**Ballot Proposition 208**
**Invest in Education Act**
**Fiscal Analysis**

**Estimated Impact**

A.R.S. § 19-123E requires the Joint Legislative Budget Committee Staff to prepare a summary of 300 words or less on the fiscal impact of voter-initiated ballot measures. Proposition 208 would establish a 3.5% income tax surcharge for single taxpayers on their taxable income in excess of $250,000 and for married persons on their taxable income in excess of $500,000.

The income tax surcharge is projected to generate $827 million in revenue, which will be deposited into the Student Support and Safety Fund (SSSF), in the first full year of implementation. SSSF monies would first be used to pay administrative costs of certain agencies. The remainder of these monies would be primarily distributed to school districts, charter schools, and career technical education districts. The state education system for committed youth and the Arizona State Schools for the Deaf and the Blind would receive monies in the same manner as school districts and charter schools.

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

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

Given this uncertainty, our revenue estimate is speculative and subject to change.

The proposition may also have other impacts on state tax collections. For example, increasing salaries for school employees may result in higher General Fund income and sales tax collections. Any shift of income outside the state or decline in business investment may also reduce existing tax collections.

**Background**

Currently, the state's top marginal individual income tax rate is 4.50%, which applies to incomes of $159,001 and above for single filers and married couples filing separately, and incomes of $318,001 and above for married persons or single persons who are heads of household beginning in tax year (TY) 2019.

The proposition would establish a 3.5% surcharge on certain incomes. While the individual income tax brackets would remain unchanged, this would effectively result in a marginal tax rate of 8.00% for those with incomes of *(see* Table 1*)*:

- $250,001 and above for single filers and married couples filing separately.
- $500,001 and above for married couples filing jointly and persons filing as heads of household.

Marginal income tax rates apply to each additional dollar earned between certain levels of income. For example, for a single tax filer with $300,000 in taxable income, the newly-created 3.5% surcharge above the marginal tax rate would only apply to the $50,000 of income between $250,000 and $300,000; the first $250,000 in taxable income would be taxed based on the 4 current tax brackets and their respective tax rates.

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| Table 1 | | |
|---|---|---|
| **Proposed Tax Rate Changes** | | |
| | **Current Law** | **Proposed Law** |
| Single/Married Filing Separately: $250,001 and above | 4.50% | 8.00% |
| Married Filing Jointly/Head of Household: $500,001 and above | 4.50% | 8.00% |

Student Support and Safety Fund
Revenues generated by the 3.5% surcharge would be deposited in the new SSSF. Monies in the fund would first be used for administrative costs of the Treasurer, Auditor General, Arizona Department of Education (ADE), Department of Revenue (DOR), and State Board of Education, before being distributed as follows:

- 50% for hiring and raises for teachers and classroom support personnel.
- 25% for hiring and raises for student support services personnel.
- 10% for new teacher retention programs.
- 12% to the Career Training and Workforce Fund, also newly-established by the proposition. Monies in the fund would first be used for administrative costs of the Treasurer and ADE, before being used for a new Career Training and Workforce Program to be administered by ADE.
- 3% to expand the Arizona Teacher's Academy, which provides tuition and fee waivers for higher education students who commit to teaching in Arizona public schools after graduation.

Monies allocated for teachers and classroom support personnel, student support services personnel, and new teacher retention programs would be distributed to school districts and charter schools based on prior year student counts. The estimated distributions of the fund are displayed in *Table 3*.

**Analysis**

To estimate the revenue impact of the proposal, the JLBC Staff relied on a DOR model which estimates the overall and distributional impact of tax law changes. This model is based on TY 2016 tax return data, which DOR has adjusted for filer and income growth between TY 2016 and TY 2020. The DOR model estimate reflects a "static" analysis which does not incorporate any "dynamic" impacts resulting from broader economic changes related to the tax law revision.

The DOR model projected that $827 million would be generated for deposit into the SSSF in the first full year of implementation. However, this estimate does not factor in any potential responses of economic behavior or the uncertainty of future economic conditions. The following factors will affect the actual fiscal impact:

- Individual income tax revenue generated from high-income taxpayers is highly susceptible to changes in economic conditions. If taxable income for high earners were to grow at a higher rate than for taxpayers of all incomes, the revenues could be higher than under the DOR estimate. Conversely, if the economy were to enter a downturn, revenues could be lower than the DOR estimate. For example, the DOR estimate does not account for the impact of the COVID-19 pandemic on the economy.
- The proposition would significantly increase the top marginal income tax rate. This could induce economic or behavioral responses that would impact the amount of revenue generated. The higher tax rates may induce some high-income taxpayers to move or shift income to other states, thereby reducing the projected revenue collections.

In contrast, the Arizona Education Association estimates that the proposition would generate $940 million.

