



Invest In Ed Tax Increase Misguided & Cynical

ANALYZING THE INCOME TAX INITIATIVE

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An initiative has resurfaced in 2020 to nearly double Arizona's top personal income tax rate. The proposal is similar to the 2018 effort insofar as it has the odious distinction of making Arizona far less business friendly while not providing significant new revenue to K-12. 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 income taxpayers, hoping that taxing "someone else" for increased spending will improve their chances at the ballot. This white paper will show that this poorly conceived tax increase will not create a sustainable source of funding that is worth the economic malady it will cause. Invest in Ed (IIE) is disastrous public policy, deleterious to Arizona's economy, and provides only uncertain benefits to schools.

Arizona Used to be a High Tax State: It Wasn't Working

Prior to income tax 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%. With a 9% corporate income tax rate, Arizona was regionally uncompetitive from a business view and had few wealthy filers. Those high taxes didn't result in a boon for government spending. Arizona collected just \$1,270 per capita in total state and local taxes in 1990 (inflation adjusted), which is roughly \$400 less per capita than is collected today.¹ Though Arizona grew in decades prior to the 1990s, high tax rates discouraged high-end 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 36% rate reductions since then and a series of deduction expansions, Arizona's IIT produces 185% more revenue in 2019 than it did in 1991, adjusted for inflation.² These gains doubled population growth. Arizona's real GDP growth was 176% between 1987 and 2016, outpacing the national increase of 100.4%.³ 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

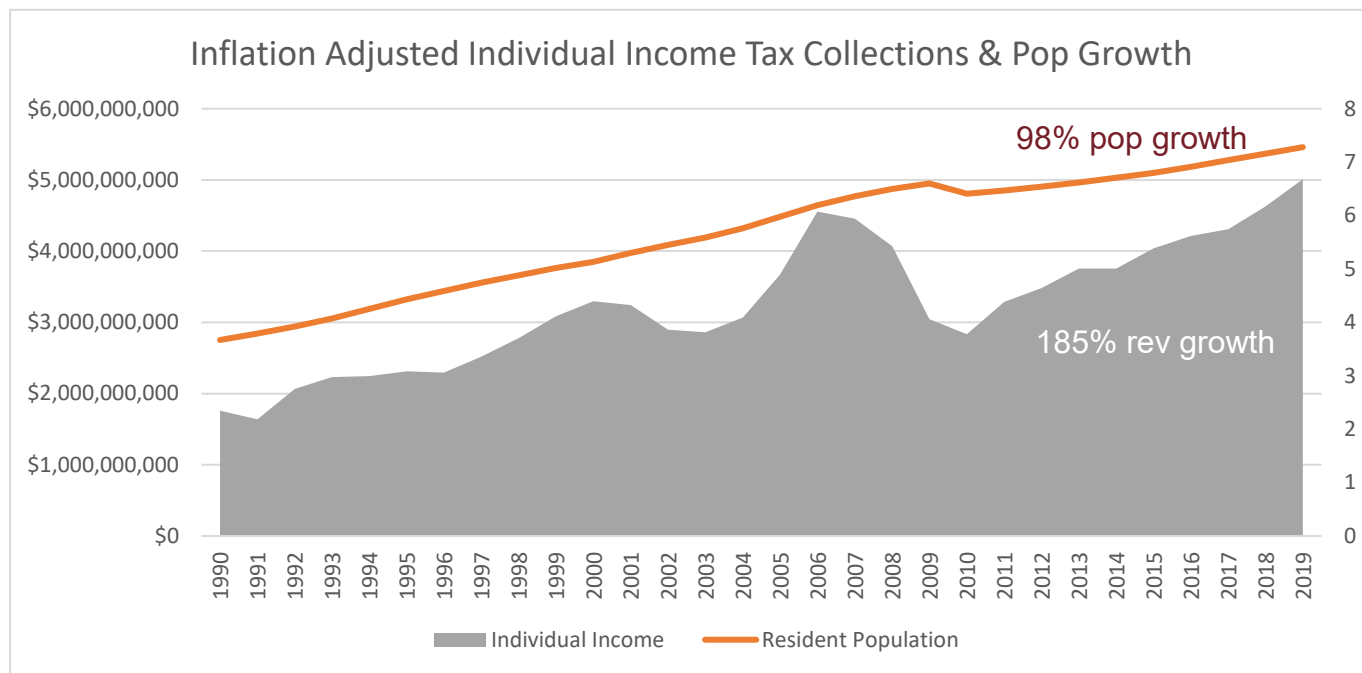
Arizona's low IIT rates have served Arizona well. The rates are low enough to be both regionally and nationally competitive, encouraging economic growth in Arizona as well as attracting new residents and businesses. Correspondingly, Arizona's IIT produces a massive sum of tax revenue, roughly \$5 billion per annum, which fund necessary government services. It provides one-third of state general fund revenues alone. Increasing rates does

