CONFORM AND REFORM:
*How Arizona Policymakers Can Use Federal Tax Reform as a Spur to Reform Arizona’s Income Tax System*

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**EXECUTIVE SUMMARY**

The federal Tax Cuts and Jobs Act (TCJA) has, for the first time in over 30 years, made significant changes to the federal tax code. The changes make the federal income tax system more amenable to new investment activity and job-creation largely by making the tax code less distortionary with respect to market decisions.

For Arizona to take full advantage of those provisions, however, policymakers will be required to “conform” the state tax code to the federal changes. State policymakers should be encouraged to conform to the new federal law because the TCJA adheres to some key principles of sound tax policy. This policy brief will outline the reasons why the state should conform to it.
But the policy actions shouldn’t stop there. Those changes will lead to increases in state income tax revenue mainly due to changes in the definition of taxable income. This is not surprising: the last time changes were made to the fundamental nature of federal tax policy occurred in 1986 and states that conformed then also saw increases in state income tax revenue. At that time, most states (including Arizona) returned the revenue windfall to taxpayers.

Arizona policymakers this year can pursue a “conform and reform” policy that conforms the state tax code to the new federal tax law but also reforms the state income tax system to maximize the economic growth potential of the TCJA. It would not require a great deal of searching for potential reform options: Arizona’s bipartisan 2013 Joint Legislative Task Force on Individual Income Tax Reform considered and favorably received a number of reform proposals and included them in its final report. These proposals are likely to be far easier to enact in the context of a guaranteed revenue windfall of the sort we’ll see with TCJA conformity than they would when originally considered at a time when “revenue neutrality” was essential.

A list of reform options can include, but not necessarily be limited to:

- Substantially expanding the standard deduction of the state’s “zero bracket” so all income brackets, particularly the poor, receive a tax cut;
- Lower the state income tax rates across the board;
- Collapse the five-bracket Arizona income tax into one that has no more than three brackets with rates ranging from 2.5% in the bottom bracket and a top rate of no more 4.5%;
- A single tax-rate income tax system also is a possible alternative with a rate in the range of 4%;
- Lower the effective capital gains tax rate by expanding the existing capital gains income tax exemption to 30% or more.

Arizona policymakers have a unique opportunity to reform the state income tax system. While policy options should be debated and revenue estimates seriously considered, legislators should keep in mind that the Arizona economy and state taxpayers could benefit from both tax code conformity and reform of the existing system.

INTRODUCTION

As a result of the recent passage of the federal Tax Cuts and Jobs Act (TCJA) of 2017, Arizona’s taxpayers — most of whom will receive a tax cut on their federal income tax bill starting in tax year 2018 — could face a state income tax increase if state lawmakers decide to “conform” state tax law with federal law as has generally been the practice in prior years. State tax revenue is expected to increase above the estimated baseline based on state tax law as it existed prior to the passage of TCJA with such a change. Estimates vary, but it is likely to be somewhere between $130 million and $235 million.1

Although the fact that a person or business might receive a tax cut at the federal level but not at the state level sounds counterintuitive, there is a simple explanation. The amount of income tax that an Arizona taxpayer owes to the state is based on federal adjusted gross income (FAGI) or, for some businesses, federal taxable income. That means it uses the federal tax code’s definition of your income as the basis for the calculation. However, unlike in prior years, these will both be calculated differently starting in tax year 2018: the federal tax code will use a more inclusive definition. Additionally, new limits on many exemptions and deductions in the federal tax code could also have an effect on state taxpayers who declare them on their state taxes too.

This is not the first time federal changes like this have influenced the state income tax tab of Arizonans. Over thirty years ago, when the federal government enacted a substantial tax reform bill under President Ronald Reagan in 1986, it had the effect of re-defining FAGI and eliminating a number of exemptions and credits that had the cumulative downstream effect of increasing taxes on
Arizona residents. In the years following the 1986 reform, Arizona returned the income tax windfall to taxpayers by allowing an additional subtraction (in the first year, it was equal to roughly 50% of federal income taxes paid) on state income tax returns to compensate. Arizona was not alone in returning the income tax revenue windfall to its residents: in 1987, only eleven states did not pass some form of income tax cut to return that money to state taxpayers.3

A solution to avoid this tax increase is to simply avoid conforming. As we explain in this study, we do not believe this is a good solution. As a practical policy matter, there are good reasons for Arizona policymakers to conform state law to the new tax provisions. Indeed, there are business tax provisions in TCJA that could lead to more investment and Arizona could see job growth as a result of conforming.

