

AZ Budget Priorities: Lower Income Taxes for the Well-Off — Economic Gold Rush or Fiscal Wreck?

“Economic gold rush? Or fiscal wreck?”

Kansas Gov. Sam Brownback took a grand gamble Tuesday with a monumental tax plan that he hopes will spur an economic revival and not an unparalleled budget crisis that leaves state services in ruins.” — Kansas City Star May 23, 2012¹

“We don’t think there is a major problem with personal income taxes; we are below average there,” (Kevin) McCarthy (President of the Arizona Tax Research Assoc.) said. “I don’t think I would look to decrease personal income taxes.” — Arizona Republic February 9, 1997²

“McGuire’s bottom line: the evidence of a link between the levels of state taxes and state economic growth is weak; too weak for McGuire to believe that cutting taxes with the goal of boosting economic growth is likely to be an effective policy play.” — Professor Therese McGuire, State Fiscal Policy expert³

¹ Cooper, Brad (2012), “Brownback signs big tax cut in Kansas,” Kansas City Star, May 23, [Brownback signs big tax cut in Kansas | The Kansas City Star](#)

² Note McCarthy and the Arizona Tax Research Association strongly opposed Prop. 208, so this quote should not be used to infer he opposes the effective repeal of the Prop. 208 personal income tax surcharge—and his public statements at the House Appropriations Committee hearing on May 25, 2021, focused on the business property tax assessment, which is modestly reduced from 18% to 17% and that Prop. 208 would have a detrimental impact on the economy. Quote from Flannery, Pat (1997), “State’s Income Tax Below U.S. Average But Sales Tax among 10 Highest,” Arizona Republic, Feb. 9.

³ McGuire, Therese J. (2014), “State Fiscal Policies and State Economic Growth,” Jan. 8, Prepared for an OpenSky Policy Institute Tax Policy Presentation, https://www.openskypolicy.org/wp-content/uploads/2014/01/OpenSky_8Jan2014_McGuire.pdf.

Introduction

Republican legislative leadership and Governor Ducey have put forward a plan to reduce income taxes by \$1.9 billion permanently under the premise that lowering income taxes for higher income households will unleash economic growth. While Arizona is in a stronger initial position than was Kansas when it adopted a significant drop in its personal income tax rates in 2012, the proposed decrease in revenues is proportionately greater than what Kansas pursued⁴ — and like Kansas — the promised economic rewards are vastly overstated. Like Kansas the math may not work out, as \$1.9 billion dollars in revenue reductions are proposed when a \$1.5 billion ongoing “surplus” has been projected for the short-term by the Joint Legislative Budget Committee (JLBC).

The JLBC narrowly defines surplus based only on ongoing expenditure commitments the legislature has made, and ignores areas deemed one-time funding even if they aren't one-time (such as some university expenditures) or areas that many argue are underfunded (such as K-12 education) and formula funding that the legislature has ignored (such as community colleges).

This is the inverse of the anti-Prop. 208 campaign which argued that passing a 3.5% surcharge on taxable incomes above \$250,000 (single) or \$500,000 (married/head of household) would effectively destroy the economy.

What passes for analysis is typically quite one-sided implying that Prop. 208 does nothing for the economy or that any further investment in K-12 is useless. Likewise no effort has been taken to compare impacts of dramatically lowering marginal tax rates for higher income households compared to investing in education and infrastructure. As the Grand Canyon Institute found during the Prop. 208 campaign, arguments on the impact of tax changes are greatly exaggerated and sometimes completely false.

⁴ Tankersley, Jim (2017), “Kansas Tried a Tax Plan Similar to Trump’s. It Failed,” Oct. 10, [Kansas Tried a Tax Plan Similar to Trump’s. It Failed. - The New York Times \(nytimes.com\)](https://www.nytimes.com/2017/10/10/us/politics/kansas-tax-plan-trump.html).

Past Personal Income Tax Rates and K-12 Education Spending

While the literature on the impact of tax changes is mixed⁵, one can look at Arizona for evidence. Arizona has, starting in 1994, systematically lowered its marginal income tax rates, primarily for wealthier households. At the same time, compared to other states, Arizona has invested less in K-12 education. After 25 years, we can look back and evaluate to what degree this policy has worked.

