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A New Tax Plan for a New Economy: How Eliminating the Income Tax Can Create Jobs

Stephen Slivinski, Senior Economist of the Goldwater Institute

EXECUTIVE SUMMARY

Policymakers in states across the country are searching for solutions to unemployment and a faltering economy. The answers, though, are simple and within reach. Legislators looking for a bold economic growth strategy should seriously consider the benefits of unshackling state economies from the income tax—a tax that penalizes workers, creates double taxation, and inhibits investment. A new tax structure can be revenue neutral while spurring economic growth. This combination is possible because the type of taxes a state imposes matter. By taxing wages, income taxes penalize work and dissuade investment and job growth. By contrast, a system of sales taxes encourages work and investment, eliminates tax loopholes, and reduces politicization of the tax code. Those changes help to spur economic growth and job creation. Properly implemented, this strategy should accomplish the following:

- Eliminate personal and corporate income taxes by broadening the sales tax base to include all final goods and services.
- Set the top state sales tax between 4.6 percent and 5.6 percent. Allow local governments to levy sales tax rates only on the state base.
- Enact a constitutional amendment forbidding state and local government from reinstating an income tax in the future.

Arizona policymakers should set their sights on big ideas that move the state into a new era of economic growth. Only by moving Arizona away from penalizing income and investment through the tax code can policymakers hope to bring Arizona into that new era. Eliminating income taxes as we know them is arguably the only policy proposal bold enough to dramatically boost new economic growth and drive widespread job creation. Revenue-neutral tax reform that eliminates the income tax could add one percentage point to the baseline private sector employment growth rate—an increase that amounts to more than 20,000 new jobs in the first year. The faster policymakers can fundamentally reform the state's tax system, the quicker we will reap the economic benefits.

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Introduction

Tax policy has a major influence on how fast an economy grows, how much investment a state attracts and cultivates, and the composition of a state's industrial base. Much of the competition between states and nations for the investment that creates long-term employment growth and prosperity is played on the field of tax policy.

Policymakers often try to spur job creation through incentive programs or tweaks to the current tax code. They usually try to anticipate new growth industries and favor them with special tax advantages. Other times, politically favored industries are the beneficiaries of a targeted tax break. In either case, to pay for the special treatment, taxes are kept high on those who do not receive the benefit.[1] In any case, there is substantial empirical evidence that such cherry picking of industries is not a driver of economic growth.[2]

Arizona is struggling to recover from a recession that has seen the loss of roughly 300,000 jobs since 2006. The historic magnitude of the loss requires a policy response that is itself historic and up to the task of creating large upswings in personal income and employment growth.

Arizona is struggling to recover from a recession that has seen the loss of nearly 300,000 jobs between 2006 and 2010. The historic magnitude of the loss requires a policy response that is itself historic and up to the task of creating large upswings in personal income and employment growth—in essence, a rising tide that can lift everyone in Arizona. Eliminating the state personal and corporate income tax and replacing it with a broad-based sales tax would be the kind of reform aggressive enough to do exactly that. If the reform was revenue neutral, the reform could add one percentage point to the state's baseline private sector employment growth rate. That's about 20,000 new jobs in the first year alone. If the tax reform also resulted in a net tax cut, that number would be even bigger. In any case, the substantial job growth that can be generated by tax reform—even one that is revenue neutral and raises just as much income as the current system—shows that the current tax system is currently dampening the job-creation potential of the state. There is a way to change this. This paper outlines one such reform as well as the principles on which any tax reform should be based.

Comparison of Arizona's Tax System to Those of Other States in the Region

Arizona's state tax system is composed primarily of the state transaction privilege tax (i.e., the sales tax), the personal income tax, and the corporate income tax. The sales tax accounts for an average of around 45 percent of state revenue, whereas the personal and corporate income tax combined account for another 44 percent. The rest of the revenue stream is composed of license and fee revenue, motor vehicle registration, and lottery revenue, among other revenue sources. In

contrast, other states in the region, such as Texas and Nevada, have a revenue stream composed almost entirely (i.e., in excess of 75 percent) of sales tax revenue.

In terms of tax burdens, Arizona tends to be in the center of the pack, normally ranking between 20th and 30th nationally, in which first place is the highest tax burden in the nation. As seen in the regional comparison in table 1, Arizona was below the national average for state and local tax burdens in the last year of the economic boom—2007—when the tax burden was measured as a percentage of per capita personal income. Although Arizona is competitive when compared to California and Utah, other states in the region, such as Texas and Nevada, have substantially lower tax burdens.

Table 1. State and Local Tax Burden as a Percentage of Per Capita Personal Income, 2007

State	Percentage
California	10.8
Utah	10.0
National	9.8
Arizona	9.3
New Mexico	9.1
Colorado	8.6
Texas	7.6
Nevada	7.4

Source: Tax Foundation.

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Simply looking at the level of taxation, however, doesn't tell the full story. How the tax system extracts revenue is important. As we will see, certain types of taxes—particularly income taxes—can adversely affect the growth rate of an economy. The types of taxes levied can also determine how prone a state government is to the boom-and-bust cycle of excessive government spending during the boom periods and large deficits during the downturns.

All revenue streams are not created equal. Some swing more wildly during economic booms and recessions than others. These wild swings have consequences for how government grows from year to year. Revenue systems that spike far beyond the growth of the state economy (as measured by personal income) during the boom periods also tend to dive dramatically below the growth rate of the economy during the recessionary periods. Those swings accompany large increases in spending during the boom periods and large deficits during the recession periods.

This volatility is important for another reason. A tax system that collects revenue at a clip faster than the growth of the economy also inhibits that economic

growth because it is usually a sign that the tax system punishes economic success by progressively higher rates on higher income levels. Income taxes, by their nature, tend to be highly volatile for that reason. In short, a government that gets riches faster than its residents signals that the government is unnecessarily burdening its economy.

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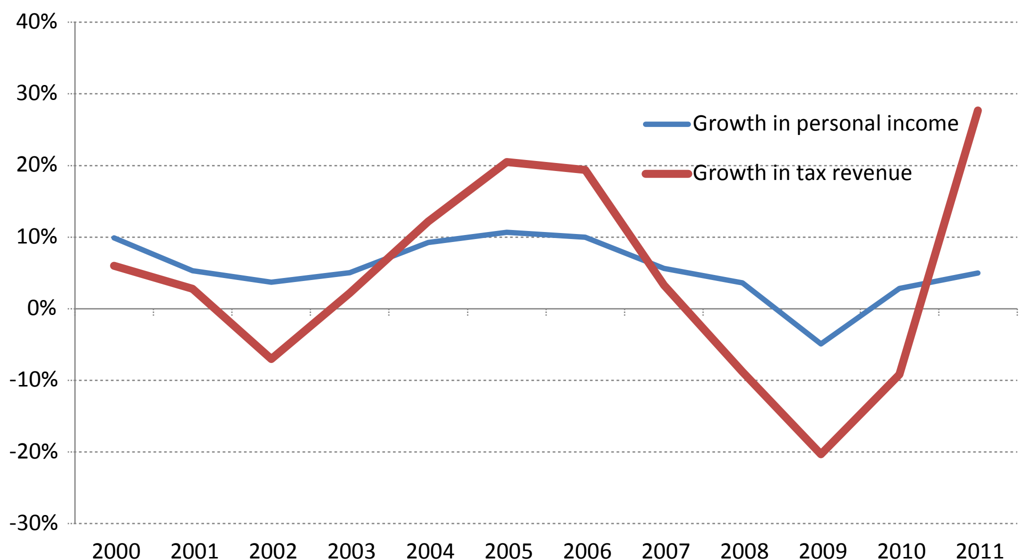
Arizona's overall general-fund revenue tax collections do exhibit a fair amount of volatility. As illustrated in figure 1, the growth rate of tax revenue rose substantially above the growth rate of personal income during the last business cycle. In fact, during the height of the boom, state government tax revenue grew twice as fast (20 percent) as personal income growth (10 percent). This boom in revenue, however, was followed by the recession that made the revenue growth rate dip substantially below the rate of personal income growth. Arizona's revenue system certainly has a tendency to reach higher rates of revenue growth—which translate to marginally less private sector income growth—that are unsustainable and result in a bigger fiscal cliff to fall from when the economy slows.