¹ 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. Adjusted to 2017 dollars.

² All references to income tax collections were made with data from ADOR Annual Reports

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

not make a taxation system more *efficient* from a revenue generation perspective. Arizona's neighbor New Mexico collects *less* IIT per capita than Arizona despite having a nearly flat rate of 4.9%, higher than any rate in Arizona.⁴ Upturning Arizona's efficient IIT system with a 77.7% increase to the top marginal rate (going from 4.5% to 8% under the proposal) permanently changes Arizona's business proposition from "low cost, high growth" to "high tax, steer clear."



Doubling Arizona's IIT highest marginal rate would add Arizona to the category of highest state income tax rates in the nation. 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 nearly doubled their top IIT rate overnight. The consequences would be substantial, particularly now that the federal government has capped the State and Local Tax (SALT) deduction, as noted by JLBC.⁵ As one of the primary legs of Arizona's three-legged revenue stool (income, property, and sales taxes), all state and local government is threatened by injecting substantial uncertainty to the IIT.

Proposed Income Tax Rate Changes for Single or Married Filing Separate Filers

Taxable Income (Single)	2019 Rates	2021 Rates	% Difference
\$0 - \$26,500	2.59%	same ↓	
\$26,501 - \$53,000	3.34%		
\$53,000 - \$159,000	4.17%		
\$159,001 - \$249,999	4.50%		
\$250,000 and up	4.50%	8.00%	77.8% ↑

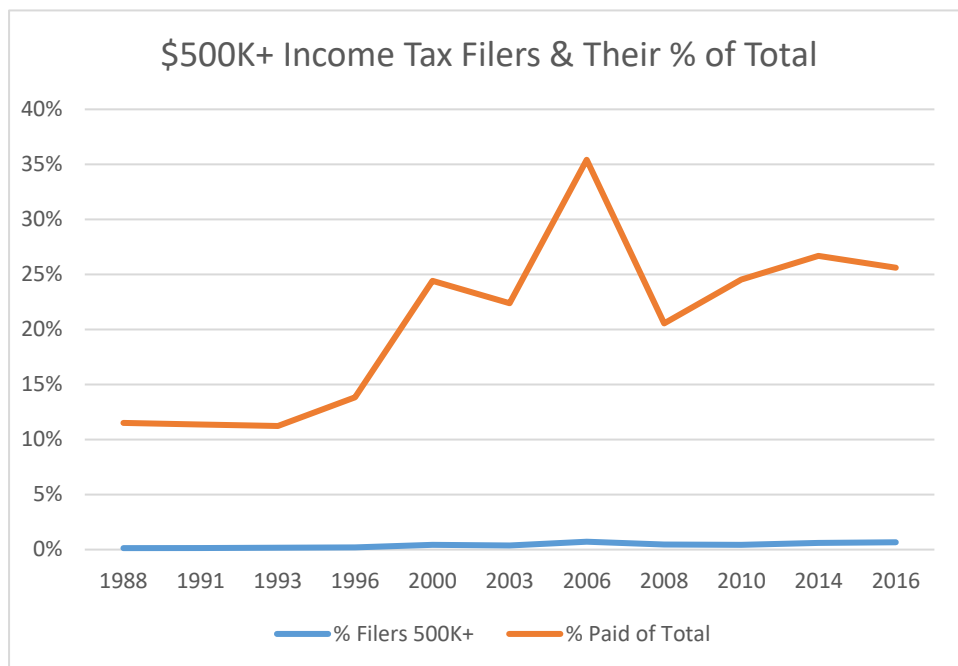
⁴ "State and Local Individual Income Tax Collections Per Capita FY 2018" *Tax Foundation*. 2020.

