Ballot Proposition I-17-2018
Invest in Education Act
Fiscal Analysis

Estimated Impact

A.R.S. § 19-123E requires the Joint Legislative Budget Committee Staff to prepare a summary of 300 words or less on the fiscal impact of voter-initiated ballot measures. Beginning January 1, 2019, Proposition XXX would create 2 new income tax rates: 1) 8% for single taxpayers with $250,001 - $500,000 in taxable income and for married persons with $500,001 - $1,000,000 in taxable income, and 2) 9% for single taxpayers with $500,001 or more in taxable income and for married persons with $1,000,001 or more in taxable income.

The 2 new tax rates are projected to deposit $650 million to $750 million into the Classroom Site Fund in the first full year of implementation. These monies would be distributed to school districts and charter schools.

The actual deposit will depend on a variety of factors, including:

- Whether high-income taxpayers leave or shift income out of the state because of the new tax rates.
- Whether higher tax rates will reduce business investment. Some high-income taxpayers pay individual income taxes on the "pass through" income from their business.

Due to several factors, Proposition XXX may also result in a General Fund impact. While difficult to determine with certainty, the annual dollar impact could be a gain or loss in the tens of millions. Proposition XXX reinstates the individual income tax brackets for incomes up to $250,000 in effect in 2014. These brackets had been indexed for inflation since that time, which reduced tax liability. As a result, reinstating the 2014 brackets would increase General Fund revenue collections.

Increased K-12 education spending may result in higher General Fund income and sales tax collections. Any shift of income outside the state or decline in business investment may also reduce existing General Fund revenue collections.

Background

Currently, the state's top marginal individual income tax rate is 4.54%, which is projected to apply to incomes above $162,925 for single filers and married couples filing separately, and incomes above $325,848 for married persons or single persons who are a head of household in tax year (TY) 2019. Proposition XXX would create 2 additional tax rates and corresponding tax brackets *(See Table 1):*

- An 8.00% rate would apply to incomes between $250,001 and $500,000 for single filers and married couples filing separately and between $500,001 and $1,000,000 for married couples filing jointly and persons filing as head of household.
- A 9.00% rate would apply to incomes of $500,001 and above for singles and married couples filing separately and $1,000,001 and above for married couples filing jointly and persons filing as head of household.

Marginal income tax rates apply to each additional dollar earned between certain levels of income. For example, for a single tax filer with $300,000 in taxable income, the newly created 8.00% marginal tax rate would only apply to $50,000 of income between $250,000 and $300,000; the first $250,000 in taxable income would be taxed based on the lower 5 tax brackets and their respective tax rates.

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Table 1		
Proposed Tax Rate Changes		
	Current Law	**Proposed Law**
Single/Married Filing Separately		
$250,001 to $500,000	4.54%	8.00%
Over $500,001	4.54	9.00
Married Filing Jointly/Head of Household		
$500,001 to $1,000,000	4.54%	8.00%
Over $1,000,001	4.54	9.00

Income Tax Bracket Indexing

Under current state law, individual income tax brackets have been adjusted annually for inflation since TY 2015. Proposition XXX would reinstate all brackets to their TY 2014 levels, and would end future bracket inflation indexing. Because of this, most taxpayers would have a small portion of their income taxed in a higher bracket, resulting in a small tax increase on most taxpayers. For example, the 4.24% rate used to start at $100,000 of taxable income for married filers, but following inflation adjustments, it is projected to start at $108,617 in TY 2019. Under current law, taxable income between $100,000 and $108,617 would be taxed at 3.36% in TY 2019. Under Proposition XXX, this amount would again be taxed at 4.24%. *(See Table 2).* A married couple filing jointly with taxable income of $101,000 would pay approximately $34 more in income tax as a result of this change.

Table 2

Impact on Existing Tax Brackets for Married Couples Filing Jointly 1/

Current Law 2/	Proposition XXX	Rate
$0 - 21,726	$0 - 20,000	2.59%
21,727 - 54,310	$20,000 - 50,000	2.88
54,311 - 108,617	$50,000 - 100,000	3.36
108,618 - 325,848	$100,000 - 300,000	4.24
325,849 and over	$300,000 - 500,000	4.54

1/ Table represents brackets by taxable income but excludes new brackets created by Proposition XXX

2/ Reflects actual TY 2017 brackets adjusted for inflation to reflect TY 2019.

Classroom Site Fund

The Classroom Site Fund was established by Proposition 301 from the November 2000 General Election. It receives funding from the 0.6% education sales tax established by Proposition 301 and any K-12 state trust land revenues. Monies generated from these sources are currently distributed by the school districts and charter schools as follows:

- 40% for teacher compensation increases based on performance and employment related expenses.
- 20% for teacher base salary increases.
- 40% for maintenance and operations purposes, including: classroom size reduction, teacher compensation, assessment intervention programs, teacher development, dropout prevention, and teacher liability insurance premiums.