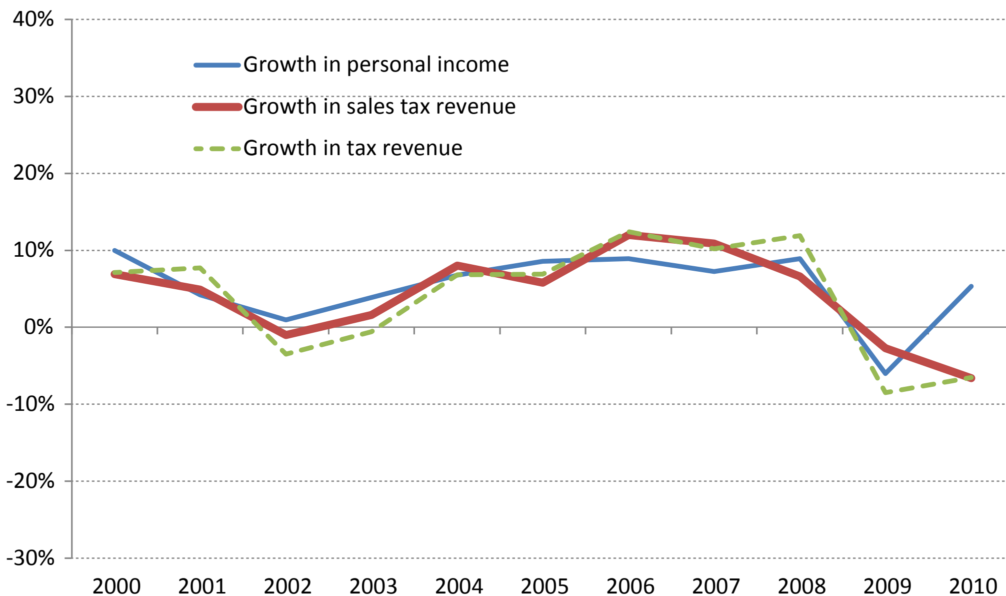
Figure 1. Arizona Tax Revenue and State Personal Income, 2000–11



Source: Author's calculations based on data from the Arizona Joint Legislative Budget Committee and the U.S. Bureau of Economic Analysis.

By way of comparison, figure 2 shows that the Texas tax system—which is based mainly on a sales tax—is less variable and extracts revenue from the economy at a rate that roughly matches the rate of economic growth. Even the high-water mark for revenue growth is only 3 percentage points higher than personal income growth. Additionally, the range of volatility is smaller than Arizona's. Whereas Arizona can range from a high of 20 percent growth and a low of negative 20 percent growth, Texas exhibits a range of no more than 12 percent growth and a low of around negative 8.5 percent.

Figure 2. Texas Tax Revenue and Personal Income Growth, 2000–10



Source: Author's calculations based on data from the Texas Comptroller's office and the U.S. Bureau of Economic Analysis

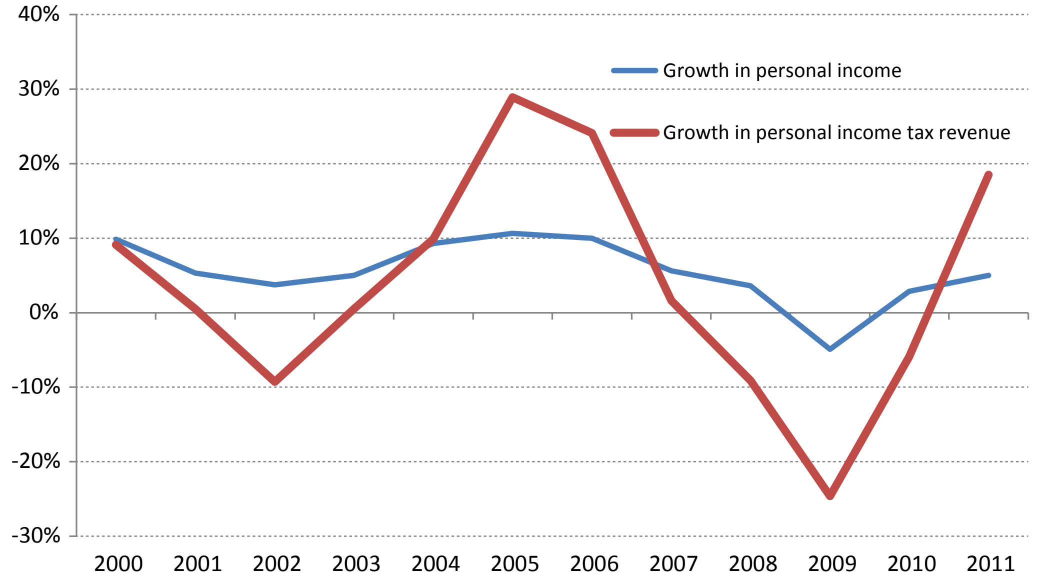
Among the many drawbacks to taxing income, one of the most visible is that it is more volatile than sales taxes.

The Problem with Income Taxes

In many states, including Arizona, the state government taxes both corporate income and personal income. As noted previously, in Arizona the personal and corporate income tax account for about 44 percent of all general-fund revenue. (The personal income tax generates most of that: 36 percent.) The sales tax generates about 44 percent. So two forms of economically inefficient taxation are needed to equal the revenue generated by the current sales tax. Yet there are costs to income taxes, both visible and invisible.

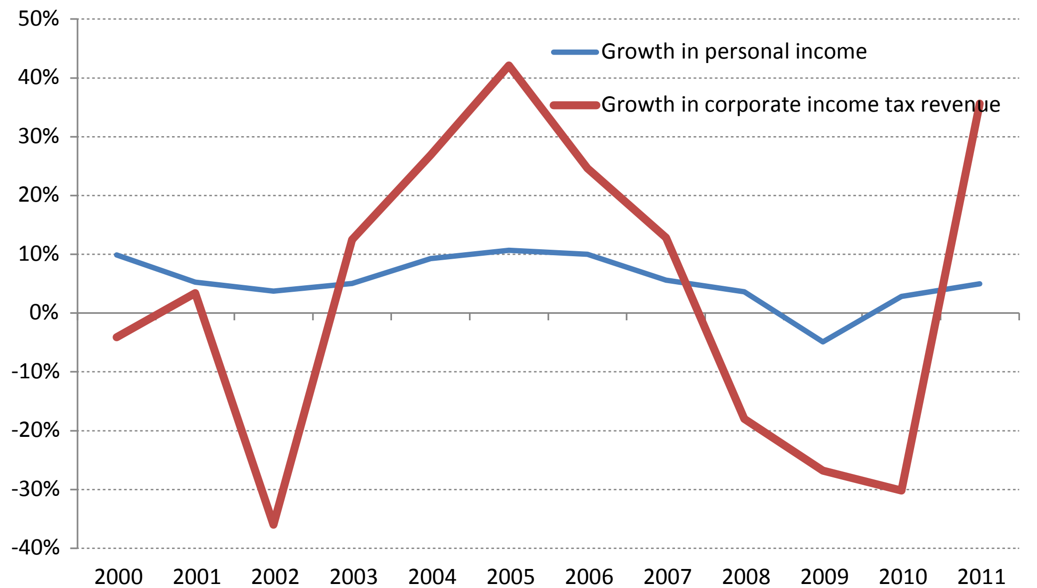
Among the many drawbacks to taxing income, one of the most visible is that it is more volatile than sales taxes. In figures 3 and 4, notice the wide swing in the high and low growth rates for both the personal and the corporate income tax when compared to personal income growth. These trends indicate that the Arizona state income tax—far from not collecting enough revenue as some may claim—succeeds in collecting revenue faster than the economic activity on which it is drawing from grows. In addition, the fiscal "cliffs" that are created in the economic downturns are all the more severe because of the relative volatility of these revenue sources across the span of the business cycle. These swings are worse in states that have high marginal personal income tax rates that penalize people as they rise higher in the income distribution.

Figure 3. Arizona Personal Income Tax Revenue and Personal Income Growth, 2000–11



Source: Author's calculations based on data from the Arizona Joint Legislative Budget Committee and the U.S. Bureau of Economic Analysis.

Figure 4. Arizona Corporate Income Tax Revenue and Personal Income Growth, 2000–11



Source: Author's calculations based on data from the Arizona Joint Legislative Budget Committee and the U.S. Bureau of Economic Analysis.

Corporate income taxes are particularly prone to swings because corporations can change their accounting structures, reincorporate their subsidiaries, and move income or capital assets (such as patents) to other states for the purposes of avoiding high income taxes. Such moves can explain some of the revenue volatility we tend to see in states that levy corporate income taxes.

Defining income is also a problem in the personal and corporate income tax systems. Again, this issue is particularly thorny in corporate income tax systems. One of the problems comes with how the tax code treats capital investments, such as machines that manufacture final use goods. Every year, businesses are able to write off a portion—but not all—of such investments. However, the schedule by which they are able to do so can fail to reflect the real economic value of the machine. This lack of symmetry can cause all sorts of economic distortions and adversely influence the decisions of business owners seeking to expand their operations and re-invest their profits.