The TCJA actually moves the federal tax code closer to the goal of achieving a tax code that distorts the economy less and is simpler is some key respects. Established principles of good tax policy — which have been generally understood by public finance professionals for decades and were included as the basis for policy proposals in the final report of a bipartisan Joint Legislative Tax Force on Income Tax Reform convened in 2013 by Arizona's speaker of the House and Senate president and on which one of us (Slivinski) served — are a good mechanism for understanding both why the TCJA gets the federal code closer to a better federal income tax code and also why conforming state tax to the new federal law could be valuable and growth-enhancing.4 This study will outline the relevant principles and explain the economic value of conforming state tax law.

However, conforming to the TCJA provisions without any additional changes to state-specific tax laws — like the dollar amount of the standard deductions or the level of income tax rates — will likely result in a tax increase on Arizona residents. This study will also outline some ideas for policymakers to consider to make state conformity with the TCJA either revenue neutral or a tax decrease and thereby augment the potential growth that can come with this federal tax reform. Most of these ideas again come from the final report of the bipartisan 2013 Joint Task Force on Income Tax Reform.

THE CASE FOR CONFORMING

Simple principles of good tax policy can help policymakers distinguish the value of the provisions enacted in the TCJA. The final report of the 2013 Arizona legislature's Joint Task Force on Income Tax Reform enumerates them: “the principles of good tax policy include simplicity, fairness, neutrality, competitiveness, and stability.”5 Most of the provisions in the TCJA, and certainly the most prominent headline-grabbing provisions, adhere to these principles and these principles can provide the best case for Arizona conforming with the federal tax code.

The public finance literature tends to conclude that broad-based tax systems that remove the onus of inefficient taxation from investment can, in turn, lead to more economic growth and job creation.6 As a result, we believe policymakers should place priority on policies that promote movement in this direction too.

PRINCIPLES OF GOOD TAX POLICY

Of the principles of good tax policy, the three that are the most relevant to the current discussion are simplicity, neutrality, and competitiveness.7

Simplicity:

Tax codes that are easy to understand and comply with reduce the transaction cost of filing taxes. This principle is probably the clearest and easiest one to understand. It is also the one that argues most obviously for conforming the state tax code. Having two separate sets of rules and definitions (one for federal returns and one for state returns) needlessly complicates the tax filing process and creates unnecessary tax compliance costs.
**Neutrality:**

Tax policy can create economic distortions over time by favoring some business activities over others. Policymakers do this by subsidizing activity through the tax code in the form of tax credits or specialized exemptions for politically favored business or individual behaviors. The distortions occur when these subsidies encourage activity that, without the subsidy, may not have occurred or subsidize activity that would have occurred anyway.

Although this may sound like an attractive feature of tax policy to some, it actually results in the misallocation of economic resources that are likely to be better used elsewhere. When policymakers second-guess individuals and businesses, they are effectively substituting their judgment for the “wisdom of crowds” that comes from market-based transactions.

Tax policy can also discourage investment. Heavy tax burdens can make hiring more employees, expanding a business, or even accepting a raise as an employee more expensive and less likely to occur. Additionally, poorly designed exemptions can skew the long-term planning of a company. If “depreciation schedules” — the timeline over which the tax code requires things like machinery purchases to be “written off” — mandate a timeframe that is longer than the useful life of the investment (a very real concern with high-tech investments, for instance), investment capital may sit on the sidelines longer than it would have otherwise and either defer or suppress beneficial economic growth.