Table 1 Historical Individual Income Tax Rates

| HISTORICAL INDIVIDUAL INCOME TAX RATES ^{1/} | | | | | | | | | |
|--|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| <u>Taxable Income</u> ^{2/3/} | <u>TY 1990</u> | <u>TY 1994</u> | <u>TY 1995</u> | <u>TY 1997</u> | <u>TY 1998</u> | <u>TY 1999</u> | <u>TY 2006</u> | <u>TY 2007</u> | <u>TY 2019</u> |
| \$0 - \$ 10,000 | 3.80% | 3.25% | 3.00% | 2.90% | 2.88% | 2.87% | 2.73% | 2.59% | 2.59% |
| \$10,001 - 25,000 | 4.40% | 4.00% | 3.50% | 3.30% | 3.24% | 3.20% | 3.04% | 2.88% | 2.59% |
| \$25,001 - 50,000 | 5.25% | 5.05% | 4.20% | 3.90% | 3.82% | 3.74% | 3.55% | 3.36% | 3.34% |
| \$50,001 - 150,000 | 6.50% | 6.40% | 5.20% | 4.90% | 4.74% | 4.72% | 4.48% | 4.24% | 4.17% |
| \$150,001 & over | 7.00% | 6.90% | 5.60% | 5.17% | 5.10% | 5.04% | 4.79% | 4.54% | 4.50% |

^{1/} For marginal rates prior to 1990, see page 90 of the 1990 Tax Handbook.
^{2/} These brackets applied to single or married filing separately filers. For married joint filers or head of households, the bracket amounts are doubled. In 1990, the brackets were altered into the present form (see Laws 1990, 3rd Special Session, Chapter 3).
^{3/} Brackets displayed in Table 8 represent amounts that were effective from TY 1990 through TY 2014. Beginning in TY 2015, tax brackets are indexed to inflation (Laws 2014, Chapter 2010 and Laws 2015, Chapter 91). See Table 7 for TY 2017 bracket amounts.

Source: Joint Legislative Budget Committee, 2019 Tax Handbook, p. 46.

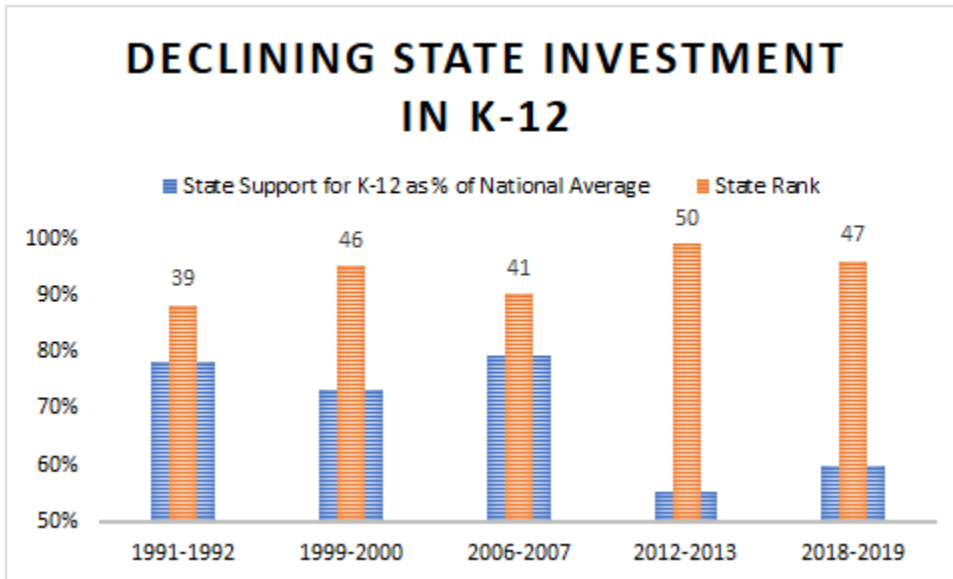
As Table 1 illustrates, while marginal rates have declined by a little over 1 percentage point for low- and middle-income taxpayers, marginal rates for higher income taxpayers have declined by more than 2%.

The impacts in Table 1 may be misleading if looked at across rows since tax brackets were only indexed for inflation in TY2015, so most taxpayers would gradually move to a higher bracket over time as nominal median household income rose about 40% from 1990 to 2020. So a \$20,000 taxable income single household in 1990 would be

⁵ McGuire, Therese J. (2014), "State Fiscal Policies and State Economic Growth," Jan. 8, Prepared for an OpenSky Policy Institute Tax Policy Presentation, https://www.openskypolicy.org/wp-content/uploads/2014/01/OpenSky_8Jan2014_McGuire.pdf.

equivalent to a \$32,000 taxable income single household in 2019, meaning their marginal rate fell from 4.4% to 3.34%. These changes across brackets occur far less frequently in the top two income categories, \$50,000 and over, for single households (married or head of households are double this amount).

Figure 1 Arizona K-12 Spending Compared to National Average and State Rankings



Source: U.S. Bureau of the Census

At the same time as Arizona was reducing personal income tax rates, it was also falling behind other states in its state investment in K-12 education. While Arizona's *local investment* was ranked 27th in 1992-1993, by 2018-2019 it was ranked 34th among the 50 states and the District of Columbia. By contrast, Arizona's *state investment* plummeted as shown in Figure 1 from being ranked 39th in 1992-1992 and nearly 80% of the national average per pupil to currently ranked 47th and less than 60% of the national average per pupil.

