Arizona's Proposition 208 Tax Hike Loses Jobs and Harms Small Businesses

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Executive Summary

This study examines the likely impact of the Arizona ballot initiative Proposition 208 tax increase on jobs, wages, interstate migration, tax revenue collections, state competitiveness, and small businesses in the state. We examine how similar types of tax increases over the past 30 years have worked in other states. We also provide an econometric projection for the number of jobs and amount of wages lost due to the rise in the state income tax on those Arizonans with adjusted gross income above $250,000 and $500,000 for joint filers.

We find significant negative effects that would make Arizona residents poorer and the state's economy less competitive.

- 50% of the tax would be borne by small business owners and operators and these businesses typically generate from half to two-thirds of the jobs in a state.
- Arizona's economic competitive position among the 50 states would fall from 10th best in the nation to 16th in the widely acclaimed ALEC-Laffer competitiveness index. Arizona would move from having the 13th lowest income tax rate on small businesses to the 9th highest in the nation.
- An estimated 200,000 jobs would be eliminated over 10 years.
- The state would lose 700,000 people in net instate migration over just the next decade.
- Personal income in the state would be reduced by $25.5 billion over the next decade.
- Because of the lost businesses, jobs and taxpaying in-migrants, the measure would at most gain half the static $1 billion in tax revenue gains that proponents of 208 advertise.
- Wage growth would decline in the state and after a decade average household income would be roughly $6,000 lower with the tax hike. It isn't only the rich that will bear the burden of the tax.

The change in federal tax policy in the 2017 federal tax law caps the deduction of state and local taxes to $10,000 per household. This means that no longer can filers deduct up to 40% of their state income tax payments from their federal taxes. As such, all of the evidence in this study UNDERSTATES the negative effects of the proposed income tax increase because Arizona will no longer be permitted to export up to 40% of the costs of the tax hike to residents of other states. There are already signs that migration from high income tax states to low income tax states is accelerating in 2019 and 2020. As such, this is the worst time for a state to be raising its income tax rate since the full cost of an increase will be borne by the residents of the state since there is no longer deductibility of any tax penalty beyond the cap.

Introduction

On November 3, 2020, Arizona voters will have a potentially larger issue to vote on than even the presidential election. Proposition 208 would increase the top marginal personal income tax (PIT) rate from 4.5% for income earners above $159,000 in adjusted gross income (AGI) to 8% for income earners above $250,000 in AGI ($500,000 for joint filers). Arizona hasn't seen a PIT that high since 1990. The reverberations from a tax increase of this magnitude will have seriously damaging effects on the state for years to come. A policy change this damaging would drop Arizona's ALEC-Laffer Economic Outlook Ranking from 10th best in the nation to 16th, all else equal. Furthermore, over the next 10 years, we estimate Arizona's population to increase by 700,000 fewer people, employment to increase by 237,000 fewer jobs and personal income in the state to increase by $25.5 billion less, all relative to their potential increases at current growth rates.

The proposition, also known as "Invest in Ed," is designed to supplement funding for education in Arizona. A study by the Arizona Center for Economic Progress estimates the initiative would generate around $940 million in new, annual and permanent revenue for Arizona's public schools.[1] Unfortunately, this is but a static estimate and doesn't account for the changes in behavior for businesses and individuals. The truth of the matter is that increasing the top marginal personal income tax rate from 4.5% to 8% will not result in $940 million in new annual revenue. When Arizona's tax rates were cut in the 1990s and beyond, revenues actually increased above projections, and Arizona's state budget surplus rose. Run the film backwards and you'll see that schools will get less money, not more. It's entirely possible that the initiative will stifle business growth and employment opportunities, as well as deter companies and individuals from choosing the Grand Canyon State as a new home.

In the first half of this study, we provide a comprehensive examination of the historical evidence of personal income tax rate changes in Arizona and other states over recent decades. There are a few exceptions, but in almost all cases, states that have raised income taxes have seen a reduction in economic benefits, and states that have lowered their income taxes have seen substantial economic gains. Job creation, for example, has been about 50% to 100% higher in low- and no-income tax states than high income tax states.

In the second half of this study we present some econometric predictions of how the state of Arizona would be impacted by the increase in taxes as proposed by Prop 208.

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[1] "The Invest in Education Initiative (Proposition 208) is the Plan Arizona Needs for Funding Our Public Schools," The Arizona Center for Economic Progress, September 2020. https://www.azeconcenter.org/wp-content/uploads/2020/09/IIE-Fact-Sheet_final.pdf

Arizona's Tax History

Arizona has a long history of reversing course on tax policy. Governor Jack Williams, at the onset of his eight years in office in 1967, raised the highest personal income tax rate from 5.9% to 8% and the highest corporate income tax rate from 6.6% to 8%. He also raised the state's sales tax rate to 3% from 2%.

In his final year in office in 1974, Governor Williams again raised the sales tax rate to 4%, the fuel tax from 7 to 8 cents per gallon, and the corporate income tax rate to 10.5%. Then came a long era of fluctuation where property tax rates went down, up, and then down again and the sales tax rate was raised to 5%. The tax dawn in Arizona began in 1990. The corporate income tax rate fell to 9.3% and the personal income tax rate dropped to 7%.