<https://files.taxfoundation.org/20200225111115/Facts-Figures-2020-How-Does-Your-State-Compare.pdf>

⁵ *Joint Legislative Budget Committee*. Invest in Education Act Fiscal Analysis. <https://www.azleg.gov/jlbc/20nov1-31-2020fn730.pdf>

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

Between 1991 and today, IIT filers with more than \$500k in adjusted gross income (AGI) grew from just 1,674 to more than 20,211. The percentage of all filers reporting income over \$500k in AGI in Arizona grew 396% over that period. The amount of taxes they paid increased from 11% of the total to 24% today. The total IIT revenues paid by these filers grew from just \$161 million in 1991 to more than \$1 billion today (in constant 2019 dollars). Arizona has far more high income filers now as a low tax state and relies heavily on those revenues.



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 resident and 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. International business centers found on the coasts that tend to have “persistent millionaires,” as described by *Millionaire Migration and Taxation of the Elite*, a study on the migration of the wealthy.⁶ Arizona is a state migrants choose; it is not forced on them.

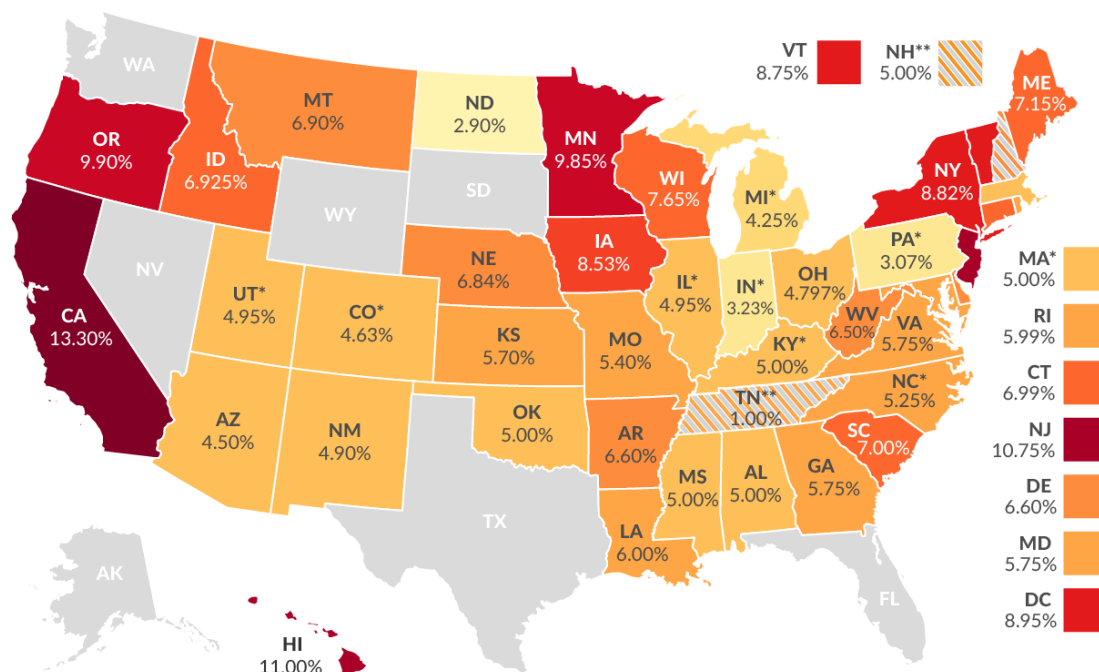
Nonresident filers with more than \$500,000 in AGI went from a rounding error at 0.01% of all filers in 1991 to 0.06% today. This may not seem like a big jump but the revenue impact is serious: their collections went from \$12.7 million in 1991 to above \$100 million today (in constant dollars). Nonresident 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 filers collectively pay nearly 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?