Prop. 301 starting in 2001 and other additional funding for K-12 education including the state briefly paying for all-day Kindergarten brought a slight resurgence as seen in 2006-2007, but cuts during the Great Recession that were not fully recovered pushed Arizona to its lowest point relative to others in education spending by 2012-2013. State-based K-12 funding modestly improved as a result of Prop. 123 settled an

education funding lawsuit in 2016 and Gov. Ducey's 20x2020 plan following the RedForEd movement in 2018 (only partly captured through FY2019). Yet, in spite of these recent investments, Arizona remains far below 80% of the national average for K-12 spending, where it previously ranked before it dramatically reduced state income taxes.

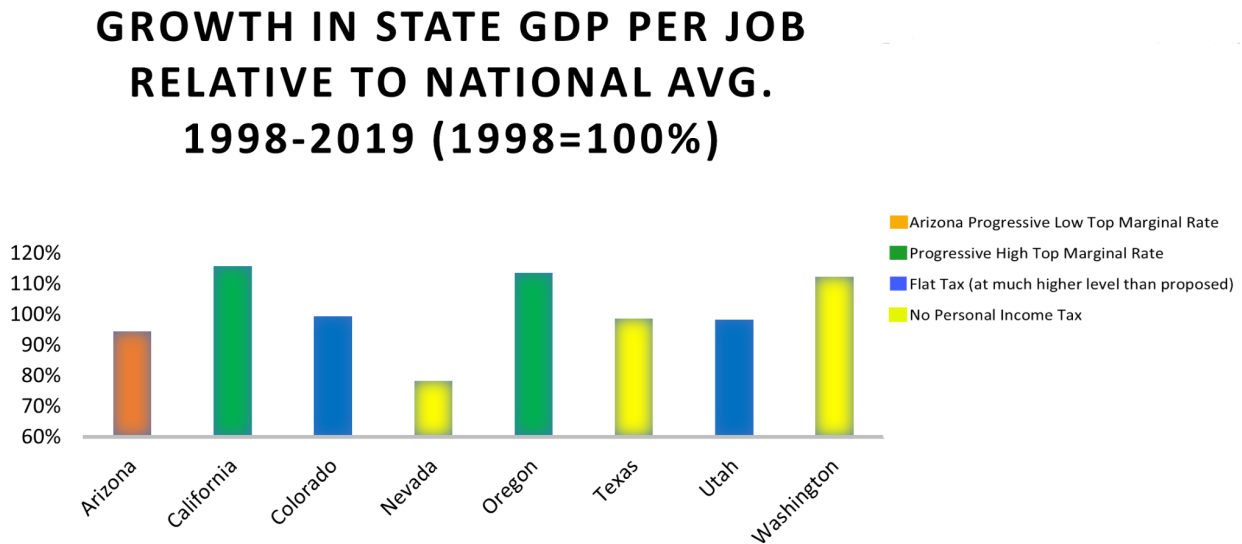
Arizona's Past Tax Cuts Failed to Improve Economic Productivity

Did the reduction in state personal income taxes impact the state's overall economic performance? For that we look at a state level productivity measure, state GDP divided by the number of jobs. If lower taxes resulted in investments that improved the overall productivity/value of the jobs produced in the state, then the measure should show positive growth. Since Arizona slashed income taxes more than most states this should have led to an overall improvement in the state's GDP divided by jobs compared to the national average. This analysis is similar to what the Office of the University Economist at Arizona State University published in January 2020, but has provided additional states to provide comparative context.⁶

Figure 2 calculates this for a number of Western states — all of whom have experienced population growth (though not recently for California). Some of these states have no personal income taxes (Nevada, Texas and Washington shown in yellow) and others have highly progressive state personal income tax structures (California and Oregon shown in green). Notably California and Oregon rank at the top for highest marginal tax rates with the top marginal rate in California rising from 9.3% in 1998 to 13.3% in 2019. Oregon's top marginal tax rate is 9.9% but kicks in at a relatively low income amount (taxable income of \$125,000 for single filers/\$250,000 for married ones). Certainly if there was empirical credence to the claimed devastating impact of Prop. 208's surcharge, California and Oregon would provide evidence. Some states have adopted a flat tax albeit at a higher rate than was recently proposed by Republican leadership and Gov. Ducey (Utah and Colorado shown in blue).

