



Arizona Leadership Institute

*Policy Research on behalf of Workers
and their Families*

Building Equity: Tax Reform for Arizona's Future

EXECUTIVE SUMMARY

Arizona suffers from two key problems in its tax structure.

- The current structure provides insufficient revenues to meet the demand for state services. Continually performance measures show the state falling short in education, health, and social services. Shortcomings here may even relate to our high incarceration rate. These are not areas the private sector can fix, but require public investment. A series of tax cuts since 1995 that now cost the state \$1.4 billion annually have severely eroded the state's capacity to deal with these issues. Collectively in today's dollars, the sum of these tax cuts is \$10 billion.¹ One-third of these tax cuts went to the wealthiest 5 percent of families in the state (see Figure 4 on page 11).
- According to the recent report from the Institute on Taxation and Economic Policy (ITEP), Arizona has one of the ten heaviest tax burdens on the poor. According to their estimates those in the bottom 20 percent among nonelderly families pay 12.5 percent of their incomes in state and local taxes, the 7th worst in the country. By contrast, the top 5 percent of earners pay less than 7 percent of their incomes in state and local taxes. Looking at just state taxes (and excluding local taxes), we estimate that families in the lowest two quintiles (40 percent) of the income distribution pay 6.5 percent of their incomes to the state, while those in the top 5 percent of families pay only 4.5 percent (see Figure 3 on page 10). The ITEP tax model is almost identical to the model used by the Congressional Budget Office, but unlike the CBO they keep a wealth of inventory on state laws to determine tax incidence.

To address the issue of needed revenues we see three primary areas of improvement:

- Adjust tax structures to increase total revenues.
- Remove or modify aspects of our current tax structure that lead to an ineffective allocation of revenues (using revenues better).
- Reinststate a more effective Budget Stabilization Fund to assure continuity in state funding and program effectiveness, especially due to the countercyclical demand for state services (e.g., housing, family maintenance and hunger program demand goes up when the economy and state revenues falter).

In addition, we seek to

- Lower or keep taxes constant on most Arizonans.

- Create a progressive state tax structure by adjusting taxes on those Arizonans who have disproportionately shared in the fruits of economic growth over the last two decades, those in the top 20 percent of families, especially those in the top 5 percent.
- Limit any tax increase for Arizonans in the fourth quintile to less than ½ percent of family income.
- Keep the current business tax burden relatively unchanged with any tax deductions compensated with tax increases in areas that will directly benefit workers (e.g., unemployment insurance).

To accomplish these objectives we propose a tax reform package that is modeled after Nebraska. We sought out a conservatively minded state that upheld these principles. Nebraska has a nicely balanced tax system that relies much more heavily on an income tax. Income taxes—unlike sales taxes—grow proportionately or better with economic growth ensuring that the state’s current structural deficit would be alleviated. In addition, by increasing income tax revenues for Arizona by \$1.5 billion, we could also follow Nebraska’s lead by lowering the state sales tax by 20 percent to 4.5 percent, reducing the total sales tax (state plus localities) in the state to around 7 percent.

The net effect is a dramatic improvement in the progressivity of Arizona’s tax structure. To further close an estimated \$2.7 billion gap between what Arizona’s state and local governments spend and what a typical state spends to address social needs, we also look to implement a real estate transfer tax, increase the gas tax by a few cents per gallon and index it to inflation, and impose a rate adjustment on Motor Vehicle License Fees based on fuel economy. The latter two policies also help to address problems of air pollution and global warming.

While Arizona is also often cited for having high business taxes, we don’t recommend changing them except for the savings businesses will receive through the lower sales tax. Business taxes, primarily, general sales (taxes on goods that businesses buy, e.g. furniture, paper, lights) and property taxes are higher than in other states. However, unlike the measures of social health indicators, which show clear shortcomings that need to be addressed, there’s a lack of evidence to suggest the tax rate has a demonstrated disincentive. Arizona continually ranks highly as a site for business. As such, while we don’t look to increase taxes on business, we don’t see a glaring need to reduce business taxes, because it would counter the ability of the state to address issues of social health. In addition, it would create economic instability at the local level, as property taxes go to localities as well as a large portion of sales taxes.

SUMMARY OF FISCAL RECOMMENDATIONS

Recommendation	Fiscal Impact
	Nebraska Plan
✓ Implement Stronger Progressive Income Tax	+\$1.5 billion
✓ Reduce State Sales Taxes by 20 percent (except Mining 3.125% and Transient Lodging 5.5%)	-\$800 million
	Other Adjustments
✓ Implement Real Estate Transfer Tax	+\$80 million
✓ Increase Gas Tax by 7 cents per gallon	+\$150 million
✓ Adjust Motor Vehicle Assessments for fuel efficiency	+\$85 million
✓ Improve Rainy Day Fund	
NET REVENUES	\$1.015 billion

THE PROBLEM: INEQUITY AND FAILING TO MEET NEED

Arizona's current state tax structure suffers from a problem of inequity—an unfair distribution of taxes—and an inability to meet the fiscal needs of the state's residents.

In Arizona the wealthy pay one-third less taxes per dollar of income than working families in the bottom two quintiles. Fairness at minimum requires that all taxpayers contribute proportionally and more generally should mean those most able to pay contribute at a higher rate than those with the least economic means. Arizona's current tax structure fails the fairness or vertical equity test.

In addition, with our current tax structure, in trying to maintain current levels of services, we face a structural budget deficit, even though current service levels fail to effectively address key shortcomings in health, education, social services, and pay levels for state employees.

Even if we only adjusted taxes relative to our economic base in a manner comparable to other states, we would need to increase revenues by 7.5 percent to begin to meet the demand for state services in Arizona. If we adjust for specific demographics of Arizona (fiscal need), we fall 20 percent short. That was the case in 1995-96 and should be the same or worse today. If we adjust these figures for continued changes in demographics and assume NO significant change to Arizona's tax structure, then we can expect the correct numbers are closer to 20 percent to meet a standard state services bundle of goods and services and 30 percent if we correctly adjust them for the changing demographics of Arizona.

For all these measures state and local government are combined because many states split revenue and expenditure responsibilities differently. To clarify this discussion we start by discussing key terms:

Fiscal Effort Index: From Hill (2000), this index is the per capita ratio of current state and local governmental expenditures to the national per capita average. ² In 1999-2000, Arizona's fiscal effort was 86, meaning Arizona's expenditures were 86 percent of the national per capita average.

Tax Capacity Index: From Tannenwald (1999), this index typically uses a representative tax system (RTS) to determine the relative ability of a state to levy taxes. Average tax rates are determined for each tax category across the 50 states and then applied to the general sales base, property base, income base, etc. to create an estimate of revenues that would be created. An index is then created relative to the national average. For instance, in 1995-96 (the latest year available), Nevada had the nation's highest tax capacity largely due to the strength of tourism relative to its population. Nevada's tax capacity was 141. By contrast, Arizona's tax capacity was 94, meaning if Arizona levied average tax rates across categories we would generate 94 percent of the revenues of a typical state, largely because incomes are lower here. Tourism dollars help Arizona, but not nearly to the extent of Nevada, a much smaller state.³

Tax Effort Index: This index measures the ratio of actual tax revenue collected by a state to its tax capacity. As a result, Nevada is better able than most states to export its tax burden to nonresidents, leading to a tax effort of 73, the lowest in the country. By contrast, Arizona's tax effort is 93, meaning we levy taxes at 93 percent of our tax capacity.⁴ If revenues to the states from the Federal Government were directly proportional to tax receipts, Fiscal Effort should equal the product of tax capacity times tax effort divided by 100.