Finally, a more neutral tax code is, by definition, one that broadens the tax base because doing so leads to more equal tax treatment of all economic activity, not the exclusion of some activities at the expense of others. This allows for lower across-the-board tax rates to collect an equivalent amount of revenue (and in a more economically efficient and less distortionary fashion) than a tax code with loopholes (i.e., arbitrary exclusions from what is taxable) and high rates.

**Competitiveness:**

State policy and economic activity do not exist in a vacuum. Other states are also competing for population, jobs, and investment capital. Multiple studies have indicated that states with policies that are freer of government intervention (including tax policies that fall outside the simple principles discussed here) tend to be more prosperous.

Any state that piggybacks off of the federal income tax code (basically any state that has an income tax) will be faced with the same choices that Arizona faces about conforming to the federal code. As will become obvious later (particularly in respect to the business tax provisions) those states that do conform will have a differential advantage over those that do not.

**HOW CONFORMING TO THE TCJA PROVISIONS CAN IMPROVE THE TAX CODE IN ARIZONA**

The principles of good tax policy listed above can guide an understanding of the reasons why conforming the state tax code to the federal provisions can be valuable and clean up quite a bit of the inefficiencies of the Arizona tax code. In so doing, it sets the stage for tax policy changes that can enhance the job and economic growth potential of the state’s economy (as we’ll discuss in the next section). Some of the most notable changes in the TCJA are:

**Limiting or eliminating individual deductions and exemptions for individuals:**

One of the ways that the income tax base is narrowed, which thereby increases the need to keep income rates higher than they would need to be if the tax base was broader, is by exempting or allowing deductions for certain expenses. These are often embedded in the tax code as a result of political reasons or an attempt to influence economic behavior.

Some of the exemptions and deductions are common to all tax codes and serve a legitimate purpose. The standard practice with income tax codes is to start with a “zero bracket” at the bottom of the income ladder.
a range of income to which no income tax rate is applied. This is to ensure that the working poor aren’t hit with taxes that might fall more heavily on them — indeed, they may be exempt from income taxation altogether. Yet, this “zero bracket” is available to all who file an income tax. Taxpayers who earn more than the income range outlined by the zero bracket are then taxed at progressively higher rates as they move up the income spectrum.

The zero bracket is the product of the “standard deduction” — a flat number, adjusted each year for inflation, that applies to people based on their filing status (single or married) — and a “personal exemption,” which is applied based on the number of people in a family.

Other exemptions and deductions beyond that have been created to encourage certain types of behavior. One of the most common is the deduction for charitable contributions. An exemption for medical expenses exists too.

Yet another common deduction is that for mortgage interest paid during the year. This is one of the more controversial deductions. Economists largely agree that this deduction is inefficient in that it either encourages excessive investment in residential real estate or simply subsidizes wealthy taxpayers by giving them a tax break on a mortgage they would have held anyway (tax treatment that, by definition, encourages higher taxes on those who cannot take advantage of it, such as those who rent their housing).

The TCJA does limit or eliminate some of these behavior- and transaction-based deductions for federal taxpayers. While it does maintain (and expand) the charitable giving deduction, the others facing new limits are:

- the medical expense deduction, which is lowered to 7.5% (from 10%) of income;
- the mortgage interest deduction which is capped at loans of $750,000 (it was $1 million) originated after 2017.

These limitations (which are also accompanied by the repeal of a number of smaller deductions, such as the write-offs that used to be available for moving expenses) will have the effect of expanding the income tax base.

As explained above, this broadening allows for a wider taxable base of income that can generate the same amount of revenue for government services but doesn’t require a higher tax rate to do so. Correspondingly, another flagship provision of the TCJA is across-the-board cuts in income tax rates. This is also part of the reason why the TCJA is a large tax cut for many.

The other big change to offset the tax base broadening is an increase in the size of the “zero bracket” explained above. The new law roughly doubles the standard deduction and eliminates personal exemptions.

