

## Arizona's New Tax Structure

### Economic Impact of Repealing the 3.50% Surcharge & Moving to a 2.50% Flat Tax

#### Key Findings

Common Sense Institute (CSI) used the REMI dynamic economic simulation model PI+, to estimate the combined 10-year effects of repealing the 8.00% progressive state income tax and replacing it with a single, flat 2.50% income tax. Specifically, CSI found that by 2032:

- Arizona would have about **58,800 more employed workers** relative to a world where the 2.50% flat tax did not take effect and the Prop 208 surcharge did.
- **State GDP would increase by approximately \$11.9 billion.**
- Real per capita disposable income would be \$684 higher.
- Due to these economic offsets, state and local government spending on all services would be reduced by \$1.4 billion on a dynamic basis, versus nearly \$4 billion on a static basis without this growth (after accounting for assumed future revenue growth).

Overall, these general results are robust to various alternative specifications, although their magnitude is sensitive to the degree and nature of indirect macroeconomic benefit (beyond the direct and intuitive effect of reducing individual personal taxes paid).

#### Overview & Why It Matters

Arizona is one of 42 states with an individual income tax. When enacted in 1933, the system had eleven rates ranging from 1.0% to 4.5%, and by 1967 the rates had increased to 2.0% at the bottom and 8.0% at the top. In 1990, the state began twenty years of modernizing reforms by consolidating the brackets and completing substantial conformity with federal definitions and deductions. In 2020, the state had a relatively simple income tax system that starts with Federal Adjusted Gross Income and applies four brackets ranging from 2.59% to 4.50%.

However, the simplicity and relatively low rates (40<sup>th</sup> lowest in the country) were jeopardized after passage of Proposition 208 in 2020 – which would have imposed a new surcharge on incomes over \$250,000 and raised the state's top rate to 8.00% (9<sup>th</sup> highest in the country). Since then, however, a State Court decision has invalidated the surcharge and policymakers enacted a 2.50% flat individual income tax. Arizona will soon have the lowest income tax rate in the country among states that levy this tax and be the 11<sup>th</sup> state to move to a flat tax structure.

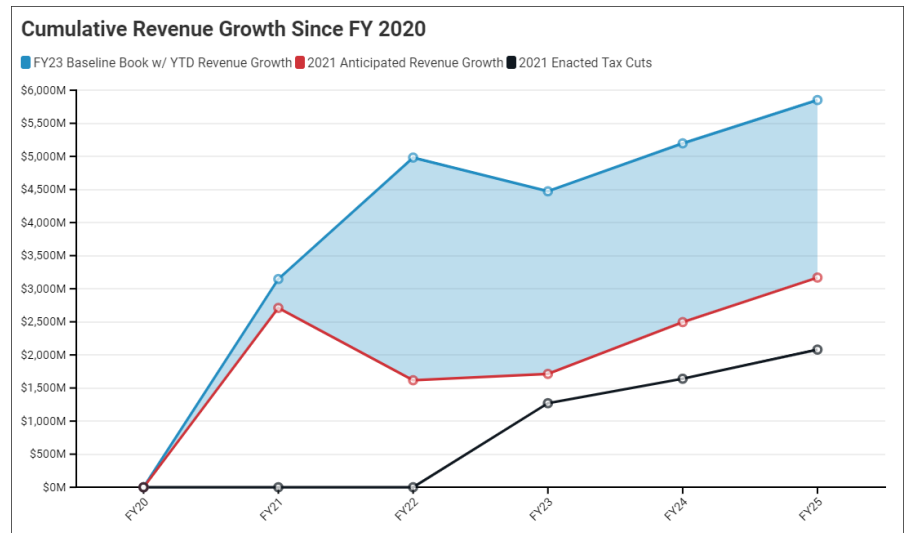
Generally, economists agree that high income taxes are economically harmful, particularly when they tax capital gains and other income on savings and investment at the same rate as ordinary income (as in Arizona and most other states). This is because the tax discourages taxpayers from saving or investing ordinary income in the taxing jurisdiction, and instead spending it today on consumption locally or moving their investment to lower taxed jurisdictions. Two papers in 2018 and 2012 found that capital gains taxes directly raise the cost of capital, and economists in 2012 found that higher state income taxes (when applied to capital gains) reduced labor productivity.