Additionally, corporate income taxes ideally allow businesses to deduct many of the costs of doing business. Once costs are deducted, the remaining number on the balance sheet is the business's profits, and that is what the corporate income tax is supposed to be applied to. However, if a business is not able to accurately represent its costs of doing business—and the depreciation schedule of capital goods often causes such a problem—then a corporate income tax can penalize a business, particularly one in a very competitive industry in which businesses must change their cost structures and business models quickly to stay competitive.

Perhaps the biggest problem with income taxes is that they penalize investment and saving, the building blocks of sustainable economic growth.

Arizona does a somewhat poor job in allowing businesses to deduct costs of doing businesses. The federal tax code, for instance, allows a "bonus depreciation" of up to 50 percent of the cost of the purchase of a capital asset in the first year for a number of investments. Arizona, however, doesn't allow businesses to make such a deduction. The state legislature passed and the governor signed a 10 percent bonus depreciation statute during the 2012 legislative session. Although helpful, the statute is a far cry from what is needed to make Arizona's corporate income tax competitive in this regard, especially when many states already allow the more generous tax write-off allowed by the federal government.

Perhaps the biggest problem with income taxes, though, is that they penalize investment and saving, the building blocks of sustainable economic growth. To see why, consider the following example: Assume you earned $1,000. You could either buy a flat-screen television or invest the money. But first, federal and state income taxes kick in and take a percentage of it. With the remainder, you could still buy the television set, although you might have to buy a smaller one. If you invested the money, you'd have to take into account that any return the investment generated would also be taxed. In addition, the corporation you work for or that

you invest in would also be taxed on its income—an income stream that you helped create with your investment. So the investment return you were hoping for would be taxed at least twice before it even reached you, not to mention the fact that your employer also had to pay taxes on the income from which your salary was paid, which was also taxable to you when you earned it. After all that, you'd probably just buy the television set.

Income taxes don't just open the door to multiple levels of taxation of each dollar of economic growth. They are also not neutral with respect to all economic decisions. Even an income tax system that existed without any extraneous credits and deductions would still discriminate against saving and investing because of its application to all forms of income. By lowering the after-tax return on an investment relative to the return on consumption, the income tax system biases the economy in favor of consumption. In other words, income taxes stack the deck against the most important elements of a vibrant economy: savings and investment.

This concern isn't just theoretical. Plenty of empirical evidence shows that taxes on capital—particularly the corporate income tax—actually depress the wages of workers. The investment forgone because of those taxes decreases overall economic growth and productivity and, as a result, leads to lower pay for workers.[3]

Income taxes, by their nature, tax work effort. If you're faced with a higher tax rate in the next tax bracket, you will face a penalty for earning more.

Income taxes, by their nature, tax work effort. If you're faced with a higher tax rate in the next tax bracket, which is the case in a progressive income tax system such as the federal and Arizona personal income taxes, you will face a penalty for earning more. And even if you remain in the same tax bracket, you may still reduce the number of hours you work or bargain with your employer to provide nontaxable benefits for that work. In either case, your productivity and the compensation for that productivity will be affected in a way that hinders both your income level and the economy's growth.

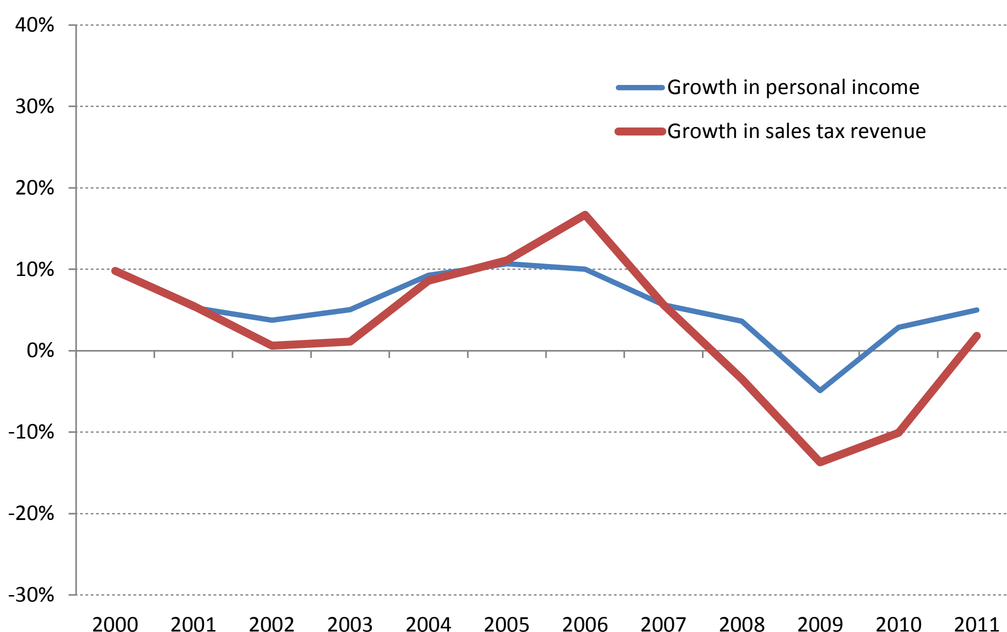
Finally, the income tax is traditionally seen as an integral part of a "three-legged stool"—which also includes the sales tax and property tax—on which a stable state and local revenue system must be based. But, as we've seen, relying too heavily on income taxes set Arizona up for revenue volatility during the last economic cycle. There are also economic costs to this three-legged-stool approach. As economist Arthur Laffer has estimated, states that do not levy either a sales tax or an income tax have higher rates of growth in state gross domestic product, state personal income, and employment growth than do states that levy sales, income, and property taxes.[4] In fact, states with no income tax or sales tax have an average rate of monthly employment growth that is almost twice as high as that of states that levy taxes using this three–legged-stool logic.

Arizona's Sales Tax System

To further understand how Arizona's tax system performs, we need to take a look at the sales tax—or, to be technically accurate, the "transactions privilege tax." Because it accounts for the largest share (44 percent) of the state's general-fund tax revenue, the sales tax can be considered the tax most important in funding general government services.

As figure 5 illustrates, the volatility of the state's sales tax, as noted in the previous section, is rather low—meaning it tracks personal income growth better than the income tax, as we'll see later. Yet it's not as closely tied to personal income growth as the Texas sales tax is.

Figure 5. Arizona Sales Tax Revenue and Personal Income Growth, 2000–11



Source: Author's calculations based on data from the Arizona Joint Legislative Budget Committee and the U.S. Bureau of Economic Analysis.

The volatility of the state's sales tax is rather low—meaning it tracks personal income growth better than the income tax.

As seen in table 2, the sales tax rate for Arizona is currently 6.6 percent. (A temporary one-cent increase is scheduled to lapse in 2013.) That puts the state's sales tax rate above most states in the region but below that of California. Also included in table 2 are the rates for the states with which compete and have no income tax and rely largely on sales taxes for much of their revenue – Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming. Even by this standard, Arizona currently has a relatively high sales tax rate. If the sales tax rate falls back to 5.6 percent as it is supposed to in 2013, Arizona will have one of the lower sales rates in the region, and the rate will put Arizona below five of the seven states in this chart that do not have an income tax.

Table 2. State Sales Tax Rates

State	Percent
California	7.25
Tennessee	7.00
Nevada	6.85
Arizona	6.60
Washington	6.50
Texas	6.25
Florida	6.00
Utah	5.95
New Mexico	5.13
South Dakota	4.00
Wyoming	4.00
Colorado	2.90

Source: Federation of Tax Administrators

The sales tax rate for Arizona is currently 6.6 percent. That puts the state's sales tax rate above most states in the region but below that of California.

The rate is only half—or even less than half—of the full story. Much of the difference between states is in their sales tax base—the goods and services to which the rate applies. States that have a "narrow" sales tax base—meaning they tax a smaller list of goods—need to have a higher sales tax rate to generate the amount of revenue that an average or low sales tax rate applied to a less narrow base would generate.

Sales tax bases have a number of common features. The main one is that most sales tax systems do not tax food. Of the states in table 2, the exceptions are Tennessee, which taxes food at a rate of 5.5 percent (less than its normal state rate of 7 percent), and South Dakota.

The big differences in the tax bases come in the number of services that are taxed by the sales tax. Every few years, the Federation of Tax Administrators (FTA) compiles a list of the services that are taxed in each state and groups them by category. This list allows comparisons of sales tax bases between states and helps determine which states have narrower tax bases.

Table 3 lists the number of services (out of a total of 168 in the FTA master list) that each state taxes. It indicates that Arizona has a tax base that is less narrow than Colorado, Nevada, and California. The base, however, is narrower than that of any of the other states in the table. States that do not have income taxes (with the exception of Nevada) tend to tax a broader number of services than Arizona does. (Nevada is an anomaly because much of its sales tax revenue comes from a particular set of taxed services paid for primarily by tourists. Hence, Nevada can get away with a narrower tax base in a way that most other states cannot.)

