



Assessing Arizona's State Tax Policy

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The State of Arizona has seen remarkable changes in its economy and demography over the past 10 years. Just from 2000 to 2007, its population increased from 5.2 million to 6.3 million. That makes it one of the fastest-growing states in the nation, continuing the trend of the 1990s when population growth was also quite rapid.

The state's economy has kept pace. Arizona's real per capita GDP averaged 2.4 percent growth from 1997 through 2006, much faster than the rest of the nation, which grew at 1.9 percent annually. This is all the more remarkable because Arizona's per capita GDP figures are skewed downward by the large fraction of new residents who are low-income immigrants.

The figures tell a powerful story: both labor and capital are flocking to Arizona. But why? True, the state's tax and regulatory policies are acceptable, but they certainly aren't stellar enough to be such a powerful magnet. New Hampshire's super-low tax levels steal economic development from its high-tax New England neighbors every day. That's not what's going on here, with the possible exception of a few California refugees who make a wrong turn on their way to Nevada.

There are myriad factors at play. One is weather. Like the rest of the South, Arizona is benefiting from people's desire to live in warmer climates. And where the desert was once daunting, technology has made it less so.

Another is the fact that along with the rest of the South and Southwest, Arizona had been below average in productivity. Areas that start off with low productivities tend to grow faster than other already high-productivity areas (Solow growth model).

Despite the fact that Arizona's economy has excelled over the past couple of decades, it has slowed recently, which is also putting a strain on state and local governments. So it is still worth looking at how the state could create a better mix of tax and spending policies.

The crucial questions when determining the optimal fiscal system in any region are: (1) identifying the public goods that government is in the best position to provide, (2) determining

what principle of taxation will be underpin public policy, i.e., ability to pay, benefit principle, etc., (3) given the answers to 1 and 2, how best to administer government policies including tax laws and spending programs, and finally (4) after weighing the costs and benefits of competing policies, deciding which should be implemented.

At the state and local levels, the answers to these questions can be drastically impacted by the decisions of other governments. While some states and localities may desire high government spending and higher taxes while others prefer low spending and low taxes, taxes and spending do not operate in isolation and must take each other's policies into account. Labor and capital flow across jurisdictional boundaries (including international), each seeking to maximize its own net return. This type of fiscal competition between entities can be both beneficial and harmful for society as a whole.

Arizona: Can It Improve Its Tax System?

This paper seeks to identify how Arizona's tax and spending policies could better accommodate the fact that some economic behavior is more sensitive to taxation than others. That is, can Arizona's tax laws fit better into the flows of the market economy?

The state levies a relatively high gross receipts type of tax (Transactions Privileges Tax) of 5.6 percent on some industries plus 2.2 percent at the local level, and the tax is unfortunately levied on many business-to-business transactions. This so-called tax pyramiding can cause distortions in both production and consumption, thereby lowering living standards compared to even a revenue-neutral system that properly taxed consumption.

To the extent that a company is unable to pass its tax payments on to consumers living in other states, the taxes it pays on business inputs and the resulting tax pyramiding decrease the economic well-being of Arizona's citizens. Either their wages are reduced, or the prices of goods and services they consume are forced up, or both. Furthermore, tax pyramiding slowly but inevitably leads to a greater fraction of investment in Arizona being sector-specific, the sectors whose organization exposes it to the least tax pyramiding.

A broad tax base, properly defined, should be the goal, but when the phrase "broaden the base" is deployed to spread the tax base to business-to-business transactions, think tanks, chambers of commerce, and all experts within state government should sound an alarm.

Arizona also has a relatively high corporate tax rate, which sits at 6.968 percent. While taxing corporations in line with the benefits they receive from government services (which flow to the shareholders through higher profits) may be ideal from a given point of view, the current level of taxation may be excessive. Furthermore, the corporate income tax's role of acting as a backstop for evasion of business income earned under a personal income tax could be served with a lower corporate rate.

