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Economic Impact of the Proposed Arizona "Flat Tax"

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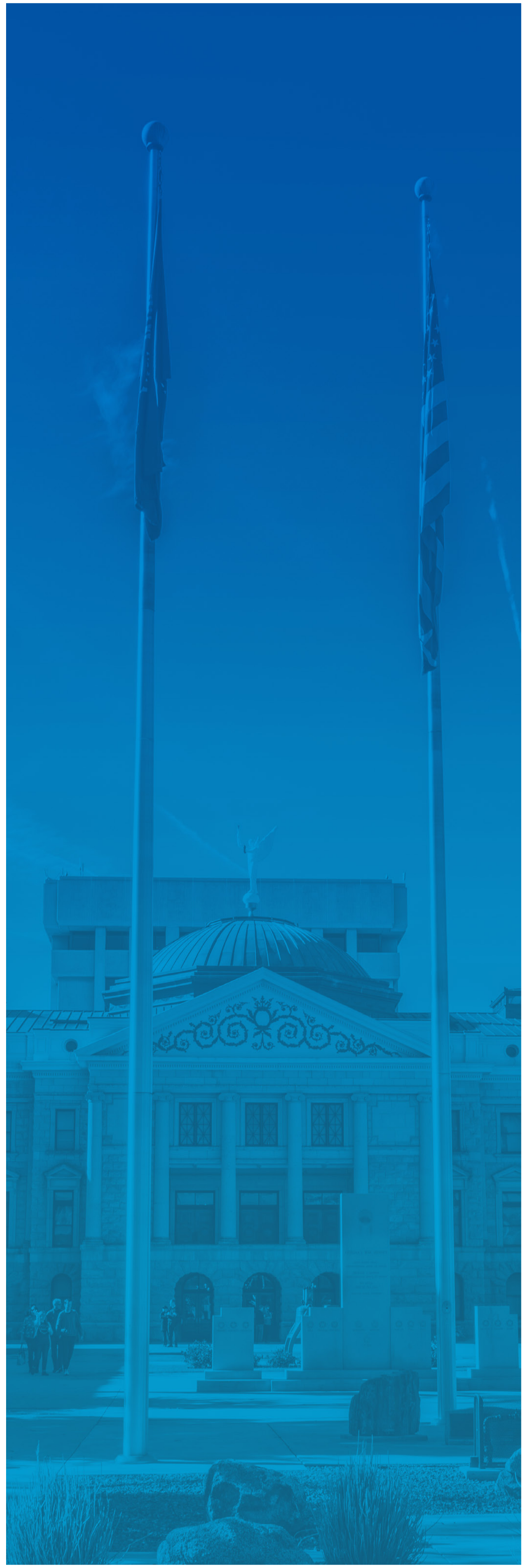

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Executive Summary

Arizona governor Doug Ducey is pushing an income tax restructuring plan that would move the state closer to a flat-rate income tax. The goal, according to Mr. Ducey, is to "make the Arizona tax system as pro-growth and pro-jobs as possible and to compete economically with neighboring states."

The plan contains the following provisions:

- Consolidates the current 4 income tax brackets (with rates ranging from 2.59 percent to 4.5 percent plus a 3.5 percent surtax on individuals with incomes above $250,000) to a flat rate of 2.5 percent over two years.
- Imposes a statutory 4.50 percent maximum rate, ensuring that no surcharge or other outside factor will force a taxpayer to ever face a higher maximum marginal tax rate above that level.
- Reduces commercial property tax rates from 18 to 17 percent.

Rates for all tax filers would fall under this plan, and most significantly from an economic standpoint, the current top rate, which is set to increase to 8 percent in April 2022, would be capped at 4.5 percent. The bill before the Arizona legislature would, over a two-year period, cap income taxes at 4.5 percent and single filers making less than $250,000 would pay just 2.5 percent. This is a simplification of the tax code (currently composed of four brackets) as well as a tax cut for all Arizona taxpayers since even the lowest tax rate is currently 2.59 percent.