Table 3. Number of Services Taxed by the State Sales Tax

States	Services
Colorado	15
Nevada	18
California	21
Arizona	55
Utah	58
Wyoming	58
Florida	63
Tennessee	67
Texas	83
South Dakota	146
Washington	158
New Mexico	158

Source: Federation of Tax Administrators

Note that the states without an income tax that also have the broadest sales tax bases are South Dakota and Washington. New Mexico has a very broad sales tax base and a lower sales tax rate, but it also has an income tax. Washington taxes many services through its "business and occupations tax," which is functionally a business-based sales tax. Finally, it's worth noting that Florida and Texas have broader sales tax bases than Arizona, and yet their sales tax rates are not much higher than Arizona's will be when Arizona returns to the 5.6 percent tax rate.

States that do not have income taxes (with the exception of Nevada) tend to tax a broader number of services than Arizona does.

Contrasting Arizona and states without an income tax—particularly Texas, Washington, South Dakota, and Wyoming—yields some useful comparisons, especially for services taxed. Table 4 outlines those differences by category.

Table 4. Taxable Services by Category

Services	States				
	Arizona	*Texas*	*South Dakota*	*Washington*	*Wyoming*
Agricultural services	1	2	4	5	0
Industrial and mining services	2	2	4	4	0
Construction	4	3	4	4	0
Utilities	12	12	14	16	10
Transportation	5	3	5	7	3
Storage	6	2	6	6	0
Finance, insurance, and real estate	0	2	7	8	0
Personal services	2	10	19	20	6
Business services	7	14	28	33	6
Computer services	0	8	8	8	2
Automotive services	1	1	5	5	4
Admissions and amusements	9	12	13	13	6
Professional services	0	1	5	9	0
Leases	3	1	4	4	4
Fabrication, repair, and installation	2	10	18	16	16
Miscellaneous	1	0	2	0	1
Total number of taxable services	55	83	146	158	58

Source: Federation of Tax Administrators

States on the western side of the country that do not have income taxes tend to tax more services than Arizona does—in particular, personal services, business services, and repair services. Each of the other states is able to maintain a sales tax rate of 6.5 percent or lower while avoiding the need to institute an income tax. Personal services usually include salon and cleaning services, for example. Business services include design, copy, or car services. Taxation of professional services—legal, engineering, and accounting services, for instance—tends to be more controversial; thus, such services are not frequently taxed. Nevertheless, they are indeed taxed in South Dakota and Washington. In the latter state, however, they are taxed at a lower rate (1.5 percent) than other services.

Wyoming is the only state besides Arizona in this comparison that has a relatively narrow sales tax base. It is, however, a unique state: close to 40 percent of its revenue comes from severance taxes on mineral, gas, and oil extraction, roughly equal to the amount the state raises in the sales tax.[5] Unlike Texas, which generates less than 2 percent of its revenue from comparable severance taxes, Wyoming can operate with such a narrow sales tax base and the absence of an income tax.[6]

The picture that emerges when comparing state sales tax bases and the rates that are assessed on them indicates that tax policy textbooks are generally correct:

states can raise sufficient revenue to finance state government without an income tax if the base is broad enough and it includes services. A potential problem with taxing some professional and business services, however, is "tax pyramiding." As explained later, tax pyramiding occurs when services that go into the creation of taxable final use consumer goods are themselves taxed. Tax pyramiding is thus a form of double taxation. So any movement to broaden the sales tax base—as this paper will argue—needs to address this problem in some way.

Finally, it's also important to note that the sales tax in Arizona is different from the sales tax in Texas and Florida, for instance. The sales tax base in Arizona differs from city to city. Something that is not taxable in one jurisdiction may indeed be taxable in another. This lack of a unified tax base leads not only to confusion for shoppers, but also to increased complexity and compliance costs for businesses. A business that operates in multiple jurisdictions not only has to keep track of each sales tax base and changes to those bases, but also can be subject to multiple audits—by the state and each local government—for the same set of transactions or the same fiscal year. Thus, to make the state at least as competitive as other states—with or without an income tax—it is vital that all jurisdictions within Arizona operate under a unified sales tax base. If the state decides something should or should not be taxed, the local government should be required to abide by that decision too. The only thing that should be allowed to vary is the local sales tax rate that can be assessed in addition to the state rate.

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States without Incomes Taxes Lead in Economic Growth

An important reason to consider eliminating state income taxes is the empirical evidence that states without an income tax see substantially stronger economic growth than the national average and the growth of states with income taxes.

It's possible that these desirable economic outcomes are the result not of the tax structure in those states but something else, perhaps some natural advantages and attributes the states possess. But plenty of empirical evidence suggests that, even after adjusting for a number of different attributes of each state, tax policy matters greatly.

For example, Barry Poulson and Jules Gordon Kaplan, professors at the University of Colorado, Boulder, analyzed how state tax policies affect state economies. They first adjusted for each state's underlying characteristics such as a regional advantage or whether a state is playing "catch up" with other, more inherently prosperous states. As it turns out, the existence of a state income tax had a significant negative effect on gross state product growth.[7]

More evidence comes from the work of Thomas Dye and Richard Feiock of Florida State University. They looked at nine states that adopted income taxes between 1967 and 1992 and compared the growth rate in personal income before and after the enactment of the tax. The growth rate was indeed significantly and negatively affected in most of those states.[8]

What's Wrong with Arizona's Tax System?

Arizona has seen some strong economic growth over the past two decades. In some respects, Arizona's growth rate in certain sectors and by certain measures compares favorably with those of states such as Texas that don't have an income tax. The boom in housing and construction, for example, boosted employment and personal income growth to levels that were historically high for Arizona. That growth, however, has proved to be unsustainable, whereas growth in states without income taxes continues apace. The recent recession from which Arizona is still recovering has shown that the state's economy needs to undergo some big structural changes to compete with other states and countries in the decades ahead. The composition of Arizona's economy is in large part a direct reflection of the tax system we have. Therefore, the best way to unleash the sustainable and vibrant economic growth that will carry Arizona into the future requires some institutional changes. Fundamentally changing the tax system is one of the most important structural changes that can be made.

The recent recession from which Arizona is still recovering has shown that the state's economy needs to undergo some big structural changes to compete with other states and countries in the decades ahead.

To understand the full scope of the problems with Arizona's tax system generally, it is important to illustrate how Arizona's tax system saps the state's economic potential:

1. *It penalizes wealth creation, employment growth, and economic vibrancy.* In 2010, Arizona took $3.4 billion from the private economy through personal and business income taxes.[9] In addition, the current income tax system assesses a levy on income regardless of whether it is re-invested in the economy or whether it is consumed. As a result, it also creates multiple levels of taxation: the production process is taxed, the wages are taxed, and the final good is taxed.

2. *It discriminates against some companies and taxpayers.* Two taxpayers with similar attributes should not have to pay different tax rates depending on whether they undertake a certain type of government-encouraged activity. The current income tax system, with its myriad tax credits and exemptions, encourages investment in some industrial sectors but not others. The current sales tax base is also not broad enough to avoid favoring one type of economic activity over another. In addition to being discriminatory, these narrowly defined tax bases create political pressure to keep the tax rates higher than they might otherwise need to be to maintain a steady stream of revenue.

3. *The current tax system creates an uncompetitive business environment.* The Tax Foundation, a nonpartisan tax research group based in Washington, D.C., publishes an annual comparative analysis of business tax climates in the states.[10] Instead of measuring the tax burden (where Arizona usually ranks in the middle of all states), this index ranks states on the basis of how they tax workers and capital, using criteria such as the unity of the tax base (in other words, whether it discriminates against certain types of investments) and tax rates. In the most recent edition of that report, Arizona ranks 27th. By comparison, competitor states rank far higher: Nevada is 3rd, Utah is 10th, Texas is 9th, and Colorado is 16th. (The only neighbors that Arizona beats are California, which languishes at 48th, and New Mexico at 38th.) What's worse, however, is that Arizona has actually fallen six places in the ranks since the 2010 edition (which reflects policy actions in 2009), when the state ranked closer to the middle at 28th place. So for Arizona to be competitive, state policymakers need to look beyond simply lowering the tax burden; they need to be conscious of how best to create employment opportunities and economic growth through fundamental structural reform of the tax system.