## Arizona's Income Tax Continues to Outperform Forecasts

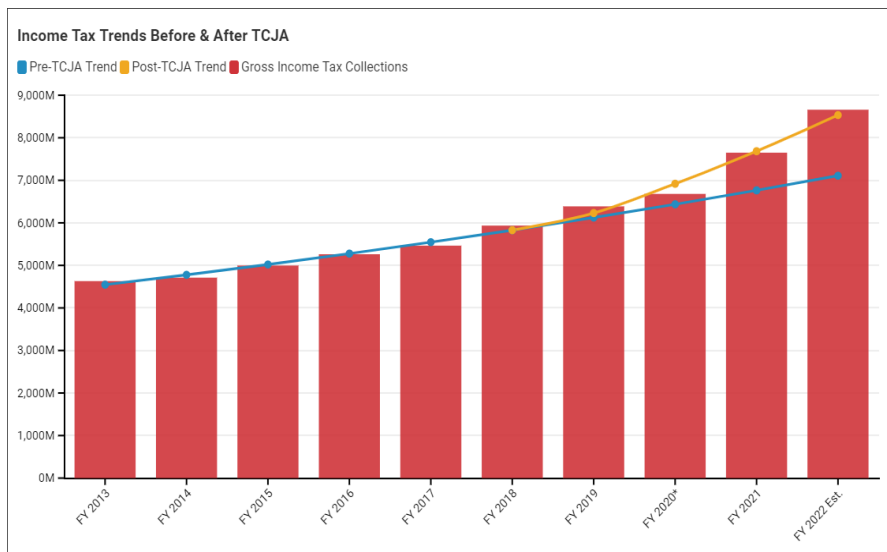
Combining General Fund performance through [March](#) with the most current legislative [forecasts](#), **the State of Arizona is on track to add more than \$5.8 billion in new revenues by FY 2025** (over FY 2020), even after enacting the largest tax cut in state history and more than enough to fully cover the costs of those cuts.

Last year, when the 2.50% flat tax plan was originally enacted, the State was expected to add only about \$3.0 billion over the same period – meaning **just in the last 6-12 months, revenue**

**overperformance has added nearly \$2 billion in unexpected surplus.** This new surplus alone is sufficient to cover the expected cost of the flat tax reform.



Arizona has a revenue problem, not a spending problem. Since FY 2018, the State has experienced unprecedented annual growth in income and sales tax collections, and – as demonstrated in CSI's [Budget Then & Now Report](#) last month - surpluses have grown unsustainably large despite massive investments in priority areas like public education, due to the new remote sellers sales tax and conformity to the federal

