



## Soaking the Rich Lowers the Tide for All Boats

ANALYZING THE INCOME TAX INITIATIVE

SEAN MCCARTHY

A proposal to double Arizona's personal income tax rates on high income filers and direct those dollars to K-12 employee salaries is disastrous public policy, deleterious to Arizona's economy, and provides only uncertain benefits to the beneficiaries. Riding the recent populist political wave, the authors of this ballot initiative dubbed the "Invest in Education Act" did not have the courage to ask all Arizonans to pay for a tax increase for public education. Instead, they cynically pit the majority against a tiny fraction of filers, hoping that taxing "someone else" for the increased spending will improve their chances at the ballot. This white paper will show that this poorly developed tax increase will not create a sustainable source of funding that is worth the economic malady it will cause.

### Arizona Used to be a High Tax State: It Didn't Work Out

Prior to rate cuts in the 1990s and smaller adjustments in the mid-2000s, Arizona was a high tax state, with a top marginal individual income tax (IIT) rate of 7%. Combined with a 9% corporate income tax rate, Arizona was regionally uncompetitive and had few wealthy filers. Those high taxes didn't result in a boon for government spending. Adjusted for inflation to 2017 dollars, Arizona collected just \$1,270 per capita in total state and local taxes in 1990, which is roughly \$400 less per capita than is collected today.<sup>1</sup> Though Arizona grew in population through the 1990s, high tax rates discouraged millionaire filers from Arizona.

To achieve regional competitiveness, Arizona aggressively cut income tax rates in the 1990s and made small cuts in the mid-2000s. Despite 35% rate reductions and a series of deduction expansions, Arizona's IIT produces 145% more revenue in 2017 than it did in 1991, adjusted for inflation.<sup>2</sup> These gains outpaced population growth by 60%. Arizona's real GDP growth was 176% between 1987 and 2016, outpacing the national increase of 100.4%.<sup>3</sup> Arizona's economic success story and sustained in-migration cannot be fully understood without appreciating its low income tax burdens.

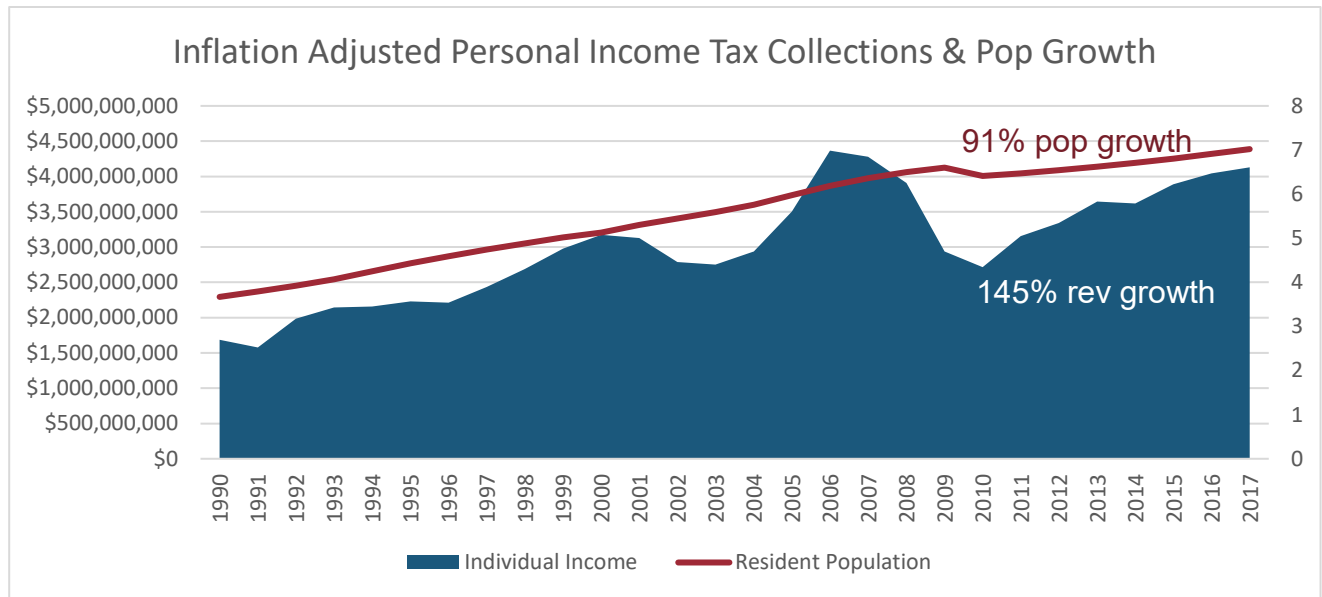
### Arizona's Pro Growth Strategy Has Produced an Effective Income Tax System