⁶ Hoffman, Dennis and Tom Rex (2020), "Declines Relative To The Nation In Arizona's Government Finance, Educational Attainment, And Economic Performance: A Report from the Office of the University Economist," W.P. Carey School of Business, January, [taxeducon01-20.pdf \(asu.edu\)](#)

Figure 2 Growth in State GDP Per Job Relative to National Average



Source: Bureau of Economic Analysis

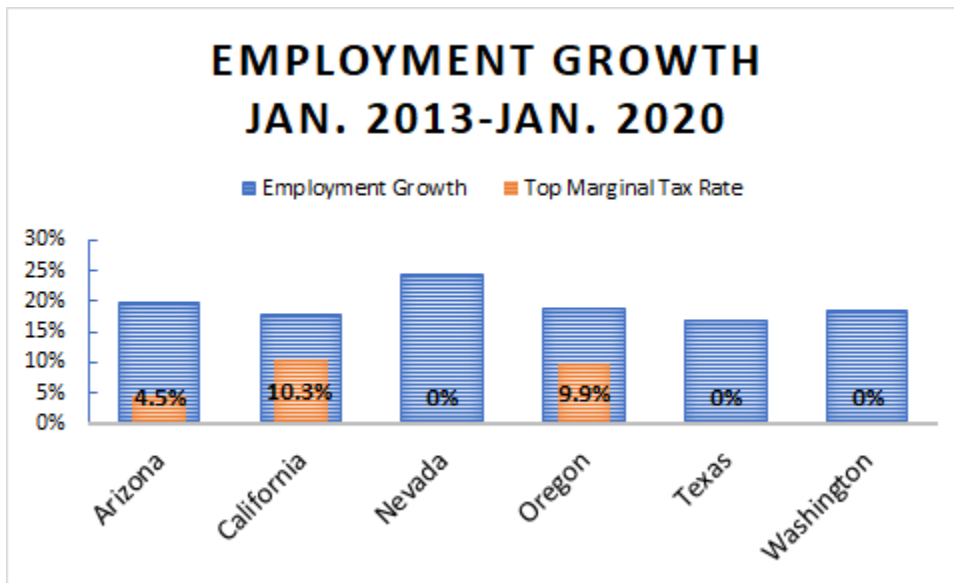
Figure 2 shows that a state's personal income tax policy does not clearly correlate with productivity improvement. The two states with progressive income and high margin rates comparatively on wealthy taxpayers (California and Oregon) along with one of the states with no income tax (Washington) increased their productivity per job by 12% to 16% above the national average. While Nevada, also a state with no personal income tax, dropped dramatically, growing at 78% of the national average. Colorado, Texas and Utah pretty much stayed even with the national growth rate. Colorado and Utah have flat tax rates--though at levels well above what has been proposed here. Texas, like Nevada and Washington state, has no personal income tax.

Arizona's experience with tax cuts provides no evidence to suggest that further reducing the personal income taxes of more wealthy households will improve the state's productivity per job compared to other states or the national average.

Arizona’s productivity fell relative to the national average during the time period, slowing to 95% of the national average — showing the second worst performance of these eight states in GDP per job growth. Consequently, Arizona’s experience with tax cuts provides no evidence to suggest that further reducing the personal income taxes of the more wealthy households will improve the state’s productivity per job compared to other states or the national average.

Proponents of Arizona’s economic growth often point to a weaker measure, employment growth. Employment growth does not capture the quality or productivity of jobs and may simply reflect population growth due to population migration due to Arizona’s sunshine and mild winters as opposed to underlying economic policies. Population migration creates economic demands that create jobs regardless of tax rates.

Figure 3 Employment Growth and Top Marginal Personal Income Tax Rates



Source: U.S. Bureau of Labor Statistics, Nonfarm employment based on industry monthly survey.

Looking at employment growth in Figure 3 from Jan. 2013 to Jan. 2020, the bulk of the recovery, the top states for job growth were Nevada and Arizona, followed by Oregon, California, Washington, and Texas (flat tax states with higher tax rates than the proposal

were omitted). Arizona and Nevada were also the two states hit hardest by the Great Recession, so their depth of job loss was greater which may have contributed to their subsequent greater gains. Oregon performs just a touch better than neighboring Washington, and California outperforms Texas, though that too could relate to the depth of the Great Recession in California compared to Texas.

The bottom line is that no clear pattern emerges that suggests that high top marginal personal income tax is inhibiting employment growth. Note that by 2020, the highest marginal tax rate in California was 13.3% for millionaires, though the rate that matched roughly where Oregon's 9.9% rate begins (\$125,000 for single filers/\$250,000 for married couples) was 10.3% as noted in the graph. These rates are impacting proportionately more filers than the Prop. 208 surcharge does in Arizona. Again suggesting claims of economic ruin are gross exaggerations.