While the entire post-World War II period was a bonanza for the western states, there was a definite preference for Nevada and California over Arizona – more than coincidentally until Arizona started cutting tax rates. Once tax cuts took hold, Arizona took off.

The Theory

If you want less of something, tax it. We tax smokers to get them to stop smoking. We tax speeders on the freeway to get them to stop speeding. In the same vein, why then would anyone want to tax jobs, employment and output? Of course, we tax jobs, employment and output to generate revenue to provide government services rather than to discourage jobs, employment and output, but that doesn't change the fact that taxing income—or anything else for that matter—is a sure-fire way to ensure you get less income.

While some on the left refute the proposition that there are any substantial negative effects on migration and a state economy from higher tax rates, our book "The Wealth of States" cites more than 100 academic studies in prestigious economic journals which, on balance, validate these adverse consequences. Higher tax rates at the local, state and national level are deleterious to growth in a jurisdiction's incomes, population and jobs. One study by a sociology professor at Cornell University has received some attention in the state for predicting very tiny and inconsequential effects of the Prop 208 tax hike. We show in the appendix to this report the flaws in that analysis.

The Lessons of Other States Can Predict the Future in Arizona

One way to assess the potential impact of an income tax rate hike as high as is being proposed in Arizona is to examine what has happened in other states with these kinds of measures. A good parallel to the 208 proposal is to examine the detrimental effects a personal income tax had over time in the 11 states that have introduced and raised this tax going back to 1961. The first in this group was West Virginia in 1961 and the most recent was Connecticut in

1991. For each state that introduced an income tax since 1961, we examine their share of total U.S. population, gross state product (GSP), and total state and local general revenue relative to the 39 other states that did not introduce a personal income tax from 1961-1991. Every single state that decided to impose a tax on work and employment at the employee level declined relative to the other 39 states in every single measure. And we aren't talking about small declines here, either. These states universally declined by upwards of 40% relative to the rest of the nation. Income tax increases are almost always very negative for growth at the state level.

Table 1
The 11 States That Introduced an Income Tax Since 1961

				Share of Remaining 39 States								
		Maximum Tax Rate		Population			GSP			Total State and Local Revenue		
	First Year of the Tax	Initial	Current	5 Years Before	2019	% Change	5 Years Before	2019	% Change	5 Years Before	2017	% Change
Connecticut	1991	1.50%	6.99%	1.8%	1.4%	-22.8%	2.4%	1.7%	-27.5%	2.4%	1.6%	-31.2%
New Jersey	1976	2.50%	10.75%	4.9%	3.5%	-29.5%	5.4%	3.8%	-28.9%	5.4%	3.8%	-29.4%
Ohio	1972	3.50%	4.80%	7.6%	4.6%	-39.6%	8.0%	4.2%	-47.8%	6.1%	4.6%	-24.0%
Rhode Island	1971	5.25%	5.99%	0.7%	0.4%	-38.9%	0.6%	0.4%	-41.8%	0.7%	0.4%	-35.6%
Pennsylvania	1971	2.30%	3.07%	8.5%	5.0%	-41.0%	8.5%	4.9%	-42.6%	7.7%	4.9%	-36.3%
Maine	1969	6.00%	7.15%	0.7%	0.5%	-28.8%	0.6%	0.4%	-29.7%	0.6%	0.5%	-21.6%
Illinois	1969	2.50%	4.95%	8.1%	5.0%	-38.5%	9.8%	5.3%	-45.7%	7.8%	4.9%	-37.4%
Nebraska	1968	2.60%	6.84%	1.1%	0.8%	-31.1%	1.0%	0.8%	-24.0%	0.9%	0.8%	-14.0%
Michigan	1967	2.00%	4.25%	6.3%	3.9%	-38.1%	7.9%	3.2%	-58.9%	6.6%	3.6%	-45.9%
Indiana	1963	2.00%	3.23%	3.8%	2.6%	-30.5%	3.8%	2.3%	-40.0%	3.4%	2.1%	-38.6%
West Virginia	1961	5.40%	6.50%	1.5%	0.7%	-54.4%	1.2%	0.5%	-60.1%	1.1%	0.7%	-39.5%

Source: BEA, U.S. Census Bureau

Take Connecticut, for example. Connecticut was the most recent state to impose a state level income tax, which occurred in 1991. Five years before imposing the tax, Connecticut was growing like no other and its population was

1.8% of the population of the 39 states not listed in the table above; now Connecticut's population sits at 1.4% of the other 39 states. Similarly, Connecticut's GSP was 2.4% of the 39-state cohort in 1986 and is now down to 1.7%. State and local revenue dropped from 2.4% to 1.6%. The story is the same across the board for Connecticut and every state that made the fatal decision to tax personal income: A reckoning will come. Arizona is no exception. Those who don't know history are bound to repeat it.

We expect Arizona's hot streak in regards to growth to be curtailed by this income tax increase, especially since the new top PIT rate in Arizona will be higher than 10 out of the 11 states listed in the table above.

As of 2020, there are nine states that have no earned income tax—Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming.[2] In our analysis, we will focus on seven of these states—excluding Alaska and Wyoming—and compare their performance over the past decade to the performance of the nine states with the highest marginal income tax rates over the same period. We exclude Alaska and Wyoming from our analysis because energy production and mining account for a large percentage of Alaska (25 percent) and Wyoming's (nearly 35 percent) economies.[3] The economies of Alaska and Wyoming are highly dependent on energy prices and fluctuate considerably over time. Low energy prices have stymied GSP growth in both Alaska and Wyoming over the past decade. Texas is also an energy state, of course, but its economy has been widely diversified over the last 30 years or so.