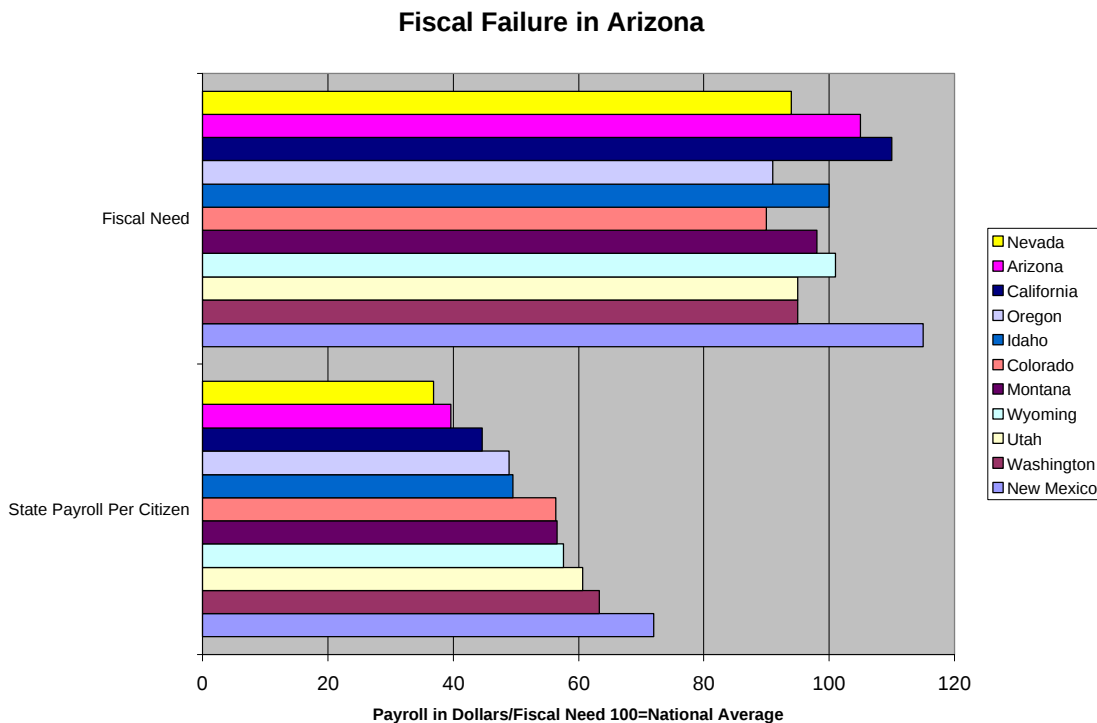
Fiscal Need Index: Demand for many state services vary proportionately with population, but demand for some services are influenced by other factors as well. The Representative Expenditure System (RES) identifies six such

areas: K-12 education, higher education, public welfare, health and hospitals, highways, and police and corrections. For instance, a larger state like Arizona would have more demand for highways per capita than Delaware. The system then estimates a cost factor for providing these services for each state. An index is created by weighing each state relative to the national average. Arizona with its greater expanse, new immigrant population, and growth in demand for its educational system has a higher fiscal need than most states at 105 in FY1996. Note that meeting the fiscal need would mean doing as well as an average state.

From these indices we create a **Fiscal Need Effort Index**. Fiscal Need Effort would reflect the degree to which fiscal needs are met in the state. This should be the minimum goal of Arizona's policy makers. The index would be found by taking 100 times the Fiscal Need Index divided by the product of the tax capacity and tax effort. We should find that tax capacity times tax effort (divided by 100) should be similar to Fiscal Effort. In our case we find Fiscal Effort is 85 in 1995-96, while the formula gives us 87. Using the latter number gives a Fiscal Need Effort Index of 120. What this means is that Arizona should be spending 20 percent more than it does presently to meet its fiscal need.

However, our tax capacity is only 94. To increase revenues by 20 percent would require that our tax effort increase by 20 percent from 93 to 112. While this is not unusual, no Western state is at that level.⁵ If we only have 94 percent of the resources of a typical state, then one might argue we cannot yet afford to meet our Fiscal Need fully. At minimum Arizona should increase its tax effort to 100. By increasing our tax effort to 100 (taxing equal to the average state modified by our lower tax base), revenues would still rise 7.5 percent and the Fiscal Need Effort Index would fall to 112. These added revenues would help Arizona address under served needs within the state.

Figure 1



Source: Fiscal Need: Tannenwald (1999); State Payroll: Mark Waters January 13, 2003, *Arizona Republic* using Census Data.

The base for the RTS is the General Revenue tax fund for state and local governments which includes general sales taxes, selective sales taxes (e.g., alcohol, tobacco, gasoline), corporate and personal income taxes, property taxes, license taxes, and gift or estate taxes. In FY2000 these totaled \$13.3 billion and represented half of all revenues the state received. To increase this amount by 20 percent would mean \$2.7 billion in new revenues. A 7.5 percent rise would mean \$1 billion in new revenues. What portion of that would come from the state tax system is beyond the scope of this study. However, a cursory review of expenditure data from the Bureau of the Census for fiscal year 2000 shows the state spending at or above the national average on public safety and transportation, but falling particularly short in K-12 education (82 percent of the national average per capita⁶), social services and income maintenance (67 percent) and wages and salaries of government employees (83 percent). The state tax system, as opposed to localities, would be a critical source to address many of these shortcomings.

While funding does not solve every problem, it's critical in providing adequate resources. State employees are underpaid leading to costs of turnover and poor morale, which undermines governmental effectiveness. Arizona's state payroll per citizen is only \$39.60 and ranks 10th out of 11 Western states and 47th in the country (see Figure 1). This is a combination of inadequate staff levels (in part because of high quit rates) and poorly compensated workers. Leading examples include corrections officers paid \$25,000 a year with a 25 percent annual turnover rate. CPS case workers with a masters degree start at only \$26,000 and have nearly the same turnover rate. Overall, Arizona state analyses show wages to be 17 percent below similar jobs in the private sector.⁷

The consequences of Arizona's failure to adequately provide services and retain experienced employees shows up in numerous rankings. In education Arizona ranks 44th according to the "Smartest State" Index and United Health Group's rankings place Arizona 38th for overall health and healthcare. While no ranking system is ideal, anyone who's lived in Arizona knows Arizona continually ranks low on numerous social welfare indicators.⁸

Increasing revenues by \$2.7 billion would mean just meeting what the typical state does. Given our relatively low starting point, becoming like a typical state in terms of meeting fiscal need would be a vast improvement and would likely give us the long-term ability to enhance our tax capacity by developing and utilizing the human capacity of our state's residents better.

But even if we came up with \$2.7 billion tomorrow, Arizona would still need a tax structure that is sufficiently strong to continue to generate revenues as the economy grows. However, our current state tax structure is one of the nation's most poorly equipped structures to meet the demands of the future. Consider two states. One relies primarily only on income taxes. The other relies primarily only on sales taxes. If incomes in the states rise by ten percent, then citizens in the income tax state will be paying at least ten percent more in taxes as income taxes are taken out proportional to income, possibly higher if one moves into a higher tax bracket. By contrast, in the state that relies primarily on the sales tax, government revenues will only rise 9.5 percent according to Honey (1999). This occurs because as people's income rises they spend more on untaxed services and less on taxed goods.⁹

If demand for state services also declined this would not be problematic, but increasingly states face under funded federal mandates such as the "No Child Left Behind" Act and Homeland Security. In addition, during the past two decades most income growth has gone to the wealthiest citizens, meaning that although overall income has risen, the gains have not been equally distributed.¹⁰ So many families see little, if any, income gains.

As Kent Hill noted in a recent study of Arizona's tax competitiveness for the Arizona State Business Research Center in detailing Harold Hovey's research (see Table 1):

Table 1

Ability of State Tax Systems to Maintain FY1998 Service Levels in FY2006

Rank	State	Percent
1	Iowa	2.7%
2	Nebraska	1.5
3	North Dakota	0.9
4	Ohio	0.9
5	Kentucky	0.5
6	Connecticut	0.4
7	Michigan	0.4
8	New York	0.3
9	Maine	0.1
10	Minnesota	0.1
11	Massachusetts	0.0
12	Oregon	-0.1
13	Illinois	-0.4
14	Pennsylvania	-1.3
15	West Virginia	-1.4
16	Wisconsin	-1.5
17	Missouri	-1.8
18	Kansas	-1.9
19	Mississippi	-2.0
20	Oklahoma	-2.1
21	Arkansas	-2.3
22	Louisiana	-2.5
23	California	-2.8
24	Rhode Island	-2.9
25	Delaware	-3.0
26	New Jersey	-3.3
27	North Carolina	-3.7
	United States	-3.8
28	Utah	-4.3
29	South Carolina	-4.6
30	Vermont	-4.6
31	Alabama	-4.8
32	South Dakota	-5.0
33	Indiana	-5.7
34	Montana	-5.7
35	Georgia	-6.5
36	Washington	-6.7
37	Virginia	-6.8
38	Colorado	-7.0
39	Maryland	-7.1
40	Texas	-7.8
41	New Hampshire	-8.2
42	Florida	-8.8
43	Tennessee	-9.1
44	Arizona	-10.5
45	Wyoming	-10.6
46	New Mexico	-12.0
47	Idaho	-13.2
48	Hawaii	-15.1
49	Alaska	-16.4
50	Nevada	-18.3

Source: State Policy Research, Inc., 1998.

from Hovey (1999)

According to a recent study by Harold Hovey, Arizona has a *structural* budget deficit and will not be able to support even current service levels without an increase in tax rates ("State Spending for Higher Education in the Next Decade," <http://www.highereducation.org>). Hovey made baseline budget forecasts for each U.S. state using standard demographic projections from the U.S. Census Bureau and the economic assumptions used by the U.S. Congress in its budget deliberations. The results indicate that, in most U.S. states, revenue growth over the next decade will be insufficient to keep pace with the growth in expenditures needed to maintain current service levels.¹¹

So current services fail to meet our current needs and our current tax structure will give us a future where we are even less able to meet those fiscal needs.