Conforming Arizona tax law to the tax base broadening provisions of the TCJA would make the Arizona tax code less onerous, simpler, and more neutral. That’s because the individual income tax provisions of the TCJA adhere to principles of good tax policy as explained above:

- They abide by the principle of neutrality. The base broadening necessitates getting rid of extraneous and economically distortionary tax provisions that reroute economic activity into politically preferred routes rather than the endeavors they may enter if the choices were left solely to market participants.
- They abide by the principle of simplicity. By making tax filer “itemizing” less attractive — both by repealing and limiting some deductions and by greatly increasing the “zero bracket” standard deduction — paying taxes and planning for the future become easier. For most people, simply taking the standard deduction on their tax form each year will result in vastly more tax savings than itemizing.

Conformity legislation in 2018, therefore, allows Arizona policymakers to achieve these goals in a cleaner and more comprehensive way than they have been able to in the past. The Arizona tax filing process would be simpler if the state uses the same definitions of income and availability of special deductions as the federal tax
code. The state also will be more competitive as a general rule if they can maintain the goal of a broader tax base with a simpler tax code and lower rates, particularly as this relates to reducing distortions to economic decisions. Finally, the urgency to conform is enhanced by the fact that other states will potentially conform to the federal changes and the failure of Arizona to do so may put the state at a disadvantage relative to others.

**Expanding deductions for businesses:**

While the tax base is broadened for individual tax filers, the TCJA also pursues the principle of minimizing economic distortions by lowering the tax burden on investment in the economy. This abides by the neutrality principle of good tax policy as it creates fewer distortions, increasing competitiveness, and making tax planning (and therefore long-term business planning) simpler.\(^1\)

The main way the TCJA accomplished this is by allowing companies to deduct all new investment they make in the tax year. For example, an owner of a small business may need to buy some new computers or invest in manufacturing technologies. Under current law, they'd have to write off that investment on their taxes over a long period of time — sometimes too long for them to recoup the investment. Under the new “instant expensing” and “bonus depreciation” provisions, however, the business owner would make those investments when it most benefited the business. This, by definition, makes the tax code more neutral with respect to economic decisions and would likely have a beneficial impact on economic growth.\(^12\)

The TCJA also creates new limits for business tax filers, including:

- limits on the deductibility of interest payments (a policy that is more neutral by definition because it reduces the tax subsidy that goes to companies that issue debt instead of financing operations in a way that isn’t tax-advantaged);
- limits on the deductibility of business losses.

If Arizona policymakers conformed the state tax code to the business provisions of the TCJA, even with the limits listed above, it would result (on net) in a tax decrease for businesses in Arizona. The competitiveness advantages are obvious here due to the lower tax burden, but the simplicity advantages that apply to individual taxpayers and the neutrality principles are clearly honored here too.

The businesses that want to expand and invest more heavily in Arizona will get the biggest tax advantages, but these changes will also vastly decrease the tax-driven distortions in the economy when compared to the status quo because any sort of investment — not only the types that are favored by state policymakers in the form of tax credits or targeted deductions — will be eligible for this tax treatment. Indeed, just as the newly generous standard deductions in the individual tax code will likely decrease the demand to itemize by using other more specific deductions, so too might these broader investment deductions reduce the demand to use existing tax credits or activity-specific exemptions in state law.

Bear in mind that Arizona state tax law already conforms to a portion of these pre-existing federal tax laws on investment expensing. To put it another way, a policy consensus has already formed around the importance of having these expensing allowances. This year’s tax policy debate can, therefore, maintain this consensus and simply increase the ability of businesses to take full advantage of new investment opportunities while also increasing the simplicity of tax filing.

**A NEW OPPORTUNITY FOR ARIZONA TAX REFORM**

The paradox of conforming to the TCJA is that, without corresponding changes to existing state tax law, it may result in tax increases for some individuals and businesses. This is mainly because the act of conforming to the deduction limits and tax base expansions of the new federal tax law would, in traditional stand-alone
conformity legislation, not also automatically reduce state income rates or change the state standard deduction to adjust Arizona’s “zero bracket.” As a result, some taxpayers may find themselves in higher tax brackets. This includes small- and medium-sized businesses — indeed, the largest driver of employment in the state — many of which (as either S-corps, partnerships, proprietorships, and LLCs) pay income taxes through the individual income tax code.