The monies generated by Proposition XXX would not be subject to the distribution requirements of other monies currently deposited into the Classroom Site Fund. Instead, 60% of the additional Proposition XXX revenue would be allocated to teacher and staff base pay raises (rather than having 40% set aside for performance-based raises) while the remaining 40% would be allocated to maintenance and operations purposes.

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Proposition XXX would also expand the definition of teacher to include any non-administrative personnel who teach students or support student academic achievement, a definition which includes (but is not limited to): nurses, counselors, social workers, psychologists, speech pathologists, librarians, and academic interventionists. Additionally, the proposition would expand eligible maintenance and operations expenditures to include student support services personnel compensation and full day kindergarten.

Analysis

To estimate the revenue impact of the proposal, the JLBC Staff relied on a Department of Revenue (DOR) model which estimates the overall and distributional impact of tax law changes. This model is based on TY 2014 tax return data, which DOR has adjusted for filer and income growth between TY 2014 and TY 2018. The DOR model estimate reflects a "static" analysis which does not incorporate any "dynamic" impacts resulting from broader economic changes related to the tax law revision.

The DOR model projected that $689 million would be generated for deposit into the Classroom Site Fund in the first full year of implementation. Because the proposed tax rates would become effective in TY 2019, the JLBC Staff adjusted the DOR estimate by an additional year of projected revenue growth, using a growth rate of 4.8%. After this adjustment, the Classroom Site Fund is projected to receive a deposit of $722 million in the first full year.

However, this estimate does not factor in any potential responses of economic behavior or the uncertainty of future economic conditions. Due to these factors, the JLBC Staff estimates that Proposition XXX would raise between $650 million and $750 million for the Classroom Site Fund in the first full year.

The following factors will affect the actual fiscal impact:

- Individual income tax revenue generated from high income tax payers is highly susceptible to changes in economic conditions. If taxable income for high earners were to grow at a higher rate than for taxpayers of all incomes, the revenues could be higher than under the adjusted DOR estimate. Conversely, if the economy were to enter a downturn, revenues could be lower than the adjusted DOR estimate.
- Proposition XXX would almost double the top marginal income tax rate. This could induce economic or behavioral responses that would impact the amount of revenue generated. The higher tax rates may induce some high-income taxpayers to move or shift income to other states, thereby reducing the projected revenue collections.

Proposition XXX may also affect the General Fund. The annual dollar impact could be a gain or loss in the tens of millions, and may be influenced by the following factors:

- The proposition reinstates the individual income tax brackets for incomes up to $250,000 in effect in TY 2014. These brackets had been indexed for inflation since that time, thereby reducing tax liability. As a result, reinstating the rates may generate a General Fund gain of up to $49 million in the first full year of implementation.
- Increased spending on teacher salaries and other educational expenses may provide a fiscal stimulus, which may lead to higher General Fund sales and income tax collections.
- If the higher tax rates shift income outside of the state or reduce business investment, existing General Fund income tax collections may be reduced (along with generating less revenue for the Classroom Site Fund).

Distributional Impacts and Economic Conditions

Table 3, below, shows the distributional impacts of Proposition XXX by adjusted gross income (AGI). This analysis is based on the estimate derived from the DOR model, and does not factor in any of the elements of uncertainty discussed above. Of the total revenue generated, an estimated 93.5% would come from Arizona residents, while the remaining 6.5% would come from non-resident filers. The DOR model does not provide information on the number of non-resident filers. Due to limitations with the model, DOR is unable to estimate the distributional

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impact by taxable income tax bracket. Taxable income is generally lower than adjusted gross income, because it factors in various deductions and adjustments. Filers' tax rates are determined by their taxable income, and not by adjusted gross income.

Table 3

Distributional Impacts of Proposal

Tax Filer Adjusted Gross Income [1/ 2/]	**Projected Number of Returns**	**Average Increase**	**Total Increase**	**% of Total Impact**
$0 to $200,000	2,728,559	$12	$32,337,074	4.2%
$200,001 to $500,000	99,110	212	21,032,796	2.7
$500,001 to $1,000,000	14,634	4,711	68,947,948	9.0
$1,000,001 to $5,000,000	5,981	45,409	271,572,384	35.2
Over $5,000,000	646	506,798	327,225,317	42.4
Non-Resident Filers [3/]	199,821	250	50,045,418	6.5
Total	**3,048,751**	**$252**	**$771,160,937** [4/]	**100.0%**

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1/ The DOR tax return model displays impact by income in terms of AGI rather than taxable income. Taxable income is typically lower than AGI.

