R E V I S E D

BILL # HB 2475

TITLE: ~~luxury tax; exemption; technical correction~~
NOW: taxes; corporate reduction; family credit

SPONSOR: May

STATUS: House Engrossed

REQUESTED BY: House

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	FISCAL YEAR		
	2001	**2002**	**2003**
REVENUES			
General Fund – Corporate Income Tax *	$-0-	$(19,100,000)	$(60,500,000)
– Individual Income Tax	-0-	(28,800,000)	(28,800,000)
General Fund – Total	$-0-	$(47,900,000)	$(89,300,000)

* The JLBC Staff estimates a fully annualized cost of $(177.8) million in FY 2006 related to the corporate income tax provisions. By comparison, after adjusting for previously enacted corporate income tax cuts that will begin in FY 2002, a Department of Revenue analysis assumes a fully annualized cost related to the same corporate income tax provisions of $(143.5) million beginning in FY 2007.

FISCAL ANALYSIS

Description

The bill would reduce the corporate income tax rate from the current 6.968% of net income to 6.5% in 2002, 6.0% in 2003, 5.5% in 2004, and to 5.04% in 2005.

In addition, the bill would raise the income threshold for individuals to qualify for the family income tax credit. However, the amount of the credit and the provision that it is non-refundable and available only for the tax year of the filing will not change under this bill. The amount of the increased threshold depends on filing status, number of dependents, and income level, as shown in the table below.

FAMILY INCOME TAX CREDIT

Number of Dependents	Current Income Threshold	Proposed Income Threshold
MARRIED FILING JOINT		
0 or 1	$20,000	$32,500
2	23,600	38,350
3	27,300	44,362
4 or more	31,000	50,375
HEAD OF HOUSEHOLD		
0 or 1	$20,000	$32,500
2	20,135	32,719
3	23,800	38,675
4	25,200	40,950
5 or more	26,575	43,184
SINGLE or MARRIED FILING SEPARATE		
0 or more	$10,000	$16,250

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Estimated Impact

Fiscal Note Revision
After the JLBC Staff issued the first fiscal note on this bill, the Department of Revenue (DOR) informed us that the higher income threshold for the tax credit would reduce revenues by $(7.7) million more than originally reported. The revised estimate was due to a misreading of the original data output from DOR's individual income tax model.

Corporate Income Tax
The JLBC Staff estimates the bill will reduce General Fund revenues by $(19.1) million in FY 2002, and by $(60.5) million in FY 2003. When fully implemented in FY 2006, the bill will reduce General Fund revenues by an estimated $(177.8) million.

The Department of Revenue (DOR) has also issued an analysis of this bill. The analysis includes a FY 2002 cost of $(52.6) million, and a FY 2003 cost of $(88.2) million, with a fully implemented cost of $(180.5) million occurring in FY 2007. Upon closer inspection, the DOR analysis indirectly includes the tax cuts related to Laws 1999, Chapter 5, 1st Special Session. This $(37.0) million in FY 2002 corporate income tax reductions are already accounted for in the current revenue forecast and should be omitted from any costs associated with this proposed legislation. After making an adjustment for these already counted tax cuts, the DOR analysis includes revenue reductions of $(15.6) million and $(51.2) million in FY 2002 and FY 2003, respectively. The full cost of the bill under the DOR analysis, or $(143.5) million after the above adjustment, will be realized in FY 2007. The DOR analysis, however, does not allow for future growth in corporate income tax collections and may understate the fully implemented cost of the bill.

This direct cost of a rate reduction will likely be partially offset in the long run by increased revenue collections associated with increased economic activity. A substantial rate reduction, all else being equal, will make Arizona more attractive for businesses and could stimulate new economic growth. This "dynamic" impact cannot be determined with certainty. However, there are some published studies on dynamic revenue forecasting that should provide some perspective on the topic.

The California Department of Finance has one of the few in-depth dynamic forecasting models. The California model assumes that after a tax cut is in place for a minimum of 5 years, each $1 in corporate income tax reductions is partially offset by 18 cents in higher tax revenue from greater economic growth.

Other studies offer the possibility of more aggressive dynamic returns to corporate income tax cuts, but these studies should be viewed with caution. For example, one study concludes that a move by the state of New York to modify its apportionment formula to include only a company's sales in the equation (this is a form of a corporate income tax rate reduction), would add 1% to personal income tax collections. If loosely translated into an Arizona dynamic impact, this would represent about a 40-50% dynamic return on the tax cut investment. In addition, a study offered by a local economist concludes that corporate income tax rate reductions, either through a direct tax rate reduction, or by modifications to the apportionment formula, more than pay for themselves in the long run.

