

# **Not Just Corporate Tax Breaks: Options for Restructuring Arizona Taxes**

Citizens for Tax Justice  
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2004 could have been a pivotal year for tax reform in Arizona. After almost a year of public hearings and private deliberations, in January a tax reform panel appointed by Governor Janet Napolitano issued its recommendations for revamping the state's tax system. The recommendations of the Citizens Finance Review Commission (CFRC) have prompted a wide-ranging discussion of options for structural tax reform in Arizona.

Meanwhile, lawmakers have faced difficult choices between painful spending cuts and politically unpopular tax increases as they dealt with a budget deficit of at least \$300 million for the fiscal year beginning in July 2004. This projected shortfall represents a short-term challenge to Arizona lawmakers seeking to balance the books by any means possible—but it also provides an opportunity for policymakers to craft tax reform solutions that reduce the unfairness of the state's tax structure while simultaneously ensuring that Arizona's state and local tax collections will, in the long run, support the level of public services demanded by its residents. However, legislative debate in the current session has ignored most of the recommendations of the Citizens Finance Review Commission and other groups. In fact, the state tax changes sought by lawmakers this year have mostly taken the form of dozens of tax breaks for large corporations (see box on this page). These proposals amount to piecemeal tax breaks for business, rather than broad, structural tax reform for lower- and middle-income Arizonans.

As an aid to taking a broader view of tax reform, this report describes Arizona's current regressive tax environment, and shows how various approaches to tax reform would improve tax fairness and adequacy in Arizona, while other changes would make the Arizona tax laws even more unfair. The options examined in the report include various corporate tax breaks being considered by the legislature as well as other options recommended (or not recommended) by the CFRC.

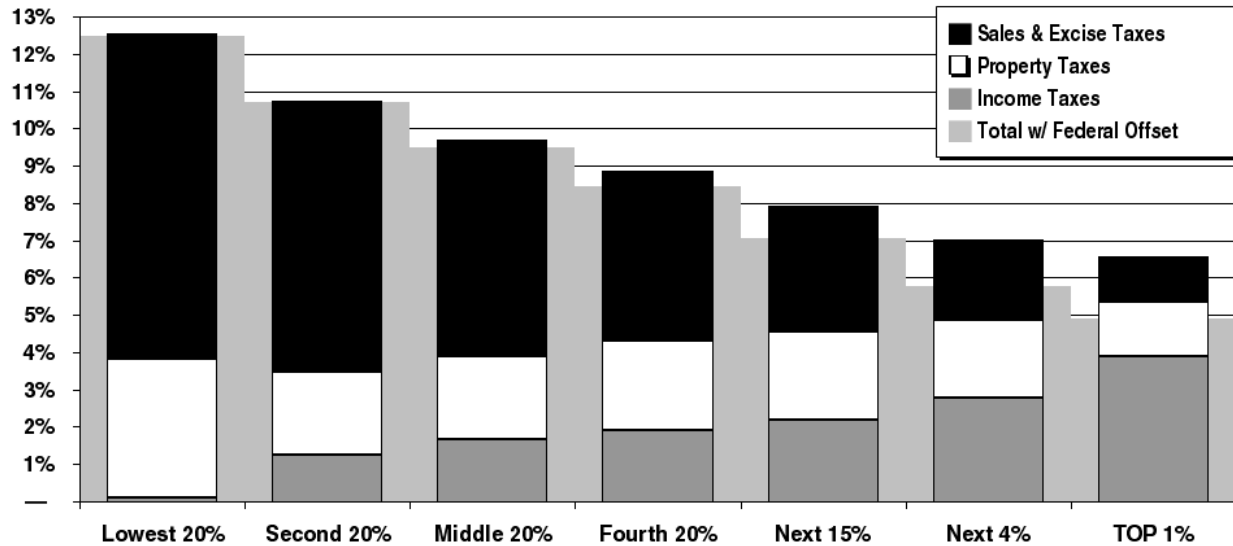
In particular, the report shows that the CFRC's recommendations to reduce the state's business property taxes would make Arizona's tax system even more unfair, by shifting more of the property tax burden to homeowners and renters. Enacting further corporate tax cuts would similarly make it more likely that these lost revenues would be made up in the long run by increasing taxes on everyone else. By contrast, tax reforms aimed at making Arizona's comparatively low personal income tax more progressive and closing corporate tax loopholes would simultaneously address the state's current tax equity and adequacy concerns by shoring up the state's tax base and asking the wealthy Arizonans who currently enjoy the lowest effective tax burdens to contribute to the support of public services more commensurate with their ability to do so.