Arizona's low IIT rates have served Arizona well. The rates are low enough to be both regionally and nationally competitive, encouraging economic growth in Arizona as well as attracting new residents and businesses. Correspondingly, Arizona's IIT produces a massive sum of tax revenue, roughly \$4.2 billion per annum, which fund necessary government services. It provides one-third of state general fund revenues alone. Upturning this effective system with a 100% increase to the top marginal rate permanently changes Arizona's framework from "low cost, high growth" to "high tax, steer clear."

<sup>1</sup> Data compiled from biannual *Arizona Tax Digest*, produced by Arizona Tax Research Association which compiles tax revenue data from the AZ Dept of Revenue (ADOR) and other state agencies.

<sup>2</sup> All references to income tax collections were made with data from ADOR Annual Reports

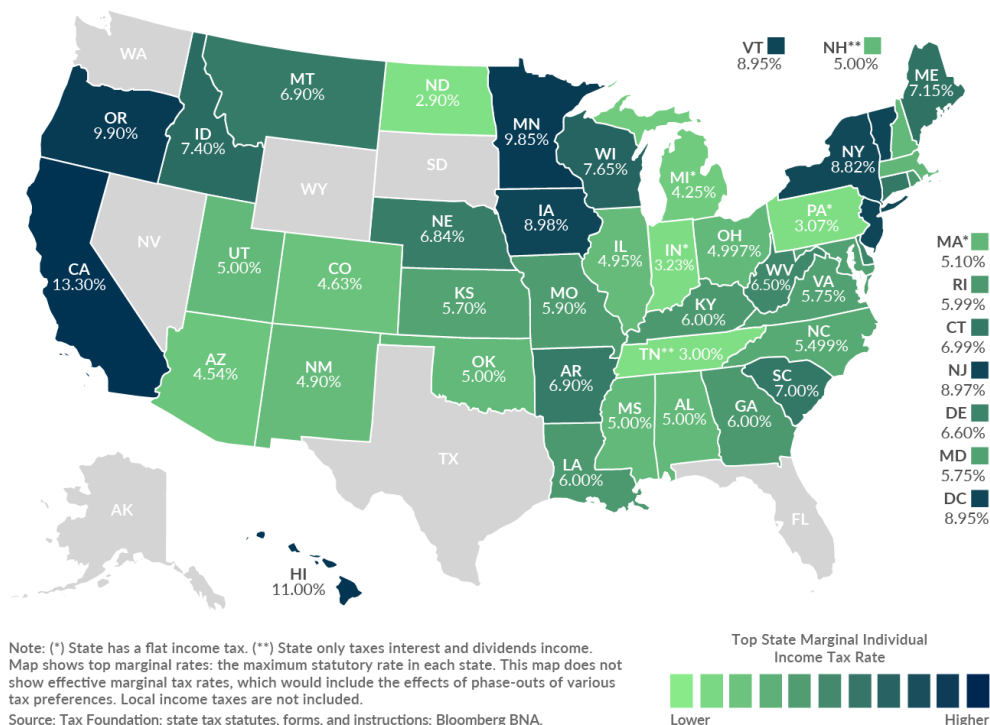
<sup>3</sup> Pacific Northwest Regional Economic Analysis Project <https://www.reaproject.org/>



Doubling Arizona's IIT highest marginal rate would rank Arizona in the top five nationally for income tax rates, ahead of New York, New Jersey and Washington DC. This radical change will reverberate through the economy, impacting thousands of small businesses and leaders in Arizona's economy. The resulting impacts are impossible to predict but it is fair to say no state comparable to Arizona has ever doubled their IIT rates overnight. The consequences would be severe. As one of the primary legs of Arizona's three-legged revenue stool (income,

## How High Are Income Tax Rates in Your State?

Top State Marginal Individual Income Tax Rates, 2018



property, and sales taxes), all state and local government is threatened by injecting substantial uncertainty to the IIT.

