Memorandum

Date: June 10, 2021

From: Jim Rounds, President and CEO

Re: State Income Tax and Budget Plan - Considerations and Suggestions - Updated

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Background

Over the past two weeks our office has received numerous requests to opine on the state budget proposal including the flat income tax. The requests came from lawmakers at the state, leaders within county and city levels of government, economic development professionals, members of the business community, and several other interested organizations.

In some cases, our informal feedback has been accurately conveyed, while in other instances our opinions have been misrepresented. To avoid further confusion, the following bullet points are provided to clearly summarize our position on these matters.

We were not formally engaged to conduct this research. This is a volunteer effort. In terms of our history in dealing with related issues, we helped design the economic development and tax policy changes following the Great Recession, analyzed and forecasted all major tax categories at the state and local levels, examined optimal funding for the Budget Stabilization Fund, and reviewed and monetized scores of tax policy bills including this year's Qualified Facilities Tax Credit and changes to the business property tax assessment ratio. We were also the primary economic analyst on all things related to Proposition 208 and provided the economic impact figures that are widely referenced.

Overview

This memorandum includes three brief sections. First, we provide clarification on the broader economic and tax policy issues that should be considered. Next, a list of recommendations is provided that reflects our opinion of how to best implement a tax cut in the state. Additional economic considerations are then provided.

We began with a review of the concepts outlined in the 5/24 budget proposal. The proposal was reviewed and modifications are listed for making the plan more efficient in terms of growing the economy. This memorandum is not an outline for a bipartisan tax plan with the intent of gaining support from both sides of the political aisle.

Broader Economic Concepts

- ***The state has enough excess revenue for a tax cut to indeed be warranted***. The concept is not in question, only the extent of the tax cut. Also, the entire tax cut does not need to be based on permanent changes to the tax rates. A portion can be one-time taxpayer rebates.

- ***One-time federal stimulus dollars are flowing into the state and tax collections have increased in proportion. This means a portion of current revenue collections is similarly one-time money. This adds risk to the revenue forecast.*** To mitigate this risk, the forecast can be reduced, the scale of the ongoing tax cuts can be reduced, or spending can be reduced. The level of acceptable risk must be set by the Legislature and the Governor.

- ***The recent comparisons with Kansas are not fully applicable in this case.*** Kansas has a very different economy. Budget problems arise when there is a significant imbalance between taxes and spending. Lawmakers in Kansas were not careful with these imbalances, and they overestimated the extent the tax cuts would provide a dynamic return to the state.

- ***Dynamic benefits from a tax cut will indeed occur***. Unlike Kansas, the dynamic benefits listed in this memorandum were calculated using conservative inputs.

- Tax rates matter, but many things make the economy "tick." Tax rates need to be competitive. ***The current budget situation provides an opportunity to address the primary area where the state has become out of balance in its tax code – the top marginal income tax rate from Proposition 208.***

- ***The proposed tax cuts will have a better chance of eventually breaking even if the state continues to be aggressive in other areas that build the economy***. Notable items are listed under Additional Considerations below.

- ***Not all changes need to be formally implemented in 2021.*** There is nothing wrong with waiting until the 2022 or 2023 legislative session to debate and implement select items. The economic forecast will be much clearer at that time.

- ***The revenue sharing issues brought forward by the League of Arizona Cities and Towns are legitimate***. Cities provide the primary services to the new businesses that locate or expand in the state. At the city level, new economic activity means there is a need for more infrastructure, public safety, basic services, etc.

- ***Economic analysis consistently identifies that sales taxes are more efficient than income taxes.*** However, there must be a reasonable balance between the different tax types.

Based solely on how the economy works, and what would grow the economy at a faster pace, ***a proposal for a modest sales tax increase should also be considered.***

- The sales tax is more regressive, but lower income individuals also pay far less in taxes compared to the value that is received in public benefits. Higher income earners also pay exponentially more in taxes. ***Very little economic harm would arise from the sales tax rate advancing to 5.8%, or even 6.0%, to support current education funding demands.*** The extra revenue could then be used on other projects or to reduce the cost of any tax cut proposals.

Recommended Tax Policy Changes

- **Income Tax Rate Reductions:** The 5/24 plan proposed 2.55%/2.98% tax rates then a "flat" 2.5% tax rate starting the following year. ***Costs would be reduced significantly if the second phase, the grouping of the rates into a single 2.5% rate, were removed or postponed.***

- Since the state's income tax rate is mostly competitive (less the Proposition 208 requirements) few economic benefits would be derived from the full move to 2.5%. ***The state's target individual income tax rate (flat tax) should be between 3.0% and 3.5%. Otherwise, later deficits will likely be realized. Keep in mind that spending will also need to match the new revenue base.***

- **Dynamic Economic Benefits:** We used the same models from the previous Proposition 208 analyses to estimate the dynamic economic gains from the tax cut proposal. Our low-end estimate is that the economic benefits from all the tax rate reductions will generate an additional $480M in state tax collections when fully implemented. The mid-point estimate is $672M. The upper-end estimate is $860M.