#### Current Proposals for Corporate Tax Breaks

HCR2032 - taxpayer bill of rights  
HB2262 and SB1370 - R&D tax credits  
HB2263 and HB 2264 - property tax  
HB2270 - corporate sales factor  
HB2271 - 529 plans  
HB2472 - tax credit for stay-at-home moms  
HB2531 - homestead exemption  
HB2566 - tax credit for land conservation  
SCR1042 - prop tax  
SB111 - repeals corporate income tax  
SB1143 and SB1341 - other sales factor bills  
SB1209 - corporate income tax rate cut  
SB1239 - car license tax exemption for widows of vets  
SB1280 - tuition tax credit for corporations  
SB1315 - small business program tax credit  
SB1354 - TPT clarity  
SB1389 - IRS partial conformity  
SB1390 - IRS full conformity  
Source: Arizona Leadership Institute

# Arizona State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



## Arizona's Current Tax Situation: The Poor Pay More

The current Arizona state and local tax structure is *regressive*—that is, it requires low- and middle-income Arizonans to pay higher shares of their incomes in taxes than the wealthiest taxpayers have to pay. In other words, Arizona's tax laws actually redistribute income away from ordinary families and towards the richest Arizonans. A January 2003 report by the Institute on Taxation and Economic Policy<sup>1</sup> found that:

- The poorest twenty percent of Arizonans paid, on average, 12.5 percent of their income in Arizona taxes, while the wealthiest one percent of taxpayers paid only 6.6 percent of their income in state and local taxes.
- After taking account of the deductibility of state income on federal tax forms, the effective tax rate on the wealthiest 1 percent of taxpayers was an average of 4.9 percent—less than half the tax burden on the very poorest Arizonans.

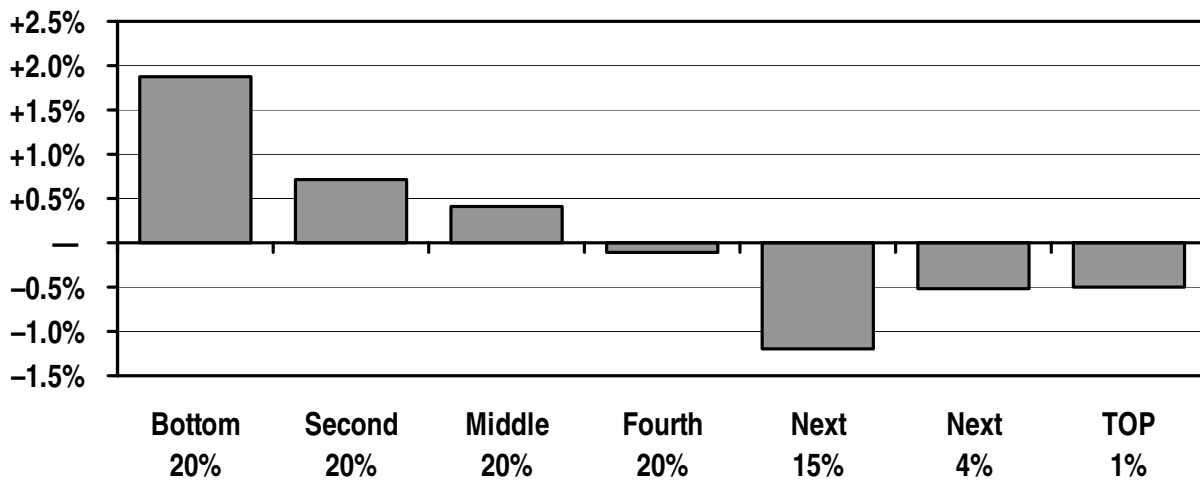
The ITEP report also showed that the Arizona tax system became even more unfair as a result of tax changes enacted in the 1990s. Changes over the last decade have made the income tax less progressive, and have increased regressive sales and excise tax burdens—making the Arizona tax system more regressive in 2002 than it was in 1989.