This presents a unique opportunity for state policymakers to use this realignment of the federal tax base on which Arizona’s tax system rests to also reassess state-specific provisions. The state could simply send the money back to people in the form of refunds or temporary tax credits or write-offs similar to what the state did in the wake of the 1986 tax reform. This would, however, miss a historic chance to reconsider reform proposals — many of which have already been considered during the deliberations of the state’s Joint Task Force on Income Tax Reform in 2013 and made it into that task force’s final report. It may also minimize the economic growth potential that tax reform can achieve.

The passage of the TCJA creates a new environment this year for discussion of state tax policy. Tax reform discussions at the state level usually take place in an environment in which policymakers are rightly concerned about overall budget balance. Revenue windfalls are rarely predictable and so reforms often need to be cautious and maintain some certainty of revenue neutrality. But this year, conformity legislation — routine and advisable in prior years and advisable for the above-stated reasons this year as well — is almost guaranteed to increase revenues even if the exact dollar figure varies depending on which government entity is doing the estimating. We do know that the revenue impact will not be zero but instead will be a revenue increase of some sort. To say this is a historic opportunity isn’t necessarily hyperbolic: this sort of opportunity has not been seen in over 30 years so it’s at least accurate to say it’s a unique one.

Luckily, there are a number of ways state policymakers can pair conformity of the state tax code with steps toward fundamental tax reform for Arizona. These reforms, however, should also have the effect of making conformity “revenue neutral” at least and a net tax cut at best. How to achieve that balance is a mathematical issue and one that should be open to debate. Policymakers could consider the broad contours of reform options, outlined next as a policy menu. They cohere to both the logic of the TCJA as well as the principles of good tax policy.

1) INCREASE THE STATE STANDARD DEDUCTION

This one reform could go much of the way to solving the main conflict that conforming with the TCJA illuminates: the fact that the Arizona tax base would expand without an offsetting increase in the state income tax “zero bracket” that federal tax filers would be receiving. The amount of the deduction increase is subject to fiscal scoring by legislative budget experts and revenue estimators. One idea would be to create a zero bracket that roughly mimics the federal poverty line for the purposes of shielding the working poor from income taxation (around $25,000 for a family of four in 2017). A way of doing this would be to replace the standard deduction with a per-person deduction that, when aggregated for a family of four, reaches the poverty line.

However, a simpler and more straightforward way of doing this would be to simply eliminate the existing standard deduction/personal allowance structure and start from scratch. The replacement could be a generous standard deduction based on filing status (single or married) and a dependent allowance to account for children and seniors. This also has the additional advantage of, if generous enough, making itemizing less attractive and could reduce the political demand for other extraneous exemptions or deductions. One proposal that was considered by the Joint Legislative Task Force was one that created a standard deduction (around $25,000 for a married couple) and an $11,000 dependent exemption,
thereby equaling a “zero bracket” that reaches to about $47,000 for a family of four.\textsuperscript{14}

2) **LOWER INCOME TAX RATES ACROSS THE BOARD**

Tax rates could be lowered across the board for all tax brackets without doing anything to standard deductions or personal allowances. The percentage decline that can be approved will have to be based on how much of the revenue increase from conforming state policymakers want to devote to rate cutting. However, across-the-board rate cuts could also be enacted in conjunction with increases in the current standard deduction, with some amount of the increased revenue being devoted to each.

3) **REDUCE THE NUMBER OF AND BROADEN THE INDIVIDUAL INCOME TAX BRACKETS**

A more fundamental reform could include both of the steps proposed above but go further to make the state’s income tax code flatter. The existing structure of five Arizona income tax brackets could be overhauled. This could be done by broadening the brackets — i.e., increasing the range between the bottom of the bracket and the top — and reducing the number of brackets.