#### Proposed Income Tax Rate Changes for Married Filing Joint Filers

Taxable Income	2018 Rates	2019 Rates	% Difference
\$0 - \$20,325	2.59%	same	
\$20,326 - \$50,812	2.88%		
\$50,813 - \$101,623	3.36%		
\$100,624 - \$304,868	4.24%		
\$304,869 to \$500,001	4.54%		
\$500,001- \$1,000,000		8.00%	76.2% ↑
\$1,000,001 and over		9.00%	98.2% ↑

#### Arizona's Competitive Rates Led to a Surge of Small Business & High Income Filers

Between 1991 and today, IIT filers with more than \$1 million in adjusted gross income (AGI) grew from just 493 to 6,500. The percentage of all filers with over \$1 million in AGI in Arizona grew 450% over that period. The amount of taxes they paid increased from 4.4% of the total to 7.2%. That growth may not sound like much, but the total IIT revenues paid by \$1 million filers grew from just \$100.7 million in 1991 to more than \$700 million today (in constant 2017 dollars). Arizona has far more high income filers now as a low tax state and relies heavily on those revenues.

1997-2015	US	Arizona	Minnesota	Oregon	Connecticut
Millionaire Filers	106%	446%	198%	191%	118%
Millionaire Filers as % of Total Filers	151%	205%	145%	133%	139%

#### Retirees, Snowbirds, and Athletes Have Choices

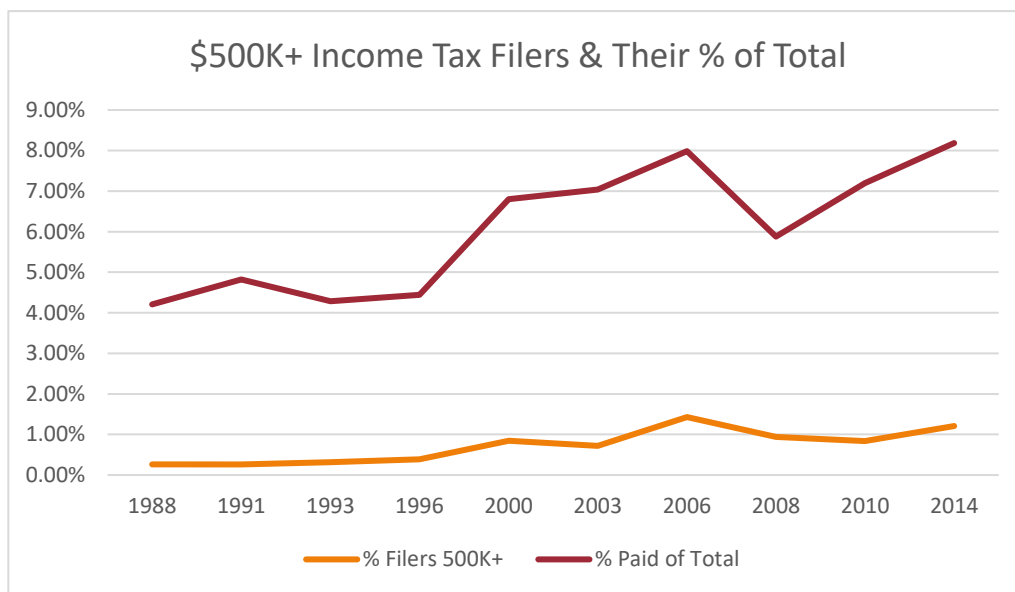
Arizona is not California or New York. They have a disproportionate share of wealthy filers despite high IIT rates for a variety of inherent factors which Arizona does not share. With attractive rates, wealthy nonresident filers in particular have flocked to Arizona. Pointing to the sustained presence of wealthy filers on the coasts as evidence of keeping these filers in Arizona— especially nonresidents, is folly and ignores obvious trends.

Nonresident filers with more than \$500,000 in AGI went from a rounding error at 0.01% of all filers in 1991 to 0.05% today. Again, this may not seem like a big jump but the revenue impact is serious: their collections went from \$11.8 million in 1991 to above \$100 million today (in constant 2017 dollars). Nonresident filers are wealthier on average than resident filers and enjoy an increased ability to determine where they will file their state taxes. More than half of the revenue received from all nonresident filers will be subject to a tax shock.

This tiny group of just 500 filers collectively pay 3% of all income taxes. The massive increase in revenues from this mobile cohort reflects the dynamics in Arizona: there is a large segment of wealthy filers who chose Arizona. Will they stay if their taxes double? Will future migrants choose Arizona with tax rates worse than almost every other U.S. state?