- The poorest sixty percent of Arizonans paid more of their income in state and local taxes in 2002 than the same group did in 1989—with the very poorest quintile of Arizonans experiencing the biggest tax increase as a share of income.
- The wealthiest 20 percent of non-elderly Arizona taxpayers—those earning more

<sup>1</sup>*Who Pays? A Distributional Analysis of the Tax Systems in All 50 States.* McIntyre, Denk, Francis, Gardner, Hsu and Sims (Institute on Taxation and Economic Policy, 2003).

than \$65,000 in 2002—enjoyed, on average, a substantial cut in their state and local taxes during the 1990s.

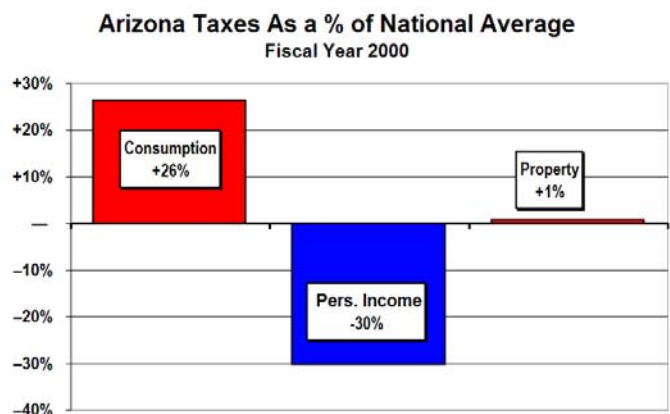
### Changes in Arizona Taxes as Shares of Income, 1989 – 2002



### What Makes the Arizona Tax System Regressive?

Like most states, Arizona relies primarily on three types of tax revenue: sales and excise taxes, property taxes, and personal income taxes. Of these taxes, only the personal income tax is *progressive*—that is, upper-income families pay a larger share of their income in this tax than do those with lower incomes. Property taxes are moderately regressive, and sales and excise taxes are quite regressive. The overall regressivity of the Arizona tax system is due primarily to the imbalance in the state’s reliance on these various taxes:

- Arizona sales and excise taxes, or consumption taxes, are tenth highest in the nation as a share of income—more than 25 percent above the national average. These are the most regressive taxes levied in Arizona.
- Arizona’s progressive personal income tax, by contrast, is more than 30 percent *below* the national average.



- The Arizona property tax burden is moderately regressive, and is near the national average overall.

The state’s over-reliance on regressive taxes, and its under-reliance on progressive personal income taxes, produces a tax system that is quite regressive overall.

### Arizona’s Very Low Personal Income Tax

The Arizona income tax burden is among the lowest among the 41 states levying such a tax: only three states without broad-based income taxes impose a lower income tax burden on their residents. In 2000, Arizona personal income taxes were 1.8 percent of

personal income, ranking 38<sup>th</sup> highest nationally. The Arizona income tax is similarly low as a share of all taxes levied in the state. In 2000, the personal income tax represented 17.2 percent of Arizona state and local tax collections—well below the national average of 24 percent.

One reason for this low aggregate tax is the state’s relatively low top income tax rate. Arizona’s top income tax rate is 5.04 percent. That’s lower than all neighboring income-tax states.

This low top tax rate is frequently cited as a competitive advantage to Arizona in attracting businesses to the state. But this “competitive advantage” is partially an illusion. Focusing only on the effective state income taxes in different

states tends to overestimate the real difference in tax rates between states. The reason that interstate income tax rate differentials are never as large as they appear has to do with the interaction on between state and federal income taxes. The following table shows the effective income taxes on the wealthiest 1 percent of Arizonans and New Mexicans in 2003, before and after the federal offset is taken into account. Looking just at the state income tax, one might think that the wealthiest New Mexicans pay 1.8 percent of their income more in state income taxes than do the wealthiest Arizonans. But the deductibility of state income taxes on federal tax forms means that residents of high-income-tax states can reduce their federal taxes more than residents of low-income-tax states. As a result, the real state income tax paid by high-income New Mexicans is much smaller than it would seem at first glance.

This “leveling” effect of the federal offset—reducing the apparent differences in income tax burdens between states—punishes low-income tax states and rewards high-income tax states. The impact on Arizona is that its tax advantage over New Mexico—and most other income tax states—is reduced.

The leveling effect of the federal offset also has important implications for proposed changes to the income tax structure. Progressive state personal income tax increases will always reduce federal income tax payments—and the more progressive the income tax hike, the greater the share of state tax hikes that will be offset by federal tax cuts.

