a tax cut due largely to the lower rate. (See Table 5 for context.)

Another element that should be integrated into this new exemption system is a permanent "instant expensing" provision. This would allow all businesses that pay taxes through the income tax system to write-off immediately the full value of any capital investment they make in their business.[30] This could be capped at the current limit ($500,000, which would cover most of the investment done by a small- or medium-sized business each year) and indexed for inflation. This would, by definition, further redefine the income tax as one that more closely approximates a consumption tax than an income tax. The same goes for exempting capital gains income completely from the income tax base, which could be done in this flat tax plan. Both of these moves, when coupled with the single tax rate, would likely provide substantial economic growth potential for the state and set a strong foundation for future economic and revenue growth that will be used to ratchet-down the income tax rate over time.

Implementing reforms that make nobody any worse off than under the current system would result

TABLE 5
A Flat-Rate Tax for Arizona (brackets by taxable adjusted gross income)

Old System (single filer)	
$0–$10K	2.59%
$10K–$25K	2.88%
$25K–$50K	3.36%
$50K–$150K	4.24%
$150K and over	4.54%
New System	
$0 and over	4.10%

in an income tax cut (relative to the baseline) estimated at around $362 million in the first year. The rate can be raised slightly to neutralize this, but the 4.1% was estimated to both achieve a target as close to revenue-neutrality as possible and also shield as many taxpayers as possible from a tax increase.

In later years, the income tax rate can be cut by either a set amount each year or made contingent on a revenue "trigger." The trigger could be tied to the rate of revenue growth and as long as a revenue growth target is met each year, the minimum income tax rate "buy down" kicks in. Another option would be to commit a specific share of the supplemental revenue (described in "Component 2" below) not to new spending but to exclusively cutting the income tax rate each year.

Component 2: Changes to the sales tax system. To safeguard the "buy-down" of the income tax rate over time and to make sure the state general fund has a steady source of general fund revenue that is more heavily based on consumption taxation instead of income taxation, either a broadening of the sales tax base (along the lines of what was outlined in Scenario 3) or an increase in the sales tax rate could be enacted. If the sales tax base were broadened in the way described above – to a number of professional, business and personal services that are currently not subject to the sales tax – then the sales tax rate would likely not need to be more than 6% (5.4% plus the Proposition 301 tax rate).[31] If the sales tax base were not broadened, then the total state sales tax rate would be 7.4% (or, in other words, the base state sales tax would be 6.8% plus the 0.6% Proposition 301 rate). For the sake of keeping the sales tax rate competitive both nationally and regionally, an overall 6% rate would be preferable.

The sales tax rate and income tax rate phase-down schedule is depicted in Chart 1. The line represents the sales tax rate. The bars represent the top income tax rate for both the personal income tax and the corporate income tax. To give taxpayers and businesses time to adjust to the new tax rate and sales tax base, the new sales tax base and rate can be activated during the second year of the tax reform. By that point, the top income tax rate could be less than half of what it is today (from 4.54% to around 2.0%) by the time the new sales tax rate is in place.

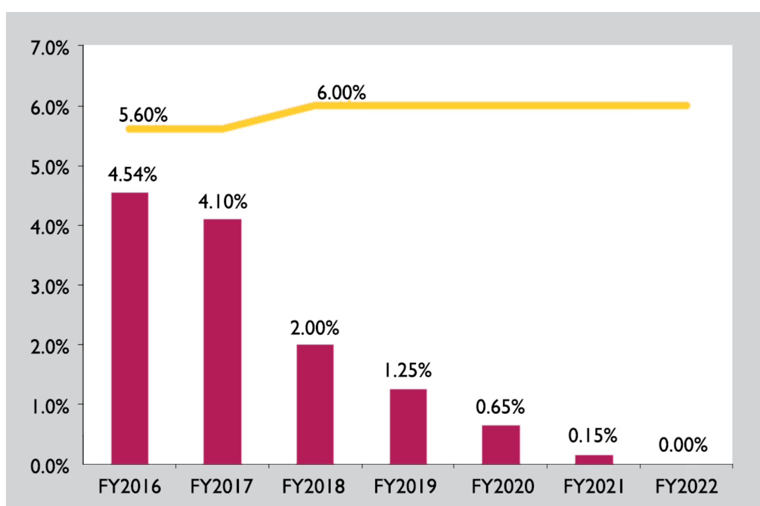
The best approach, for the purposes of maximizing the economic impact of the reform, would be to commit to a minimum buy-down of the income tax rate each year. Forward-looking businesses need the security of the consistent and downward trajectory of income tax rates so they can feel safe making long-term investments that will yield the most economic growth.