Unfortunately that's not the end of the story. Arizona also has an equity problem.

The Institute on Taxation and Economic Policy (ITEP) provides the nation's best estimates of tax incidence at the state and local level. In January 2003, they issued their latest tax incidence study for the 50 states. Due to tax law adjustments that vary for elderly versus nonelderly taxpayers, ITEP looks only at nonelderly families by income quintiles using 2000 income data and 2002 tax rates. The top quintile is broken down further 15-4-1 to isolate impacts on the wealthiest taxpayers.

They find the lowest quintile paid 10.4 percent of their income in Arizona state and local taxes in 1989, but 12.5 percent in 2002. The middle quintile saw their taxes rise from 9.1 percent of income to 9.7 percent. But earners at the top fared much better. Within the top 5 percent, the top one percent saw their burden remain unchanged at 6.6 percent of family income. The four percent just below them saw their burden drop from 7.4 percent to 7.0 percent. As a state, the 12.5 percent rate upon the lowest income families was the seventh highest in the country (see Table 2)¹²

So in reforming Arizona's tax system we must also be cognizant of equity.

OBJECTIVES:

Our objectives are then to accomplish the following:

- Increase revenues by at least 7.5 percent.
- Create a tax system that provides sufficient resources to the state automatically without need for future tax increases.
- Create a progressive tax system at the state level, where low income families pay a lower percent of their family income in state taxes than do more financially prosperous families.
- Lower or keep taxes constant for most Arizonans.
- Lower or keep taxes constant for business.

METHOD:

The report analyzes tax incidence as well as makes revenue estimates based on changes in tax structures. Tax incidence refers to who ultimately pays a tax. Conventional logic holds that incidence would equate with who directly pays the tax, but that's not necessarily true. Economic analyses regardless of political orientation hold to a set of principles that underlie the estimates we use from the Institute on Taxation and Economic Policy (ITEP). It's important to recognize that in tax incidence study all taxes are ultimately borne by individuals, so business taxes either are passed on to consumers, workers or owners.

Individual Income Taxes: Income taxes are borne by the individual paying them.

Corporate Income Taxes: In ITEP's analysis costs borne by businesses are transferred either to consumers, workers or to the owners of the business. Corporate income taxes, a tax on profits, are generally borne by the owners of the business—including owners who might reside out of state.

Residential Property Taxes are generally seen as being borne by residents, whether they own or rent. Hence, a low income family that rents typically pays these property taxes through their rent. Resident homeowners on the other hand pay these taxes directly.

Commercial Property Taxes are generally passed on to the consumer as well as borne by the owner of the business with the bulk of this tax borne by the owner in ITEP's model.

Sales & Excise Taxes are typically borne by the final consumer regardless of whether the tax is initially borne by a business buying supplies or a consumer.

ITEP takes this model of tax incidence and applies it to the tax structures in each state to determine the levels of

Table 2

Arizona State and Local Tax Incidence Shares of Family Income for Non-Elderly Taxpayers 2002

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income Range	Less than \$15,000	\$15,000 – \$25,000	\$25,000 – \$39,000	\$39,000 – \$65,000	\$65,000 – \$127,000	\$127,000 – \$237,000	\$237,000 or more
Average Income in Group	\$9,500	\$20,200	\$31,100	\$50,900	\$86,600	\$168,000	\$869,000
Sales & Excise Taxes	8.7%	7.3%	5.8%	4.5%	3.4%	2.2%	1.2%
General Sales—Individuals	4.5%	4.2%	3.5%	2.8%	2.2%	1.4%	0.8%
Other Sales & Excise—Ind.	2.0%	1.3%	0.9%	0.7%	0.4%	0.2%	0.1%
Sales & Excise on Business	2.2%	1.8%	1.4%	1.1%	0.8%	0.5%	0.3%
Property Taxes	3.7%	2.2%	2.2%	2.4%	2.4%	2.1%	1.5%
Property Taxes on Families	3.4%	2.0%	1.9%	2.1%	1.9%	1.6%	0.7%
Other Property Taxes	0.3%	0.2%	0.3%	0.3%	0.4%	0.5%	0.8%
Income Taxes	0.1%	1.3%	1.7%	1.9%	2.2%	2.8%	3.9%
Personal Income Tax	0.1%	1.2%	1.6%	1.9%	2.1%	2.7%	3.7%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%
TOTAL TAXES	12.5%	10.8%	9.7%	8.9%	7.9%	7.0%	6.6%
Federal Deduction Offset	-0.1%	-0.0%	-0.2%	-0.4%	-0.9%	-1.2%	-1.7%
TOTAL AFTER OFFSET	12.5%	10.7%	9.5%	8.5%	7.1%	5.8%	4.9%

Note: Table shows 2002 tax law at 2000 income levels.

Source: Taken from "Who Pays?" Institute on Taxation and Economic Policy, January 2003, p. 20.

overall incidence we have referred to earlier in this report. However, because each state divides tax structures and expenditure responsibilities differently with municipal and county governments, for comparison purposes ITEP combines state and local taxes.¹³

Because the Citizens Finance Review Commission's primary task is to focus on reforming the state revenue system, we have worked to isolate the state tax incidence from the local tax incidence in Arizona. To create our estimates we make use of existing differences in tax structures illustrated below:

- Personal and Corporate Income Taxes are only assessed at the state level.
- Property taxes are only assessed at the local level.
- General Sales Taxes are divided between the 5.6 percent at the state level and an approximately add on of 2.4 percent (8.0 percent total) assessed at the local level (county and city taxes). However, the base for city taxes which make up the bulk of the 2.4 percent is frequently larger than the base at the state level. Cities like Phoenix, for instance, tax rent at 1.8 percent. Likewise, cities like Tempe, Chandler and Scottsdale tax groceries at rates from 1.4 to 1.8 percent. We don't have comprehensive information on how many cities tax food and rent, so with added information we could make refinements to our estimates. These kinds of taxes hit low income families harder, so we've made adjustments to the breakdown so the local weight is somewhat higher but diminishes as grocery and rent diminish as a portion of income (and for homeowners rent is zero). For instance, rather than assume sales taxes go 70 percent to the state (5.6 divided by 8), for the lowest quintile we assume that 64 percent goes to the state and for the middle quintile that 68 percent goes to the state. For higher income groups we use 70 percent.
- Sales and Excise taxes on business are divided based on ITEP's tax incidence with 70 percent assumed to go to the state.
- Specialized sales taxes (like on alcohol or tobacco) and Excise Taxes are assumed to go entirely to the state.

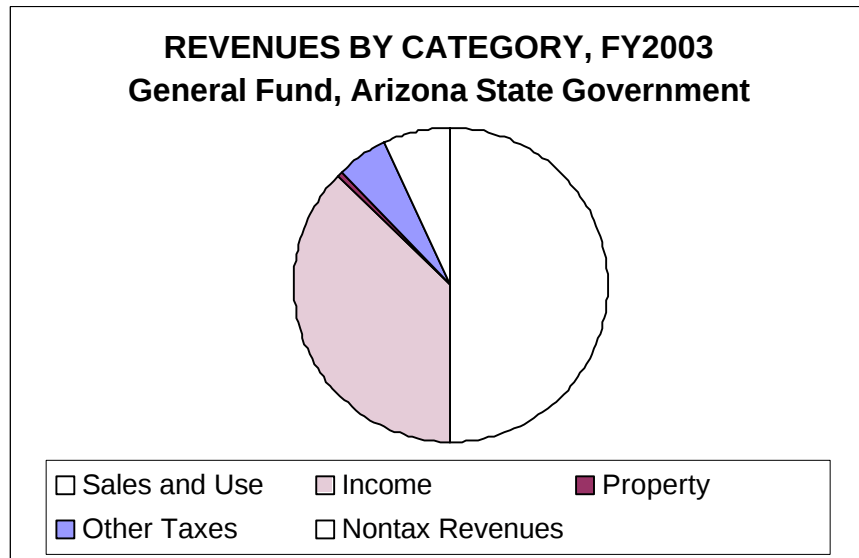
We ignore the federal offset (federal tax deductions for state and local income taxes and property taxes) in assuming tax incidence. The offsets go disproportionately to higher income groups who itemize.

When determining revenue changes from changes in income taxes, we use our estimated incidence of state tax for each income group and multiply it by the average income of the group. The result is then weighted by income group to create a base amount. Adjustments to the income tax structure are then inputted and the new weighed total is compared to the original weighted total to estimate the impact on revenues. For the Nebraska income tax this was cross checked with available information from the Bureau of the Census on Nebraska's (the state we're using as a model) income from their income tax relative to their population and income distribution.