### Arizona's Low Personal Income Tax

	% of		% of Total	
	Pers. Inc.	Rank	Taxes	Rank
<b>Arizona</b>	<b>1.8%</b>	<b>38</b>	<b>17.2%</b>	<b>38</b>
California	3.8%	6	33.0%	8
Colorado	2.7%	20	27.5%	15
Nevada	—	44	—	44
New Mexico	2.3%	35	18.3%	37
Utah	3.3%	13	28.1%	14
<b>ALL STATES</b>	<b>2.6%</b>		<b>24.2%</b>	

SOURCE: Bureau of Economic Analysis, Bureau of the Census

### Impact of Federal Offset on Income Tax Burdens as a Share of Income on Wealthiest 1% of Taxpayers

	Arizona	New Mexico	Difference
Before Offset	3.3%	5.1%	-1.8%
After Offset	2.3%	3.7%	-1.3%

## High Sales and Excise Taxes

Sales and excise taxes are the most regressive tax option available to Arizona lawmakers—and the option that state policy makers have resorted to most frequently in recent years. Consumption taxes are regressive because low-income families spend more of their income on purchases of items subject to sales and excise taxes than do wealthier taxpayers. Typically, low-income families spend three-quarters of their income on items subject to sales tax, middle income families spend about half their income on sales-taxable items, and the wealthiest taxpayers spend less about a sixth of their income on such items.

Arizona sales and excise taxes are much higher than the national average. In fiscal year 2000, Arizona sales and excise taxes amounted to 4.8 percent of personal income—tenth highest in the nation. Measured this way, Arizona consumption taxes are 26 percent above the U.S. average.

This important—but regressive—revenue source faces a critical

threat in the growing importance of services in the Arizona retail economy. States nationwide have struggled to modernize their sales tax bases, historically defined to include the tangible products that constituted the bulk of retail purchases in the early twentieth century, to include these intangible personal, professional, and business services. A 1996 study by the Federation of Tax Administrators (FTA) found that most states have been spectacularly unsuccessful in this enterprise: of 164 potentially taxable services identified by the FTA survey, less than half were taxed by most states. The FTA study found that Arizona taxes just 57 of these 164 services. Currently the tax base for services includes few business and personal services, and no professional services (like legal and accounting services).

As a result, Arizona policy makers seeking structural tax reform face a dilemma: broadening the sales tax base means aggravating the imbalance in the Arizona tax structure between sales and income taxes—but may be a necessary step to ensure the long-term viability of the sales tax as a funding source for education and other important public services.

## Declining Corporate Income Taxes

Corporate income tax reform, by contrast, could strengthen both the long-term adequacy and the fairness of the Arizona tax system. The corporate income tax is an important tool for state tax progressivity. In the 45 states that levy one, a corporate

### The Arizona Consumption Tax Burden

	% of		% of Total	
	Pers. Inc.	Rank	Taxes	Rank
<b>Arizona</b>	<b>4.8%</b>	<b>10</b>	<b>45.5%</b>	<b>13</b>
California	3.8%	24	33.1%	29
Colorado	3.6%	31	36.7%	22
Nevada	6.2%	4	61.6%	1
New Mexico	6.3%	3	50.7%	9
Utah	4.8%	11	41.4%	15
<b>ALL STATES</b>	<b>3.8%</b>		<b>35.5%</b>	
<b>Addendum: Arizona as a % of National Average</b>				
	126%		128%	

*SOURCE: Bureau of Economic Analysis, Bureau of the Census*

income tax helps offset the regressivity of the property and sales taxes which make up the bulk of state and local tax revenues. However, in recent years Arizona corporate income tax revenues have fallen both as a share of total Arizona revenues and as a share of the economy. This drop in revenue means that an increasing proportion of the tax burden is borne by individual Arizona taxpayers.

In the past two decades, Arizona corporate income taxes have fallen from 0.41 percent of gross domestic product (GDP) in 1980 to 0.35 percent of GDP in 2000. This mirrors a national trend in corporate profits taxes, but the Arizona corporate income tax burden has been lower than the

national average for much of this period. This shrinkage of the Arizona corporate income tax means that the corporate tax also represents a smaller piece of the Arizona income tax pie. In 1972, the corporate income tax generated 22.9 percent of all Arizona income tax revenue. In 2000, the corporate tax represented only 18.6 of all income tax revenue—which means that more than 81 percent of these revenues now come from the personal income tax paid by Arizona wage earners.