Year two of the reform (FY 2018) could see the biggest single-year reduction in income tax rates. That's because most of the increased sales tax revenue from the expansion of the sales tax base can go to buying down the income tax rate by as much as possible in that first year. Doing less than that would increase the overall tax burden for Arizonans.

Note that while the broadening of the sales tax base (or, alternatively, an increase in the sales tax rate) is mainly designed to be a mechanism to achieve revenue

CHART 1

Income Tax and Sales Tax Rate Schedule



neutrality, other options still exist to meet that goal. One could be to increase the amount of money the state collects in certain user fees, such as vehicle license fees. Another would be to cap or reduce the amount that the state spends on homeowner property-tax rebate. If these types of revenue options are pursued, the amount that has to be raised by the sales tax could be reduced. Neither of these options should be used to increase spending but should instead go directly to phasing down the income tax.

Note also that the estimates here suggest an average rate reduction each year (after year two of the reform plan outlined here) of roughly half a percentage-point each year. However, to address budget concerns, the buy-down of the income tax rate could be, starting in year three, tied to a revenue trigger. If, for instance, revenue does not grow as fast as the general fund budget baseline of 2.3%, the buy down in that year can be reduced for that one year. Another way to tying the buy down to revenue flow would be to pre-commit a portion of the increased sales tax revenue to buying down the income tax rate. The estimates here suggest that between 20% and 30% of the new sales tax revenue from taxing services can be committed to the income tax rate reduction each year without upsetting the 2.3% growth rate of general fund spending or the six-year phase-down.

An important part of this reform is a state mandate that cities must differentiate themselves on sales tax rates alone, not on carve-outs to the sales tax base as they often currently do. A requirement that the sales tax bases must be uniform across jurisdictions should be enacted. For example, if food is not taxed at the state level, it cannot be taxed at the local level either. Texas has this requirement and it is, as a practical matter, one of the things that make their sales tax system much less complex than other states. North Carolina, which has reformed its tax system along lines similar to what is proposed here, also has made a uniform local sales tax base a requirement.

Finally, note that this scenario assumes the amount of urban revenue sharing that the state commits will be capped at fiscal year 2017 levels even after the income tax is phased out. At least a third of the new revenue that comes from expanding the sales tax base goes to maintain current levels of urban revenue sharing. In addition, the sales tax expansion will increase the amount of overall state revenue shared by the state with localities via the current sales tax revenue sharing laws (in which they receive 25% of state sales tax collections). As a result, the amount of money that cities and counties receive could go up relative to current law. If changes are made to current law to take this account, the sales tax rate may not have to be as high to maintain revenue sharing. However, if revenue sharing reforms are considered (as they are in Scenario 5), a sales tax base expansion may not even be necessary or at least not in the magnitude estimated here if keeping the current revenue sharing system intact is not a goal.

For the sake of keeping the sales tax rate competitive both nationally and regionally, an overall 6% rate would be preferable.

<u>Scenario 5: Commit to a maximum eight-year phase-down of the personal income tax to be achieved through spending reforms to budget items such as the urban revenue sharing program.</u>

The scenarios above have mostly assumed that making room in the state budget for "buying down" income tax rates would largely come from increases in sales tax revenue. However, there is another way. State policymakers could commit to no more than an eight-year phase-down of the income tax without raising the sales tax rate or expanding the sales tax base. State policymakers could, in addition to keeping general fund budget growth rate at no more than 2.3% each year, also enact reforms to spending programs. They could start with reforms to the urban revenue sharing program and use those savings to reduce the income tax rate.

In the first year, policymakers can enact the flat tax proposal outlined in prior scenario. Then, based on the strength of economic growth and budget savings from reforming revenue sharing, the income tax rate could be lowered each year by at least half a percentage point until it reaches zero in year eight (FY 2025).