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Solution: Replace the Current System with a Broad-Based Sales Tax

Income taxes are inherently biased against economic growth because they dissuade entrepreneurs from investing in new businesses, equipment, innovations, and jobs. The lack of an income tax is one of the primary institutional advantages Texas has in terms of its competitiveness with other states and its ability to generate such strong economic growth.[11] Replacing income taxes with a single-rate consumption tax in Arizona could also enhance economic growth and job creation by removing the penalty paid when people invest and earn money. To be fair and revenue neutral, an Arizona sales tax should embody the following attributes:

1. *It should have a broad and unified base.* A sales tax should be broad so as to facilitate the lowest tax rate possible. Yet, perhaps more important, a broad base can also be more economically efficient by being nondiscriminatory; businesses would be free to meet customers' wants and needs instead of being subject to political whims. To decrease complexity, the base should also be unified over the entire state. Cities or counties should not be able to craft their own tax base.
2. *It should not raise more revenue than current taxes.* At the very least, any tax reform should be revenue neutral. Of course, any tax reform the legislature undertakes could be constructed as a net tax cut, and the

spending discipline that would require should be encouraged. The most important point is that policymakers should be careful to avoid tax reform that results in a tax increase, which would increase the burden on Arizona's economy and taxpayers and would reduce the beneficial effects of the tax reform. Making sure that the sales tax rate that applies to the newly broadened base does not raise more revenue than the old system is important.[12]

3. *It should not double-tax goods.* Although as many goods and services as possible should be included in the tax base, it should not include most business inputs and wholesale transactions. Their inclusion would create a form of discrimination in the tax code. As University of Michigan economists Joel Slemrod and Jon Bakija note, "If businesses pay sales taxes on their inputs and then again when they sell their outputs, a problem of 'cascading' develops. Goods that require more intermediate steps in production and distribution end up being taxed more heavily."[13] Slemrod and Bakija further explain that this cascading "distorts incentives in the economy, leading to inefficient changes in the types of goods that get produced and consumed, and the way businesses are organized."[14] This situation would also violate the axiom of nondiscrimination as outlined earlier. And because the taxes would be folded into the price of the good, it would be difficult for consumers to know how much of what they were paying for the good was the result of taxation. The tax would be less visible too. The solution is to tax goods and services only at the point of sale to the final user and to avoid taxing wholesale transactions and business inputs. The tax can be handled much the same way that wholesale sales are taxed today in Arizona.[15] Businesses could apply for a business identification number from the Arizona Department of Revenue and transactions between two firms holding such identification numbers would be assumed to be usual business input transactions.

The lack of an income tax is one of the primary institutional advantages Texas has in terms of its competitiveness with other states and its ability to generate such strong economic growth.

With these attributes in mind, here is what such a tax reform for Arizona could look like:

- *Eliminate the personal and corporate income tax in exchange for lowering the sales tax rate while also broadening the sales tax base.* If necessary, this reform can be accomplished over five years in which a broadening of the sales tax base can occur in the first year in exchange for a "buy down" of the income tax rates today (as explained in the "Getting There from Here" section below). This step can be done in revenue-neutral fashion.[16] Any plan—either a one-year transition to a sales tax or a multiyear phase-in—requires broadening the sales tax to as many final use goods and services as possible, including food, and setting the tax rate at the lowest possible level in one of the following ways:

- *The 4.6 percent option.* This option assumes that all revenue sharing with cities and counties is terminated. In exchange, localities will have full control over their tax rates but will be required to raise all their revenue. To ease the sales tax burden on poor families, the state could enact some form of rebate. (For more details on revenue sharing and the rebate options, see the following sections.)
- *The 5.6 percent option.* This option keeps current levels of revenue sharing intact and the usual statutory sales tax rate intact. Rebates may still be issued to the poor to reimburse them for the increased tax cost on certain items.

The tax rates quoted above include the 0.6 percent education sales tax (Proposition 301). Bear in mind that the broader base will bring in much more revenue with the 0.6 percent rate than the old sales tax base did. (For example, in fiscal 2010, the tax generated $514 million. On the broadened base proposed here, the same rate would generate more than $900 million.) As a result, this proposal assumes that the legislature would require as part of the overall tax reform that the Arizona Joint Legislative Budget Committee be responsible for calculating annually the amount of money that the tax would have generated if applied to the base that was in existence at the time of Proposition 301's passage. That estimate will dictate what revenue will be apportioned by the proposition's formula.

A 5.6 percent sales tax rate would keep current levels of revenue sharing intact and the usual statutory sales tax rate intact.

Any change to the Proposition 301 system that people are used to now would likely spark a legal challenge. However, the legislature should be able to credibly argue that the reform does not violate the intent and spirit of the original proposition and it holds harmless the entities that currently receive Proposition 301 funding.

Also note that these rates are subject to assumptions and estimates about the taxable base and the revenue target that needs to be met. If any of the underlying fundamentals change, the rates will need to change. (See the appendix for a description of the calculation on which these estimates are based.) Instead of committing to a particular rate, the legislature could instead stipulate a cap on the rate that will become active once the new tax system is in place but leave the determination of the final rate to a rate-setting committee that would meet in the year before enactment. In any case, the rates quoted here could serve as a proposed cap. Any total tax rate cap, however, should keep the sales tax rate at a regionally competitive level. Eliminating the income tax and keeping the rate under 6 percent will make Arizona much more competitive with states that have income taxes, such as New Mexico and California, and will even allow Arizona to compete directly with Texas, which has no income tax.

- *The sales tax should not apply to business inputs.* Exempting business inputs—primarily wholesale transactions, legal services, and accounting services, for example—would eliminate the hidden double taxation described previously and is an important element in facilitating economic growth.[17] As noted previously, the reform options outlined here assume that the state could expand the system currently in use for exempting wholesale purchases intended for resale. Business input transactions can be declared as exempt when the company remits sales tax receipts to the state. This system would more effectively and more efficiently exempt business inputs from sales tax liability than the current system of broad categorical exclusions does.[18]

- *Mandate that localities conform to the new broad sales tax base.* The economic advantage that comes with having a broad base would be reduced if localities were able to create their own exemptions in the sales tax base. Thus, the state legislature should require that the base remain consistent across the entire state. This requirement would also decrease the number of audits to which businesses would be subject and would decrease costs of compliance by businesses engaged in taxable transactions. In return, localities would retain the ability to set their own sales tax rate on the entire base of taxable transactions. Depending on whether the legislature decided to maintain the current system of revenue sharing, the legislature may also decide to cap the maximum tax rate that localities may levy.

Legislators need to decide whether the income tax–based revenue sharing system—enacted in the early 1970s—is worth salvaging.

- *Enact a constitutional amendment forbidding state and local governments from reinstating an income tax.* One of the advantages of eliminating income taxes is the beneficial long-term business climate that the reform creates. That benefit could be neutralized if there were a threat of a new income tax, either at the state or local level, being piled on top of the new broad-based sales tax. As such, tax reform of the sort proposed here should be coupled with a ballot referendum asking voters to amend the constitution to include a prohibition on any sort of Arizona income tax.

Impact of Income Tax Reform on Revenue Sharing

Currently, a portion of both state income tax and sales tax revenue is shared with cities and counties. Eliminating the income tax would terminate some of that earmarked revenue. Therefore, legislators need to decide whether the income tax–based revenue sharing system—enacted in the early 1970s—is worth salvaging.

They should also consider whether the sharing of sales tax revenue should be continued.

A system in which localities rely even in part on revenue from the state is very inefficient and antithetical to principles of good government. The current system shields local officials from political accountability because they do not have to cover their spending with money raised directly from their taxpayers. They are instead able to hide the cost of local government by taxing citizens through the general statewide sales or income tax. This situation encourages overspending. When taxpayers don't know exactly how much of each transaction is taxed for the purposes of city or local government spending, city and county officials can expand the city budget without much protest from taxpayers. Any tax reform should encourage the visibility of taxation, and ending revenue sharing would be a vital step toward that end.

The claim that eliminating revenue sharing would irreparably hurt localities rings hollow. The proposed sales tax reform would not preclude local governments from determining what tax rate they want to assess on the new sales tax base. All things being equal, a broadened sales tax base with no changes in local tax rates would automatically lead to higher sales tax revenue to cities, thereby helping to replace shared revenue. At that point, local policymakers and taxpayers would need to decide whether current local government spending levels could be cut or whether taxes should be raised. Over time, local governments would be forced to be more efficient.

Any tax reform should encourage the visibility of taxation, and ending revenue sharing would be a vital step toward that end.

However, if the legislature chose to keep the current revenue sharing system intact, policymakers could choose the revenue-neutral rate of 5.6 percent. This rate would ensure that current revenue from the income tax portion of the revenue sharing pie was replaced and that the sales tax sharing could continue. Yet legislators should also keep in mind that retaining revenue sharing would require keeping the state sales tax rate about one percentage point higher than it would be otherwise. Doing so would reduce the economic boost from having a lower sales tax rate merely for the sake of keeping in place an inefficient revenue sharing system that discourages local government accountability.