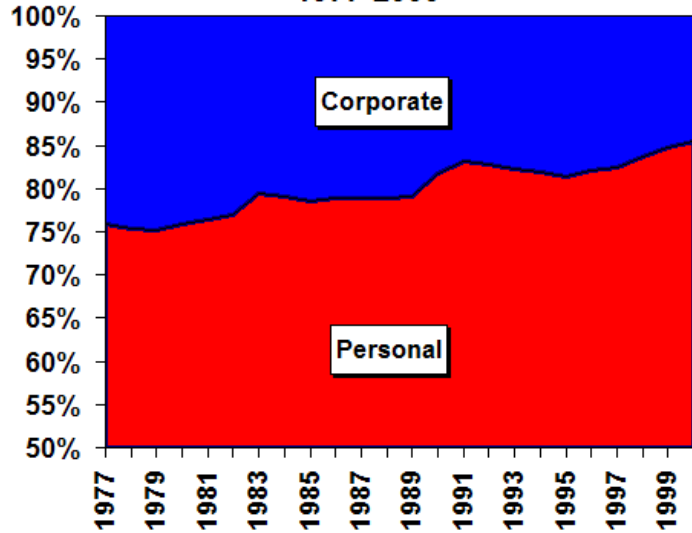
The lack of effective corporate tax disclosure at the state level makes it difficult to know how much of these decline is due to tax loopholes enacted by the Arizona legislature (or developed by creative corporate accounting). But existing loopholes such as the double-weighted sales factor and the lack of a “throwback rule” (described in the following section) reduce the fairness and yield of the Arizona corporate tax.

### Tax Reform Options for Arizona

This analysis has identified a variety of structural flaws that reduce the long-term yield and the fairness of the Arizona tax system. This section shows the impact of a variety of options for changing the state’s tax structure, including (but not limited to) options recommended by the Citizens Finance Reform Commission. Some of these options would reduce the regressivity of the overall tax system. There are other revenue options, however, that would make Arizona’s tax system even more unfair.

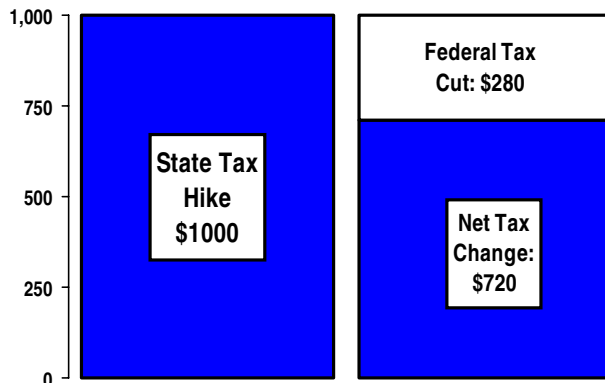
For each option described below, the accompanying bar charts show the impact of these options on each Arizona income group, expressed as a percentage of personal income. The solid portion of each bar represents the net tax change (after taking federal tax changes into account) for each income group. The transparent part of the bar shows each proposal’s effect on the federal income taxes paid by each group of Arizonans. The entire bar, including both the solid and transparent part, shows the state tax change, before taking account of federal tax changes, for each income group. We have presented

**Composition of Arizona Income Taxes  
1977-2000**



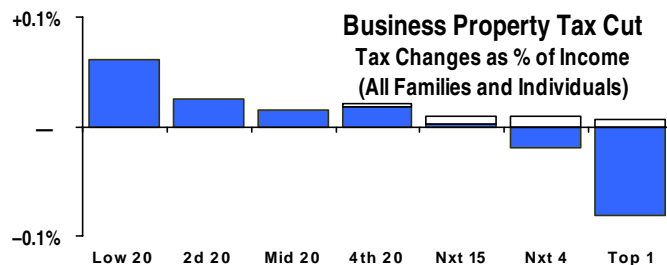
our data in this way because for those Arizonans who itemize deductions on their federal tax returns, changes in state and local income or property taxes can produce partially offsetting changes in federal tax liability. When state and federal taxes interact in this way, it is important to assess the effect of state tax proposals on the *overall* taxes paid by Arizonans, including federal taxes. The simplified example at right shows how to interpret these charts.