The first reform that should be made to revenue sharing is to decouple it from the income tax by making it part of the general fund appropriation process and ending the automatic deferral of income tax revenue away from the general fund. Making this program part of the appropriations process, just like a typical government program, would mean that it would be competing with general fund resources just like other programs must. To justify the expense, cities would need to at least prove they are wisely using the money the state is sharing with them. Policy accountability metrics could also be tied to the shared revenue as a condition of receiving it.

Nor would the legislature necessarily need to keep the overall level of revenue sharing constant. In fact, keeping the current level of revenue sharing would likely require budget cuts in other general fund programs. If the legislature believes that cities, particularly wealthier cities that already receive a large portion of shared revenue because they have a large population, could raise the revenue and make the spending program reforms necessary to finance city budgets on their own, that would be the prerogative of the legislature. They may decide to avoid program cuts to other programs and reduce the amount of urban revenue sharing. They also could introduce a "means-test" to the urban revenue sharing formula wherein large cities with robust tax bases get less or no revenue sharing money while small, rural cities with a less robust tax base would be held harmless. Making such a policy change could potentially save the state around $400 million each year relative to the current-law baseline and those savings could help pay for each year's income tax rate reduction. An alternative criterion would be to lower the amount of shared revenue for cities that already have a high tax burden.

The cities would continue to have the flexibility under this reform to raise the local sales tax rate contingent on state law (which requires ballot approval). As a result, this reform would also give local taxpayers more control over the size of government in their cities. If city policymakers want to finance an increase in the city budget in a fiscal year that would have been financed otherwise by state-shared revenue, they need to ask for the money back from taxpayers instead of receiving that portion of money automatically from the state government.

The income tax phase-out could be hastened by further budget savings in other programs. A good target might be the revenue transfers that currently fund the Arizona Commerce Authority (ACA), which currently amounts to around $53 million. Eliminating the income tax would be a very substantial leap forward in terms of economic competitiveness and it's very unlikely that the economic potential that would result from income tax elimination could ever be matched by any ACA-driven industry favoritism or activity they currently undertake. Besides, one of the current roles of the ACA is to administer various and sundry tax credits that would disappear in a reform that phases-out the income tax over time (see Appendix B). Therefore, the role of the ACA could be streamlined and reduced in the process of phasing out the income tax and, as a result, so could their budget.

An income tax phase-out could be hastened by further budget savings in other programs.

Other general fund budget programs could be reformed – and wasteful spending within them targeted

TABLE 6
Tax Reform Scenario Summary

	Timeframe (years)	Personal or Corporate Income Tax Eliminated?	State Sales Tax Rate (total)	Sales Tax Base Broadened?	Changes to Revenue Sharing?
Scenario 1	1*	Both	5.6%	No	No
Scenario 2	10+	Personal only	5.6%	No	No
Scenario 3a	1	Both	9.6%	No	No
Scenario 3b	1	Both	7.2%	Yes	No
Scenario 4a	6 to 7**	Both	7.4%	No	No
Scenario 4b	6 to 7**	Both	6.0%	Yes	No
Scenario 5a	7 to 8**	Both or personal only	5.6%	No	Yes
Scenario 5b	6 to 7**	Personal only	6.6%	No	Yes

* Not revenue neutral ** Assumes flat income tax reform in year one

– to provide budget savings to speed up the phasedown of the income tax rate. A reappraisal of the scope of state government and scaling it back to a smaller role than it currently plays could also yield substantial budget savings that could be put toward tax reform.

The corporate income tax could be phased out in a fashion similar to that proposed in prior scenarios. That would require additional budget savings averaging around $58 million each year. In the absence of savings in that amount, an extra year or two of tax rate phase-out could accomplish the same goal. However, the usual cautionary note about the potential for another business downturn over this longer time-horizon should be heeded.

Finally, policymakers may still deem in necessary to augment sales tax revenue. However, instead of expanding the sales tax base to services, another option that might be worth pursuing (and would likely have fewer political challenges than expanding the sales tax base) is a sales tax rate increase of no more than one cent on the existing sales tax base. That could, when paired with the spending reforms outlined here, potentially speed up the personal income tax phasedown to no more than five or six years. Because the sales tax rate would increase if this path is chosen, voter approval is required. The sales tax increase, however, should only be temporary and the ballot language should be specifically worded to indicate that most or all of the new revenue would go exclusively to buy down the income tax rate and that it will sunset after the income tax rate reaches zero or seven years has passed, whichever is sooner.