Tax Reform, the Poor, and Seniors

A common argument against a sales tax is that it hurts the poor because they spend a larger share of their income on consumption, especially of food and medicine, than do people above the poverty line. Food is currently exempt from the Arizona sales tax because of this perceived regressivity.

Yet the food exemption in the current sales tax is an imperfect way to make the sales tax progressive. The exemption not only shields the necessities of poor families from taxation; it also shields the luxuries of rich families, such as caviar and filet mignon, from taxation.

A better way to shield poor families from any burden of a sales tax, if the legislature wishes to do so, is to issue cash rebates to poor families to reimburse those most in need. Based on data from the U.S. Bureau of Labor Statistics, a married Arizona couple with $30,000 in gross income would pay an average of roughly $290 in sales tax on food and services that would now be taxed under the proposed plan each year at a sales tax of 5.6 percent.[19] By way of comparison, an Arizona couple in this income group pays an average of $110 in state income taxes each year.[20] In this specific comparison, broadening the base of the sales tax and eliminating the income tax could result in a net tax increase of around $178, or roughly $15 a month.

A system of sales taxes instead of income taxes would be better for the poor in the long term because it would create economic growth and greater job opportunities.

Currently, the state tries to mitigate increased tax costs on the poor at least in part through an income tax "family credit" as well as a tax credit created to help offset the increased tax burden from the 0.6 percentage point increase in the sales tax because of Proposition 301. Those with federal adjusted gross income of $10,000 or less, for instance, can receive a family credit in the amount of $40 per person in the family, with a cap of $240 for married couples, or $120 for a single parent. The Proposition 301 credit is capped at $25 per person. The legislature could combine amounts allocated to those tax credits and turn them into a rebate to compensate for the new taxes on food and services if it so wished. A family of four, for instance, could receive a rebate of at least $260 by mirroring the policies currently in place. If these payments were turned into rebates instead of income tax credits, these could be sufficient to offset the average change in tax burden for low-income family under this plan.

Even a small amount of the economic growth unleashed by eliminating the income tax could generate sufficient revenues to allow the legislature to re-route this amount or slightly more to rebates for the poorest families in Arizona, such as those on cash assistance already. (Indeed, the allocation of Proposition 301 revenue already funds the income tax credit created to help mitigate the 0.6 percent add-on tax rate. That revenue might go to funding rebates in the case of the termination of the income tax.) The rebates could take the form of checks sent to these families on the basis of their federal adjusted gross income as reported on their federal income tax forms or an increase in the balances of the electronic debit cards that those on state assistance use to purchase food.[21]

On the whole, a system of sales taxes instead of income taxes would be better for the poor in the long term because it would create economic growth and greater job opportunities. The employment growth that would occur in the wake of such

a reform would increase upward economic mobility and income growth. That increase would vastly outstrip the modest increase in tax cost that exists when looking at a static, one-year snapshot. People who are poor today would not be as poor tomorrow under this tax reform.

Another concern frequently expressed is that senior citizens who are retired often live on fixed incomes that come either from pensions or from saving and investing over their working life. Senior citizens have already paid income taxes over the course of their lifetime and, as seniors, are able to take advantage of exemptions on some types of pension income specified in the income tax code as well as take advantage of age-based income tax deductions and property tax abatements. If sales taxes were extended to goods that are not currently taxed, some argue that doing so would force seniors to pay taxes on goods and services with dollars that have already been taxed, thereby creating a form of double taxation.

Such an issue would be encountered by any state trying to transition from an income tax system to one based on consumption. Yet providing more subsidies to seniors is not the best answer. The current income tax system provides substantial subsidies to seniors in the form of special income tax deductions. The property tax system provides property tax abatements for eligible Arizona seniors. This latter subsidy will persist even if the income tax is eliminated.

People who are poor today would not be as poor tomorrow under this tax reform.

The income tax subsidies, of course, would cease under the proposal outlined in this study. But if seniors were in a low-income household and the legislature had decided to reimburse those below a certain income level for a portion of the sales tax burden, then these seniors could claim these rebates in the same way as other taxpayers. Data from the Arizona Department of Revenue suggest that just over 40 percent of tax filers who took advantage of the "aged 65 and older" tax deduction had below $30,000 in gross income.[22] This finding suggests that a sizable number of seniors—about 25 percent of all seniors in the state—in this gross income range would receive the same sort of rebate. Additionally, seniors who currently have a net positive tax liability—perhaps from income derived from pension plans based in another state, which is fully taxable, or from capital gains and dividends—are likely to receive a net tax cut with elimination of the income tax. Their increased sales tax bill, which may equal an average of $600 to $700, would in most cases be smaller than the income tax bill they already face.[23]

Finally, it's also important that all taxpayers understand the nature of the shift in the sales tax base to goods and services that are currently not touched by the sales tax today. Broadening the sales tax base in exchange for eliminating the income tax does not mean that many goods that were once "untaxed" are now taxed. The truth is that they were simply taxed in a different, less visible, and more economically inefficient way before. The prices of goods and, particularly, services that all Arizonans purchase today are higher than they would otherwise be as a

result of current income taxes on the seller or producer of the good. Eliminating the income tax would also eliminate the need to keep prices higher to cover the cost of paying the income tax. Presumably, therefore, the price of all goods and services—and the price of selling those goods—would certainly go down. Job growth would also rise as a result of the income tax burden being lifted for all. All of these factors need to be considered when discussing how the tax reform might affect the tax bill of any specific Arizonan.

Getting There from Here

The quicker a proposal of this sort is enacted, the stronger the economic boost the state will receive. However, there are valid reasons for favoring a phase-in of such a tax reform plan. Policymakers might desire some time to plan such a change in the tax system. Businesses may need time to plan and change their accounting and pricing practices.

The quicker a proposal of this sort is enacted, the stronger the economic boost the state will receive.

The first step of a phase-in of this plan could be to "buy down" all income tax rates with an expansion of the sales tax base in the first year. Then, in each subsequent year, the income tax rate would be lowered until it reaches zero. An income rate phase-down was the approach that was proposed in 2012 by Mary Fallin, the governor of Oklahoma, for her state.[24]

The expansion of the sales tax base, as defined in this paper, could generate enough revenue to reduce all personal income tax rates to a single 2.6 percent rate and also to lower the corporate income tax rate to the same level to avoid economic distortions that would result from having some businesses taxed at a higher rate than others. Such a change would basically put all income tax filers in what is now the bottom income tax bracket. All current exemptions, deductions, and credits would remain intact. However, the overall rate could be reduced by 0.5 percentage points every year while the sales tax base was broadened to other services and goods. That approach would eliminate all income taxes in about five years. This phase-down is especially important for the small and medium-sized businesses that generate much of the job growth in Arizona. Those businesses currently pay their income taxes through the personal income system and often do so at the top rate, which is currently 4.54 percent.

The phase-down could also be tied to a revenue trigger. If, for instance, actual revenue growth exceeds a certain threshold—say, 5 percent—then the phase-down proceeds. If it doesn't, the phase-down is put on hold. However, if revenue doesn't reach the trigger threshold, that doesn't mean that the incremental tax rate phase necessarily has to cease. If the state legislature holds spending down and produces

a surplus, a portion of that surplus could be devoted to buying down the income tax rate as well.

So the first year of implementation could result in an Arizona sales tax rate of around 5.6 percent on a broadened sales tax base and a 2.6 percent income tax rate (which would result in a substantial and economically beneficial tax cut to small and medium-sized businesses). Then the next step would be for policymakers to double down on such an aggressive pro-growth tax plan by phasing down the income tax as quickly as possible while simultaneously acclimating Arizona governments to rely mainly on the sales tax.