Dynamic Effects Overstated and Lack Context

The Rounds Consulting Group has noted that the \$1.9 billion cost of the proposed “flat” tax combined with the added carve out for those impacted by Prop. 208's surcharge will have a minimum of a \$500 million growth effect compared to the \$1.9 billion cost of the overall tax cuts.⁷ The impact Rounds suggests could be as much as \$860 million. He, however, fails to say how long it would take for a dynamic effect of this size to take place. Given his prior analysis of Prop. 208 which he says followed a similar methodology, it is likely a 10-year effect, which is important given all the things that can occur over a decade and that a \$1.9 billion tax cut with a \$1.5 billion ongoing “surplus” makes the dynamic effect imperative to avoid significant budget cuts.⁸ Rounds, nonetheless, does not back the current GOP ‘flat’ tax package, but suggests it be scaled back to something less aggressive.

Rounds also suggests the state's priorities are off, though carefully couches this view when he says, “The proposed tax cuts will have a better chance of eventually breaking even, if the state continues to be aggressive **in other areas that build the economy**”

⁷ Rounds, Jim (2021), “Memorandum: State Income Tax and Budget Plan - Considerations and Suggestions,” June 5.

⁸ Again “surplus” as defined by the JLBC means ongoing expenditures against revenues--excludes one-time funding which often is not really one-time, areas that many argue are under funded and formulas that the legislature has chosen to not fully fund.

(emphasis added). Rounds then cites areas like university investments (he has also done analyses related to their projected impacts) and on an “opportunity weight” for at-risk children that GCI has emphasized in prior research.

But most critically, just because an input-output proprietary economic model can generate dynamic gains does not mean the projected results will come to fruition. While economic studies have **projected** that tax increases reduce economic growth, retrospective data demonstrate that **tax cuts have failed to generate a net positive benefit** when looking at different/more recent time periods.

Due to the aggregate nature of these studies and that tax policy really does not drive economic outcomes as much as policymakers often assume, there is no consensus among economists that cutting taxes for the wealthy is the best option for the economy—even if growth, regardless of who most benefits, is your only measure of success.⁹

One of the most recent studies has found diminished economic growth from a tax increase, but suggests that government expenditures such as in education would be more than twice as effective.¹⁰ See Table 2 below, which shows a dollar increase in taxes leads to a decline in 45 cents over two years in per capita personal income. However, a rise in operational spending by one dollar increases per capita income by over a dollar after six years producing a net positive benefit. Likewise an increase of a dollar in capital spending leads to a \$1.44 gain over three years. That is not to say this study is necessarily right—but the assumption that dramatically reducing marginal tax rates is the best policy seems dubious at best.

⁹ A good summary of the failure to replicate studies, small measured impacts, and contradictory outcomes is found here, Gale, William G, Aaron Krupkun, and Kim Ruben, (2015) , “The Relationship Between Taxes And Growth At The State Level: New Evidence,” National Tax Journal, December, Vol. 68, No. 4, <https://www.brookings.edu/wp-content/uploads/2016/06/Gale-Taxes-and-Growth-42915.pdf>.

¹⁰ Srithongrung, A., & Kriz, K. A. (2014). The Impact of Subnational Fiscal Policies on Economic Growth: A Dynamic Analysis Approach. Journal of Policy Analysis and Management, 33(4), 912-928, https://www.wichita.edu/academics/fairmount_college_of_liberal_arts_and_sciences/hugowall/documents/Research-Wichita-State-University-Hugo-Wall-School-Public-Affairs-Kansas-Public-Finance-Center_Impact-Subnational-Fiscal-Policies-Economic-Growth-Approach-Kenneth-Kriz-Arwiphawee-Srithongrung.pdf.

Table 2 Response of Per Capita Personal Income to Changing Variables

Table . Response of Per Capita Personal Income (\$ change) to a Dollar Change in Taxes, Operational Spending and Capital Spending as well as Other Non-Fiscal Variables (i.e., Private Stocks, Labor, and Lagged/Leaded Personal Income)

| Response of Per Capita Personal Income (i.e., Dollar Change in Real Per Capita Personal Income) to a Unit Change in the Model's Variables Listed Below | t | t+1 | t+2 | t+3 | t+4 | t+5 |
|--|----------|----------|----------|----------|----------|----------|
| \$1 Increase in Annual Personal Income (y) | 0 | -0.11** | -0.06** | 0 | 0 | 0 |
| \$1 Increase in Tax (τ) | -0.30** | -0.15** | 0 | 0 | 0 | 0 |
| \$1 Increase in Operational Spending (d) | 0.27** | 0.21** | 0.16** | 0.14** | 0.12** | 0.12** |
| \$1 Increase in Capital Spending (c) | 0.71** | 0.43** | 0.20** | 0 | 0 | 0 |
| \$1 Increase in Private Stock (k) | -0.03** | -0.03** | -0.02** | -0.02** | -0.02** | -0.02** |
| 1 Person Increase in Total Labor Force (L) | 0.0002** | 0.0002** | 0.0002** | 0.0002** | 0.0002** | 0.0001** |

Note: The number in each cell indicates responses of real per capita personal income in dollar value due to a dollar shock in the model variables listed in the first column at different periods ranging from year t-1 to year t+5. **indicates the point estimated response that does not include zero value in 95% confidence interval. The results reported in this table are scaled to be a dollar multiplier based on the original PVAR results in a form of response to one standard deviation shocks. The original results are reported in Table A2.1 of Appendix 2.