CONCLUSION

The best hope Arizona policymakers have to eliminate the income tax is to phase it out over a number of years while maintaining budget balance. The speed of how fast the income tax rate can fall will depend critically on how strictly state policymakers adhere to spending discipline and to how fast revenue and the economy grows.

The best time to consider fundamental tax reforms is when a state is on surer fiscal footing. Now that the state government has reached a semblance of genuine structural balance for the first time since the recession, it's incumbent on Arizona policymakers to take a look at important and necessary reforms over the next couple of years. As the state prepares to face a new era of economic growth and the tax competition between states that has been occurring in earnest for decades, waiting longer may result in losing a golden opportunity.

APPENDIX A
METHODOLOGY

The estimates in this study use publicly-available data and are based on assumptions about the future that take into account the fiscal history of the state. The estimates are explained in more detail below.

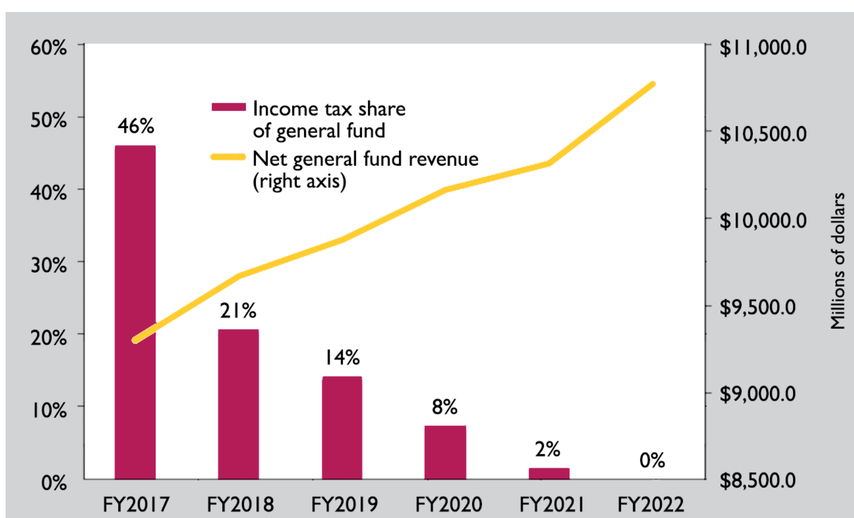
Revenue estimates

Revenue estimates for all taxes for fiscal year 2017 and 2018 are based on data from the Office of Strategic Planning and Budgeting in its January 2015 budget summary. The estimates within that document are based on analysis by the L. William Seidman Institute at Arizona State University. The projected growth rates of future revenue are annualized averages that are based on estimates for fiscal 2014 through fiscal 2018 from this same document.

Annual growth estimates for base sales tax revenue years after fiscal 2018 are an historical average based on data from the Joint Legislative Budget Committee. The average is derived from the growth rate already experienced during the last business cycle period (1999-2007). The growth rate assumed in the estimates in the study is around 7.7% each year. It should be noted that the period upon which the average is based included at least two years of unusually low revenue growth. Taking out those two years brings the average sales tax revenue growth rate to just over 10%. Therefore, the 7.7% average used in this study is potentially conservative for the timescale addressed in this study.

For the purposes of illustration, the growth rate of general fund revenue, net of the "buy down" of the income tax, is right around 2.3%. Chart 2 depicts the growth of general fund revenue that is spendable by the government as well as the percentage of general fund revenue that is reliant on the income tax (both personal and corporate). As you can see, the general trajectory of general fund revenue can remain intact as the revenue stream transitions to greater reliance on the sales tax.

CHART 2
Income Tax and Sales Tax Rate Schedule



Source: Author's calculations.

Taxable income growth estimate

The estimates of taxable income growth past fiscal year 2018 are an average of prior year trends based on historical taxable income growth as published by the Department of Revenue (DOR) in their annual publication, "Individual Income Tax Statistics." The data provided by DOR is lagged by a number of years (the most recent is for tax year 2010), so the income tax data was scaled-up to the present day, using an average based on annualized growth rates from the prior seven years, for the purposes of the analysis.