## Arizona's Rates Are Already Substantially Progressive

Arizona's IIT is set up to charge little to nothing to low-income earners while applying more regionally competitive rates to upper middle and high income filers (including businesses who file via the IIT). This is captured by Arizona's ranking in per capita collections of IIT: last in the nation among states with a traditional IIT.<sup>4</sup> (See graphic on next page). For example, Arizona and Utah's top marginal rate are similar with Utah's at 5.0% and Arizona's rate at 4.54%, Utah has a flat tax while Arizona's is highly progressive which results in Utah collecting \$1,054 per capita versus \$551 in Arizona. Doubling Arizona's top marginal rates would make Arizona's IIT the most unbalanced in the nation. No other state has such a wide disparity of rates between middle income and higher earners as is proposed. How that would impact Arizona economically is difficult to project but from a social order perspective, it creates an



improper balance where services demanded by the public are not paid for by the public at large. Taxpayers should know and understand the cost of government. Shifting burdens to a small class of wealthy filers and businesses is unhealthy governance.

## Initiative Will Not Raise Contractual Salaries for Teachers

Under the proposed initiative, school district employees are the beneficiary of this tax increase, which would take form as a bonus of sorts. These restricted dollars would be funded by a single revenue source; they will be volatile and subject to market forces. School administrators will not be able to place these monies in base pay. Any money derived will likely be paid twice a year in the form of a bonus much like Prop 301 dollars. Prop 301 is a sales tax, which historically is far more stable than income tax collections from high income earners. If school administrators cannot trust a single revenue source in the form of a sales tax, they certainly cannot with a high wealth income tax. Given the volatile nature of this fund source, beneficiaries will not be able to rely on this money. The next inevitable economic downturn will create pressure to raise taxes elsewhere to solve this obvious problem

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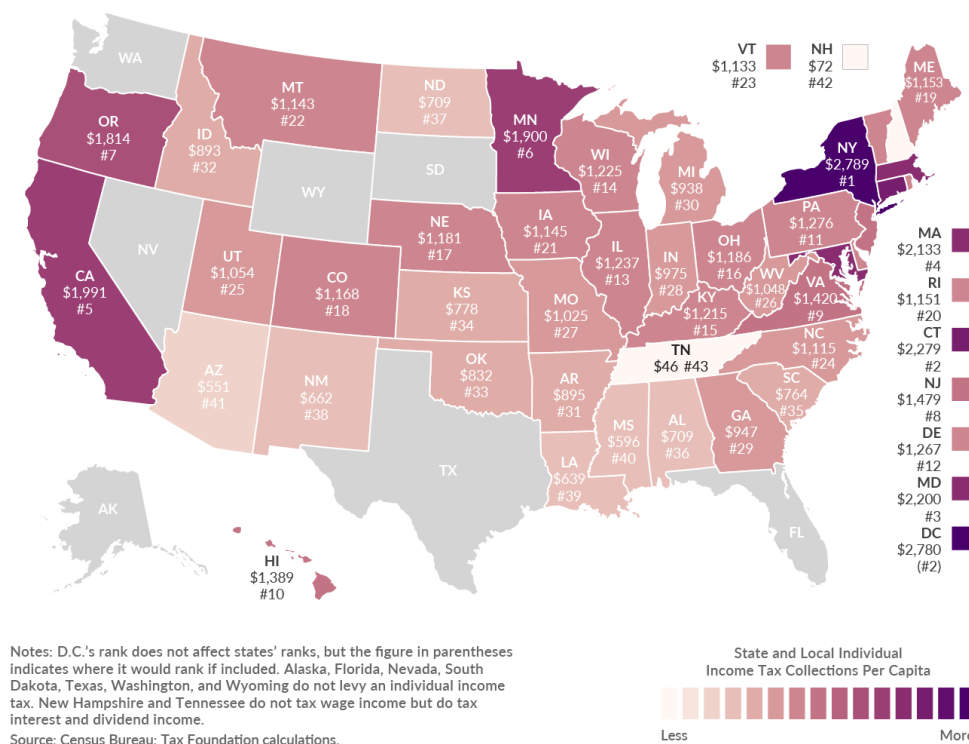
<sup>4</sup> "State and Local Individual Income Tax Collections Per Capita" *Tax Foundation*. 2018.