**How Increases in Federally Deductible Taxes Reduce Federal Tax Burdens:  
An Example**



Suppose an itemizing Arizona taxpayer in the 28 percent federal tax bracket is subject to a \$1,000 increase in Arizona income taxes. The value of her federal itemized deductions will increase by \$1,000. This means that \$1,000 *less* of this taxpayer’s income will be subject to federal tax after the Arizona tax increase. Since this last increment of income was originally taxed at 28 percent, this person’s federal tax liability decreases by \$280. So the net *overall* tax hike for this itemizing Arizona taxpayer from a \$1,000 hike in state tax liability is actually \$720, not \$1000. Our distributional analysis of this proposal (the second column in the chart on the previous page) shows that taxpayers do not pay the full \$1,000 tax hike, since \$280 of that hike is directly offset by federal tax cuts. An analysis that looked only at the *state* tax impact of the proposal (the first column in the chart) would overestimate the additional tax burden on Arizonans from the proposal.

**Option 1. Reduce business property taxes.** Currently, Arizona assesses most business property at 25 percent of its market value, while owner-occupied residential property is assessed at 10 percent of its market value. The option modeled here would reduce this difference, assessing business property at 20 percent of its market value. Our analysis assumes that local taxing districts would increase tax rates to exactly compensate for the revenue loss from this change (leaving overall local property taxes unchanged), but that property tax rates set by the state would remain unchanged. As a result, the tax loss due to the business tax cut would be only partially offset by residential tax hikes. Because the share of property taxes paid by homeowners would increase under this proposal, it constitutes a regressive “tax shift” from business to individual taxpayers. Because property taxes are deductible on federal tax forms, some of the homeowner property tax hike would be offset by federal tax cuts.



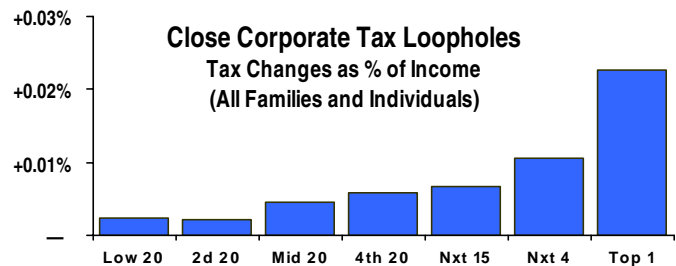
**Revenue Loss:** \$143 million (\$5 million exported)

## Option 2. Close corporate loopholes and shelters.

Many states are taking a hard look at how accounting firms have helped big multi-state corporations artificially shift profits into states that don't tax them. In 2002, New Jersey passed legislation curbing more than \$1 billion a year in corporate tax shelters. The following are some of the corporate reforms that policy makers could consider:

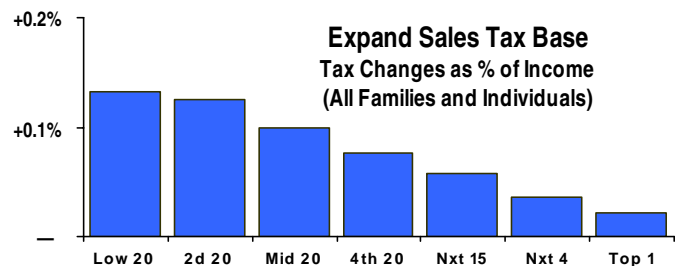
Enact a “throwback rule” to tax corporations that shift income to states without a corporate income tax. The “throwback rule” applies to income that cannot be taxed in Arizona if it is taxed elsewhere but *can* be taxed if it is *not* taxed elsewhere. In other words, if the income is not taxed by another state, the income can be taxed as Arizona income.

Return to the traditional “unweighted” formula for apportioning corporate taxable income. Arizona’s current formula for apportioning corporate profits allows substantial taxable income to be shifted out of the state. The current system of “double-weighting” the importance of in-state sales in determining taxable income arbitrarily discriminates between corporations doing business in Arizona, reducing corporate taxes for some and increasing them for others. Returning to the traditional “unweighted” three-factor formula, based on sales, payroll and property, would help insure that companies benefitting from Arizona public services pay taxes more commensurate with those benefits. (By contrast, the CFRC’s recommendation to worsen this discriminatory tax treatment, by moving to a “single sales factor” that eliminates the payroll and property component of the tax calculation, could reduce tax revenues by \$50 million annually.)