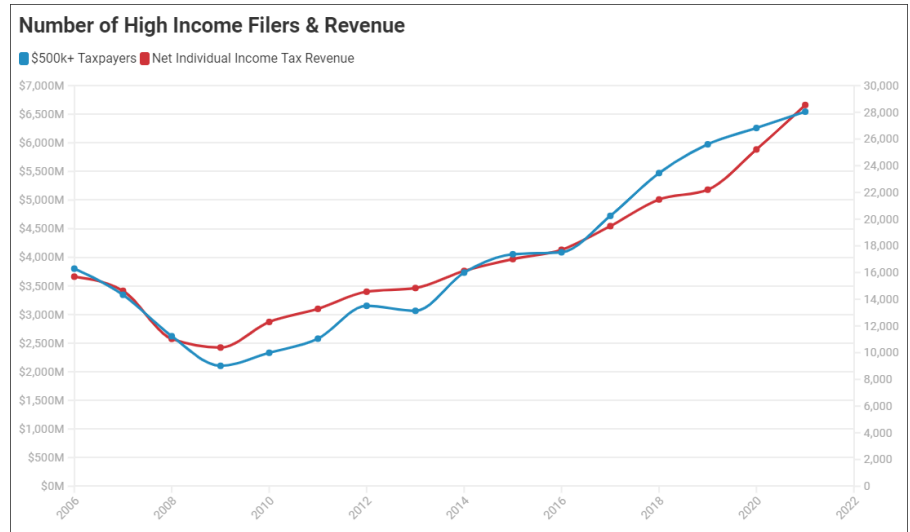


**Tax Cuts & Jobs Act. The State is collecting at least \$2.4 billion more per year due to the 2019 Tax Omnibus, passed by the Arizona state legislature, than it was under the pre-2018 tax base.** The problem is best addressed by revisiting the states tax structure adopted in 2019, and not by trying to use one-time spending to absorb the excess cash. The 2.50% flat tax plan helps further the intended goal begun back in 2019: a revenue-neutral modernization of the state tax code, and not a permanent tax increase.

## State Income Taxes Are Particularly Sensitive to Economic Behavior

Unlike the federal government, most states (including Arizona) tax all income – ordinary and gains on capital – the same way. This makes state income taxes particularly harmful to capital formation and

particularly sensitive to taxpayer behavior since capital formation tends to be a relatively mobile economic activity. A taxpayer can deliberately schedule or move the realization of capital gains into relatively more favorable tax regimes. For example, in 2012 ahead of the expiration of the 2001 national 15% tax rate on capital gains, **capital gains realizations surged which temporarily inflated Arizona’s individual income tax receipts**. When they returned to prior trend from and after 2013, the state entered a period of sustained fiscal deficit.



Economic theory suggests high income taxpayers will relocate *income* in response to tax and other fiscal policy, without necessarily relocating themselves. For example, in 2012 taxpayers realized capital gains ahead of an anticipated tax increase, relocating future income across time. Taxpayers residing in California may relocate taxable business activities and entities to more favorable tax jurisdictions even as they themselves remain in that state for cultural or geographic reasons. This migration of *capital* (even more than *people*) is what creates disparate long-run economic growth prospects in low-tax versus high-tax states; a 2018 analysis by *Forbes*, for example, **found that low-tax states saw nearly twice the job growth of high-tax states in the year immediately following passage of the Tax Cuts & Jobs Act**.

A 77% increase in the states marginal tax rate on its highest earners would have reduced both Arizona’s long-term growth prospects and short-term revenue collections.

### Economic Simulations Confirm Recent Tax Policy Changes Enhance Arizona’s Growth Prospects

To assess the economic impacts of the combined repeal of the 3.50% income tax surcharge and the gradual shift to a 2.50% flat tax, Common Sense Institute used the REMI regional economic model. First, we identified the amount of personal tax cuts taxpayers would likely realize by both the repeal of Prop 208 and enactment of the 2.50% flat income tax, by relying on analyses by the Joint Legislative Budget Committee. The value of the tax cut was projected to grow by 4.6%/year (the 15-year average growth rate in individual income tax revenue). Correspondingly, we assumed that these tax cuts would be fully offset by equivalent government spending cuts. The roughly \$830 million in foregone surcharge revenues were realized as direct reductions in public educational services output, because the Prop 208 surcharge revenues were statutorily directed to specific educational programs. The approximately \$2.1 billion costs of the 2.50% flat tax were modeled as general reductions in State spending, only, since the revenues would otherwise have accrued to the General Fund and the law includes protections intended to mitigate local revenue effects. This analysis covered the 10-year period through 2032.

However, the REMI model does not directly consider potential interactions between specific personal tax reductions and consumer expenditure versus savings and investment behavior, or corresponding changes in business demand for capital and labor. For example, the Prop 208 surcharge was limited to high-income taxpayers, and mainstream economic theory holds that higher income taxpayers consume relatively smaller proportions of their income (and, correspondingly, save and invest relatively higher proportions) compared to low-income taxpayers. This theory is borne out in IRS [abstract](#) data. Despite being only about 17% of total income, taxpayers making over \$500,000 paid two-thirds of all Arizona capital gains.