One should keep in mind that the family income groups here do not include all taxpayers. Comparing the distribution of these taxpayers with all families and households in Arizona, one finds that this group is more likely to have a lower income than Arizona as a whole and slightly less likely to have higher incomes. Thus, the income distribution for our comparison group is shifted downward, especially on the low end, relative to Arizona as a whole. To test for sensitivity we adjust the weights to match census data for all families to see how much this impacts our revenue projections. So our estimates should, therefore, only be used as an initial guide.

Based on issues of equity and improved revenue growth over time, we sought to replace much of the existing state sales tax with an income tax, especially an income tax that would generate higher revenues than our current one. Recognizing Arizona's historic concern with tax levels, we sought conservative-minded moderately taxing states that had achieved this result. There are a number of states that fill this bill, but only two have systems comparable to

Figure 2



Source: Table 5 from Rex, Tom "Public Finances in Arizona." Based on data from Joint Legislative Budget Committee, "Historical General Fund Revenue Collections" spreadsheet

Table 3

2002 State Tax Collection by Source

(Percentage of Total)

	Equity	Property	Sales	Selective Sales	Individual Income	Corporate Income	Other
Arizona	-	3.9	50.6	12.6	24.7	4.1	4.2
Montana	+	12.6	--	25.7	35.9	4.7	21.1
Nebraska	+	0.2	35.7	14.6	38.5	3.6	7.3
Nevada	-	2.9	52.5	32.1	--	--	12.5
Oregon	+	--	--	12.7	71.5	3.8	12.0
Texas	-	--	50.8	31.5	--	--	17.7
Washington	-	11.5	62.6	16.2	--	--	9.7
U.S Total		1.8	33.5	15.4	34.7	4.9	9.8

Source: Adapted from Federation of Tax Administrators <http://www.taxadmin.org/fta/rate/02taxdis.html> data from U.S. Bureau of the Census.

--- tax not levied at state level.

Arizona with a significant reliance on the sales tax, Nebraska and Ohio. Overall, Nebraska does better in creating a progressive state-based income tax system, so for illustrative purposes we explore the consequences if Arizona were to adopt Nebraska's income tax system.

CURRENT STATE TAX STRUCTURE AND TAX INCIDENCE:

The objectives of lowering taxes for most families, yet increasing revenues, sound contradictory. If we relied on the current distribution of taxes it would be. Overall, Arizona relies disproportionately on the sales tax. Currently 50

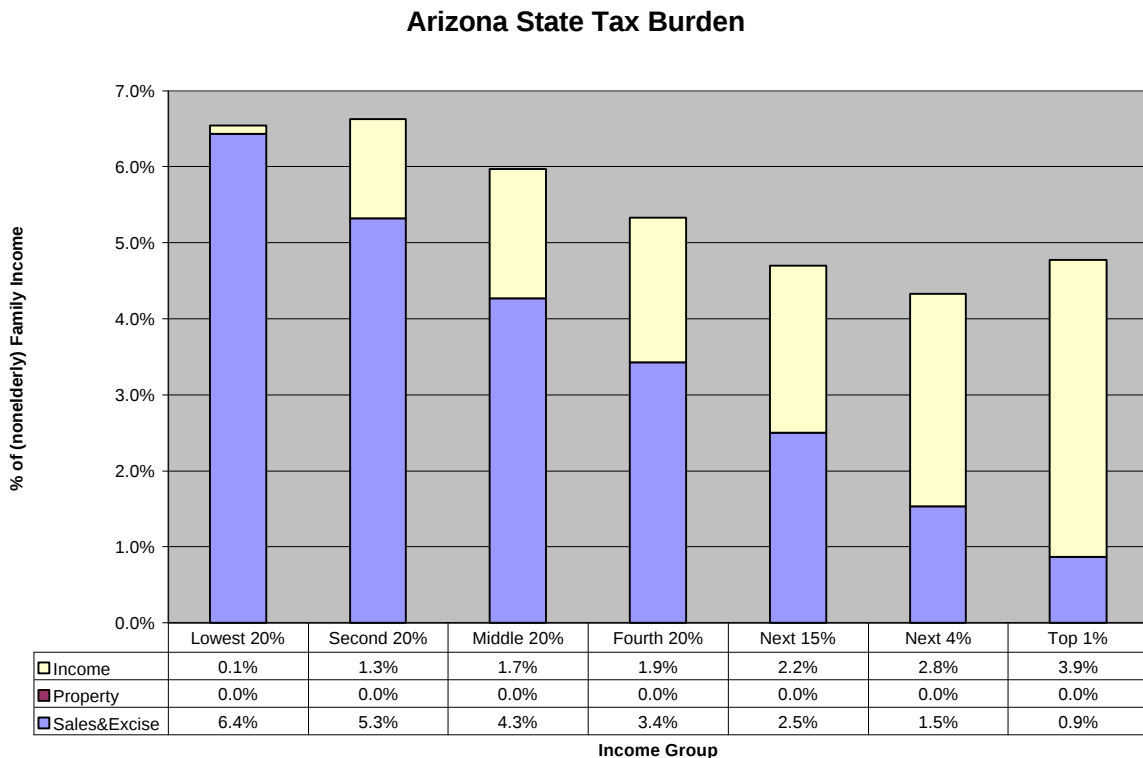
percent of revenues for the General Fund come from the statewide sales tax (see Figure 1). On a per capita basis sales revenues are 25 percent higher in Arizona (state and local) than the per capita average for all 50 states.

The high reliance on sales taxes places a disproportionate burden on the lower income households in a state. By contrast our low weight on income taxes (60 percent of the national per capita average) gives financially prosperous Arizonans a relatively free ride on their state taxes. Most states that have a progressive tax system (taxing higher income households at a higher rate than lower income households) do not have a sales tax (e.g., Montana and Oregon). By contrast some of the states with the most regressive tax systems have no income tax (e.g., Washington, Texas and Nevada) and rely extensively on a sales tax.

Sales taxes are regressive because the portion of income that lower income families pay on items that are taxed is significantly greater than higher income families (local sales taxes are even worse as in Arizona they may tax groceries and/or rent). A good example might be clothes. Even though wealthier people might wear more elegant or trendy clothes, as incomes increase relative expenditures on clothes decline. Wealthier people are also more likely to shop via the internet and avoid any sales taxes on items that they buy.

Arizona's tax system overburdens lower income families relative to higher income ones. With the repeal of the statewide property tax in 1996, a modest portion of overall property taxes, the state leaves property taxes to counties, cities and towns. However, the overall distribution of taxes is regressive as seen in Figure 3.

Figure 3



Source: Author's calculations using State and Local tax burden estimates from "Who Pays?" Institute on Taxation and Economic Policy, January 2003.

The top 5 percent of families pay only 2/3 the amount per dollar of income that families in the bottom 40 percent of families pay (see Figure 3 on previous page). If we were to include local taxes (regressive sales and property taxes), then the top 5 percent of families pay only 3/5 the amount per dollar of income that families in the bottom 40 percent of families pay. Table 3 (page 9) compares states, illustrating some states that have high degrees of equity and those that do not with the overall distribution of taxes.

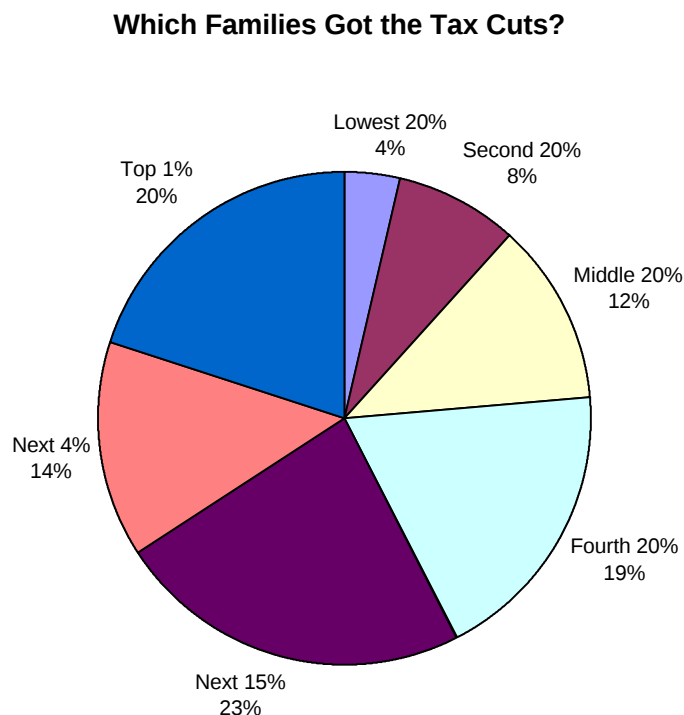
RESULTS

PART I: The \$1.4 Billion Revenue Hole And Who Got It:

Starting in 1995 a series of significant tax cuts were implemented. Marginal tax rates on individual income taxes were reduced 25-30 percent. Likewise, the corporate income taxes were reduced from 9 to a shade under 7 percent. In 1996 the state property tax was repealed. In 1998 and 1999 the Motor Vehicle License Taxes were cut by 20 to 30 percent. Together these cuts have reduced current revenues by \$1.4 billion.¹⁴ As Tom Rex has noted in "Public Finance in Arizona," these tax cuts failed to deliver the economic growth that was promised. Sure Arizona's economy continued to grow, but the rate of growth in both earnings and employment moved closer to the national average after the tax cuts. This is not to suggest that the tax cuts caused the relative slowdown, just that they failed to deliver as promised.¹⁵

While all taxpayers saw their taxes reduced, taken as a whole, it's worth considering who got the \$1.4 billion. To

Figure 4



Source: Author's calculations based on estimates from "Who Pays?" Institute for Taxation and Economic Policy, Joint Legislative Budget Committee Internal Memo, "Fiscal Impact of Tax Relief Provisions,," and calculations by Ryan Konig in *Arizona Republic* February 18, 2001.