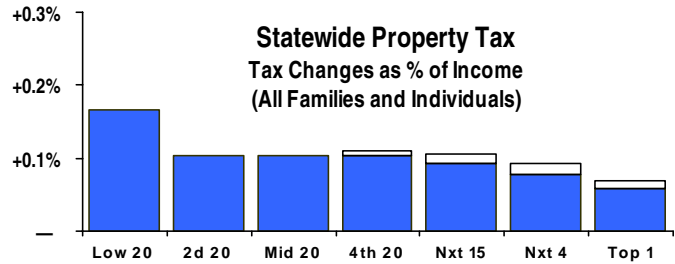
**Additional Revenue:** Uncertain.

**Option 3. Expand the state sales tax base to include more personal services.** This option would expand the state sales tax base to include health clubs, dry cleaners, and other personal services. Because these services are an increasing percentage of total consumption, expanding the sales tax base is an essential step to help ensure the future viability of this tax—but would also make the tax system more regressive. This option could be expanded to include business services, which would increase the yield of this option but would also result in some of the tax increases being passed through to residential consumers. Because sales taxes are not deductible on federal income tax forms, none of this tax increase would be offset by federal tax cuts.



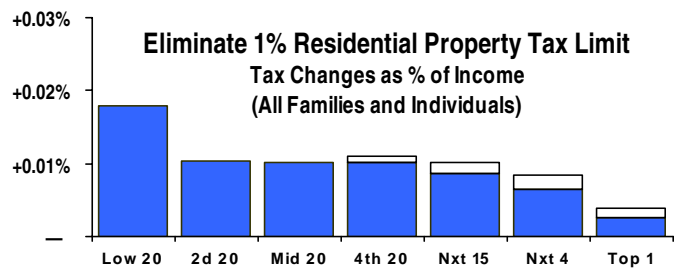
**Additional Revenue:** \$100 million.

**Option 4. Reintroduce a statewide property tax of \$0.50.** This option would introduce a statewide property tax levied at the same rate in each jurisdiction. This tax change would make the Arizona tax system more regressive, but would not exacerbate the inequity between taxing districts generated by local property taxes. Some of the added property tax burden would be paid initially by businesses. Because property taxes are deductible on federal tax forms, some of the added property tax burden would be offset by federal tax cuts.



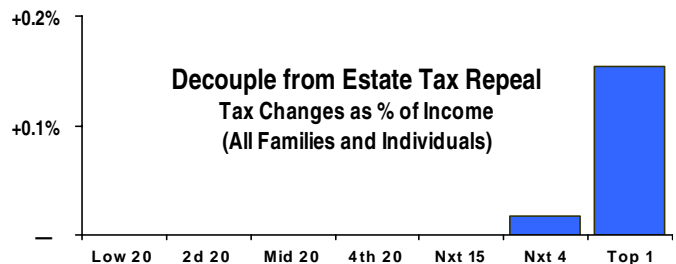
**Additional Revenue:** \$186 million (\$10 million exported)

**Option 5. Eliminate 1% limit on residential property taxes.** The Arizona Constitution limits the primary property tax burden on any residential home to 1 percent of the property's market value. This option would eliminate this constitutional limit, resulting in a regressive property tax increase in those high-rate taxing districts around the state that would currently levy a tax over the 1 percent threshold but for the limit. The initial cost of this tax change has been estimated at around \$11 million, but the long-term cost of this tax hike to Arizona homeowners is likely to be higher. Because property taxes are deductible on federal tax forms, some of the added property tax burden would be offset by federal tax cuts.



**Additional Revenue:** \$11 million (\$1 million exported)

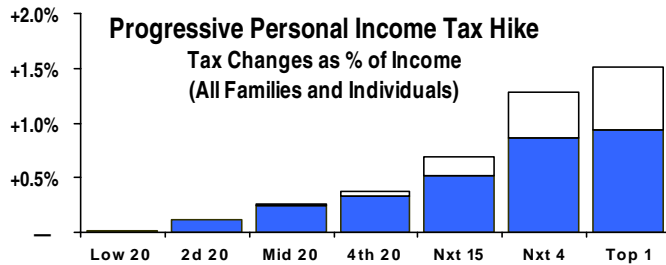
**Option 6. Decouple estate tax.** Decoupling from recent federal estate tax changes would have very little impact on most Arizonans, because of generous exemptions in the federal tax as it existed before 2001. The impact of decoupling would be borne primarily by the wealthiest one percent of taxpayers. While the revenue yield from decoupling is uncertain, it has been estimated that this change could increase revenues by over \$30 million annually. Because the estate tax is one of the few progressive tax options available, this option is an important source of tax fairness.