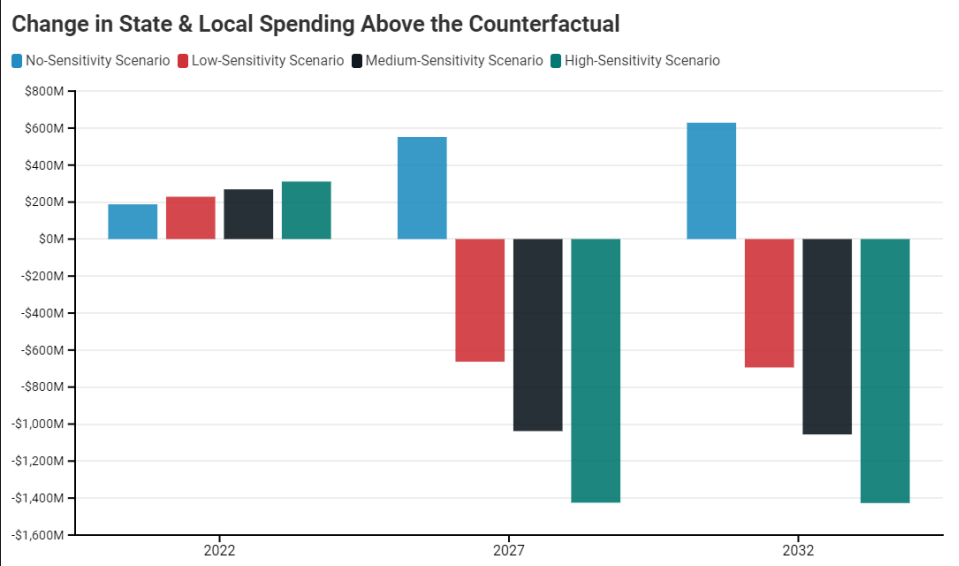
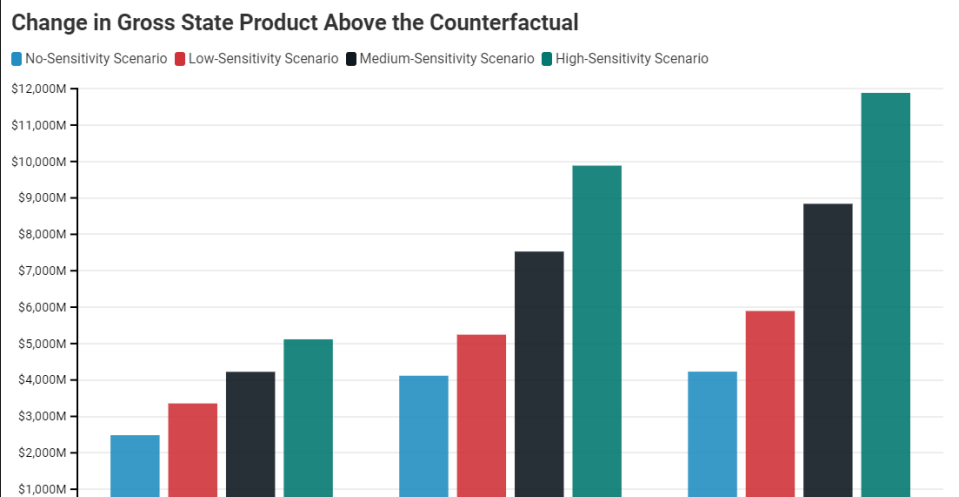
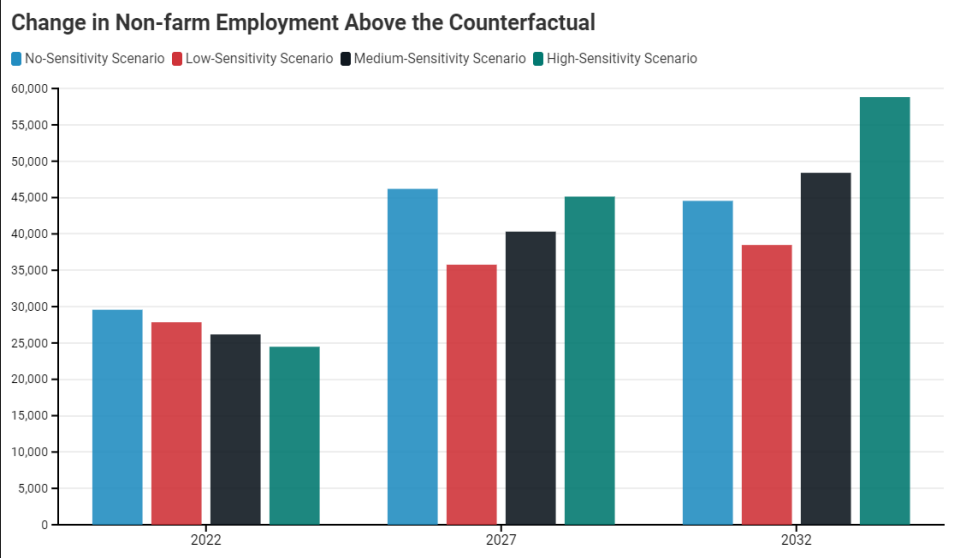
To model these effects, CSI relied on two separate economic studies: McPhail, et al (2010)<sup>i</sup>, who found that a 10% increase in tax rates on capital gains could be expected to reduce labor productivity by about 0.25%, and Huzinga, et al (2012)<sup>ii</sup>, who found that average effective capital gains taxes in the United States raised the cost of capital by 5.3% relative to its no-tax level.