2/ Does not differentiate between single, married, and other filing status.

3/ The DOR tax return model does not report a number of non-resident filers. This number was derived by the JLBC Staff from TY 2015 data and adjusted upward to reflect TY 2019.

4/ Represents $721,931,739 for the Classroom Site Fund and $49,229,198 for the General Fund as the result of reinstating TY 2014 tax brackets.

While the DOR model estimate only provides revenue impact data by AGI, DOR has separately provided information on the number of filers by taxable income for TY 2016. *Table 4* shows up to 22,198 tax filers would be affected by the new tax rates. This number is overstated, since it includes single filers and married couples filing separately with between $200,000 and $250,000 in taxable income, who would not be affected by the new marginal rate brackets.

Table 4

Filers by Taxable Income

	# of Filers
Single or Married Filing Separately	
$200,001 to $500,000 [1/]	7,144
$500,001 and Above	2,193
Total	9,337
Married or Head of Household	
$500,001 to $1,000,000	8,646
$1,000,001 and Above	4,215
Total	12,861
Total Filers	**22,198**

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1/ DOR cannot provide a breakout of single or married and filing separately filers with taxable income between $250,001 and $500,000. The number of filers in this income group thus exceeds the actual number that would be affected by the proposed 8.00% tax rate.

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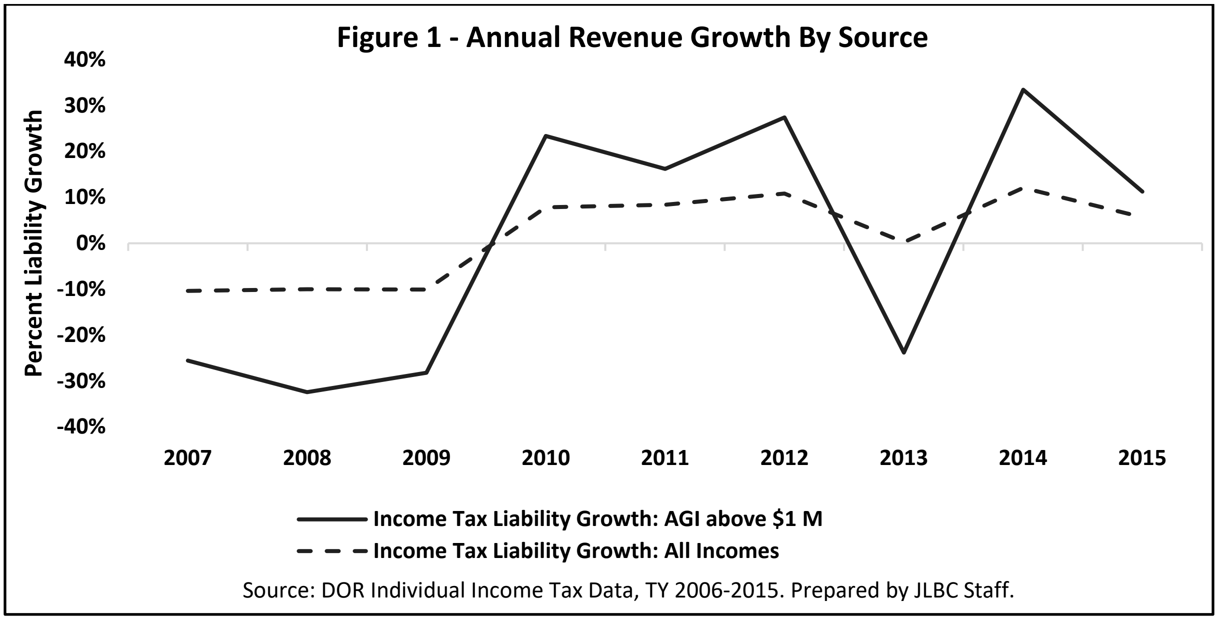
Because the vast majority of the revenue generated by Proposition XXX would come from high-income taxpayers, this revenue source could be more volatile than individual income taxes in general. For example, in TY 2007, total individual income tax liability decreased by (10)%, while the decrease for taxpayers with AGI above $1,000,000 was (26)%. Conversely, in TY 2014, overall individual income tax liability growth was 12%, while liability growth for taxpayers with AGI above $1,000,000 was 33%. *(See Figure 1).*



<u>Potential Economic Impacts</u>

The actual fiscal impact will depend on several potential economic factors which could result from Proposition XXX. Some of these potential factors include taxpayer migration, business behavior, and effects on wages and spending.