In a previous comprehensive study published in 2020 on the Arizona tax system, we examined the impact of the Ballot Proposition that raised the income tax with a 3.5 percent surcharge on individuals with incomes above $250,000. That initiative was approved by voters. We predicted a negative impact on jobs, GDP, and other economic barometers. We also noted that Arizona has gone from being a state with a below average top income tax rate (nine states have no income tax on earned income at all), to a state with one of the 10 highest rates among the 50 states.

Using the same econometric analysis we employed in our 2020 study, we have now estimated the impact of the Ducey flat-tax plan.

Compared to the state's current economic position with the surtax increase, the reduction in both the number of brackets and the tax rates would, over ten years, yield:

- 253,000 more jobs
- 886,000 more domestic migration
- $31.6 billion in personal income growth
- $7,400 higher average household income

The effects from these changes would be to not only reverse the coming damage to Arizona's economy, but to strengthen it beyond its position in 2020 before the surtax was passed. In addition to reversing the predicted damages outlined in our 2020 study, these changes would, over a decade, increase net domestic migration by 186,000 and jobs by 53,000. Personal income would increase

$6.1 billion over a decade and average household income would also increase by $1,400. The combined effect of reversing the tax increase and further improving the tax code would produce the figures in the bullet points above.

In terms of economic competitiveness, we believe that Arizona would move from 16th most competitive among the 50 states on the ALEC-Laffer state competitiveness index, to 10th.

Background

In 2020 voters approved Proposition 208, a ballot initiative with an income tax surcharge that raised the highest income tax from 4.5 percent to 8 percent. The Committee to Unleash Prosperity conducted an economic analysis using dynamic econometric models of those changes and found highly negative effects over the next decade.

We found that half of that tax increase will be borne by small business owners, people who generate at least half the jobs in the state. Arizona moved from the 13th lowest income tax rate to the 9th highest, and the state's competitiveness was impaired. Over the course of a decade, the surtax was expected to cost the state of Arizona 200,000 jobs and 700,000 people in net domestic migration losses. Personal income would be reduced by $25.5 billion over the same period and wage growth would decline with average household income decreasing about $6,000 compared to without the tax hike.

With reduced businesses, jobs, taxpaying in-migrants, and slower growth, the surtax would only generate about half the revenue of its static estimates. Furthermore, when high-income earners leave the state, or decide not to migrate into the state from elsewhere, the low-income jobs that are supported by high-income earners' economic activity are also lost. Thus, many people shoulder the burden of the tax, not just the "rich."

The effects from the Ducey flat-tax plan would place Arizona's economy in a stronger and more competitive position than it was in 2020 before the surtax was passed. Not only would the predicted economic losses detailed above be forestalled, but these economic indicators would improve beyond the state's previous economic situation. The positive impact from these tax changes, as compared to before the tax increase, would be, over a decade, to increase net domestic migration by 186,000 and jobs by 53,000. Personal income would increase $6.1 billion over the same time and average household income would also increase by $1,400.

Since the surtax proposition has already passed, however, it is more sensible to compare the effect of the Ducey flat-tax plan to the coming tax increase. In that case, using the same dynamic econometric modeling, we expect, over a decade, that the proposed Ducey flat-tax plan would yield:

- 253,000 more jobs
- 886,000 more domestic migration
- $31.6 billion in personal income growth
- $7,400 higher average household income

Since Arizona's projected surplus for fiscal year 2022 is $3.9 billion,[1] it seems unlikely that these changes to the tax code will necessitate significant, if any, additional borrowing by the state. Indeed, the additional domestic migration and economic activity will yield a broader tax base from which to extract tax revenue for the state's coffers. Furthermore, reducing the burdensome commercial property tax rate makes it easier for Arizona's businesses to compete in what has become an increasingly competitive national and international marketplace, where tax advantages or disadvantages can determine a business's fate.