Over the past decade, these seven states have outperformed the nine states with the highest marginal income tax rates, as well as the nation as a whole, in population growth, employment growth, personal income growth and GSP growth (Table 2).

If passed, Arizona would replace Delaware as the ninth highest income tax rate state in America. In other words, it would join the category of the loser states, not the gaining states.

[2] New Hampshire and Tennessee tax interest and dividend income, but not ordinary wage income.

[3] "Energy production and other mining account for a large percentage of some state economies." U.S. Energy Information Administration. August 7, 2014. https://www.eia.gov/todayinenergy/detail.php?id=17451

Table 2

Performance of the Seven States with the Lowest and Nine Highest Marginal Personal Income Tax Rates vs. Arizona

(as of January 1, 2020)

	As of 1/1/2020	*10-Yr. Growth*				
		2009-2019				*2007-2017*
State	**Top Marginal PIT Rate†**	**Population**	**Employment**	**Personal Income**	**Gross State Product**	**State & Local Tax Revenue§**
Florida	0.00%	15.15%	23.75%	63.51%	50.89%	6.47%
Nevada	0.00%	14.73%	23.47%	61.81%	46.66%	28.61%
South Dakota	0.00%	9.61%	9.14%	50.04%	47.28%	55.33%
Texas	0.00%	16.91%	23.78%	67.21%	62.19%	43.74%
Washington	0.00%	14.21%	21.18%	76.65%	69.56%	44.04%
New Hampshire‡	0.00%	3.31%	9.42%	47.01%	43.04%	41.35%
Tennessee‡	0.00%	8.30%	19.18%	54.14%	51.72%	22.53%
Avg. of 7 Zero Earned Income Tax Rate States*	**0.00%**	**11.75%**	**18.56%**	**60.05%**	**53.05%**	**34.58%**
Arizona	**4.50%**	**14.75%**	**20.75%**	**58.75%**	**50.12%**	**10.73%**
50-State Avg.*	**5.61%**	**6.44%**	**12.54%**	**50.39%**	**43.01%**	**28.09%**
Avg. of 9 Highest Earned Income Tax Rate States*	**10.54%**	**5.15%**	**12.68%**	**51.15%**	**45.12%**	**37.25%**
Delaware	7.85%	9.20%	11.84%	45.63%	32.61%	27.94%
Vermont	8.75%	-0.13%	6.29%	40.57%	34.47%	29.52%
Maryland	8.95%	5.50%	9.60%	42.13%	41.60%	45.91%
Minnesota	9.85%	6.79%	12.28%	55.39%	46.51%	45.34%
Oregon	10.67%	10.74%	20.36%	65.23%	56.63%	53.47%
Hawaii	11.00%	5.14%	10.65%	46.06%	48.09%	43.10%
New Jersey	11.75%	1.45%	7.84%	43.58%	32.54%	22.12%
New York	12.70%	0.76%	14.58%	52.26%	50.23%	32.63%
California	13.30%	6.90%	20.68%	69.49%	63.40%	35.25%

* Averages are equal-weighted. † Top Marginal PIT Rate is the top marginal rate on personal earned income imposed as of 1/1/2020 using the tax rate of each state's largest city as a proxy for the local tax. The deductibility of federal taxes from state tax liability is included where applicable. § State & Local Tax Revenue is the growth in state and local tax revenue from the Census Bureau's State & Local Government Finances survey. Because of data release lag, these data are 2007 to 2017. ‡ New Hampshire and Tennessee tax interest and dividend income—so-called "unearned" income—but not ordinary wage income. Tennessee's unearned income tax, the Hall Tax, is being phased out.
Source: Laffer Associates, U.S. Census Bureau, Bureau of Labor Statistics, Bureau of Economic Analysis

Table 2 compares the seven no earned income tax states to the nine states that currently have the highest income tax rates across several performance metrics over the past decade. On average, the seven zero-income-tax states outperformed the nine highest income tax states in population growth by 6.60 percentage points, employment growth by 5.88 percentage points, personal income growth by 8.90 percentage points and GSP growth by 7.93 percentage points over the past decade.

State and local tax revenue growth is the only category presented in Table 2 in which the seven zero-income-tax states trail the nine highest income tax states. From 2007 to 2017, state and local tax revenue growth in the seven no-income-tax states lagged state and local tax revenue growth in the nine highest income tax states by 2.67 percentage points.

Arizona's top marginal personal income tax rate of 4.5% currently ranks as the 13th lowest top marginal state personal income tax rate in the U.S. With a top marginal rate below the U.S. average, Arizona has performed exceptionally well over the past decade, outperforming the U.S. average across all metrics except for state and local tax revenue growth (Table 2). Arizona's performance profile is quite comparable to the performance profiles of Florida and Nevada, two states that have performed well over the past decade due to their strong, pro-growth policies.