Taxpayer Migration

Proposition XXX would make Arizona's top income tax rate the fifth highest nationally. As a result, some high-income taxpayers may choose to shift their income or relocate to other states with lower rates. This could have 2 impacts:

1) The new rates on high income taxpayers may not generate as much as expected for deposit into the Classroom Site Fund.
2) General Fund revenue collections may be affected. For example, revenue raised on any income below the newly created tax brackets would continue to be deposited into the General Fund. If a taxpayer leaves, the General Fund would lose this revenue.

The magnitude of the taxpayer migration impact is difficult to determine. Academic studies on this topic have led researchers to varying conclusions.

One academic study by Varner and Young (2016) estimated that a 10% increase in the top marginal income tax rate corresponds to a 1% decrease in the millionaire population. Proposition XXX would increase the top tax rate by roughly 100%; thus, under the stated estimate, Arizona could lose 10% of its existing millionaire population. However, it is unclear if this estimate can be applied to the magnitude of the tax rate change in Arizona.

The same authors produced a separate study in 2011, which analyzed the results of New Jersey increasing its top marginal rate to 8.97% in 2004 (an increase of 2.6 percentage points). After adjusting for factors unrelated to the

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tax law changes, the study found that over the 3 years following the tax increase, New Jersey lost 70 millionaire tax filers and approximately $16.4 million in revenues as a direct result of the higher tax rate. However, another study of the 2004 New Jersey tax increase produced by the New Jersey Office of Revenue and Economic Analysis concluded that by 2009, the tax increase had resulted in a reduction of 20,000 taxpayers associated with a revenue loss of $125 million.

Estimates from these studies cannot be applied to Arizona's specific economic and policy environment with any degree of certainty. Furthermore, these studies were produced prior to the recent federal tax law changes, which, among other provisions, capped the deductibility of state and local taxes to $10,000. Because of this change, taxpayers may have a greater sensitivity to state tax rate changes, as they are no longer able to deduct the full amount of their state tax liability from their federal taxable income. These changes further complicate the projection of future taxpayer behavior.

While the proposed tax rate increases could induce some number of high-income taxpayers to leave the state, there could also be positive migration effects. For example, increases to teacher pay could draw additional teachers to the state, while increased funding for schools could result in other unknown migration effects.

Business Behavior

According to a report by the Brookings Institute, the majority of business income is taxed at the individual, rather than corporate tax rate nationally. These businesses, such as S Corporations, Limited Liability Companies, Sole Proprietorships, and Partnerships are often referred to as "pass through" businesses, since their owners pass through their business income to be taxed at the individual level. Some of the taxpayers impacted by Proposition XXX will derive at least a portion of their income through their business. According to Internal Revenue Service data, in TY 2015, 66% of Arizona tax filers with AGI above $500,000 derived a portion of their income from S-Corporations or Partnerships.

The majority of these businesses are relatively small. According to the report by the Brookings Institute, roughly 99% of pass through businesses have gross receipts of less than $10 million. However, a small number of businesses constitute the majority of pass through income. For example, the Brookings report identified 90% of partnership income accruing to businesses with over $10 million in gross receipts.

To the extent that the new tax rates are levied on pass through business profits, they will reduce the after-tax return on investment for these business owners. According to economic theory, this could reduce the incentive to re-invest profits. Reduced business investment may impact Arizona's economy, and as a result may reduce overall state and local tax collections to some degree. The magnitude of this impact is difficult to determine.

Following the tax increase, Arizona's top individual income tax rate would be 9%, compared to the 4.9% corporate income tax rate. Because of the disparity between these rates, there may be an incentive for some businesses to incorporate as corporations and instead pay the corporate income tax rate. If this shift were to occur, the proposition would generate less revenue than the DOR model run projection. While a tax advantage will exist for certain businesses, there may be other, non-policy reasons why businesses may not alter their business structure. For example, corporations face reporting and regulatory requirements that do not apply to other types of businesses. Additionally, businesses may already be more likely to alter their business structure based on federal, rather than state, tax laws. For example, the new TY 2018 federal corporate tax rate is 21% compared to the top federal marginal individual income tax rate of 37%

Effects on Wages and Spending

The tax increase initiated under Proposition XXX would directly lead to increased government spending on education, including teacher and staff salaries. To the extent that schools spend these funds on salaries and local products, this spending will create a direct economic impact. Salary increases would lead to increased individual

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income tax collections, while spending on goods and services would generate additional state and local TPT revenues. This effect would be partially offset by reduced spending on goods and services by high-income household's subject to the new tax rates, as these households would have reduced after-tax income. However, lower-income households tend to spend a greater percentage of their income, thus generating more sales tax revenues.

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