⁶ Young, Cristobal & Charles Varner. *Millionaire Migration and Taxation of the Elite*. 2016.

How High are Individual Income Tax Rates in Your State?

Top State Marginal Individual Income Tax Rates, 2020



Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.

(*) State has a flat income tax.

(**) State only taxes interest and dividends income.

Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.

Top State Marginal Individual Income Tax Rates



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Arizona Imports Wealthy Filers

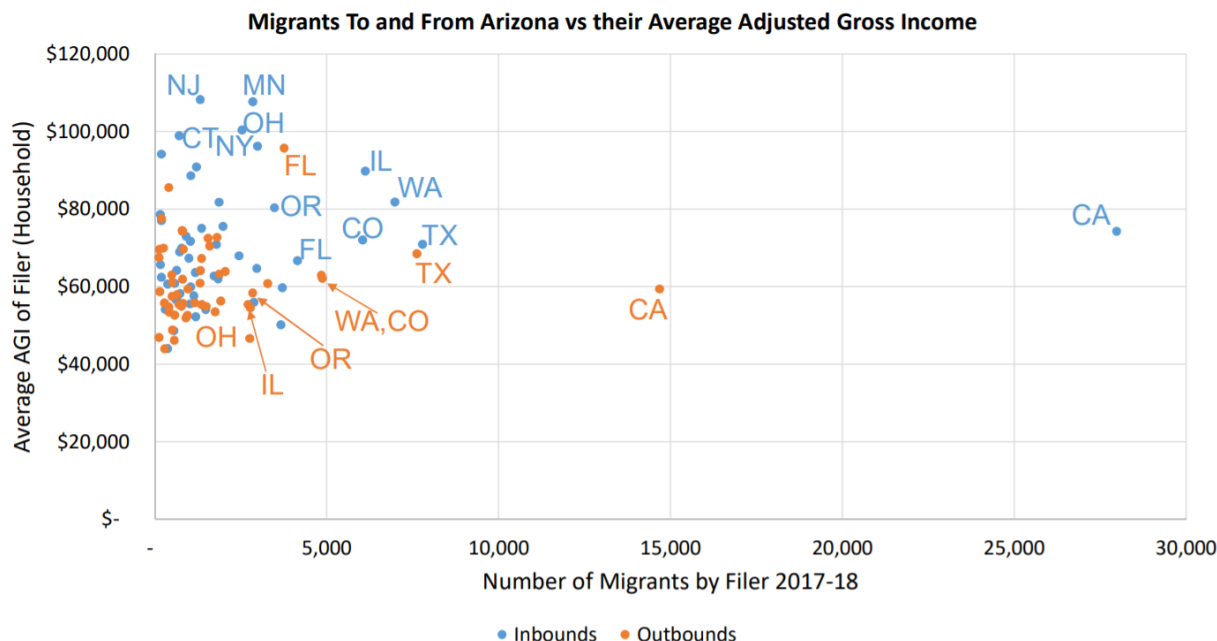
In the last five years of available data, Arizona has imported a net increase of 120,466 income tax filers from domestic migrants, meaning people who moved from one U.S. state to Arizona in the following year. The increase has led to a gain of \$11.6 billion in taxable income, which was 7% of all taxable Arizona personal income in 2018.⁷ With an average liability of 2.4%, this translates to \$282 million in state income taxes. The Internal Revenue Service (IRS) tracks and publishes this two-year data, which shows migrants both to and from states. They report the AGI of filers who departed a state and also the AGI at the state where migrants arrived after they have moved.