Table 2 clearly shows the economic advantages that low income tax states hold over their high income tax counterparts. If Proposition 208 passes, Arizona will replace Delaware as the state with the ninth highest top marginal earned income tax rate. While Arizona's performance metrics currently track closely with the metrics for the states with no earned income tax, a 3.5 percentage point increase in the highest marginal tax rate threatens Arizona's economic stability and sets Arizona on a path towards lower population, employment, personal income and GSP growth rates. The bad results will only encourage politicians to say we did not do enough and lead to even higher tax rates and worse results.

Hypothetically, if Arizona were to pass Prop 208 and their population growth rate declined to that of the nine highest PIT states, there would be 700,000 fewer people in Arizona by 2029 than if they continued at their current rate of growth. In the same vein, if Arizona slumped to the employment growth rate of the nine highest PIT states, Arizona would have over 237,000 fewer jobs over the 10-year period. Personal income in Arizona would fall by over $25.5 billion relative to what they would have by staying the course with the 4.5% top PIT. No matter how you slice it, the income tax increase from Prop 208 will be bad.

Arizona and Migration

Since Arizona began lowering its top marginal PIT rate in 1991, Arizona has been perennially ranked in the top echelon of states for population growth and net domestic migration. The Copper State is like a magnet for residents of higher taxed states such as California, Illinois, and New York. According to the IRS, since the 1992 tax year (conveniently in the midst of Arizona's tax cutting spree), Arizona has gained over 201,000 tax returns and almost $12

billion in adjusted gross income (AGI) from California alone. Illinois has lost over 65,000 tax returns to Arizona and about $5 billion in AGI over the same period. For New York, the numbers are 37,000 tax returns and $2.3 billion in AGI lost to Arizona. In fact, almost every single state has lost net AGI and tax returns to Arizona since the 1992 tax year. The only states gaining either AGI or tax returns are Texas, Idaho, South Carolina, Arkansas, Tennessee, and Nevada. As it happens, every single state that Arizona lost AGI or tax returns to has a total tax burden (total state and local taxes as a share of personal income within the state) of less than or equal to the 50 state equal-weighted average.

Since the 1992 income year, Arizona ranks third overall in both net domestic in-migration of tax returns as well as the amount of net AGI flowing into the state. Over $41 billion in net AGI has poured into the state from over 630,000 new tax returns over the same period. More people and more AGI in the state equates to higher tax revenue. You can get more tax revenue from lowering tax rates. The only states which have gained more AGI and tax returns since 1992 are Florida and Texas, which are both zero income tax states.

The story is further corroborated by evidence from the U.S. Census Bureau. From July 1, 1990 to June 30, 2019, Arizona ranks third in total net domestic migrants by bringing in about 1,779,000 net new residents from other states. Once again, only Florida and Texas have added more net migrants. But this is only part of the story and only deals with net migration in absolute terms. A separate way to examine the Census Bureau migration data is to look at net domestic migration for a given year or time period as a share of the base population number. In other words, how much did a state increase or decrease their population via net domestic migration relative to their population at the beginning of a time period. Using this measure, Arizona ranks as high as 1st (July 1, 2004 to June 30, 2005) and as low as 20th (July 1, 2008 to June 30, 2009).[4] Arizona ranks in the top ten in 24 of the 29 years for which we have data and in the top five for 19 of those 29 years.

Finally, there is one more way we may examine net domestic migration, which is somewhat of a hybrid between the absolute measure and the percent of population measure. The calculation is made by using a state's net domestic migration from a specific time period and dividing it by the square root of that state's population multiplied by the U.S. population less the population of the state being examined. This method attempts to account for the ability of a state to gain or lose migrants based on their population relative to the rest of the U.S. population.[5] Using this more

[4] The trend in domestic migration drastically changed during and shortly after The Great Recession of 2007-2009. For example, Washington DC, which is normally ranked at the very bottom of all states for net domestic migration as a share of population, shot up to number two in the period ending June 30, 2009, number one in 2010 and 2011, and number two in 2012 and 2013. As of the period ending June 30, 2019, Washington DC is yet again close to the bottom (38th).