Progressive State Income Taxes Are Associated with Lower Growth Rates

One way to assess the potential impact of an income tax rate change as is being proposed in Arizona, is to examine what has happened in other states with these kinds of measures.

States with rising income taxes have statistically significant slower growth rates in employment, income, and population growth. States with falling income taxes (or no income tax at all) have faster growth. This is comprehensively summarized in a book co-authored by one of us (Moore), entitled The Wealth of States. One of us (Antoni) also examined the relationship between higher state tax rates and lower growth rates in his Ph.D. dissertation, and confirmed the thesis that the higher taxes do cause decreased growth. (See Antoni, Erwin, Fiscal Triumvirate 2020)

In The Wealth of States, we examine the share of total U.S. population, gross state product (GSP), and total state and local revenue, of 11 states with large increases in income tax rates and compared those results with the other 39 states that did not have substantial income tax hikes between 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 are not talking about small declines here, either. These states universally declined by upwards of 40 percent relative to the rest of the nation. Income tax increases are almost always very negative for growth at the state level.

We also have compared the states with no earned income to the nine states that currently have the highest income tax rates across several performance metrics over the past decade. On average, the 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.

Arizona's top marginal personal income tax rate of 4.5 percent prior to the passage of the tax referendum ranked 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.

1 https://www.azleg.gov/jlbc/facag041521.pdf

Arizona's performance profile is quite comparable to the performance profiles of Florida and Nevada, two states that have performed well in the last ten years (pre-pandemic) due to their strong, pro-growth policies.

The Copper State became 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 $12.7 billion in adjusted gross income (AGI) from California alone. Illinois 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 lost net AGI and tax returns to Arizona since the 1992 tax year.

The only states gaining either AGI or tax returns from Arizona 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 through 2017, Arizona ranked 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 equate to higher tax revenue. Indeed, you can generate more tax revenue by 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 ranked 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.

There are clearly other determinants of changes in migration, however, the relationship between state income tax rates and migration is undeniable. 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 percent to 5.75 percent. They also cut the corporate income tax rate from 6.9 percent to 5 percent. Both of these tax changes put North Carolina in direct competition with its neighboring states. As a tax rate capstone, North Carolina also eliminated its state death tax, which had a rate of 16 percent. North Carolina actually did something very 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 much 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 percent to 5.7 percent and the state's unemployment fund went from a sizable deficit to a surplus. Their state budget also ran a 6 percent 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 has now been eliminated. 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 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 percent 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 percent 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 percent of total AGI) of all the states.

All of this evidence shows that a tax hike is the best way to turn off 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 increased 75 percent from prior to tax reform. This means that the economic impact of state income tax rate changes is magnified.

Concluding Comments

The income tax hike approved by voters last November will have a substantial negative impact on Arizona's economy. Governor Ducey's tax plan would make the Arizona tax system even more pro-growth than before Prop. 208 was passed. The state can expect substantial gains in population, jobs and income with the flat tax of 2.5 percent and a cap at 4.5 percent. Our analysis also suggests that the increased growth in jobs and taxable income in the state will compensate for well more than half of the expected static revenue loss over the next decade. Because small businesses pay income tax at the personal income tax rates, we also believe the small business sector will benefit the most from the proposed flat tax structure and rates.

Endnote

There are many other econometric studies documenting the effect of income tax rate changes on growth. These include: Shuai, X., Chmura, C. "The Effect of State Corporate Income Tax Rate Cuts on Job Creation." Bus Econ 48, 183–193 (2013). 8 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.

A review of the statistical/econometric techniques used for this updated paper are summarized in the Committee to Unleash Prosperity white paper #9 published in 2020: "Arizona's Proposition 208 Tax Hike Loses Jobs and Harms Small Businesses" Arthur Laffer, Stephen Moore, and E. J. Antoni.

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