

Who Benefits from Repealing Arizona's Income Taxes? Institute on Taxation and Economic Policy April 2000

An initiative currently circulating in Arizona would repeal the state's personal income and corporate income tax. The following analysis examines the consequences of this proposal for Arizona taxpayers at different income levels. Among the principal findings of the analysis are that:

- # The wealthiest five percent of Arizonans would receive nearly 47 percent of the tax reductions from the proposed initiative, while the poorest 80 percent would realize less than 29 percent of the tax cuts.
- # If the initiative were to become law, Arizona taxpayers would pay \$450 million more in federal taxes.

The personal income and corporate income tax combined are responsible for about 34 percent of all Arizona state taxes; the personal income tax is forecast to raise \$2.5 billion in fiscal year 2001, while the corporate income tax will raise over \$500 million.

In addition to eliminating over \$3 billion in state revenue—which is nearly as much the state budgets for both K-12 and higher education combined—the proposed initiative would also require that any tax increase be put to a referendum of the voters. This would make it harder to create new funding sources to replace the revenue loss that would result from passage of the initiative.

Since the personal income tax is Arizona's only progressive tax, most of the benefit of repealing it would be enjoyed by the wealthiest Arizonans. In particular:

- # The richest five percent of Arizona's population—those with incomes over \$130,000—would receive nearly 47 percent of the benefit.
- # The poorest 80 percent—those earning less than \$64,000—would get less than 29 percent of the benefit.
- # The wealthiest one percent, with an average income of \$888,000, would save an

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Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%			
					Next 15%	Next 4%	Top 1%	
Income Range	Less Than \$16,000	\$16,000 – \$26,000	\$26,000 – \$40,000	\$40,000 – \$64,000	\$64,000 – \$130,000	\$130,000 – \$361,000	\$361,000 Or More	
Average Income In Group	\$9,600	\$20,900	\$32,500	\$51,300	\$86,200	\$182,000	\$888,000	
Tax Cut as a % of Income	-0.6%	-1.1%	-1.5%	-1.8%	-2.2%	-2.6%	-4.0%	
Average Tax Cut	\$ -54	\$ -232	\$ -491	\$ -928	\$ -1,911	\$ -4,810	\$ -35,619	
Share of Total Tax Cuts	0.9%	3.9%	8.4%	15.7%	24.3%	16.4%	30.4%	100%

SOURCE: Institute on Taxation and Economic Policy Microsimulation Model, March 2000. Data based on statistically-matched IRS samples and the Jan 2000 Biennial Budget Adjustment to the FY00 & FY01 Appropriations Report, Arizona Joint Legislative Budget Committee. Income analysis is of all Arizona residents in calendar year 2000.

average of \$35,619, while the poorest 20 percent of the population, with an average income of \$9,600, would only save \$54.

The middle 20 percent of Arizona residents, those with an average income of \$32,500, would receive a tax savings of \$491.

If the initiative were to become law, Arizona taxpayers would pay \$450 million more in federal taxes. The 700,000 Arizona residents who itemize their deductions on their federal return can presently deduct both their state personal income and property taxes. If the income tax is repealed, they lose a substantial deduction, and their federal income tax goes up. In effect, this proposal would take \$450 million which otherwise would go to the state of Arizona and send it off to the federal government in Washington, DC.

This illustrates an important issue in state and local taxation. States which rely more heavily on taxes deductible on the federal return—income and property taxes—versus non-deductible taxes (such as sales taxes), can lower their federal tax burden. In 1996 (the latest year available), Arizona ranked 10th highest in the country in its state and local sales and excise tax burden. Arizona's sales and excise taxes were 5.0 percent of personal income, compared with the U.S. average of 4.0 percent. In contrast, Arizona's personal income tax as a share of personal income, 1.8 percent in 1998, ranks 38th nationally, well below the U.S. average of 2.5 percent. Arizona's heavier-than-average sales tax reliance translates into relatively higher federal income taxes for Arizona taxpayers. Eliminating income taxes altogether would not only make the state's tax system one of the most regressive in the nation, but would force many Arizona taxpayers to pay substantially higher federal tax bills.

ITEP METHODOLOGY

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

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- # rates—including special rates on capital gains,
- # inclusion or exclusion of various types of income,
- # inclusion or exclusion of all federal and state adjustments,
- # exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- # standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- # itemized deductions and deduction phase-outs, and
- # credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the revenue yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue yield and incidence of current corporate

income tax law, possible rate changes and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Addendum: Data Sources

The ITEP model is a “microsimulation model.” That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets:

IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey: Consumer Expenditure Survey; U.S. Census, 1990.

Partial List of Aggregated Data Sources:

Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

A more detailed description of the ITEP Microsimulation Tax Model can be found on the ITEP internet site at www.ctj.org\itep\.