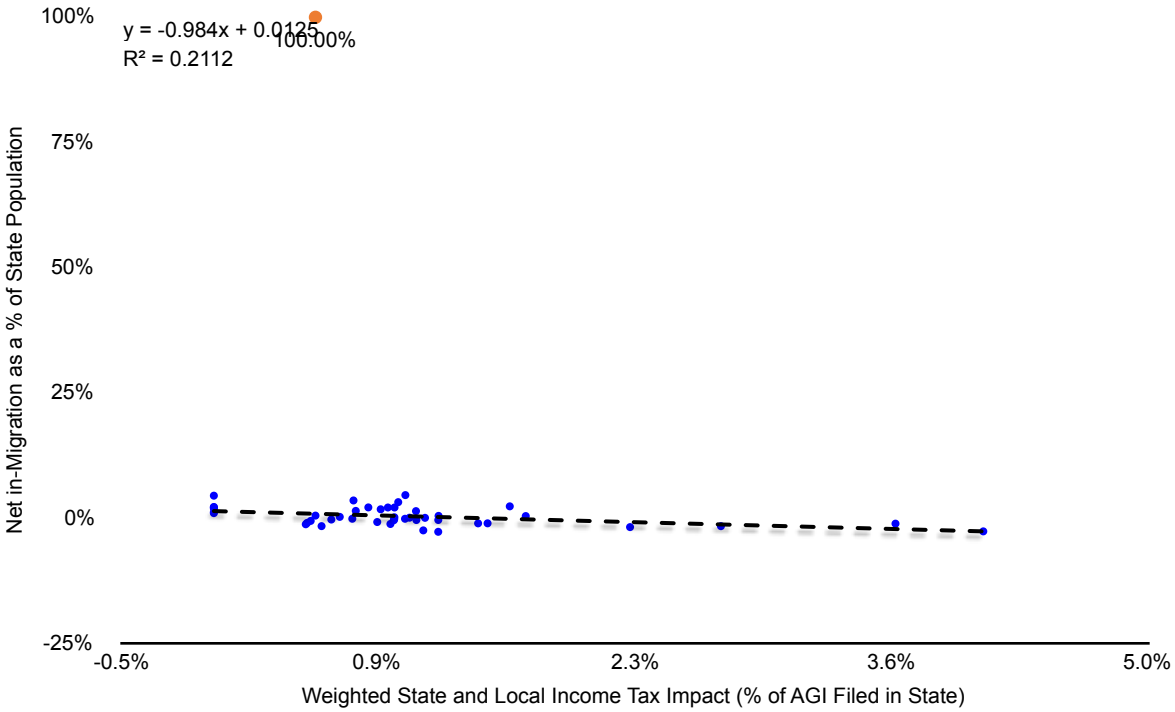
[5] For more on this methodology, please see: Arthur B. Laffer and Richard Neikirk, "California's Choice," Laffer Associates, April 1, 2020.

comprehensive measure of net domestic migration, Arizona tops the list four times (1995, 2006, 2018 and 2019) over the 29 year period and is ranked 16th at their lowest point (2009).

Let us assume Arizona voters do decide to raise their top PIT rate to 8%, making them the 9th highest PIT states in the nation. If the migration patterns of the nine highest PIT states are any indication of what is to come for Arizona, we expect to see over 125,000 Arizonans leave the state on net over the next 10 years, instead of the 512,000 net in-migrants we would expect them to see given their current trend. That is a difference of about 640,000 people. Even more worrying is the fact that this negative trend for the highest PIT states is somewhat mitigated by Oregon, which has a large net-in migration as a percent of their population. The reason? Oregon has no state sales tax and is located adjacent to California—a state with high taxes in all categories, save property taxes. Arizona has a high state sales tax with local options to tack on more, as well, so they do not have the same cushion as Oregon.

Unfortunately for Arizona's state coffers, high income earners are the most likely and capable to leave the state. Those contributing the most tax revenues will flee the state or reside in the state for less than six months and avoid paying any income tax at all. So, in these cases, the tax collections from such "snowbirds" may fall from current levels to zero. This, of course, depends on what state they are coming from. In these cases, Arizona's schools will be in even worse financial shape than they already are.

Figure 1
Weighted State and Local Income Tax Impact vs. Three-Year Net Domestic Migration
(Weighted for earners that report over $500,000 in AGI, excluding states with population below one million)



Source: U.S. Census Bureau, IRS Statistics of Income

Using historical migration and tax rate data, we can estimate the effect of top personal income tax rates on domestic migration. In Figure 1, we plot the impact of state personal income tax rates on three-year net domestic in-migration as a percentage of population. The impact of personal income tax rates (horizontal axis) is measured as the state's top rate times the percentage of total state AGI earned by individuals reporting incomes over $500,000. The migration response metric is net interstate migration from 2017 to 2019 as a percentage of total population, measured at 2017 levels. The states included are limited to those with populations larger than one million. There are clearly other determinants of changes in migration, however, the relationship between state income tax rates and migration is undeniable.

Using this trend line, we are able to project the direction of Arizona's met migration over the next three years. In Figure 1, the value for Arizona is calculated using their current highest income tax rate of 4.5%. The state's net migration relative to their population is 3.7%. If Arizona were to pass Prop 208, assuming the trend will remain consistent, the state's migration ratio will drop to a value of -0.06%. This would be a loss of 3.76 percentage points, or in absolute terms, a loss of about 250,000 residents over the first three years of the tax increase compared to Arizona's current trend at their current highest income tax rate.

Evidence from Other States

Analyzing state tax policies and outcomes from the other 49 states also sheds light on the potential impact that Proposition 208 could have on Arizona's economy. Over the years, plenty of states have experimented with increasing or decreasing personal income tax rates, as well as other tax rates.

For example, in 2013, North Carolina cut its top marginal personal income tax rate by 200 basis points from 7.75% to 5.75%. They also cut the corporate income tax rate from 6.9% to 5%. Both of these tax changes put North Carolina in direct competition with their neighboring states. As a tax rate capstone, North Carolina also eliminated its state death tax, which had a rate of 16%.

North Carolina actually did something really interesting by instituting revenue triggers for tax rate cuts, something Massachusetts also instituted. If revenue growth year over year exceeds a certain threshold level, the tax rate for the following year is slashed. This provides the incentive for people and companies to accelerate production rather than lag behind and wait for a better day to produce. It is a sure-fire way to slingshot an economy and, for Massachusetts and North Carolina, the proof is in the pudding.