Sales tax base estimate

Estimates of the revenue expected from expanding the sales tax base to services were based on the Department of Revenue's publication, "The Revenue Impact of Arizona's Tax Expenditures: Fiscal Year 2013/2014," November 15, 2014. To estimate the portion of annual transactions that would be exempt because of the need to keep business-to-business transactions tax-free, an Ernst and Young study, prepared for the Council on State Taxation (COST), was used. ("Sales Taxation of Business Inputs," by Robert Cline, John Mikesell, Tom Neubig, and Andrew Phillips, January 25, 2005.)

As a result of the proposal to exempt business-to-business transactions, the estimates of potential revenue gains from expanding the sales tax base generated by the Arizona Department of Revenue are larger than what can be expected under a tax system that exempts from sales taxes the purchase of services that are not to a final-use consumer. Based on the COST study, estimates of the percentage of the three major business service categories that is composed of business-to-business transactions appear below in Table A.

TABLE A

Portion of Business Services Category Due to Business-to-Business Transactions

Professional, Scientific, and Technical Services	50.6%
Administrative and Business Services	32.8%
Financial Services	66%

Source: Author's calculations based on data from COST and the Arizona Department of Revenue

A note on Proposition 301

Expanding the sales tax could also increase the sales tax base to which the Proposition 301 sales tax rate is applied. Doing so could generate at least $160 million each year for Proposition 301 programs. Because that revenue stream would be automatically re-routed to voter-approved education programs, that increased revenue was excluded from overall growth of government estimates used in this paper. If included, overall education-inclusive state spending would actually grow faster than the 2.3% estimated in this study.

APPENDIX B
WHAT ABOUT INCOME TAX CREDITS?

There are a number of tax credits that are attached to the existence of the personal income tax. The disappearance of the income tax would obviously have an impact on them. Thus, it is important to consider what reforms might be necessary and desirable for those programs and whether those credits are worth keeping in the future. In addition, it should also be remembered the elimination or reform of some of these credits could yield budget savings (relative to the baseline) that could help state government make the transition to the new tax system and those savings should be considered in any discussion of whether to keep the credit.

For starters, by far the largest income tax credit is aimed at allowing tax filers to recoup some of the taxes they paid to other states and countries. The state awards over $90 million in those credits annually. These credits are meant to help taxpayers subtract out of their tax bill the out-of-state income that is included in their taxable base (i.e., federal adjusted gross income) but should not be subject to tax by the state of Arizona. That this credit would disappear if the income tax were to be eliminated should not be a concern. The problem the tax credit was designed to remedy is a problem created entirely by using income as the basis for taxation. In a consumption-based tax system, where the income was earned or to what external governmental entity a tax was paid based on it would be irrelevant. Instead, taxation would be based on in-state consumption only.

There are, however, a number of other income tax credits that tax filers can take advantage of to lower their income tax liability. These tax credits fall into four different categories and are discussed below.

Tax credits for the poor

Two credits – which together account for nearly $40 million in tax credits awarded – are aimed at mitigating tax burdens on the poor: the tax credit to compensate for increased excise taxation (A.R.S. § 43-1073) and the working poor family tax credit (A.R.S. § 43-1072.01). The former was enacted when the 0.6% sales tax rate was added after the passage of Proposition 301 in 2000 for the purposes of financing more education spending and was designed to help poor families who were now paying a higher sales tax burden because of the new higher rate. The latter, which is a credit that can be claimed only by a tax filer family at below $31,000 ($10,000 for single filers) in federal adjusted gross income, is primarily a way to help poor families working their way out of poverty.

These income tax credits are best described not as discrete credits but as part of an overall welfare program administered by the state. What makes them peculiar is that they are administered through the tax code and not through the general fund the way other welfare spending is. However, the elimination of the income tax doesn't necessarily have to make the poor worse off relative to the status quo in which the income tax and these credits still exist. As we've seen, any shift away from the income tax can be structured in such a way as to avoid hurting poor workers. And, as discussed previously, such a push to eliminate income taxation should be seen as a way of setting free currently pent-up economic growth potential and could therefore increase the number of new job opportunities for poor workers. Additionally, folding this form of financial support for the poor back into the yearly budget appropriation process instead of relying upon the auto-pilot nature of the current tax credit regime could increase the transparency and accountability of all the funds being spent by state government to alleviate poverty in the state and potentially lead to more effective outcomes overall.