--Nonelderly Families Only.

estimate this we took the tax incidence estimates of the Institute on Taxation and Economic Policy for 2002 and determined what share of each tax category was paid by each income group. In doing so we were assuming that the tax cuts did not significantly alter the distribution of tax incidence. For instance, we found that the lowest 20 percent of families paid 8.4 percent of all sales and excise taxes. We assume that therefore they also received 8.4 percent of all reductions in sales and excise taxes. For income tax cuts we made an additional adjustment since the lowest quintile now pay virtually no income tax. Therefore, we assume they used to pay a larger share of the income tax and use information from 1989 from the Institute for Economic and Tax Policy and a comparison of taxes owed conducted by the Arizona Republic to adjust current shares of income taxes to past ones. The result increases our estimate of how much of the income tax cuts went to lower income groups. For instance, we estimate that although the 20 lowest percent of families currently pay 0.1 percent of income taxes that they paid 0.4 percent of income prior to the tax cuts.¹⁶

Using these estimates we are able to suggest where the \$1.4 billion goes. This is a critical public policy issue because the question it raises is whether the state is collectively better off with the money distributed like this or if it would be preferable to have retained these funds to meet public investment needs. Collectively from fiscal years 1995-2004, \$10 billion has been diverted from state government to these individuals. As you can see in Figure 4 the vast majority of the tax cuts went to the most prosperous citizens. In other words, income that was formerly used by the state to meet critical social needs has largely been given to the wealthiest citizens in the state.

The more difficult challenge is to adjust for families not represented here for which we have no tax incidence data. To test for adjustments we reweighted the families by the distribution of income groups for households in the census, assuming each dollar denominated income group paid the same percent in taxes as our families. Under that specification no income group sees more than a two percent adjustment. We find that the top 1 percent receives 18 percent, the next 4 percent 13 percent, the middle quintile 14 percent and the bottom quintile four percent.

PART II: The Nebraska Model of Income and Sales Taxes

The state primarily relies on sales and excise taxes and the income tax. Given that sales taxes are nearly 10 percent in some localities and surpassed 10 percent in Winkelman due to added taxes at the county and state level, we don't think it's reasonable to expect Arizona to achieve a progressive system by eliminating the sales tax.

In reviewing states that had a similar tax structure but implement it in a more progressive fashion, the best state for comparison purposes is Nebraska. Nebraska relies primarily on its income tax, also collects no property tax at the state level, and current has a statewide sales tax of 5.5 percent.¹⁷ But unlike in Arizona, in Nebraska localities cannot have a sales tax of more than 1.5 percent. As a result, the highest sales taxes are 7 percent, a full percent lower than typical sales taxes in Arizona.¹⁸

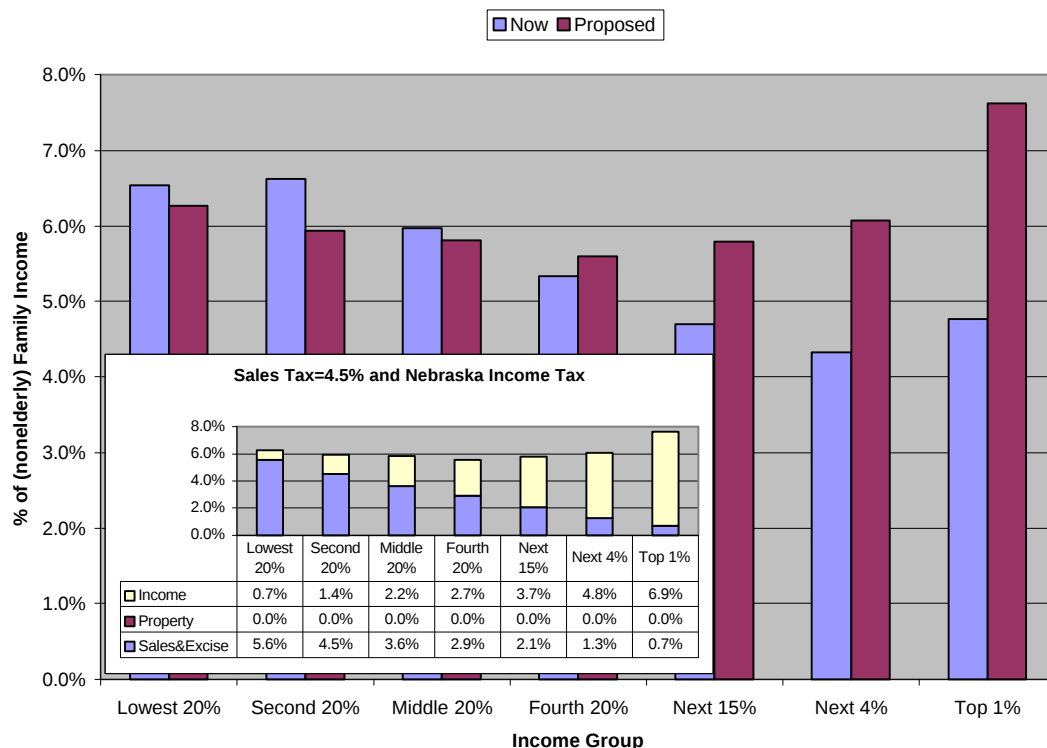
Nebraska is particularly appealing because its distribution of tax sources is also quite similar to the national average. Ultimately we discover that if Arizona were to adopt Nebraska's highly progressive income tax system, we could lower our state sales tax by 20 percent (from 5.6 percent to 4.5 percent) and still increase overall state revenues by \$700 million. At the same time, 60 percent of Arizona families (bottom three quintiles) would see their taxes fall, 20 percent would have their taxes stay almost constant, and only the top 20 percent of income earners would see an increase in their taxes. Business taxes would fall, as corporations would benefit from the 20 percent decline in the state sales tax, approximately 30-40 percent of which is paid by business in the state (see Figure 5).¹⁹

The Nebraska model has other advantages. Fiscal conservatives frequently argue against high marginal rates of taxation and argue for consumption taxes and flat taxes. Typically progressive income taxes come at the cost of higher marginal tax rates. Fiscal conservatives argue these high rates create a disincentive for primarily wealthier people to go out and seek out even high incomes that would help spur economic growth. While economic research has so far failed to find any significant impact of marginal tax rates on labor supply that doesn't mean those fervently opposed to higher marginal rates change their position. Nebraska's income tax system is unique in that it is a progressive tax system with a highest marginal tax rate of 6.68 percent. While this rate is lower than Arizona's top marginal rate of 7 percent in 1993, it's actually a rate paid by a larger segment of Nebraska's families as it kicks in for single tax payers for taxable income (after deductions) of \$26,500 and roughly double that for married couples.²⁰

However, the unique structure in Nebraska is that for those with much higher incomes, their deductions and exemptions (which take the form of a tax credit in Nebraska) phase out. The personal exemption tax credits begin to phase out for single individuals at \$69,000 adjusted gross income (\$114,000 for married couples). Standard or itemized deductions gradually phase out at \$137,000 and taxpayers are also made to pay an add on tax due to the lower tax rates they paid on the first \$26,500 to \$50,000 (depending on if single or married) of their incomes. However, the phase out is gradual and constructed inversely so that at the margin the rate of phase out slows over time. While the phase out initially jumps the marginal tax rate to 10.85 percent it gradually drops back down to 6.68 percent. To the degree any disincentive exists, this tax structure is designed to minimize it.