North Carolina went a lot further with a highly controversial set of changes to the way the state deals with unemployment. They lowered unemployment benefits from $535 per week to $350 per week and reduced eligibility from 26 weeks of benefits to a schedule ranging from 12 weeks to 20 weeks. Immediately, the state was engulfed in major demonstrations in the capitol.

After a short while, these demonstrations disappeared as new jobs soared by some 200,000 from 2013 to 2015. The unemployment rate fell from 7.8% to 5.7% and the state's unemployment fund went from a sizable deficit to a surplus. Their state budget also ran a 6% increase in total revenues, even though tax rates were cut. During this era of tax cuts and overall pro-growth policies, North Carolina maintained its AAA bond rating.

In 2016, Tennessee had no earned income tax at all. Tennessee also began phasing out its unearned income tax, the Hall Tax, which will be eliminated by 2021. Tennessee also eliminated its state death and gift tax in 2016. And, as the cherry on the top, as of 2016, Tennessee had the ninth lowest property taxes in the nation. It doesn't get much better than that.

In all, Tennessee has the third lowest tax burden in the country.

In 2016, Tennessee had a 2 billion dollar surplus in its state budget of $35 billion. Tennessee's credit rating (2016) was tied for the highest in the nation: AAA from all three major credit rating agencies. Tennessee state and local government employee pensions were rated fifth best in the nation (98.8% in 2018).

Tennessee focuses almost exclusively on its finances and its overall citizenry, thereby not overpaying for government employees. Tennessee had the eighth lowest pay in the nation for full time equivalent employees (FTEEs) in 2015. Tennessee also ranked 14th lowest in the nation for full time equivalent employees per 10,000 of population in 2015.

From November 2015 to November 2016, Tennessee had the absolute largest increase in employment to population in the nation (55,600 additional jobs or 2.2% of the state's population). In 2016, Tennessee's highways ranked 18th best in the nation, a stark improvement from its ranking of 37th in 1987. And, on the money side, Tennessee had the nation's 12th greatest net inflow of adjusted gross income (4.5% of total AGI) of all the states.

But where state and local policies matter most is in education. Nothing is more sacred than preparing the youth for our nation's future. As measured by the National Assessment of Education Progress (NAEP), Tennessee's NAEP scores saw the biggest improvement of any state in the nation in 2013 for all students tested in 4th grade math, 4th grade reading, 8th grade math and 8th grade reading. Notably, growth was very strong for African-American students and, in 2016, Tennessee's student science scores improved by more than any state in the nation.

Summarizing the Economic Effects of the Tax Hike

1. **Domestic Migration**[6]

   Arizona has benefited tremendously over the last decade from its relatively low tax rates and limited government spending. US Census data show that people have flocked to Arizona from states with high taxes, particularly income taxes. Over 453,000 more people moved to Arizona than left in the decade from 2010 to 2019. That influx of people brought more economic activity, and more tax revenue since states compete with one another when it comes to their respective tax codes. The ultimate determinant of the popularity of a policy is how people vote with their feet. As high-income earners in particular have moved to Arizona, they have brought with them a large amount of spending power that fuels businesses and government alike. A tax hike is the best way to turn off that spigot of economic growth, especially now with State and Local Tax (SALT) deductions being capped after tax reform. Since the passage of the Tax Cuts and Jobs Act in 2017, the effect of the top marginal income tax rate on domestic migration has

[6] For a thorough treatment, including a comprehensive analysis, of this topic, see Antoni, Erwin "Fiscal Triumvirate" Northern Illinois University Press (2020).

increased 75% from prior to tax reform. This means that state income tax rate increases are much more harmful to the state's people and economy.

The proposed 3.5% tax rate increase would decrease Arizona's domestic migration rate by 1.2 percentage points. While that may not seem significant, Arizona's population is over 7.2 million people, meaning a drop in domestic migration of more than 87,000 people – every year. A mere six years under these higher tax rates would undo the ten years of gains from Arizona's domestic migration. Fewer people mean less representation in Congress and less of a voice in Presidential elections, less federal funding for Arizona, and less economic activity overall. A lower domestic migration rate also hamstrings employment growth.

2. Less than Expected Revenue

The fallout from California's 2012 tax rate increase is a good recent example[7] of what to expect in terms of revenues from 208.

After increasing the top tax rate by 3 percentage points, half a percentage point less than Arizona's current proposal, more high-income earners flooded out of the state. Additionally, those who remained in California engaged in various behavioral responses to reduce their tax liability. The result was that the tax rate increase collected just a little more than half of what had been predicted. Despite this abysmal performance to bring in additional revenue, old habits die hard, as evidenced by tax bill AB 1253 in California, which would further increase the top tax rate there to 16.8%. There is no evidence that Arizona will fare any better with an even larger percentage point increase than California's 2012 rate increase. Instead of raising $940 million a year, the rate increase could bring in as little as an annual average of $450 million over the next decade. People can simply choose not to come to Arizona, or they will choose another state as their primary residence. The so-called "snow-birds" who spend their winters in warmer states like Arizona and their summers in cooler states like South Dakota, Utah and Colorado will just enjoy the lowers income tax rates of the latter states.