  While dynamic scoring of tax law changes is not used by the legislature, for voting purposes a conservative $500M revenue gain can be assumed. Including modest dynamic benefits reduces the effective cost of the tax cut package to $700M ($1.2B - $500M = $700M).

Additional Tax Considerations

- **Other Revenue Sources/Uses:** Revenue gains in other areas should be considered along with the aforementioned tax cut costs.

  - **Gaming Revenue** - For policy setting purposes, ***the $300M in estimated annual gaming revenue should have been discussed in the context of tax cuts and revenue impacts.***

- **Tax Rebate for Lower Income Families** - If fewer dollars are used for permanent tax law changes, one-time tax rebates should be considered. ***Lower income individuals were more severely impacted by the COVID-19 recession than middle- and high-income earners. A one-time tax rebate for this income group (< $50k in annual earnings) is recommended with a cost of $250M.***

  This translates into a tax rebate of $150 per taxpayer. Since the math is mostly linear, a $500M rebate equals $300 to each taxpayer. If a modest sales tax increase is included, the tax rebate can increase to $500M.

- **Debt Payments** - Shifting a portion of the tax cuts from permanent to one-time also allows for more debt reduction. ***Retiring the sale/leaseback debt ($470M in one-time costs) adds another $50M in savings each year*** that can be applied to the ongoing tax reduction cost.

RCG Recommendation – Pay down additional debt with the current surplus and consider the fact that new gaming revenue should be scored against the cost of the tax package. Include a one-time rebate to low-income families.

The elimination of debt allows for more policy choices if the state is later faced with a severe recession. This would reduce the effective cost of the proposal to $350M ($700M - $300M - $50M = $350M). Even if the new gaming revenue is excluded from the discussion, the effective cost of the plan still declines to $650M.

- Tax Cut Alternatives: If the aforementioned changes to the 5/24 tax plan do not gain majority support and if lawmakers begin to negotiate lower-level tax cuts, then it may be easier to apply an across-the-board rate reduction to the current tax brackets to equal a predetermined tax cut cost. ***However, something more significant needs to be done to address the top marginal income tax rate imposed by Proposition 208.***

Remaining Considerations/Recommendations

The following points will also yield a high return on investment (ROI) for taxpayers and will enhance the dynamic benefits from the tax cuts.

- ***Change the property tax class for manufacturers from Class 1 to Class 6***. Cost = $100M or less; long term ROI > 5X.

- Revise the calculation for “hold-harmless” revenue sharing to cities and towns to match any revised tax rate reductions. ***If possible, hold the cities harmless from this plan so they can continue to be aggressive economic development partners.***

- ***Add another $50M for ABOR New Economy Initiative projects****.* Begin with enhanced Promise program funding.

- ***Utilize recovery package funding to develop one of several large-scale economic development projects currently being designed by the universities and the Arizona Board of Regents***. The creation of a public/private partnership on healthcare industry expansion with emphasis on virology/ immunology/ bio-security/ etc. will yield a high ROI and has the potential to create a new industry in the state. Economic gains = $Billions; State cost = $0.

- Utilize recovery package funding in the amount of ***$25M to support an enhanced statewide tourism campaign with emphasis on rural tourism***. ROI = 3X. State cost equals $0.

- Provide ***additional funding for use by the Arizona State Land Department*** to maximize state revenues. Extremely high ROI.

- Create a committee and a ***pilot program to address poverty related influences on educational attainment.*** Later review the program results and findings from more aggressive research and create a list of policy solutions.

- ***Develop a strategy for the state to become a national leader in environmental technology R&D and manufacturing.*** If the state simply catches up to the U.S. average in these "green" employment categories, state and local tax collections would increase by $250M per year and 40,000 new jobs would be created. Modestly advancing past the U.S. average would generate $500M in additional annual tax collections along with 85,000 new jobs.

- ***Load up on the state's "rainy day fund." The cost of a recession ranges between $1.5B and $2.5B. A $1.5B target is optimal.***

- ***Taxpayers are our customers. More thought needs to go into the current plan if the intent is to indeed look out for our customers.***

"It's not a memo, it's a Mission Statement."

\- ***Jerry Maguire***