**Labor Productivity.** Considering the Prop 208 surcharge, and assuming it would have fallen on approximately 65% of capital investment activity in Arizona, the foregone 77% effective marginal capital gains rate increase prevents a future approximately 1.25% decrease in Arizona’s labor productivity. Correspondingly, the move instead to a 2.50% flat income tax regime is expected to increase labor productivity by approximately 1.50% over three years relative to the economic baseline. Both effects are expected to result in lagged responses from suppliers and consumers of labor.

**Cost of Capital.** CSI assumes that the states contribute to the tax-induced increase in the United States’ cost of capital in proportion to their share of combined income tax collections within that state, and further assumes that moving from a possible 8.0% progressive income tax structure to a single 2.50% rate reduces Arizona’s contribution to that cost by approximately 80%, or an effective 1.15% decrease in the cost of capital in Arizona relative to the economic counterfactual (phased in over three years).

After incorporating all model parameters – personal tax reductions, government spending reductions, an increase in labor productivity and decrease in the cost of capital – **Arizona is expected to gain 58,800 net jobs and \$11.9 billion in additional Gross State Product by 2032 relative to the counterfactual where the Prop 208 surcharge is allowed to take effect and the 2.50% flat tax is not allowed to take effect.**

In practice, this analysis assumes high sensitivity of the economy to these policy changes. For example, given record surpluses, policymakers may not respond perfectly to the tax reductions by reducing public spending relative to a baseline where the surcharge takes effect, and the flat tax does not. Instead, policymakers may respond by reducing future cash surpluses to preserve the baseline level of spending. Similarly, some of the taxable capital gains realized in Arizona due to these policies are likely to have been on investments outside of the state, such that not all the savings to the cost of capital or increases in labor productivity would be captured by Arizona. To account for this, CSI includes four alternative scenarios in the summary tables on page 5 (beyond the full second-order effect scenario discussed above): a no-sensitivity scenario (no second-order effects); a low sensitivity scenario (33% of the predicted second-order effects); and a medium sensitivity scenario (66% of the predicted second-order effects). The exception is public education services reduction due to the repeal of Prop 208; given the dedicated nature of this funding (and Arizona’s Voter Protection Act), we assume this spending is fully foregone under all scenarios.



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<sup>i</sup> McPhail, Joseph E., et al. "The poverty of states: do state tax policies affect state labor productivity?" Economics Working Papers, 115. 2012.

<sup>ii</sup> Huizinga, Harry, et al. "Capital Gains Taxation and the Cost of Capital: Evidence from Unanticipated Cross-Border Transfers of Tax Base." Journal of Financial Economics, 129. 2018. 306–328.