Source: Table 2, Srithongrungs, A., & Kriz, K. A. (2014) Journal of Policy Analysis and Management.

Note that targeted educational investments which increase the high school graduation rate by one percentage point and the college completion rate by one percentage point both likely have more significant economic returns than the \$1.9 billion tax cut proposal. Holtz-Eakin and Lee note:

- A 1 percentage-point increase in the growth rate of a state's population with bachelor's degrees is associated with about a 0.08 percentage-point increase in the state's real GDP growth rate; and
- A 1 percentage-point increase in the growth rate of a state's high school graduation rate is associated with about a 0.05-percentage point increase in the state's real GDP growth rate.¹¹

¹¹ Holtz-Eakin, Douglas and Tom Lee (2019), "The Economic Benefits of Educational Attainment", June 4 <https://www.americanactionforum.org/project/economic-benefits-educational-attainment/>

These targeted improvements in educational attainment result in economic growth that provide far more meaningful results than improving the economic standing of people living in Paradise Valley.

What About the Study Showing “Devastating” Impacts of Prop. 208?

Last year the Goldwater Institute put out a report co-authored by Jim Rounds claiming that Prop. 208 would result in¹²:

- 124,000 job losses by the 10th year of implementation (i.e., more than 10,000 lost per year).
- 90,000 filers impacted, more than half are small businesses.
- \$120 million lost in General Fund revenues annually due to diminished economic activity.
- No upside benefit to Prop. 208 to counter any of this, i.e., improved educational outcomes, economic benefit of increased income for school teachers and other staff.

The Grand Canyon Institute found the results grossly exaggerated, noting the following¹³:

- While their logic was explained, unlike GCI, their methodology was opaque.
- Only 30,000 filers impacted, half of whom receive some income from small business-and that income is generally not their main source of income.
- The job loss due to the tax portion of Prop. 208 are projected as one-tenth the amount.
- The gains from Prop. 208 reallocating funds to education were ignored.

Presumably by retaining a limit of 4.5% as the top marginal tax in the state all these impacts suggested by the Goldwater study would be prevented. The following provides more detail with regard to the issues that GCI finds with the Goldwater Institute’s anti-Prop 208 analysis.

¹² Beienburg, Matt and James Rounds (2020), “Good for Special Interests and Unions, Bad for Arizona: The Economic Impacts of Proposition 208,” Goldwater Institute, September 15, <https://goldwaterinstitute.org/prop208-bad-for-arizona/>.

¹³ Wells, Dave with Lillian Le (2020), “Impact of Prop. 208: Invest in Ed,” Grand Canyon Institute, Oct. 8, https://grandcanyoninstitute.org/wp-content/uploads/2020/10/GCI_Policy_Analysis_Prop_208_Invest_in_Ed_Oct_8-_2020.pdf.

GCI is always transparent with its methodology. That wasn't the case with the Goldwater study. Their analysis was done based on interviews with people with a vested personal or business interest in keeping taxes low as well as using one of the input-output proprietary models, which was not even named but was presumably REMI or IMPLAN.¹⁴

The input-output analysis means interactions occur within a black box and depend on the inputs. Since this study decided Prop. 208 provided no economic benefit it was as if the money was simply pulled from economic actors and burned. Rather, the initiative (just like the current tax proposal does in reverse) transfers funds from one set of economic actors and provides it to another. Within the input-output analysis are sets of assumptions about economic behavior that are not subject to scrutiny due to their black box proprietary nature.

In addition, GCI found the analysis exaggerated by three-fold the number of household filers impacted by Prop. 208; GCI found 30,000, not 90,000. As noted below half of those impacted households have small business income.

GCI estimates that approximately 10,000 Arizona jobs might be lost by the 10th year of implementation of the tax increase. This estimate of jobs lost is ONLY due to changes in the pass-through companies impacted and does not include the eventual likely economic growth due to the estimated impact on improved educational outcomes. So in other words, the Goldwater analysis in GCI's estimation overestimates job losses by more than 10-fold.

Keep in mind the Proposition and the legislative proposal focus on personal income tax rates. The personal income tax will impact individuals who own a business structured as a pass-through organization such as an S Corporation or Partnership. The individual business owner's income will be taxed after all business expenses are deducted and profit is "passed through" to the individual. An analysis of overall income suggests among these taxpayers that the pass-through income is about one-third of their taxable income, though in some cases it is higher.