The Economic Benefits of Eliminating the Income Tax

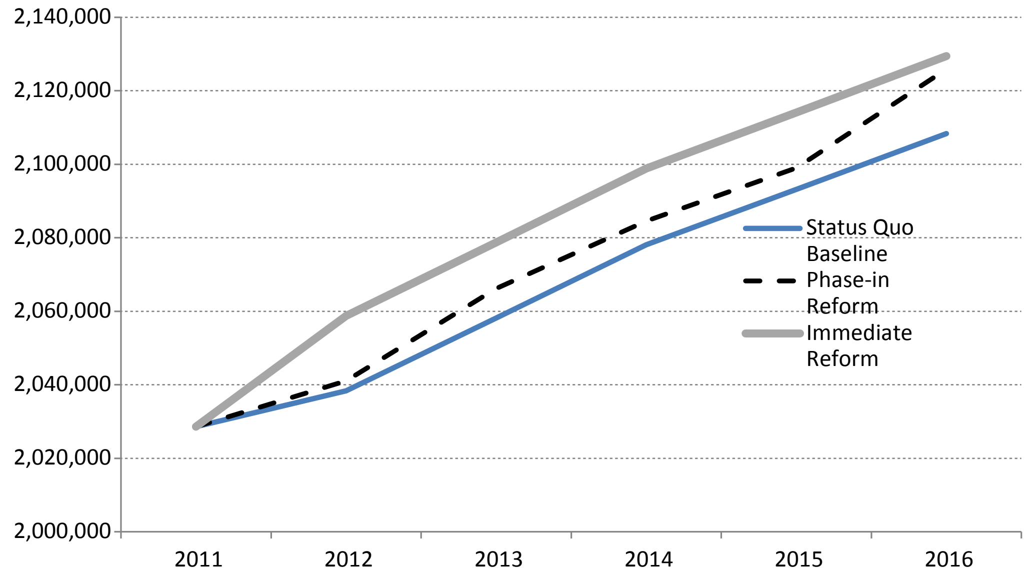
We can compare estimates of economic growth under the old tax code and the hypothetical new one. Using the State Tax Analysis Modeling Program (STAMP) developed by the Beacon Hill Institute at Suffolk University in Boston, we can see how much more job growth would occur in Arizona if we eliminated the income tax and broadened the sales tax base in the way that is outlined in this paper.

Arizona could experience growth of more than 20,000 new jobs in the first year if the income tax were eliminated immediately.

The STAMP model is a dynamic CGE (computable general equilibrium) model that is able to simulate changes in taxes, costs (general and sector specific), and other economic inputs over a prospective five-year period. As such, it provides a mathematical description of the economic relationships among producers, households, governments, and the rest of the world. It is constructed in terms of supply and demand for each economic variable included in the model, where the quantity supplied or demanded of each variable depends on the price of each variable. Tax policy changes are shown to affect economic activity through their effects on the prices of outputs and of the factors of production (principally, labor and capital) that enter into those outputs. In this way, the model is able to generate a baseline assumption about the future of the economy based on past trends under the old tax system and compare it to the baseline generated by economic changes estimated to occur under the new tax system.[25]

As you can see in figure 6, relative to the baseline, Arizona could experience growth of more than 20,000 new jobs in the first year if the income tax were eliminated immediately. The overall job gains would be spread over five years if the income tax elimination is phased in over such a period of time. It's also possible, however, that the potential job gains would increase over that period because businesses would anticipate the next year's lower income tax rate each year until the rate reached zero. In addition, job gains could increase because of the economic growth that materializes each year as a result of the transition to a new, pro-growth tax code.

Figure 6. Baseline Estimates of Private Sector Employment Growth under Each Tax Reform Scenario



Source: Author's calculations.

Even though this tax plan raises the same amount of revenue, it does so in a fundamentally different way—indeed a better way—than the current system.

Also remember that this estimate is compared to the baseline job growth that is likely to occur anyway. These 20,000 new jobs represent a one percentage point add-on to the job growth that was already estimated to be on tap before the tax reform. This figure also only a bit lower than the number of private jobs created between 2010 and 2011 in Arizona. Additionally, investment in the state could rise in the amount of $419 million, which is a little more than a one percentage point add-on to baseline growth. Over time, such investment can translate to even more job growth.

Bear in mind that the tax reform plan that the STAMP model is using to make these estimates is revenue neutral. If the tax reform were also a net tax cut, the economic benefits would be even higher. Indeed, many of the estimates of job growth related to tax policy that the general public hears about are usually the result of net tax cuts. However, it's also important to note that even though this tax plan raises the same amount of revenue, it does so in a fundamentally different way—indeed a better way—than the current system. So the job and investment growth we see in these estimates is best seen instead as an estimate of the economic costs of keeping the current system: the jobs and investment levels that will not materialize—relative to the baseline—without fundamental tax reform.

Conclusion

Arizona policymakers should set their sights on big ideas that move the state into a new era of economic growth. The best way to do so is to fundamentally uproot an outdated tax structure that weighs the state down and gets in the way of long-term economic and employment growth. Only by moving Arizona away from penalizing income and investment through the tax code can policymakers hope to bring Arizona into that new era. The best way to make Arizona more economically competitive is to eliminate income taxes altogether.[26]

Given Arizona's current economic state, a new, modern tax structure can't come too soon. A shift to a sales tax base can be revenue neutral while encouraging job creation and making governments more transparent and accountable. In today's international economy in which capital can flee harsh investment climates almost instantly, making Arizona a more appealing place for all businesses is imperative. Eliminating income taxes as we know them is arguably the only policy proposal bold enough to dramatically boost new economic growth and drive widespread job creation.

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Appendix: Explaining the Estimates of the Tax Base and Sales Tax Rates

The rates estimated in this paper are based on an attempt to calculate a revenue-neutral sales tax rate on an expanded sales tax base.

The first step taken in the analysis outlined in this paper was to determine the revenue target. The target needed to include all the revenue from the taxes being eliminated—in this case, the personal and corporate income taxes—as well as to include the revenue of the tax that is being retained, or the transaction privilege tax (TPT). The revenue estimates come from the Arizona Department of Revenue's annual report. The revenue target used is the amount collected by the personal income tax, the corporate income tax, and the TPT for fiscal year 2011. The target does not include the revenue collected by the temporary one-cent sales tax. (In the case of the estimated rate for the scenario in which revenue sharing is terminated, the amount of revenue committed to such government-to-government transfers was subtracted from the target revenue amount.)

Based on these assumptions, the revenue target is $8.4 billion. That amount includes revenue collected through the 0.6 percent Proposition 301 sales tax add-on. When revenue sharing is stripped from the target, the target drops to about $7 billion.

Next, the new tax base needed to be estimated. The Arizona Department of Revenue annual report includes estimates of the current sales tax base for each year. The Department of Revenue also publishes an annual estimate of the revenue that could be generated by expanding the sales tax to services. This estimate assumes a sales tax rate of 5 percent would apply to services. Thus, the revenue estimate can be divided by 0.05 to determine the value of all taxable service transactions.

Third, the revenue that would be forgone by exempting business inputs was estimated. Wholesale transactions, as estimated by the Department of Revenue, were subtracted from the taxable base. Service transactions that could be considered business inputs were estimated on the basis of a study authored by analysts at Ernst & Young and commissioned by the Council on State Taxation (COST).[27] Table A.1 shows the percentage of the major categories of service purchases that are made by businesses.

The categories used in the COST study are based on the same service categories used by the U.S. Census Bureau, which are also the same service categories used by the Arizona Department of Revenue in its tax expenditure estimate. As such, these business share percentages that can be applied to the Department of Revenue estimates for taxable services. The amount of the remainder (i.e., the revenue expected from nonbusiness service purchases) can then be used as the basis for a new revenue figure and taxable base estimate for each of these service categories.

Table A.1. Business Share of Service Purchases

Services	Percent
Advertising	98
Architecture and engineering	96
Employment	94
Management and technical	88
Data processing	84
Accounting and legal	71
Securities and investment	66

Source: Council on State Taxation

Table A.2 includes the final taxable base estimates by category for all goods and services that would be taxable under the new system after adjustments were made to reflect the potential impact of exempting business inputs. In other words, the share of the taxable base that consists of business-to-business transactions was subtracted from the total taxable base for each category. For some categories, this is a larger share than others. An example is professional, scientific, and technical services, which has a taxable base in Table A.2 that is about 50 percent of the potential total taxable activity in that field as estimated by the Department of Revenue.

Table A.2. Estimate of Taxable Base (in millions)

Services	Taxable base (millions)
Professional, scientific and technical	$9,455
Health care	$18,058
Administrative and business	$5,969
Personal care	$1,466
Educational	$988
Financial	$2,372
Other unclassified	$1,314
Current sales tax base	$89,266
Other goods and services	$13,906
Prescription drugs	$7,016
Food	$12,575
Aggregate taxable base	$162,385

Source: Author's calculations based on Arizona Department of Revenue data.

Finally, the proposed sales tax rates were estimated by determining which overall TPT rate (including the Proposition 301 rate) could be applied to the new taxable base to meet the revenue target. The rates proposed in this study

are revenue neutral with respect to all the general-fund revenue collected by the personal income tax, the corporate income tax, and the TPT.