It is unlikely that corporate income tax rate reductions have this much of a dynamic return. A number of western states have tax rates below that of Arizona, however, we have not experienced a mass exodus of local companies to these states. The tax rate in Colorado is 4.63%, Oregon is 6.6%, and Utah is 5.0%, as compared to Arizona's recently reduced 7% rate (before this past January, the Arizona rate was 8%). Most studies that look at what factors influence a company's relocation choice list the tax rate as a concern, but also include many other items like the availability of educated workers, transportation infrastructure, weather, and business cluster development. While most tax scholars agree that a tax rate reduction influences business development, the extent to which this business development actually occurs is inconclusive.

Individual Income Tax
The JLBC Staff has no means to independently estimate the fiscal impact of the provisions in the bill related to the family income tax credit. However, according to the revised DOR estimate, this bill would reduce the individual income tax liability by $(28.8) million in both FY 2002 and FY 2003. This amount should be compared with the original DOR estimate of $(21.1) million for the same period. The revised estimates are displayed in the above fiscal impact.

Assumptions

Corporate Income Tax
Under current law, the corporate income tax rate in FY 2002 will be about 7.0%. The bill would reduce the tax rate to 5.04% by the middle of FY 2005. This represents a tax cut of about 29.0% of corporate income tax collections. This would

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Assumptions (Continued)

represent the fully implemented cost of the tax cut in terms of a percent reduction. However, there are items that complicate this analysis.

First, it is difficult to predict with any certainty what corporate income tax collections will be over the next few years under current law. Since the cost of a tax reduction is calculated by comparing the amount of taxes that would be collected under current law with the amount of taxes that would be collected under the proposed law, this value is important. The corporate income tax is the most difficult tax category to forecast. Growth rates over the past few years have ranged from a high of 36.4% to a low of (12.6)%. This analysis uses the current JLBC Staff corporate income tax revenue forecast of $535.6 million in FY 2002 and $564.5 million in FY 2003. Currently there is no revenue forecast through FY 2005. To calculate the fully implemented cost of this bill, the FY 2003 collection amount is grown by 5% in FY 2004 and FY 2005.

In addition, the proposed series of tax cuts take place in the middle of each fiscal year. Again, for simplicity, we assume that the tax cut will have an immediate impact on tax collections in the year each tax cut will be enacted, and that there will be no delays in realizing any costs.

There is uncertainty to the extent that companies will immediately take advantage of the rate reduction. It is likely that companies will immediately adjust their estimated payments to coincide with any new tax rates. However, similar to individuals, companies must make payments each year to reconcile the past year's income activity. This means that collections in a particular fiscal year are partly influenced by activity in the prior fiscal year. Furthermore, many companies file for extensions, thus delaying their tax payments even further. Any delays in companies taking full advantage of the tax rate reduction would reduce the cost to the state in the short run. However, in the long run the timing issue is irrelevant.

To calculate the annual cost of this bill, the above forecast amounts are simply applied to the proposed percent rate reduction, also accounting for part-year implementation of the tax cut. The bill is estimated to reduce General Fund revenues by $(19.1) million in FY 2002, $(60.5) million in FY 2003, and by $(177.8) million when fully implemented in FY 2006.

As noted above, the cost estimates included in this analysis do not include any potential positive dynamic benefit associated with a rate reduction on corporations, although a partial offsetting positive impact is likely. See Estimated Impact section for examples.

Individual Income Tax
The family tax credit is currently $40 per family member for a maximum amount of $240 for married filing joint returns and for head of household filers. The corresponding credit limit for married filing separate returns and for single filers is $120. (Note that this bill would change the income threshold for the credit, but not the amount that can be claimed.) Because the family tax credit can only be used to offset tax liability in the tax year for which an individual files, the difference between available and actual credits can be significant. For example, in tax year 1999, DOR reported that an estimated $(29.3) million of family tax credits were claimed, but only $(7.7) million were used to offset actual tax liabilities.

DOR estimates that the higher income thresholds under this bill will result in lost tax revenues of $(28.8) million in both FY 2002 and FY 2003. This estimate is derived from DOR's individual income tax simulation model. The data in the model, which is from tax year 1996, is extrapolated to represent tax year 2000 and to reflect the filing population in tax year 2001. We do not have a means to independently estimate the impact associated with this portion of the bill.

Local Government Impact

Each year local governments receive an amount equal to 15.0% of income tax collections from two years prior. The reductions in income tax collections would result in a reduction in local government distributions in FY 2004 and later.

Amendments

The House Ways and Means Committee adopted a strike-everything amendment to the original bill. This fiscal analysis is based on this amendment.

4/18/01