The largest number of annual domestic migrants (by filer) to Arizona is California, which also is the largest

What migrant filer data shows is Arizona is not only a destination state for moving Americans from a variety of regions, those who migrate to Arizona tend to earn high incomes on average.

⁷ <https://www.irs.gov/statistics/soi-tax-statsmigration-data>

source of net AGI growth. In the last five years, Arizona's AGI has grown by \$3.5 billion due to California migrants. Illinois is second at \$1.6 billion. Migrants to Arizona tend to file higher AGIs than the migrants from Arizona to that state, by an average of \$9,000 per filer. What migrant filer data shows is Arizona is not only a destination state for moving Americans from a variety of regions, but those who migrate to Arizona tend to earn high incomes on average.



Arizona's Rates Are Already Substantially Progressive

Arizona has a unique personal income tax. Regionally, states either have no personal income tax in Texas, Nevada, Washington, and Wyoming, a flat or basically flat tax in Utah, Colorado, New Mexico, Idaho, Montana, and Oklahoma, and two states with very high progressive income tax rates, California and Oregon. Arizona's IIT is designed to charge little to nothing to lower-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: consistently near the bottom of states with a traditional IIT.⁸ For example, while Arizona and Utah's top marginal rates are similar, with Utah's at 5.0% and Arizona's rate at 4.50%, Utah has a flat tax while Arizona's is progressive which results in Utah collecting \$1,263 per capita versus \$634 in Arizona. Doubling Arizona's top marginal rates would arguably make Arizona's IIT the most unbalanced in the nation insofar as it charges very little to most of the population but high rates to high end filers and businesses who file using the IIT. 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.

Finally, it's important to remember the federal income tax system is already highly progressive, with AGI amounts over \$207k already taxed at 35% at the federal level. The combined top marginal rate in Arizona is 41.5% for amounts over 500k (single filers)! Adding an additional 3.5% to Arizona's top bracket moves it from 39th to 9th highest in the nation for its combined top tax marginal income tax rate.

⁸ "State and Local Individual Income Tax Collections Per Capita FY 2018" *Tax Foundation*.

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 \$500k 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 profits and capital gains 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 fluctuations of the business cycle.

Initiative Will Not Raise Contractual Salaries for Teachers

Under the proposal, school district employees are the beneficiary of this tax increase, which would take form as a bonus of sorts because the money is paid in grants and does not go into base K-12 funding. 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 is historically 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.

JLBC estimates this tax increase generates about \$827 million in new revenue, of which \$702 million goes to K-12 schools. This estimate acknowledges no dynamic revenue impacts from economic losses, so these estimates are likely high. It is less revenue than the state added to K-12 schools in the last three years for the 20% teacher pay raise (20x2020) and additional assistance restoration. Those two alone cost the state roughly \$1 billion annually. Only \$413 million is earmarked for hiring and raises for teachers and classroom support personnel, which is a larger group than the state's definition of teacher for the 20x2020 program. Ergo, teachers can expect a far smaller pay bonus than what was achieved through 20x2020 should this pass. K-12 advocates should wonder aloud: is a 10% teacher pay bonus that fluctuates wildly each year worth making Arizona a high income tax state and driving away future economic growth?

School administrators will likely not place these monies in base pay.

This Tax Increase Likely Cuts Base Revenues Because it Impacts Arizona Businesses

There is no doubt this tax increase will generate new revenues. However, a 78% 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, which include taxes on profits, must change their decisions. Whether it's foregoing future hiring, an expansion, or adding locations, substantially increasing 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.

Fifty-eight percent of Arizonans in the private sector work for a business that pays its income taxes via the IIT.⁹ Per the most recent IRS data, 27% of Arizona filers with Partnership or S Corp income will be impacted by this tax increase, which contradicts argumentation that only a tiny fraction of businesses are impacted.¹⁰ Importantly, 91% of federal IIT revenues from businesses come from filers who pay in these brackets, meaning a similar percentage of Arizona's revenue would be impacted by this increase since Arizona's progressive system is similar to the federal system. Arizona should not threaten the taxpayers paying the vast share of the business taxes with a shock to the system.