**Additional Revenue:** \$30 million

### Option 7. Make the personal income tax more progressive.

Arizona's personal income tax is progressive, but the state's relatively low top tax rate makes it less progressive than most other state income taxes. This proposal increases the income tax burden in a progressive way by increasing tax rates "across the board" and narrowing the upper tax brackets. This proposal would replace the current five-bracket tax structure with a four-bracket structure with tax rates of 3, 4, 5 and 8 percent, with the top tax bracket applying to Arizonans earning more than \$60,000 annually (for married couples—half that for single taxpayers). Low-income taxpayers would be mostly unaffected by this change. Because state personal income taxes are deductible on federal tax forms, some of the added property tax burden would be offset by federal tax cuts.



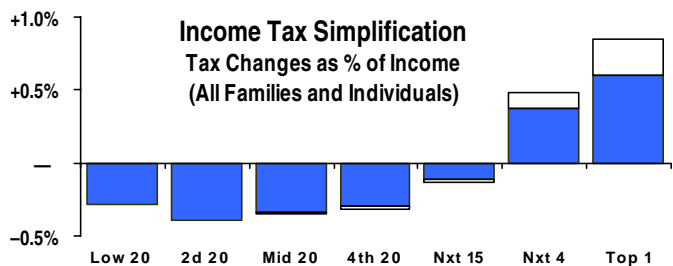
**Additional Revenue:** \$1 billion (\$260 million offset by federal tax cuts)

### Option 8. Personal income tax simplification.

"Tax simplification" is the professed goal of many tax reformers, and the CFRC report recommends achieving this by "follow[ing] the federal income tax returns as much as possible." There are several ways of achieving this; the most simple (and the most progressive) approach is to calculate Arizona income tax liability as a flat percentage of the federal income taxes paid by Arizonans. In theory, this reform could allow Arizonans to file their taxes on a postcard-sized form.

This option replaces the current Arizona income tax with a flat tax equal to 20.8 percent of the federal tax. This option is revenue-neutral, leaving Arizona income tax collections unchanged if implemented in tax year 2003. Almost all Arizonans would, on average, see a tax cut from this plan.

Because this option shifts some of the income tax burden from low- and middle income Arizonans who do not itemize their federal taxes to wealthier Arizonans who do, this "revenue neutral" change gives Arizonans a \$45 million tax cut overall (in the form of federal income tax cuts for wealthier taxpayers.)



**Additional Revenue:** None. (\$45 million offset in federal tax cuts)

## Conclusion

The work of the Citizens Finance Review Commission has provided Arizona lawmakers with an opportunity to discuss comprehensive, long-term tax reform—even as the state’s recent budget shortfalls have forced policymakers to think practically about ways of closing the state’s short-term fiscal gap. This analysis has identified a variety of areas in which the state could seek to achieve one (and, in some cases, both) of these objectives. Arizona’s tax system, more so than most other states, has redistributed income in favor of the wealthiest taxpayers and at the expense of low- and middle-income Arizonans. In addressing the current revenue shortfall, lawmakers can choose to continue this regressive approach, or they can finally decide to move toward a fairer tax system that better serves the needs of the vast majority of Arizonans.

On the one hand, lawmakers can adopt reforms that add a measure of progressivity to the state’s income tax and curb corporate tax abuses. In doing so, Arizona would ask those with the highest incomes—and the most ability to pay taxes—to contribute to the support of public services more commensurate with their ability to do so. Or instead, Arizona could raise regressive consumption taxes that would further burden those with the least ability to pay and make the state’s tax system even more regressive.

We hope this report will help inform these important decisions.

## APPENDIX III: ABOUT THE ITEP MICROSIMULATION TAX MODEL

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The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

### What the ITEP Model Does

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with a sampling of records from the U.S. Decennial Census "five percent sample" (which contains a random sample of five percent of all census forms received by the Census Bureau); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2003, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study was released jointly with Citizens for Tax Justice. *Who Pays?* shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP Model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.