¹⁴ AKRF, Inc. (2013), IMPLAN, RIMS-II, and REMI Economic Impact Models: Comparisons, in Context of EB-5 Analysis, May, [Microsoft PowerPoint - EB-5 model comparison_May 2013 \(ilw.com\)](#).

GCI estimates that up to 360,000 people in Arizona are employed at pass-through small business organizations whose owners will be impacted by Prop. 208. So in effect, Goldwater claims that one in six jobs with pass-through organizations will disappear and that a job multiplier of about two, doubles the impact over 10 years.

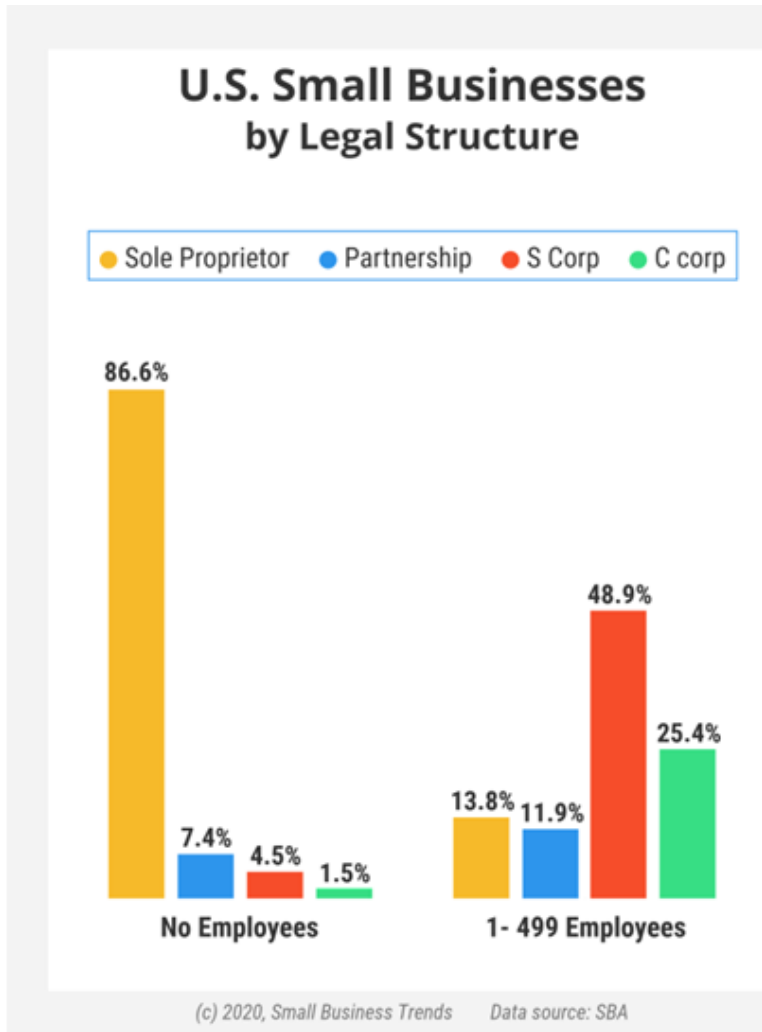
In fact, GCI estimates that 0.7% of the positions could be impacted over two years and 1.4% of them impacted over 10 years, leading to a loss of 5,000 positions over 10 years. If there was a job multiplier of two, as many as 10,000 positions may be impacted over the 10-year period. This is less than one-tenth of the estimate by the Goldwater Institute.

In a 2017 paper, Giroud and Rauh of Columbia and Stanford Business Schools, respectively, looked at how state taxation impacted business relocation.¹⁵ This analysis used the top marginal personal income tax rate as part of its analysis. The authors looked at all forms of corporate structures. For this analysis, GCI only examines the pass-through forms that are impacted by Prop. 208.

Giroud and Rauh only included pass-through S Corporations, Partnerships, and Sole Proprietorships that employed a minimum of 100 people AND had operations in multiple states. GCI's analysis looks at only S Corporations and Partnerships—since very few sole proprietorships employ anyone beyond the proprietor and that information is not readily discernible from IRS filings. However, GCI's analysis looks at a much wider range of S Corporations in terms of employment—and includes those that exist only in Arizona and may have significant obstacles to relocating, in addition to organizations that exist in multiple states. Consequently, by adopting Giroud and Rauh's findings, GCI is likely overstating the likely impact of Prop. 208. However, Giroud and Rauh provide the best academic study to apply to an analysis of Prop. 208 due to the quality and detail of their data sources as well as their wide scope.

¹⁵ Giroud, Xavier and Joshua Rauh (2017), "State Taxation and the Relocation of Business Activity: Evidence from Establishment-Level Data," December, published in *Journal of Political Economy*, <http://www.columbia.edu/~xg2285/Taxes.pdf>

Figure 4: Business size by number of employees



Arizona Small Businesses



Note that because C Corporations, which are most major employers, pay Corporate Income Tax they are not impacted by Prop. 208 and therefore not included in this analysis. Giroud and Rauh's test included C Corporations in their hypothesis and found no support that C Corporations were impacted by individual income tax rates.