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

- Increased spending on teacher salaries and other educational expenses may provide a fiscal stimulus, which may lead to higher General Fund sales and income tax collections. *(See Effects on Wages and Spending section for more information.)*
- If the higher tax rates shift income outside of the state or reduce business investment, existing General Fund income tax collections may be reduced (along with generating less revenue for the SSSF).

Distributional Impacts and Economic Conditions

*Table 2*, below, shows the distributional impacts of the proposition by adjusted gross income (AGI). This analysis is based on the DOR model and does not factor in any of the elements of uncertainty discussed above. Of the total revenue generated, an estimated 93.8% would come from Arizona residents, while the remaining 6.2% would come from non-resident filers. The DOR model does not provide information on the number of non-resident filers. Due to the limitations of the model, DOR is unable to estimate the distributional impact by taxable income tax bracket. Taxable income is generally lower than adjusted gross income, because it factors in various deductions and adjustments. Filers' tax rates are determined by their taxable income, and not by adjusted gross income.

**Table 2**

**Distributional Impacts of Proposal**

| Tax Filer Adjusted Gross Income [1/] [2/] | Projected # of Returns | Average Increase | Total Increase | % of Total Impact |
|---|---|---|---|---|
| Under $200,000 | 2,854,671 | $0 | $0 | 0.0% |
| $200,000-$499,999 [3/] | 111,963 | $120 | $14,000,000 | 1.7% |
| $500,000-$999,999 | 17,425 | $5,549 | $97,000,000 | 11.7% |
| $1,000,000-$4,999,999 | 8,127 | $40,287 | $327,000,000 | 39.5% |
| $5,000,000 and above | 956 | $353,448 | $338,000,000 | 40.9% |
| Non-Resident Filers [4/] | | | $51,000,000 | 6.2% |
| **Total** | | | **$827,000,000** | **100%** |

1/ The DOR tax return model displays impact by income in terms of AGI rather than taxable income. Taxable income is typically lower than AGI.
2/ Does not differentiate between single, married, and other filing statuses.
3/ The DOR tax return model does not provide a breakout of tax filers with AGI between $250,001 and $499,999.
4/ The DOR tax return model does not report a number of non-resident filers.

Revenues from high-income taxpayers tend to be more volatile year-to-year than individual income taxes in general. Because the revenue generated by the proposition would come from high-income taxpayers, SSSF collections could fluctuate from year to year. For example, in TY 2008, total individual income tax liability decreased by (11)%, while the decrease for taxpayers with AGI above $500,000 was nearly (30)%. Conversely, in TY 2014, total individual income tax liability growth was 12%, while liability growth for taxpayers with AGI above $500,000 was 28%. *Figure 1* illustrates tax liability growth over 10 years until TY 2016, the last year of DOR data available.

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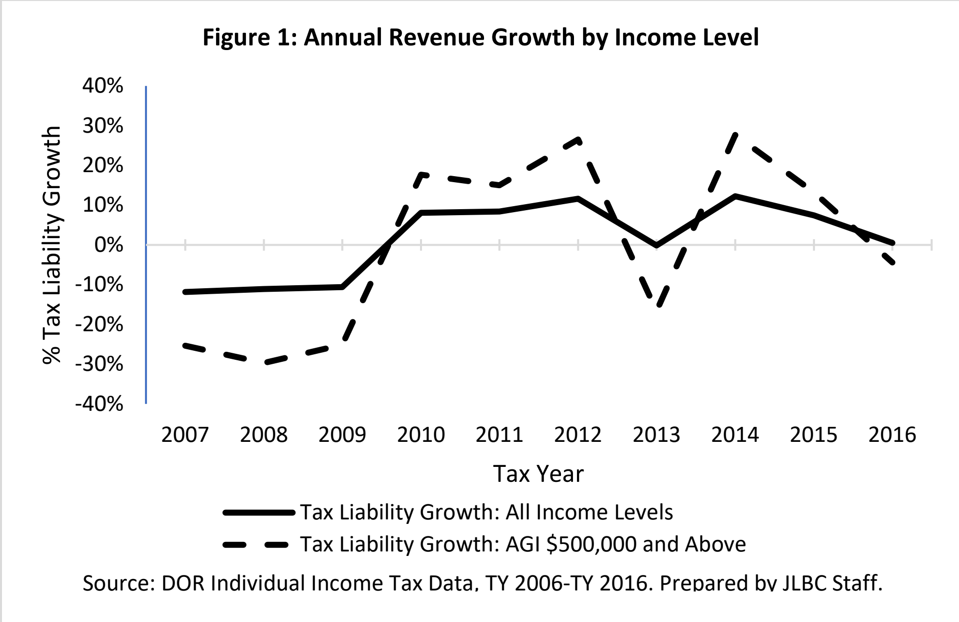


Potential Economic Impacts

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

*Taxpayer Migration*

The proposition would make Arizona's top income tax rate the ninth highest nationally (out of the 50 states and the District of Columbia). As a result, some high-income taxpayers may choose to shift their income or relocate to other states with lower rates. This could have 2 impacts:

1) The new surcharge on high-income taxpayers may not generate as much as expected for deposit into the SSSF.
2) General Fund revenue collections may be affected. For example, revenue raised on any income below the newly-created tax brackets would continue to be deposited into the General Fund. If a taxpayer leaves, the General Fund would lose this revenue. In addition, out-migration of taxpayers may reduce General Fund sales tax collections.