Figure 5

Current Versus Proposed Arizona State Tax Burden



Source: Author's calculations using State and Local tax burden estimates from "Who Pays?" Institute for Taxation and Economic Policy, January 2003

Certainly one could develop other ways to accomplish similar objectives, but the Nebraska system works well in keeping the effective marginal rate fairly low. In addition, for those still concerned about the higher marginal rates, it's instructive to remember that state income taxes (but not state sales taxes) are deductible on federal returns. So by changing the distribution of taxes from sales to income, many taxpayers will save on their Federal income tax returns. This also reduces any marginal disincentive concerns that Fiscal Conservatives might raise. Essentially, if you're paying a state effective marginal rate of 7 percent, Federal deductibility makes the effective marginal rate closer to 5 percent. Currently due to Arizona's low marginal rates, this form of tax savings is underutilized relative to those who live in other states.

Even if one has quibbles with the details of the Nebraska system, what it accomplishes financially and conceptually is what we're most interested in. Since the income distribution of nonelderly family taxpayers is nearly identical in Nebraska to Arizona we have simply replaced the personal income tax burden for each group in Arizona with Nebraska's. Meanwhile, to adjust for a 20 percent cut in the sales tax, we have cut each group's general sales tax burden by 20 percent from their estimated incidence.

The net effect is a dramatic turn around in progressivity. As seen in Figure 5 the tax rate varies minimally from 6.3 percent to 5.6 percent of income for the bottom 99 percent of families with most seeing their taxes go down. Only the wealthiest five percent of families would pay more than 6.3 percent of their income in state taxes, but this is fair as they are also the group that has benefited the most from the \$1.4 billion in tax cuts and have experienced the most rapid improvement in incomes. Likewise, Arizona businesses would also be paying 20 percent less general sales tax.

The income tax change should increase personal income tax revenues by close to 65 percent. In FY2001, such revenues were \$2.3 billion, so a 65 percent increase would generate \$1.5 billion.

The general statewide sales tax including the education tax generated approximately \$4.2 billion in FY2002, so a reduction of 20 percent would reduce collections by \$840 million. However, the tax rate on mining is already below 4.5 percent, so it is unchanged. In addition, the tax rate on transient lodging (hotels) would also be excluded from the deduction, as this represents an opportunity to export taxes to nonresidents who use Arizona's services. With these adjustments, we estimate the net sale tax loss to be closer to \$800 million.

Part III: Other Sources of Revenue:

Real Estate Transfer Tax:

Reinstating a statewide property tax is certainly an option for broadening the base of the state revenue system. Property tax dollars are a reliable source of revenues that are less cyclical than sales or incomes taxes. However, if the state adopts a budget stabilization fund cap of 15 percent and we become less reliant on sales taxes, then the need for the statewide property tax is diminished. In Arizona a statewide property tax raises further issues of concern. Businesses are already concerned about their level of property taxes in the state. Plus, property taxes unless you provide an exemption for those who own typical homes are regressive (see Table 2). But if you exempt business and half of homeowners, you've limited the tax base considerably. In seeking an alternative, we propose the state adopt a Real Estate Transfer Tax. The tax would be simple to collect at the time of closing and depending on how it's structured could be made progressive. According to Tom Rex's research 37 states have this tax.²¹ For purposes of comparison we look at Wisconsin. Wisconsin is approximately the same size as Arizona and levies a real

estate transfer tax of \$3 for each \$1,000 of the purchase price (0.3 percent). In the last calendar year, Wisconsin raised \$68 million.²²

If Arizona with its growing population and subsequently greater level of real estate transactions were to adopt the same system as Wisconsin, we'd likely garner \$80 million annually. A real estate transfer tax exempts those not purchasing property, so its cost would primarily be borne by taxpayers in the upper three quintiles. To the degree the value of real estate transactions are proportional to income, the effect would be equal. However, in practice the ratio of income to real estate transaction value declines as incomes rise so the tax would fall slightly harder on families in the middle of the income distribution. But this effect is modest due to the relative size of this tax and that most residents would not pay it in any given year. For a \$150,000 home, the tax amounts to \$450.

A progressive adjustment to the Real Estate Transfer Tax would be to establish a real estate transfer tax of \$50 for the first \$100,000 and then \$7 for each \$1,000 thereafter. A home selling for \$150,000 would net \$400 under this structure (average rate of under 0.3 percent). But a property selling for \$300,000 would generate \$1450 (average rate of 0.5 percent). The progressive alternative would likely also generate about \$80 million annually.

Regressive Taxes and Fees to Address Pollution and Environmental Concerns:

While we advocate reducing the sales tax by 20 percent if a Nebraska-like progressive tax system is put in place, there are two fees that we'd also recommend increasing that would provide additional revenues to the state. These revenues could be used to promote public transportation or transportation assistance programs for lower income people. Likewise, these added revenues could be used to support environmental improvement.

Table 4	
	Gasoline Tax (Cents per Gallon)
Arizona	18
California	18
Nevada	23
New Mexico	17
Utah	24.5
States which Index Gas Tax to Inflation	
Nebraska	24.5
North Carolina	22.1
Wisconsin	30.3
Note: Bold, Italics indicate notable tax changes during 2002.	
Source: Adapted from Tax Foundation Web Site: http://www.taxfoundation.org/variousrates.html . Tax Foundation Special Report, No. 121, "State Tax Collections and Rates"; State Revenue Departments; Commerce Clearing House; Federation of Tax Administrators; Department of Agriculture, American Petroleum Institute.	

The brown cloud that engulfs Phoenix causes respiratory distress for asthmatics and elderly people as well as reducing lung capacity for our youngsters. Likewise, as we're learning with the impact of Global Warming, we need to gradually nudge consumers to make different choices. As glaciers melt, weather systems become more severe and erratic, we must recognize that the environmental cost of our use of fossil fuels are not being sufficiently borne by those of us most contributing to it. The primary methods Arizona could nudge consumers to think more about the cost of our current choices would be through gas prices and greater vehicle license costs to vehicles that are not fuel efficient (and lower fees to fuel efficient vehicles). Businesses including ranches and farms could be exempt from the surcharges, but would share in the reductions for fuel efficient vehicles.

Arizona has not altered its 18 cents per gallon gas tax for more than a decade. Economically we need to be mindful of

what border states charge so that gas stations in towns on the border are not hurt by this change, but as long as the difference is only a few cents the impact should be minimal. For the most part, there are very few gas stations in this situation as compared to a place like the District of Columbia, a concentrated population center, surrounded by states with different tax structures. The wisest path, we think would be to index the gas tax to the inflation in fuel costs. Perhaps every two years the tax could be set at 19 percent of the average retail gasoline price less state

taxes. If the average retail price were \$1.50 for the past two years then the result would be 19 percent of \$1.32, yielding a gasoline tax of 25 cents per gallon. This could be phased in over two years and then automatically adjusted biannually. As you can see in Table 4, states which index their gas tax to an inflation measure are able to be competitive with other states, while raising significantly greater revenues.

We estimate increasing the gas tax (assuming a 2 percent decline in gas use for every 10 percent rise in prices) would increase revenues by \$150 million.

In 1998 and 1999 the fees for registering Motor Vehicles were drastically cut from \$4 per \$100 of assessed value during the first 12 months and \$3.40 thereafter to \$2.89 per \$100 of assessed value during the first 12 months and \$2.80 thereafter. During the first year assessed value is 60 percent of the retail value and it declines by 16.25 percent each year thereafter.

However, due to concerns about local air pollution and Global Warming, the state should make efforts to better capture the greater costs some vehicles (business vehicles excluded) place on the environment.

Hence, a vehicle which gets less than 15 mpg in combined city/country driving (e.g., Suburban, Expedition, Hummer) might pay an 80 percent surcharge raising its assessment to \$5.04 per \$100, while a vehicle that gets 30 mpg in combined city/highway driving might pay a 60 percent reduced rate leading to an assessment of \$1.68 per \$100 (e.g., Insight, Prius, Echo). If the rate were structured to initially generate an average surcharge of 15 percent, this policy change would increase revenues by approximately \$85 million.

Options Not Pursued—Broadening the Base of the Sales Tax

Some also argue that we expand the tax base for sales taxes and lower the rate. But the sales tax is not a simple tax to collect and an analysis of sectors listed in the Arizona Department of Revenue's Tax Expenditure Report finds that outside a few high end personal services that the scope is limited. Business and Professional Services taxation would create a "cascading" impact of sales taxes, where sales taxes aren't levied on the final consumer, but intermediate products, as well as the final product. In addition, some professional services like legal services and health care services are ones we're reluctant to advocate taxing.

Expansions into food and rent would be highly regressive unless a refundable credit was provided on the income tax. But again the expansion of the base in these directions complicates the tax code rather than simplifies it.