When considering revenue-neutral sales tax rates, always consider the base on which it will be applied and the target revenue that must be met. In fact, a sales tax rate of 5.6 percent might actually be a bit high. If so, the legislature should seriously consider lowering the rate in accordance with more current estimates or the goal of buying down the income tax rate more quickly. However, if the legislature decided to keep food and medicine out of the tax base, the sales tax rate would have to be set at around 6 percent to replace all of the revenue currently collected through income and sales taxes. Another option, however, would be to include those goods in the tax base but tax them at a lower rate. The same can be done for certain services, too – as noted in this study, Tennessee taxes food at a rate lower than its normal sales tax rate and professional services are taxed in Washington at a 1.5 percent rate which is lower than its normal 6.5 percent. Doing so would put upward pressure on the main state sales tax rate, but it would still likely be a worthwhile trade-off for eliminating the income tax. Furthermore, if the legislature decided to cap revenue or cut spending in some way, all sales tax rates could stay low.

All of these rates are based on the current level of goods and services purchased in the state. Presumably, the taxable base will grow as the economic recovery picks up. The revenue target will also rise as a result. Thus, it's very important for the legislature to weigh the benefits of raising more revenue than is necessary to carry on government operations and compare it to the economic and taxpayer costs of a tax rate that could be lower if spending were restrained.

ENDNOTES

1 From an economic perspective, revenue-neutral taxation is at best a zero-sum game: when one person or company is given a special exemption from taxation, then someone else has to bear a higher tax for the same amount of revenue to flow to the government treasury. This tax shifting is especially pronounced in the state's property tax system. The tax shifting that occurs when some businesses receive special treatment leads to a direct shifting of the tax burden onto other taxpayers. See Mark Flatten, "Shifting the Burden: Cities Waive Property Taxes for Favored Businesses" (Special Investigation 10-01, Goldwater Institute, Phoenix February 18, 2010), http://goldwaterinstitute.org/article/shifting-burden-cities-waive-property-taxes-favored-businesses.

2 See Alan Peters and Peter Fisher, "The Failures of Economic Development Incentives," Journal of the American Planning Association 70, no. 1 (2004): 32.

3 See Kevin Hassett and Aparna Mathur, "Taxes and Wages" (American Enterprise Institute Working Paper 128, June 2006), http://www.aei.org/papers/economics/fiscal-policy/taxes-and-wages-paper/.

4 Donna Arduin, Arthur Laffer, Wayne Winegarden, and Ian McDonough. "Enhancing Texas' Economic Growth through Tax Reform" (Texas Public Policy Foundation, Austin, April 2009), https://docs.google.com/viewer?url=http://www.texaspolicy.com/sites/default/files/documents/2009-04-taxswap-laffer-posting.pdf&chrome=true&pli=1.

5 See table 1 of "Wyoming State Government Forecast, Fiscal Year 2012–2016" (State of Wyoming Consensus Revenue Estimating Group, Cheyenne, January 2012), http://eadiv.state.wy.us/creg/GreenCREG_Jan12.pdf.

6 For data on Texas revenue collections by major tax, see "Revenue by Source for Fiscal Year 2011," Texas Comptroller of Public Accounts, Austin, http://www.window.state.tx.us/taxbud/revenue.html.

7 Barry W. Poulson and Jules Gordon Kaplan, "State Income Taxes and Economic Growth," Cato Journal 28, no. 1 (winter 2008): 53–71, http://www.cato.org/pubs/journal/cj28n1/cj28n1-4.pdf.

8 Thomas Dye and Richard Feiock, "State Income Adoption and Economic Growth," Social Science Quarterly 73, vol. 3 (1995): 648–54. A version of this study published by the National Taxpayers Union Foundation is available at http://heartland.org/sites/default/files/sites/all/modules/custom/heartland_migration/files/pdfs/6926.pdf.

9 This figure is based on data from the Arizona Joint Legislative Budget Committee. It includes the amount earmarked for revenue sharing with localities.

10 Mark Robyn, "2012 State Business Tax Climate Index" (Tax Foundation Background Paper 62, January 2012), http://taxfoundation.org/article/2012-state-business-tax-climate-index.

11 Byron Schlomach, "Smooth Out the Bumps: Lessons from Texas on Building an Economically Healthier Arizona," (Goldwater Institute Policy Report, forthcoming).

12 Even a revenue-neutral rate would, over time, result in a net increase in overall tax revenue. Most estimates of the revenue-neutral tax rate, including this one, do not take into account the new economic growth—and, as a result, new revenue growth—that will materialize as a result of the tax change. Therefore, lowering the sales tax rate incrementally shortly after enactment of the tax reform proposed here would be warranted.

13 Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform* (Cambridge, MA: MIT Press, 1996), 209.

14 Ibid.

15 For an explanation of how Arizona handles wholesale sales intended for resale, see "Business Basics: A Guide to Taxes for Arizona Businesses" (Publication 622, Arizona Department of Revenue, revised December 2011), http://www.azdor.gov/LinkClick.aspx?fileticket=BPeFIxQ09vY%3d&tabid=85.

16 This change is revenue neutral in a static sense. That is, it assumes there are no economic "feedback" effects from the tax reform, such as growth in personal income, which would lead to more consumption and, consequently, more sales tax revenue.

17 Medical services would also be taxed. This, however, is not a case in which a tax is being placed on a service that was never taxed before. Indeed, like most services provided in Arizona, medical services were already taxed via the incomes of the providers through the income tax. Because this plan eliminates income taxes altogether, double taxation of the product—and, hence, the tax cost of providing the good that was hidden in the price—is eliminated.

18 This system would likely increase the number of audits the state would need to do to determine that the business that received these forms of identification were indeed businesses producing a product for final sale. However, the revenue generated and the increased economic growth resulting from the overall tax change would, on the whole, likely outweigh any increase in monitoring costs. It is also important to note that eliminating all income taxes would free up a substantial amount of resources at the Department of Revenue, which the department could use to enforce the new tax laws. Because it's quite plausible that income tax audits consume more time and resources than sales tax audits, it's also possible that eliminating the income tax in Arizona may facilitate a decrease in the personnel and budget the Department of Revenue needs to enforce tax laws.

19 Author's calculations based on U.S. Bureau of Labor Statistics Consumer Expenditure Survey data. These estimates are not Arizona specific. Instead, they are national averages. They may be high or low depending on Arizona's consumer behavior relative to the national average.

20 Arizona Department of Revenue, "Individual Income Tax Statistics, Tax Year 2006," http://www.azdor.gov/Portals/0/Reports/2006-Arizona-Individual-Income-Tax-Statistics.pdf.

21 These rebates would help the poor over the hurdle of paying the state sales tax bill for food and services, which are currently untaxed. The Arizona income tax system does not currently try to reimburse families for the cost of the state sales tax on other items. The sales tax plan envisioned here does not either. One benefit of broadening the sales tax base is that all Arizonans have at least some stake in paying taxes to the state. Additionally, any assistance that is provided to the poor may come from state or federal income-support programs or through the federal Earned Income Tax Credit, all of which will still exist even if the Arizona income tax is eliminated. As a matter of implementation, the rebate could be based on a household's federal adjusted gross income just like the current tax credits mentioned here. As such, filing a federal tax form could be a prerequisite for receiving the rebate as proof of a household's income.

22 See Arizona Department of Revenue, "Individual Income Tax Statistics, Tax Year 2008," http://www.azdor.gov/Portals/0/Reports/2008-Arizona-Individual-Income-Tax-Statistics.pdf.

23 If the legislature wanted to exempt prescription drugs from the sales tax, it could do so, but it would have to weigh this action against the cost of such an exemption (i.e., a higher sales tax rate). The rate would need to go up by about 0.3 percentage points, bringing the rate to 5.9 percent. Another option could be to allow residents over the age of 65 to receive a small rebate in an amount that approximates the average subsidy a senior would have received in the income tax code. The goal, however, should always be to keep rebates to a minimum and use them mainly to reimburse the poor for the costs of sales taxes.

24 See Michael McNut, "Gov. Fallin details state personal income tax reduction plan," Newsok.com, February 6, 2012, http://www.maryfallin.org/news/view_article.cfm?ID=493.

25 For more detail on how the STAMP model works, see http://www.beaconhill.org/STAMP_Web_Brochure/STAMP_EconofSTAMP.html.

26 Another way to do it would be to restructure the current income tax in a way that is dramatically less hostile to investment, through something similar to a flat income tax. See Stephen Slivinski, "The Right Cure for What Ails Us: A Prescription for Comprehensive Tax Reform in Arizona" (Goldwater Institute Policy Report 182, June 9, 2003). See also Arthur Laffer, Donna Arduin, and Wayne Winegarden, "How to Restructure Arizona's Tax Code: A Smarter, Flatter Tax Plan to Create Jobs" (Goldwater Institute Policy Report 231, February 24, 2009).

27 Robert Cline, John Mikesell, Tom Neubig, and Andrew Phillips, "Sales Taxation of Business Inputs" January 25, 2005, http://www.cost.org/WorkArea/DownloadAsset.aspx?id=69068

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