3. Lost Jobs

The percentage of Arizonans with jobs has increased every year in the past decade, even as the state's population grew by more than 870,000. This population growth has played an intricate part in Arizona's employment gains over the same period. The proposed tax increase, however, would slow

[7] Rauh Joshua, Ryan J. Shyu. "Behavioral Responses to State Income Taxation of High Earners: Evidence from California The National" Bureau of Economic Research NBER Working Paper No. 26349 Issued in October 2019.

Arizona's population growth from reduced domestic migration, which would indirectly reduce the rate of employment growth.

Aside from the effect on population, the tax rate increase would also have a negative effect on employment directly, via decreased economic activity.[8] Any tax increase leaves people with less money to spend and businesses with less of a need for employees. This, combined with the population effect, is estimated to decrease job growth by 0.74 percentage points, cutting the rate of job growth by over 43%. This results in 221,000 fewer jobs over the next ten years.[9] The job losses are also not concentrated among high-income earners, but among blue-collar workers.

4. Tax Incidence

While the proponents of Arizona's tax rate increase argue that it will be paid only by the "wealthy," the reality is very different. Tax incidence, or who actually pays a tax, can be very different from who is being taxed. A good example of this are gasoline taxes. Oil companies do not pay gasoline taxes, no matter how much they are being taxed. Gasoline retailers simply pass those taxes along to the consumer by increasing the price at the pump. Similarly, state income taxes are not necessarily paid for by those who are supposedly being taxed.

The modeling work by the Congressional Budget Office (CBO) changed in 2012 to reflect the reality that companies do not bear the entire burden of the corporate income tax, with the CBO settling on a 25-75 split, the former portion falling on individuals, not the corporations themselves.

Income taxes on small business owners behave similarly and for the same reasons. Likewise, a tax rate cut, whether corporate or personal income, does not exclusively increase owners' profits. Rather, a substantial

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[8] Shuai, X., Chmura, C. The Effect of State Corporate Income Tax Rate Cuts on Job Creation. Bus Econ 48, 183–193 (2013).
Anne Case. "Interstate Tax Competition after TRA86." Journal of Policy Analysis and Management 12, no. 1 (1993): 136-48
John Douglas Wilson. "Comment on "Interstate Tax Competition after TRA86"." Journal of Policy Analysis and Management 12, no. 1 (1993): 152-55.
Donald Bruce, and John Deskins. "Can State Tax Policies Be Used to Promote Entrepreneurial Activity?" Small Business Economics 38, no. 4 (2012): 375-97
Thomas R. Dye, and Richard C. Feiock. "State Income Tax Adoption and Economic Growth." Social Science Quarterly 76, no. 3 (1995): 648-54.
Carl M. Campbell III. "The Effects of State and Industry Economic Conditions on New Firm Entry." Journal of Economics and Business 48, no. 2 (1996): 167-183.
Boris Korneychuk. "International Tax Competition in the Global Economy." Journal of Economic Integration 32, no. 4 (2017): 842-72.

[9] The unemployment rate would be higher at the end of the decade but not significantly, since the state's population, including its labor force, is also expected to be reduced as a result of the tax rate increase.

portion is passed on to employees in the form of higher wages (the determinants of tax incidence are the respective elasticities of supply and demand).[10]

Half of those whose tax rate will be increased in Arizona are small business owners who would be disproportionately affected by the proposed tax rate increase.[11] This group contains thousands of job creators who operate on relatively slim margins and can ill-afford to absorb a 75% increase in their state income tax liability. The result will be small business closures, more lost jobs, and/or higher prices for consumers as some of the costs are passed on to them in the form of higher prices.[12]

5. Economic Losses, Lower Revenues, and Less Funding

The fallout from Arizona's proposed tax rate increase would reach across the state, affectingly acutely those on government assistance and state welfare programs. As investment, job growth, and spending all decline from their projected growth rates, Arizona will see state and local tax revenues decline by $2.35 billion over ten years.

Other states that have greatly increased their tax rates invariably find themselves in the unfortunate but not unforeseen situation of needing to offer tax incentives (firm-specific tax rate reductions) in order to attract business and economic activity for the purposes of increasing tax revenue. While lower overall tax rates increase economic growth, wage growth, and job growth, tax incentives designed to lure specific businesses in an otherwise high-tax rate environment often show minimal increases in economic growth.[13] In other words, high tax rates necessitate tax incentives that neutralize the negative effects of those higher rates, but not completely. The state, as well as its businesses and people, would be better served with no specific tax incentives but overall lower rates, yielding the same tax revenue but with fewer distortions in the marketplace.

6. Wages Will Fall

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[10] Empirical evidence suggests that half of the corporate tax reduction from the Tax Cuts and Jobs Act went to increase workers' wages. Auerbach, Alan J. "Measuring the Effects of Corporate Tax Cuts." The Journal of Economic Perspectives 32, no. 4 (2018): 97-120.

[11] More profitable firms, those with larger margins, tend to be more mobile over time and are less likely to be subject to the tax incidence of rate increases.

[12] The excess burden of a tax is heightened by the fact that those who are mobile can avoid the tax, leaving those left behind to bear the tax incidence.

[13] Slattery, Cailin, and Owen Zidar. "Evaluating State and Local Business Incentives." The Journal of Economic Perspectives 34, no. 2 (2020): 90-118.