However, S Corporations, Sole Proprietorships and Partnerships are "pass-through" organizations for whom net income shows up on individual income tax returns and would be subject to Prop. 208.

For pass-through entities, Giroud and Rauh find that a one percentage point increase in the top state personal tax rate decreases employment in pass-through organizations by 0.2%. In a 10-year analysis of the impact of a 1% increase in the top state personal tax rate, they found that employment decreases by 0.4%, though they caution that the analysis didn't adequately take into account other factors that might be relevant over 10 years. Prop. 208 raises the top marginal tax rate by 3.5 percentage points—so the effects are 0.7% and 1.4%, respectively.

GCI used IRS details from 2018 to estimate the number of business owners in Arizona. GCI used the Giroud and Rauh methodology to determine what portion in each income group will be subject to the initiative.

Small businesses as defined by the Small Business Administration employ under 500 employees. The average small business in Arizona employs 11 people and almost all small businesses employ less than 20 people as seen in Figure 4.

From this analysis, we can estimate the likely jobs impact over two years (0.2%) and 10 years (0.4%). Prop. 208 raises the top marginal tax rate by 3.5% and therefore would be expected to diminish employment 0.7% among small businesses in the first two years and 1.4% in the next 10 years.

Although Giroud and Rauh looked at firms operating in multiple states, GCI presumes the same tax elasticity of employment applies to impacted pass-through organizations in Arizona. As noted before this may upwardly bias GCI's impacts.

GCI ignores sole proprietorships as they frequently employ only the operator, but does include partnerships and S Corporations. Using a 2018 IRS analysis of Arizona returns, GCI identified the number of returns in tax brackets impacted by Prop. 208 that reported income from an S Corporation or Partnership. While the same S Corporation

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and Partnership could appear on multiple returns—if two different people operate the company, for instance—GCI presumes each represents a separate entity.¹⁶

Table 3: Impacted Pass-Through Businesses

| Adjusted Gross Income Range | Estimated Filers with Pass Throughs | Estimated Portion Subject to Initiative | Number Business Filers Impacted | 350 Basis Point Impact | Est. Employees Impacted | Employment Lost | |
|-----------------------------|-------------------------------------|---|---------------------------------|------------------------|-------------------------|-----------------|---------------------|
| \$200,000 to \$499,999 | 34,090 | 5% | 2,045 | 0.70% | 6,141 | 43 | |
| \$500,000 to \$999,999 | 9,910 | 82% | 8,145 | 0.70% | 74,333 | 520 | |
| \$1,000,000 or more | 6,060 | 100% | 6,060 | 0.70% | 280,281 | 1,962 | |
| | | TOTALS | 15,868 | | 361,488 | 2,517 | 2 years |
| | | | | | | 5,034 | 10 years |
| | | | | | | 10,069 | With Job Multiplier |

¹⁶ GCI therefore is likely slightly overstating the number of small businesses impacted, but as the profits are divided across returns, the total employment estimate and therefore jobs impacted should still be accurate.

GCI examined the distribution of small business employment available from the Small Business Administration for Arizona, including the portions that were likely C Corporations, and estimated the likely range covered by those with pass-through business income for each of three income classes that matched up with the IRS income range categories for income from S Corporations or Partnerships.¹⁷ In addition, GCI examined the average income from businesses based on 2019 earnings as calculated by the Urban-Brookings Tax Policy Center for those reporting business income. Business income is not typically the main source of income for these taxpayers. Their business income averaged \$50,000 for those in the \$250,000 to \$499,999 taxable income range, \$145,000 for those in the \$500,000 to \$999,999 income range and \$455,000 for those with \$1 million or more in income. This matches up well with the GCI estimated number of employees per business in each income range of 3, 9 and 46.

The Grand Canyon Institute (GCI) is dedicated to informing and improving public policy in Arizona through evidence-based, independent, objective, nonpartisan research. GCI makes a good faith effort to ensure that findings are reliable, accurate, and based on reputable sources.

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¹⁷ Internal Revenue Service, “SOI Tax Stats—Historic Table 2” Arizona Tax Year 2018, <https://www.irs.gov/statistics/soi-tax-stats-historic-table-2>. For business employment distributions Small Business Administration, “Firm Size Data,” <https://www.sba.gov/node/12162>, and for Distribution of legal structure and employment: Small Business Trends <https://smallbiztrends.com/small-business-statistics>.

AZ Budget Priorities:

Lower Income Taxes for the Well-Off—Economic Gold Rush or Fiscal Wreck?

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