Part IV: Holding Business Taxes Constant

Under the Nebraska Plan, business taxes would decrease through the 20 percent drop in the state sales tax, an estimated 30-40 percent of which is paid by business. However, we'd hold the line on other tax changes. Business interests are a powerful force in Arizona politics, and businesses can correctly claim that overall business taxes are higher in Arizona than in most other states. But this is not a new situation. Under this system of higher business taxes, business has flourished in Arizona. One would therefore not be surprised to find that business taxes are rarely a key criteria in business location, though that rarely stops local elected officials from wanting to shower new businesses with "economic development incentives." But if the business was already headed to the community or is merely picking say Scottsdale over Phoenix as Dial Corporation did in the late 1990's, then such incentives are a net loss to Arizona. We don't advocate raising business taxes, but relative to the fiscal needs in the state don't see the state gets much bang for the buck by lowering them generally.

There may be strategic area exceptions, mostly likely within the tax on personal property that affects particular industries and would be worth careful examination. But generally the business tax structure, including property taxes, has been in place for some time and Arizona continues to be a leader in business investment.

The case for the strength of the Arizona business climate is made clearly by the Arizona Chamber of Commerce's web site (Note that the information is dated, but business taxes have decreased since this time, including the corporate income tax rate which is not mentioned below).

Taxes

Arizona's tax structure is highly competitive and given the following examples, favorable to business. In January 1997, *Money* magazine reported that the state has the 14th lowest total state and local tax burden in the nation. The state's effective property tax rate is seventh lowest in the nation at 0.66 percent, compared with a national average of 1.5 percent. The Arizona Legislature reduced state personal property taxes on business equipment by \$31.7 million in 1995, and set aside \$200 million for property tax cuts in 1996. Businesses may carry net operating losses forward for five years. A parent company may receive an income tax exemption on dividends from subsidiaries when the parent company owns at least 50 percent of the subsidiary. Business inventories have a property tax exemption, and sales of machinery or equipment used directly in manufacturing, processing, fabricating, job printing, refining, and other metallurgical operations have sales tax exemptions.²³

One finds further evidence that current tax issues are not significant when considered more broadly also at the Chamber's web site:

Land Availability

Since the frontier days, Arizona has been associated with wide open spaces. Many companies have recently expanded into Arizona because of the abundance of land available for growth that still exists today. Sizable tracts of land for office space, industrial sites, and residential use are available at competitive prices throughout the state. The cost of leasing office space in the Phoenix area was \$18.12 per square foot in the fourth quarter of 1996, compared to \$29.46 in San Francisco, \$24.53 in San Jose-Silicon Valley, \$22.50 in Las Vegas, \$22.12 in Dallas-Fort Worth, \$22.04 in Los Angeles, \$21.98 in Denver, and \$19.86 in San Diego.

Low Operating Costs

Lower overall operating costs are another positive factor in locating a business in Arizona. A recent study found that the annual cost, including wages, of operating a 200,000 square foot manufacturing facility in Maricopa County, which includes metropolitan Phoenix, was 10 to 20 percent less than the cost of operating a similar facility in California in either Orange County or Los Angeles County.²⁴

It's instructive to compare the measured effect of tax differences with factors of production. As Tom Rex notes in his "Public Finance in Arizona," state and local taxes are less than two percent of operating costs.²⁵ Generally interstate tax differences would rarely be more than ½ of one percent of operating costs. Other costs are substantially more meaningful. Take for instance the impact of property taxes on rent. Let's assume the property value of a 2,000 square foot office was \$300,000 and renting for \$18.12 a square foot as described under "Land Availability" above. Since property taxes are transferred to the tenant in Table 5 (next page), you can see that property taxes would make up \$3.75 of the rent. Yet even if these property taxes are higher than the other cities, it's not sufficient to make Phoenix more expensive than other cities. Land remains a competitive gain, especially when you add that labor costs would also be more in California. In Las Vegas, rents were significantly higher, \$4 more per square foot—more than our hypothetical total of property taxes, much less any relative difference in property taxes.

Another significant business expense is labor. If labor costs are 10 percent less than in a competing location, as long as labor is more than 10 percent of total costs, then the cost savings will be larger than one percent of operating costs. In fact, if labor costs are 50 percent of total costs, then the savings would be 5 percent, 5 to 10 times the maximum likely difference in tax savings.

Table 5

Illustrative Example of Business Property Taxes in Rent

Market Value	\$300,000
Assessment Rate	X 25%
Assessed Value	\$75,000
Divide by 100	\$750
Property Tax Rate per \$100	\$10.00
Total Property Taxes	\$7500
Divide by 2000 sq. feet	\$3.75 per sq. foot

Then there are business concerns related to the quality of public services, whether the local labor market has sufficient specialized labor, location relative to consumers or key suppliers. Ultimately taxes are a small and often insignificant determinant of business location.

Another indicator of business climate has been the manufacturing sector. This sector is targeted by proponents of the single-weighted sales factor for determining corporate income taxes, yet here, too, we find little evidence such a change would benefit Arizona.

When corporations are profitable they owe state income taxes on those profits. When a corporation operates in just one state, the formula for determining taxes is irrelevant. However, when a corporation operates in multiple states, states have to determine what portion of those profits come from that state and should be taxed. Historically, states used an equally-weighted formula that gave 1/3 weight each to the percent of in-state sales to total sales, in-state property to total property and in-state payroll to total payroll in determining tax owed.

Arizona was one of the first states to change its formula to double-weight sales (50 percent sales, 25 percent property, 25 percent payroll). Today Arizona is one of 23 states that does so. As those who advocate a single factor sales formula, the rationale for double-weighting sales was to favor “export” industries that primarily sell out of state, but employ workers within the state. Among our neighboring states, California and New Mexico follow the same formula as Arizona. Nevada does not levy a corporate income tax, and Utah retains the equally weighted formula.

In the mid-late 1990’s Arizona was #2 in the country in manufacturing job growth—the sector “single factor sales” desires to target. However, among the top 10 growth states, only Nebraska (#7) was a “single factor sales” state. Meanwhile, three of the top five states had traditional equally weighted formulas. In fact, one of these states Kansas (#2) clearly outperformed its neighboring two single factor sales states (Iowa #13 and Missouri #31) (see Table 6).

Iowa and Missouri have had single factor sales formulas since the 1970’s and while Iowa has experienced a modest growth in manufacturing jobs (0.5 percent total growth since 1979), Missouri has lost more than 13 percent of its manufacturing jobs. Anecdotally, Raytheon, a major lobbying force urging Massachusetts to adopt a single factor sales formula in 1995, subsequently reduced its Massachusetts workforce by 3,000 workers and even transferred a contract from Massachusetts to Arizona.²⁶

Table 6

Manufacturing Employment Growth, States with Corporate Income Taxes 1995-2000 National Top 10 plus Regional States, and Single Factor States		National Rank (of 45)
<i>North Dakota</i>	17.4%	1
Arizona	10.8	2
<i>Kansas</i>	9.8	3
<i>Vermont</i>	8.4	4
California	8.4	5
Idaho	8.2	6
NEBRASKA	6.9	7
Colorado	6.7	8
<i>Montana</i>	6.0	9
Oregon	6.0	10
<i>Utah</i>	5.6	11
TEXAS	5.2	12
IOWA	4.3	13
MASSACHUSETTS	-2.3	27
MISSOURI*	-4.1	31
<i>Italics states equally weight sales, property and payroll.</i> CAPS states have SINGLE FACTOR SALES (all such states included). Others are like Arizona and have double weighted sales factor. *Missouri allows corporations to choose alternative formulas. Source: Mazerov, Michael (2001), "The 'Single Factor Sales' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?" Center for Budget and Policy Priorities, p. 35.		

In addition, according to *Site Selection Magazine* between 1995 and 2000 for major investments by corporations in new facilities equaling at least \$1 billion, we find that Arizona did remarkably well landing 3 of 31 (10 percent) placed in states with corporate income taxes. No state had more. Other states which landed at least three were Indiana, Texas, Virginia, Oregon and California. Of these states only Texas is a single factor sales state.²⁷

Arizona's high placement occurs despite overall business taxes that are higher than most other states in the region (see Table 7).

While some academic studies looking at data from 1978-94 have suggested a modest positive relationship between having a higher weight to sales and employment growth, even these authors acknowledge that the jobs are not created, but redistributed from other states.²⁸ The more recent data discussed here suggests their employment effects are also overstated.

