POLICY *memo*

Goldwater Institute

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To: Governor Brewer, Legislators, Policymakers
From: Stephen Slivinski, Senior Economist, Goldwater Institute
Re: Investing in Arizona: How the Legislature Can Get Arizona's Economy Moving Again by Reducing the Barriers to Investment and Job Creation

Recent polling shows that Americans' number one concern about the economy is unemployment and the future of job growth. With Arizona's unemployment rate at 9%, the need to set the stage for private sector growth is critical and job number one for policymakers.

Fundamentally reforming the state's tax code is the best thing that Arizona lawmakers can do to increase investment and job growth in Arizona. It simply cannot be done by cherry-picking industries to favor or tweaks to the tax code that favor one type of investment over another. The ideas that follow range from large-scale, broad-based tax reforms that may need to be phased-in over a few years or not take effect until a later date, to things the legislature can do this year that will make the state's tax code the most friendly to job creators.

Idea #1: Repeal the income tax and broaden the sales tax base and lower the rate.

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. Additionally, much time is spent thinking about how the amount of revenue we are raising and too little on how we are raising it. Fundamental tax reform can help the economy while simultaneously collecting at least as much revenue as is collected under the current system. To those ends, eliminating income taxes is arguably the only policy proposal bold enough to dramatically boost new economic growth and drive widespread net job creation.

The legislature can do this by eliminate the personal and corporate income tax in exchange for lowering the sales tax rate while also broadening the sales tax base. This can be done in a revenue-neutral fashion. Doing so requires broadening the sales tax to all final-use goods and services, including food and medicine, and setting the tax rate at the lowest possible level in one of the following ways:

- <u>The 4.6% option</u>: This assumes that all revenue-sharing with cities and counties is terminated. In exchange, localities will have control over their tax rates below a limit but be required to raise all their revenue. To ease the sales tax burden on poor families, the state could enact some type of rebate.

- The 5.5% option: This option keeps current levels of revenue sharing intact. Rebates may still be issued to the poor to reimburse them for the increased tax on certain items.

The tax rates estimated here 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, it generated $514 million. On the broadened base proposed here, the same rate would generate about $960 million.) As a result, this proposal assumes the legislature would require as part of the overall tax reform that the 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.

Another important element of any consumption-based tax structure is that it exempt business inputs—primarily wholesale transactions, legal services, and accounting services, for example. This hidden double taxation could be eliminated by expanding the system currently in use for exempting wholesale purchases intended for resale. Localities should also be required to conform to the state tax base to avoid economic distortions and reduce the compliance costs to businesses.

Finally, 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 at the state and local level. Long-term economic growth will be maximized when businesses, investors, and taxpayers know that a new income tax cannot be piled on top of the newly-broadened sales tax.

Idea #2: Allow immediate write-off of depreciable investments.

Until the end of 2011, the federal tax code allowed business owners to write off 100% of the capital investments they made before the end of 2011. It lapsed at the start of this year and if Congress and the President don't act soon that provision will disappear for good. Arizona policymakers, on the other hand, can create some certainty in the tax code and show the nation that Arizona is serious about business expansion and investment. They can allow this write off for state taxpayers every year no matter what the federal government does.

To understand how beneficial this could be to the economy, it is important to understand what happens when a business owner makes a capital investment in his operation. Let's say he buys a productivity-enhancing machine; it could be a computer, a copy-machine, or a large widget-making device. When purchased and put into service, the IRS only allows a write off of only a small portion of that investment in the first year instead of writing off the full cost. Instead, the business would have to take a number of smaller deductions each year over the usable life of the machine as it declines, or "depreciates," in value.

This system creates economic distortions, however. Not allowing businesses to immediately write-off the amount of the purchase forces them to understate the true cost of doing business during the years when they buy new equipment. When even mild inflation is accounted for, it is possible the business may never fully recoup the equipment expense. This has a dampening effect on investment today.

Arizona policymakers could lock into the state tax code this 100% "instant expensing" deduction with a change to only a few lines of the state tax code. Short of eliminating the corporate income tax, this would be a great way to maximize the legislature's ability to reduce economic uncertainty for Arizona businesses. It would also be an important permanent fixture of the tax code that would strip away the state tax codes bias against investment. Other states, like Kansas, have realized this and enacted just such a reform in 2010. And, finally, it would be an effective way to increase the long-term business investment in Arizona that is an important component of job growth and economic prosperity. The legislature shouldn't miss this golden opportunity.

Idea #3: Eliminate taxation of capital gains for all types of investments.

Taxing capital gains – even at the rate of personal income as is currently the case in Arizona – damages the ability of companies to raise much-needed investment capital and burdens in-state investors. There is substantial empirical evidence that states that either tax capital gains at a lower rate than personal income or have no capital gains tax have generally higher rates of investment and capital gains realizations.

Any levy that penalizes investment – an economic factor that can move quickly to any state that treats capital less punitively – puts Arizona at a disadvantage. From the perspective of good tax policy, any tax system that aims to encourage economic growth would not put such burdens on the act of wealth creation and investment. Short of eliminating the income tax altogether, an important step toward taking the burden off of investment income would be to exempt capital gains from taxation.

According to Joint Legislative Budget Committee analysis based on Internal Revenue Service data, 56% of capital gains realizations in Arizona accrue from investment in businesses. The legislature has previously acknowledged that exempting capital gains from taxation would be an important step in giving Arizona a hospitable investment climate. The "jobs bill" of 2011 law allows exemptions of capital gains income from investments in small businesses with assets that do not exceed $10 million. Yet the JLBC estimates that would only impact less than 5 percent of all capital gains derived from business investments. The Arizona legislature should expand this exemption to include all capital gains.

Idea #4: Create a tax credit for regulatory compliance costs.

Regulations imposed by the federal government have been estimated to cost American businesses $1.75 trillion per year, which is roughly 14% of total national income. That's bad enough on its own; but when you consider all the regulations states, counties, and cities place on businesses, you start to get a sense of how costly the government can make it for businesses to start up and expand.

A regulatory compliance tax credit would allow businesses to reduce their taxes in an amount equal to the cost of complying with excessive regulation. It would give government a powerful incentive to avoid and reduce excessive regulation. By empowering taxpayers to align government's appetite for revenue with a limited government regulatory policy, a regulatory tax credit could help produce a regulatory environment conducive to job creation and economic growth.

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