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.¹¹ The proposed 78% rate increase projects to flush 7.8% of high income filers and prevent the same number of high income migrants from moving to Arizona. This data was taken long before the COVID pandemic changed the work from home environment. Losing future high income and small business tax filers represents a massive cut in base revenues and untold downstream economic impacts.

A Prop 105 Nightmare

Perhaps one of the worst features of the initiative is the supplanting clause that forever locks lawmakers in to all prior K-12 appropriations. Buried in the proposed law is a clause that says the State Legislature may not use these new funds to supplant other funds, meaning the Legislature cannot cut nearly any other fund to K-12 since nearly all K-12 funds are unrestricted and can be used for the same spending this tax proposes to support. Currently, the Legislature may not touch base revenues through 2025 per Prop 123 but may cut any other pot of money in the event of a major economic downturn, namely Additional Assistance. This initiative forever locks in nearly the entire amount of K-12 funding permanently, since voter initiatives are protected by Arizona's Prop 105 Voter Protection Act. In the event of a severe economic downturn, the largest portion by far of Arizona's state budget would now be almost completely insulated, forcing impossible budget balancing decisions. No one wants to see cuts to K-12 education spending, but in the event of a recession, even K-12 must take a haircut especially in non-core activities such as capital spending. This proposal neuters a key tool to surviving a recession.

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%!

With voter-approval of this initiative, high income tax rates on these filers 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 if the initiative causes economic challenges or dynamic revenue decreases to base revenues. There is no ability to "see how this works;" if approved, it's likely a permanent feature as passed.

Conclusion

The proposal to nearly double Arizona's top marginal income tax rate 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 \$800+ million, is less than the total increase in state collections year-over-year in FY 2020 alone. Economic growth in one year created more revenue. If it passes, the general public may

⁹ "Marginal Tax Rates for Pass-through Businesses by State." *Tax Foundation*. <https://taxfoundation.org/pass-through-businesses-tax-rate-2020/>

¹⁰ SOI Tax Stats - Historic Table 2. *Internal Revenue Service* <https://www.irs.gov/statistics/soi-tax-stats-historic-table-2>

¹¹ Young, Cristobal & Charles Varner. *Millionaire Migration and Taxation of the Elite*. American Sociological Review. 2016.

conclude Arizona is “done” addressing K-12 education with a proposal that will do less for teachers than the 20x2020 pay program. If education advocates want continued additional funding for schools, they should push for a strong economy providing higher wage jobs, which is the key to increasing state revenues which fund schools. In a good economy, the IIT produced nearly \$1 billion more in 2019 than it did in 2017. The IIT produced 76% more in 2019 in inflation-adjusted dollars than it did ten years ago.

A dramatic rate increase is game changing to small businesses and wealthy filers; their behavior will change. Proponents speak little of the actual impact of the revenue on Arizona’s education system and more about the rich paying their “fair share” and other populist rhetoric. They make no evidentiary claims for how this pot of revenue materially improves K-12 education. It will not materially change rankings on spending.

The obvious truth is taxation on the levels of states like New Jersey and California will not make Arizona richer. Arizona is more ‘New Mexico’ than it is ‘California’ from a demography, wealth, education, and geography perspective. A proposal like this is far likelier to push growth to western competitors like Texas, Nevada, and Colorado than it is to help the Arizona economy.

This seismic tax increase proposal is untested and unstudied. 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 misguided, populist effort. After two years of being mocked for not studying the economic impact of this tax increase, proponents still haven’t commissioned a study or produced analysis on how this massive change would impact the economy. The authors of the initiative, the ironically named Arizona Center for Economic Progress, have not only failed to study the economic impacts, they claim businesses themselves will not pay this tax because the income tax is only on pass through business profits, a myopic misunderstanding of the income tax system. Interestingly, though they claim to advance economic progress, their proposal 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 know that funding public education is everyone’s responsibility and should in turn reject this proposal.

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