So what would the benefits of a lower corporate income tax for Arizona residents be? That depends on the mobility of capital and labor in the state. Capital is highly mobile across states, but as we have seen in the case of Arizona, labor is also fairly mobile. To the extent that the high corporate income tax in Arizona forces investment to flow elsewhere, it results in lower wages

for Arizona workers. Therefore, lower taxes on corporate income in the state would be a way to boost wages for Arizona workers. However, if the labor is more mobile than capital, lower taxes on labor would be a more important priority for the state. Empirical evidence supports the argument that in the long run and between states, capital is more mobile than labor.

Arizona's income tax essentially uses federal taxable income as the income measure to which taxpayers apply the marginal income tax rate schedule. The tax rate schedule is slightly progressive with a top rate of 4.54 percent for 2008. The revenues collected from the state income tax are among the lowest in the nation. This is made possible by the state's moderate per capita spending and its high gross receipts tax, which brings in 27.5 percent of state and local general own-source revenue, far above the 16.6 percent national average for general sales and gross receipts taxes. This combination of taxes, including the availability of itemized deductions, which tend to benefit upper-income taxpayers most, makes Arizona's tax system one of the most regressive in the nation, although the desired level of progressivity is a question not addressed in this paper. Most public finance economists would agree that federal taxable income is far too narrow an income measure for income tax purposes. Arizona could improve its tax system by eliminating many itemized deductions and credits within its income tax and use that revenue to either lower its Transactions Privileges Tax or cut marginal income tax rates.

The economics of the statewide property tax that garnered attention earlier this spring is somewhat similar to the state's corporate income tax. Governor Napolitano cited state budgetary woes in vetoing a measure that would have eliminated the state's property tax.

Like the corporate income tax and the tax on capital gains and dividends, the state property tax is a tax on capital, but of a special kind. Its economic harm depends upon the extent to which capital in the state is fixed. If the tax only applied to existing capital, it would cause little economic damage, making the veto less problematic. However, given that the amount of capital investment in the state is far from fixed, Napolitano's veto will probably deter new investment in the state by lowering the net return to that investment.

One must keep in mind—and certainly the governor did—that the value of government services provided also affects investment. There is a tradeoff between higher taxes and lower government spending. Bemoaning the veto because investment will fall implicitly assumes that the foregone investment in Arizona is more valuable than the government spending that is funded by the continuing property tax revenue. That being said, most public finance economists argue that the property tax is a good tax for local governments, while at the state level, a better revenue source could be used.

Other Taxes

Other tax policies in Arizona could also be improved. The cigarette tax of \$2.00 per pack (4th highest in the nation) is egregiously high, and it has been increased in the past few years merely to raise revenue. It is rather cowardly for politicians to impose punitive taxes on a minority of individuals for the sole purposes of raising money for some spending program that benefits all of Arizona. The Tax Foundation tends to view good public finance through the lens of the benefit principle, and this is among the grossest violations of that principle of taxation. But even under

an alternative view of public finance (like ability to pay), excessive cigarette taxes are not justified.

At 19 cents per gallon, the state's gasoline tax is in the low-to-middle range of state gas taxes nationwide. Any reform of the gas tax should be in the context of transportation reform in the state, which would include the possibility of toll roads. Once again, the benefit principle is at the core of a properly administered gasoline tax. If all the revenue is being spent on popularly supported road construction and maintenance, and no overwhelming demands are being made for more roads, then the tax rate is probably at a reasonable level.

Conclusion

Arizona has seen remarkable economic and population growth over the past two decades. On top of the inevitable growth that most previously low-income states experience over time, acceptable tax rates and regulatory policies have also helped the state's economic performance. The best step that the state could take to improve its tax system is to make its sales tax look more like a proper general sales tax and less like a gross receipts tax, as well as to make its income tax look more like a good state income tax and less like the mess that is the federal tax code.