Property tax credit

This tax credit is designed to lower the overall cost of property taxes by lowering the overall income tax bill owed by low-income elderly homeowners. It amounts to roughly $7 million a year, or just over $380 per claimant. Yet, it's not clear that lowering income taxes for homeowners is the best way of lowering overall property tax burdens. Lowering property tax burdens directly is likely to be the best way.

The argument in favor of this tax credit has to do with the fact that piggybacking on the income tax form, which already requires a statement of a filer's income level, is an easy way to means-test this form of tax relief. However, alleviating the tax bill of poor elderly homeowners could easily be done through the property tax system itself in a world without an Arizona income tax. Means-testing could still be accomplished by allowing a poor elderly homeowner to prove eligibility by submitting to the county a federal income tax statement that shows their adjusted gross income. A tax credit could then be applied directly against the property taxes owed. This might increase slightly the administrative costs of local governments, but it is likely to be a small increase and could even be a cost that is shared between state and local government.

Tax credits designed to spur job creation and other specific behaviors

Most of the remaining tax credits are ostensibly aimed at subsidizing specific business decisions or other behavior, such as installing residential solar panels. It's hard to rationalize keeping these types of credits. They are mostly the product of trying to steer private investment in a specific direction, thereby creating the economic distortions that are the hallmark of most income tax systems. If the goal of tax reform is to both reduce economic distortions and eliminate the taxation of income, these credits should not be salvaged.

The credits that are particularly hard to justify keeping are the ones that are meant to subsidize the creation of new jobs. There is no evidence that they actually create new jobs, on net, that wouldn't have been created otherwise. As a result, these tax credits simply represent a transfer of wealth from taxpayers to businesses for doing things those businesses would have done anyway.

The credits aimed at subsidizing research and development would also not have a place in an environment where there is no income tax. The initial aim of these credits was to provide additional support for a specific corporate investment – R&D – that was being penalized within an imperfect income tax regime. But when all non-consumed business income that is invested would be exempt from taxation – including those that are investments in research and development – having an R&D tax credit is unnecessary.

Finally, business-activity credits of all sorts are often justified as enticements to businesses outside the state that might consider relocating to Arizona. However, telling businessmen in other states that Arizona no longer has a personal income tax is a much better recruitment tool than any particular tax credit. The benefits of using these tax credits as deal sweeteners virtually disappears when there is no personal income tax for those businesses to contend with.

Education-related tax credits

Unlike most of the other tax credits discussed here, the education tax credits are worth finding a way to salvage. There are two main types of tax credits that lower the tax liability dollar-for-dollar (up to specific dollar limits) for income tax filers who give a donation to either a public school or a non-profit organization. The first is a credit for donations to a scholarship tuition organization. The STO, in turn, uses the money donated to give out scholarships to special needs children to attend private schools or receive specialized homeschooling attention. The other type of tax credit is geared to those who contribute money to public schools to help fund various extracurricular programs. In fiscal year 2012, the most recent year of data available, personal income tax filers declared a total of roughly $116 million in these credits ($64 million for the STO credit and $52 million for the public school credit). That's the biggest overall chunk of all the existing personal income tax credit categories.

The donations that trigger these credits are best seen as a private source of funding for expenses that, in the absence of the donations, would have to be financed by the state government or the school district. So, unlike other tax credits that are meant to subsidize activities, these credits are more properly thought of as reimbursements for people who used money they would have paid in taxes otherwise and directed it instead to a specific public service. This, by definition, frees up room in the budget of those respective governmental entities and the credits are a way of taking some of that surplus and delivering it back to taxpayers.

Yet, property taxes pay finance the vast majority of school budgets so it's peculiar to administer this program through the income tax. So, in a world in which there is no income tax, state law should be changed to allow property tax payers to declare the same credit against their property tax liability.

ENDNOTES

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30 This would replace the current and somewhat arbitrary system of depreciation rules for capital investment that creates economic distortions.

31 Author's estimates based on data from the Arizona Department of Revenue.