With a revenue-neutral tax rate change venturing towards increasing progressivity, workers' effort falls, and therefore, so do wages.[14] This is exacerbated in a tax change designed to be revenue increasing, such as Proposition 208. As economic activity falls, business sales also decline and there is less of a need for employees. With fewer jobs available, people must compete through lower wages to get one of the increasing scare spots in the workplace. Arizona's forecasted job growth of 1.7% plummets after the imposition of this new tax to just 0.96%. Household incomes in Arizona could be depressed by as much as $6,500 at the end of the decade, as fewer people will have jobs and those with jobs will see lower wages. This will effectively wipe out the last three years of gains in household income.[15]

Conclusion

Arizona has been a high growth state for several decades. The beautiful weather and scenic mountains and cultural diversity of the state combined with steady reductions in tax rates have made Arizona one of America's premier destination states.

Prop 208 would, in one year, erase 30 years of steady progress in Arizona LOWERING tax rates to make Arizona more competitive. Some may take issue with our estimates of the negative economic effects of the tax, and some studies even suggest very minor deleterious impacts on the state from the higher tax rates. A massive tax hike like Prop 208 would also come at the worst time. The economy all over the nation is recovering from a once in a century pandemic that has flattened the economy and small businesses. We cannot think of a less appropriate time to be raising the taxes on small businesses by 75% than today.

Appendix: Why Marginal Rates Matter More than Effective Rates

When a person is deciding whether to pursue an economic activity, the effective tax rate is not the person's concern. When it comes to taxes, the marginal tax rate is his or her only consideration. All of economics if based on the principle of scarcity, and that principle is always approached from the standpoint of marginal benefit versus marginal cost. It is not a question of total cost and total benefit, nor effective tax rates. Using effective tax rates in empirical analysis betrays the fundamentals of economics. If we take the idea of marginal rates to an extreme example, it will illustrate the underlying mechanics of the discussion.

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[14] Koskela, Erkki, and Ronnie Schöb. "Is Tax Progression Good for Employment? Efficiency Wages and the Role of the Prereform Tax Structure." FinanzArchiv / Public Finance Analysis 65, no. 1 (2009): 51-72.

[15] https://www.census.gov/newsroom/press-releases/2020/acs-1year.html

Let us assume that the marginal income tax rate on incomes from $0 to $1 million is 1%. When an individual within that income range is evaluating whether to pursue additional economic activity, perhaps working extra hours, writing a new book, or starting a new business, that individual will keep 99% of what he or she makes. Our individual is therefore evaluating each activity as having a given marginal cost of taxes, time, effort, financial investment, etc. versus a marginal benefit of 99% of the pay they receive from that activity.

Now let us assume that the marginal income tax rate on incomes over $1 million is 99%, meaning that for every dollar you make after the first million, you owe 99 cents in taxes. Why would you want to work past the first million dollars? You would keep virtually nothing of what you make. The marginal benefit of working under such an oppressive tax rate would be almost nonexistent, almost certainly less than whatever cost would be incurred.

As far as effective, or average, tax rates are concerned, let us look at someone making $1.1 million. The first million dollars of income is taxed at 1% while the last $100,000 is taxed at 99%. Our individual's take-home pay on the first $1 million would be $990,000 but his or her take-home pay on the last $100,000 would be just $1,000. It is very unlikely that anyone would expend the time and effort necessary to earn $100,000 only to be forced to give nearly all of it back. And yet, according to the idea of effective tax rates, our individual is still in great shape – his or her effective tax rate is less than 10% so there would be no substantial disincentive to continue working. This is clearly a complete farce.

Even the most basic introductory course in economics explains the importance of marginal effects, like marginal tax rates, and why they are so much more important to the more irrelevant concepts of average or effective tax rates. If our individual worked an extra hour, in the example illustrated above, that individual would keep just 1% of what he or she made for working that last hour. You can tell our individual all you want that his or her "effective" tax rate is less than 10%, but no one is going to work very much more if you take 99% of each additional dollar he or she earns. He or she will simply stop working after the first $1 million in income.

This is why income earners sometimes "cluster" around marginal tax rate changes. This is when people stop earning more than a certain amount of income because the marginal tax rate after that point is prohibitively high. While our example here of 1% and 99% tax rates is an extreme case, it illustrates the point. The effect of incomes clustering around marginal tax rate changes can be observed in the real world, even at relatively small changes in marginal income tax rates, such as those found in the federal tax code.

States have this same problem, but they also face the problem of competition with other states. You cannot escape federal income tax unless you move to another country and give up many of the rights and protections you enjoy in America. Conversely, you can move from one state to another and retain all your federal protections and privileges. States, therefore, must compete with one another for a mobile tax base, namely, people. This is especially true for high-income earners who tend to be more mobile than lower income groups and who are more likely to be impacted by top marginal income tax rates in each state.

Regardless of this additional problem faced by states, the fact remains that people consider marginal effects when they make decisions, not total effects. If any further illustration of this concept is needed, consider this non-economic example: when you are thirsty, do you think about drinking an additional glass of water, or do you think about how much water you have drunk so far this year? Clearly, you care about the former, not the latter, when deciding if you would like one additional glass of water. That is the marginal effect, and it is what helps you determine the right choice you should make.

If an "economist" tells you that effective tax rates matter more than marginal tax rates, you should run away. That person is at worst lying to you and at best is demonstrating the parochialism of his or her own knowledge.