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

One academic study by Varner and Young (2016) estimated that a 10% increase in the top combined state and federal income tax rate corresponds to a 1% decrease in the millionaire population. We are seeking clarification from the authors on applying these results to the proposition.

The same authors produced a separate study in 2011, which found minimal migration impacts as a result of New Jersey increasing its top marginal rate to 8.97% in 2004 (an increase of 2.6 percentage points). However, another study of the 2004 New Jersey tax increase produced by the New Jersey Office of Revenue and Economic Analysis concluded that by 2009, the tax increase had resulted in a reduction of 20,000 taxpayers associated with a revenue loss of $125 million.

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Estimates from these studies cannot be applied to Arizona's specific economic and policy environment with any degree of certainty. Furthermore, these studies were produced prior to 2018 federal tax law changes, which, among other provisions, capped the deductibility of state and local taxes to $10,000. Because of this change, taxpayers may have a greater sensitivity to state tax rate changes, as they are no longer able to deduct the full amount of their state tax liability from their federal taxable income. These changes further complicate the projection of future taxpayer behavior.

While the proposed tax rate increases could induce some number of high-income taxpayers to leave the state, there could also be positive migration effects. For example, increases to teacher pay could draw additional teachers to the state.

*Business Behavior*
Some business income is taxed at the individual, rather than corporate, tax rate nationally. These businesses, such as S Corporations, Limited Liability Companies, Sole Proprietorships, and Partnerships are often referred to as "pass-through" businesses, since their owners pass through their business income to be taxed at the individual level. Some of the taxpayers impacted by the proposition will derive at least a portion of their income through their business.

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

Following the establishment of the surcharge, Arizona's top individual income tax rate would effectively be 8.0%, compared to the 4.9% corporate income tax rate. The disparity between these rates may be an incentive for some businesses to incorporate as corporations and instead pay the corporate income tax rate. If this shift were to occur, the proposition would generate less revenue than the DOR model run projection. While a tax advantage will exist for certain businesses, there may be other, non-financial reasons why businesses may not alter their business structure. For example, corporations face reporting and regulatory requirements that do not apply to other types of businesses. Additionally, businesses may already be more likely to alter their business structure based on federal, rather than state, tax laws. For example, the federal corporate tax rate is 21%, compared to the top federal marginal individual income tax rate of 37%.

*Effects on Wages and Spending*
The tax increase initiated under the proposition would directly lead to increased government spending on education, including teacher and staff salaries. To the extent that schools spend these funds on salaries and local products, this spending will create a direct economic impact. Salary increases would lead to increased individual income tax collections, while spending on goods and services would generate additional state and local sales tax revenues. However, this effect would be partially offset by reduced spending on goods and services by high-income household's subject to the new tax rates, as these households would have reduced after-tax income.

Distribution of Revenues
*Table 3* displays the distribution of revenues, based on the DOR estimate of $827 million.

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**Table 3**

**Distribution of Revenues**

| | |
|---|---|
| **Revenues** | |
| 3.5% surcharge on income over $250,000 (single/mfs) or $500,000 (mfj/hh) | $827,000,000 |
| **Student Support and Safety Fund Total** | **$827,000,000** |
| | |
| **Distributions** | |
| **Administrative Costs:** 1/ | |
| Treasurer | |
| Arizona Department of Education | $ 0 |
| Auditor General | 38,880 |
| Department of Revenue | |
| State Board of Education | 0 |
| **Administrative Costs Total** | **$38,880** |
| | |
| **85% to School Districts/Charter Schools:** | |
| 50% for hiring and raises for teachers and classroom support personnel | $413,480,560 |
| 25% for hiring and raises for student support services personnel | 206,740,280 |
| 10% for new teacher retention programs | 82,696,112 |
| **School Districts/Charter Schools Total** | **$702,916,952** |
| | |
| **12% to Career Training and Workforce Fund:** | |
| Administrative Costs: 1/ | |
| Treasurer | |
| Arizona Department of Education | $ 530,000 |
| Career Training and Workforce Program | 98,705,334 |
| **Career Training and Workforce Fund Total** | **$99,235,334** |
| | |
| **3% to Arizona Teachers Academy** | **$24,808,834** |

1/ Administrative costs are agency estimates. Blanks indicate that the agency did not provide an estimate.

7/30/20

*Prepared by Lydia Chew, Fiscal Analyst*