While one can make a logical connection between lower taxes and business incentives, that factor is not particularly strong. Think, for instance, where taxation was on the list of priorities when you chose to move to Arizona? Did it come before or after sunshine? Before or after great geographical diversity and beauty? Before or after fairly low land/housing costs? Before or after the quantity/quality of recreational facilities? Before or after the quality of

Table 7

Business Taxes Per \$1,000 of Gross State Product					
FY 2000					
	Income	Property	Gen Sales	Unemp	Total*
ARIZONA	\$3.64	\$12.10	\$11.07	\$1.15	\$30.41
CALIFORNIA	5.35	7.75	8.33	2.32	25.31
COLORADO	2.18	12.35	8.33	1.25	25.81
IDAHO	3.67	11.81	7.91	2.53	28.77
OREGON	3.48	9.57	0.00	4.40	21.31
UTAH	2.99	9.00	9.77	1.21	27.01
WASHINGTON	8.86	10.20	13.41	4.25	39.40
TOTAL	5.14	8.91	8.65	2.44	27.13

* includes some smaller tax categories not shown

Source: Utah State Tax Commission, "Western States' Tax Burdens Fiscal Year 1999-2000"

schools? Businesses consider these issues as well as labor cost relative to labor quality, strategic location to access a sufficiently experienced and/or skilled labor pool in a sector (Silicon Valley, Phoenix, Austin for computers, Michigan for autos), strategic location relative to transportation needs either to reach consumers or key suppliers (e.g., many auto suppliers in the Midwest). When it comes down to it, taxes aren't the critical issue in business relocation or investment.²⁹

Given the cost of this change, \$80 million according to the Joint Legislative Budget Committee, these revenues would be better spent in a way that improves business productivity either through a more skilled labor force or improved public infrastructure.

There is one business tax, unemployment insurance, that directly benefits workers. If say the business personal property tax were selectively or generally lowered, we recommend that unemployment insurance taxes rise. These taxes are well-below the national average and a very small portion of total taxes. Economists estimate that their cost is usually passed on to workers through lower wages, yet in Arizona workers get very little benefit from it. Maximum benefits of \$205 a week are the lowest in the country and less than 30 percent of unemployed workers receive benefits.

SUMMARY OF FISCAL RECOMMENDATIONS

Recommendation	Fiscal Impact
	Nebraska Plan
✓ Implement Stronger Progressive Income Tax	+\$1.5 billion
✓ Reduce State Sales Taxes by 20 percent (except Mining 3.125% and Transient Lodging 5.5%)	-\$800 million
	Other Adjustments
✓ Implement Real Estate Transfer Tax	+\$80 million
✓ Increase Gas Tax by 7 cents per gallon	+\$150 million
✓ Adjust Motor Vehicle Assessments for fuel efficiency	+\$85 million
✓ Improve Rainy Day Fund	
NET REVENUES	\$1.015 billion

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Endnotes:

¹ Everill, Tim (2002), "Fiscal Impact of Statutory Tax Relief Provisions," Joint Legislative Budget Committee Internal Memo, September 19 (available at <http://www.azleg.state.az.us/jlbc/fiscal.htm>). The memo estimates the nominal dollar (dollars at the time of enactment) amount for tax changes from fiscal years 1989-2004. It finds a total of \$803 million in net tax cuts that diminish current revenues. The tax cuts start in earnest during fiscal year 1995 in the Symington Administration and continue through fiscal year 2001 and the term of Governor Jane D. Hull. Using 1995 as a starting point yields a total of \$1.2 billion in tax cuts. However, this figure is an "underestimate" as Mr. Everill notes in his memo, as the JLBC estimates do not take into account inflation (a dollar is worth less today than in 1995) or economic growth. Economic growth increases the state's tax base. So if my income was \$30,000 and I paid 6% of it in taxes, then the government would receive \$1800. If my taxes are reduced to 5%, but my income continues to grow with the economy to \$35,000, I would now pay the state \$1750. The JLBC method would place the cost of the tax cut at $1800 - (.05 \times \$30,000) = \300 . However, the actual cost of the tax cut with economic growth is $(\$35,000 \times .06) - \$1750 = \$350$. You'll note that the percent of error $(350/300)$ is the same as the growth in my income $(35,000/30,000)$.

Supply-siders would counter that tax cuts cause economic growth. To come up with an estimate no one would find fault with we underestimate both inflation and economic growth factors. We assume inflation is 2% per year over the whole period, while economic growth from 1995-2000 is only 1% and then falls to 0% from 2001-04. When we conservatively adjust for inflation and economic growth the correct cost in current dollars is \$1.4 billion in lost revenues this year and a total of \$10 billion from 1995 to present.

² Hill, Kent (2000), "A Current Assessment of Arizona's Tax Competitiveness," Center for Business Research, L. William Seidman Research Institute, W.P. Carey School of Business, Arizona State University, February, <http://www.wpcarey.asu.edu/seid/cbr>.

³ Tannenwald, Robert (1999), "Fiscal Disparity Among the States Revisited," *New England Economic Review*, July/August.

⁴ Tannenwald (1999)

⁵ Tannenwald (1999)

⁶ Includes an author addition of \$350 million to adjust the figure for the passage of Proposition 301 which imposed a statewide 0.6% sales tax for education K-12 and universities. Without that addition, the figure is 77 percent.

⁷ Romero, Christine (2003), "Salaries Lag in State," *Arizona Republic*, June 1, p. D1.

<http://www.azcentral.com/arizonarepublic/business/articles/0601stateworkers01.html>

⁸ Smartest State Ranking based on variety of education Indicators (www.morganquitno.com/); For health wide indicator score developed by United Health Group (www.unitedhealthgroup.com/sr2000/)

⁹ Hovey, Harold A. (1999), "State Spending for Higher Education in the Next Decade: The Battle to Sustain Current Support," Prepared by State Policy Research for the National Center for Public Policy and Higher Education.

¹⁰ Krugman, Paul (2002), "For Richer: The Disappearing Middle," *New York Times Magazine*, October 20.

¹¹ Hill (2000)

¹² McIntyre, Robert S. et. al. (2003), *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*.

Washington, D.C.: Institute on Taxation and Economic Policy, January <http://www.itepnet.org/wp200/text.pdf>.

¹³ The tax incidence model and the economic underlying it is more fully detailed at their web site, <http://www.ctj.org/itep/itepmodel.htm>.

¹⁴ See endnote 1 for explanation.

¹⁵

	Before Most Tax Cuts	After/During Tax Cuts
Employment Growth 1993-94:	3.3%	1997-2000: 1.7%
Earnings Growth	3.8%	2.0%

Percentages are differences between Arizona and the United States, so Arizona's growth rate is higher than the United States during the entire time period. Time period focuses on main period of national expansion to avoid business cycle bias.

Source: United States Chamber of Commerce, Bureau of Economic Analysis, and Joint Legislative Budget Committee.

¹⁶ "Who Pays?" Institute on Taxation and Economic Policy (2003) and data analysis by Ryan Konig published in the *Arizona Republic*, February 18, 2001.

¹⁷ Tax Foundation "Various State Tax Rates," <http://www.taxfoundation.org/variousrates.html>. They indicate Nebraska's 5.5% rate will go down in October 2003 to 5.0% and the Tax Foundation indicates that Nebraska had changed their sales tax rate in 2002. Based on information in Nebraska's Department of Revenue's "Nebraska Revenue Sources," it appears Nebraska temporarily increased the sales tax to help improve revenues during the economic slowdown.

¹⁸ Nebraska Department of Revenue, "Nebraska Revenue Sources."

¹⁹ Raymond J. Ring (1999), "Consumer's Share and Producer's Share of the General Sales Tax," *National Tax Journal*, 52(1), March, pp. 79-90 cited as 40 percent business share in Varian, Hal (2001), "Taxation of Electronic Commerce," April, http://www.cisp.org/imp/april_2001/04_01varian.htm#note7. Author's calculations based on ITEP tax incidence estimates suggest in Arizona the business share may be closer to 30 percent.

²⁰ Nebraska Department of Revenue, "2002 Personal Income Tax Booklet" and "2002 Tax Rates on Nebraska Taxable Income."

²¹ Rex, Tom (2003), "Preliminary Examination of Arizona's Governmental Revenue System," Center for Business Research, L. William Seidman Research Institute, W.P. Carey School of Business, Arizona State University, May.

²² Wisconsin Department of Revenue, "Real Estate Transfer Tax" at web site and "Summary Wisconsin Real Estate Transfer Return Transmittal: January - December 2002," <http://www.dor.state.wi.us/slf/02coretr.pdf>

²³ For text go to http://www.azchamber.com/business_government/stateofbusiness.shtml. Web site indicates that text is actually an excerpt from "Doing Business in Arizona, A Legal Guide" by Snell & Wilmer L.L.P.

²⁴ See previous endnote.

²⁵ Rex, Tom (2003), "Public Finance in Arizona," Center for Business Research, L. William Seidman Research Institute, W.P. Carey School of Business, Arizona State University, January, <http://www.wpcarey.asu.edu/seid/cbr>.

²⁶ Mazerov (2001), "The 'Single Factor Sales' Formula for State Corporate Taxes," Center for Budget and Policy Priorities.

²⁷ Mazerov (2001).

²⁸ Goolsbee and Maydew (2000), "Coveting Thy Neighbor's Manufacturing: the dilemma of state income apportionment," *Journal of Public Economics*.

²⁹ O'Mara (1999), "Strategic Drivers of Location Decisions for Information-Age Companies," *Journal of Real Estate Research*.

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