A proposal that was considered and received positive feedback from the Joint Task Force was one that would collapse the existing bracket structure into three tax brackets with rates ranging from around 2.5% for the low bracket and around 4.5% for the high bracket. These rates can again be set in legislation based on revenue estimates. A rule that should be maintained in this case, however, should be that the “break points” on the brackets would be placed to ensure that no taxpayer pays more in taxes than they did last year (even if they don’t receive a tax cut). In other words, brackets and rates can be set to hold taxpayers harmless but still create a system that is flatter and maintains the attributes of a graduated-rate system.\textsuperscript{15}

4) **CREATE A SINGLE-RATE INCOME TAX**

If policymakers wanted to go further, they could consider a single-rate income tax system. The 2013 Task Force considered a proposal to create one with a generous standard deduction, a per-dependent exemption, and a single tax rate between 3.5% and 4.1%. Consideration of such a proposal is closer to the realm of the possible now since the context in which this discussion will take place is one in which Arizona is certain to receive a revenue windfall through the base-broadening of taxable income. This is a context in which prior discussions of single-rate taxes did not occur — in those prior years, revenue-neutrality was necessary and guaranteeing that nobody received a tax hike was more difficult mathematicaly. The realistic current scenario of conform-and-reform makes it easier to avoid tax increases for lower-income taxpayers because of the overall increase in the tax base.

5) **INCREASE THE CAPITAL GAINS TAX INCOME EXEMPTION**

In keeping with the approach taken by both TCJA and prior-year tax cuts in Arizona that were designed to move the tax code closer to one that avoids punitive double-taxation on investment, policymakers could consider further expanding the exemption for capital gains income. In 2012, the legislature passed a phase-in of a capital gains income tax exemption that equaled 25% by the time it was fully phased in (tax year 2016). This puts the top effective tax rate for capital gains income at around 3.4%. A policy proposal that the state legislature could consider is to bring that exemption to 30% or more for an effective rate closer to 3%. If the top rate ends up being lower than the current 4.54% as a result of policy changes along the lines outlined above, the effective capital gains rate could be lower than 3%.

Although this would result in a slight narrowing of the tax base, it likely would be more than offset by the increases in the tax base elsewhere in the conforming legislative package. However, decreasing the effective capital gains tax rate fits within the principles of good tax policy because it removes a layer of double-taxation. Additionally, there is substantial evidence in the academic litera-
ture that capital gains tax cuts at the state level can lead to more venture capital investment, more job creation, and can lead to higher levels of entrepreneurship.16

Coupling a capital gains exemption with changes to the zero bracket and income tax rates can provide a further jolt to the economic growth potential of conforming to the new federal tax law. How big the capital gains exemption could be is again a matter of estimating the revenue available to make such a change, but it is not inherently mutually exclusive with the other proposals listed here. In fact, it’s quite complimentary, particularly with the investment-related provisions in the TCJA.

**CONCLUSION**

Arizona policymakers have a unique opportunity to reform the state income tax system. While policy options should be debated and revenue estimates seriously considered, legislators should keep in mind that the Arizona economy and state taxpayers could benefit by both tax code conformity as well as reform of the existing system.
ENDNOTES


6 Note the modifier “inefficient” here. Double-taxation of business activity, for instance, can have the effect of dampening economic growth. More efficient taxation — that taxes what is taken out of the economy but not what is put into the economy (or, in other words, a consumption tax system that only taxes the same dollar of activity once, at the end of the production process) — should be the guide for policymakers.

7 We exclude fairness as a principle for a few reasons. It’s rather subjective and there isn’t a clear consensus as to what it means in the context of tax policy. Additionally, the kind of “fairness” that matters most to discussions of tax policy — and on which there is more general agreement among economists — is that which relates to “neutrality” and so we focus on that attribute in our discussion. Meanwhile, stability as a principle has more to do with predictability or volatility of revenue collections. It’s unclear whether TCJA would have a substantial impact on this — to the extent that it brings tax policy closer to a consumption-based tax system, it may decrease volatility of state revenue collections and increase stability. However, we suspect conforming won’t have a large effect on volatility and if it does it’s likely to be a positive one.

8 This relates to revenue volatility too. A broader tax base is more diversified by nature and is less likely to result in unexpected swings in revenue collections.


13 Information on federal poverty levels can be found through 2017 Federal Poverty Guidelines, State of Arizona Department of Revenue, see: https://www.azdor.gov/TaxCredits/FederalPovertyGuidelines.aspx.