## This is Not a Reliable Fund Source for Teachers

Arizona's K-12 system has always been funded by a combination of all the major tax revenue sources. During the Great Recession, IIT collections from filers with more than \$500,000 proved to be the most volatile. In FY 2008, the first year of the recession, IIT collections actually grew for filers under \$500K AGI while they plummeted more than one billion dollars for filers north of \$500K AGI. In just one year, IIT collections for high income filers dropped 32%! This is predominantly because of the thousands of small businesses who pay income taxes via the IIT. Business

## How Much Does Your State Collect in State and Local Income Taxes Per Capita?

State & Local Individual Income Tax Collections per Capita, FY 2015



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profits cratered first. Revenues from filers under \$500K AGI are more stable. Revenues derived from high income filers still had not recovered to prerecession levels by 2014. Tying teacher's salaries to one of the most volatile revenue sources is poor fiscal policy not witnessed in any other state and will whipsaw teacher pay based on the whims of the business cycle.

## A 100% Tax Increase Will Cut Base Revenues

There is no doubt a tax increase will increase revenues. However, a 100% rate increase on business profits will absolutely influence business decisions which negatively impact base revenues. Businesses model their cost structure to the last dime. Significantly altering their costs must change their decisions. Whether it's foregoing future hiring, an expansion, or adding locations, substantially increasing their costs will retard growth. While a minor rate change may not force a business to change their behavior, a massive and instantaneous increase is far more likely to create negative dynamic revenue impacts. The leading peer-reviewed study in tax increases on high income filers from Varner and Young concludes that for every 10% rate increase, 1% of high income filers will move and

another 1% who would have moved to Arizona will move elsewhere.<sup>5</sup> The proposed 100% rate increase projects to flush 10% of high income filers and prevent the same number of high income migrants from moving to Arizona. Losing 20% of future high income and small business tax filers represents a massive cut in base revenues and untold downstream economic impacts.

### A Prop 105 Nightmare

With voter-approval of this initiative, all income tax rates will be subject to Arizona's Prop 105 Voter Protection Act, which means they can only be changed legislatively with a three-quarters vote of the Legislature; a near impossibility on a controversial topic. This means the state would be unable to react to changes at the federal level, since Arizona conforms its income taxes to the federal structure. Even small rate adjustments to prevent tax increases would be incredibly difficult. Compliance for all taxpayers would become more burdensome as Arizona "detaches" from the federal system, making annual filing more costly and cumbersome.

### Conclusion

The proposal to double Arizona's income tax rates should worry education advocates. The initiative will be opposed by the entire business community with all serious economists arguing its flaws. The money the proponents expect to generate, some \$600+ million, is less than the total increase in state collections year-over-year in FY 2018 alone. Economic growth in one year created more revenue. But a 100% rate increase is game changing to small businesses and wealthy filers; their behavior will change. If it passes, the general public may conclude Arizona is "done" addressing K-12 education with a proposal that will not even raise contract salaries of employees. This seismic tax increase proposal is untested and unmatched in any other state. The economic impact is potentially disastrous. Even a mild slowing of the economy could impact every Arizonan, meaning the gain will be offset by revenue losses or foregone gains in other taxes. The conclusion may be: Arizona tried to raise taxes for education but it resulted in an economic slowdown.

Instead, responsible Arizonans should reject this initiative as a populist effort arising from fringe political groups. Their interest in the welfare of Arizona was so small they didn't so much as commission a study or produce analysis on how this massive change would impact the economy. The authors of the initiative, the ironically named Arizona Center for Economic Progress, produced no economic impact study or expectations for dynamic revenue impacts. Like populist ideas designed for short term gain, this group is less than a year old. Interestingly, though they claim to advance economic progress, their idea isn't supported by any reputable economist. The initiative lacks the benefit of a coalition which would have demanded vetting by policy experts and academic research justifying these changes. Arizonans should consider this proposal for as long as it took the backers to craft it.

In the first year of the recession, IIT collections actually grew for filers under \$500K AGI while they plummeted more than one billion dollars for filers north of \$500K AGI. In just one year, IIT collections for high income filers dropped 32%!

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*Funding public schools is a mandatory requirement of the State and the financial burden should be an obligation of all Arizonans. Isolating teacher pay raises on less than 2% of the population is awful public policy and should be rejected. –Kevin McCarthy, ATRA President*

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<sup>5</sup> Young, Cristobal & Charles Varner. *Millionaire Migration and Taxation of the Elite*. American Sociological Review. 2016.