BALLOT PROPOSITION # 107
Taxpayer Protection Act of 2000

Publicity Pamphlet Fiscal Impact Summary

Proposition 107 eliminates the collection of state individual income and corporate income taxes by January 1, 2005. At that time, state income tax collections are projected to be $4.2 billion on an annual basis. Of that amount, $3.7 billion would be distributed to state government. This dollar amount represents 40% of total state revenues. Another $555.4 million of state income tax collections would be distributed to cities and towns in 2005. This amount represents an unknown percentage of city and town revenue.

The ultimate impact of this revenue reduction depends on whether the Legislature or cities decide to replace the income tax with other funding sources, spending reductions, or some combination of the two. The elimination of the income tax may stimulate other economic activity, which may offset some of the revenue loss. However, the increased economic activity would not be expected to replace most of the lost revenue.

	FISCAL YEAR		
	2004	**2005**	**2006**
STATE REVENUES			
Individual Income Tax	$-0-	$(1,430,254,100)	$(3,060,789,800)
Corporate Income Tax	-0-	(284,058,400)	(596,531,600)
Total	$-0-	$(1,714,312,500)*	$(3,657,321,400)*

* The initiative's ultimate fiscal impact will depend on whether this lost revenue is offset by another revenue source and/or reductions in spending.

FISCAL ANALYSIS

Description

Proposition 107 amends the Arizona Constitution to repeal the state individual and corporate income tax after December 31, 2004. In addition, Proposition 107 requires any act that provides for a net increase in state revenues to be referred to a general election and be approved by a majority of voters.

Estimated Impact

Proposition 107 eliminates $1.7 billion in total state revenues for one-half of the year in FY 2005, and $3.7 billion in state revenues in FY 2006 when the impact is fully phased-in. This represents 40% of total state General Fund revenues in FY 2006. The ultimate impact of this revenue reduction depends on whether the Legislature decides to replace the income tax with other funding sources, spending reductions, or some combination of the two. The elimination of the income tax may stimulate other economic activity, which may offset some of the revenue loss. However, the increased economic activity would not be expected to replace most of the lost revenue.

Analysis

In FY 2001, individual and corporate income taxes are projected to generate $2.7 billion of the total of $6.3 billion in state revenues. This currently represents 42% of total state General Fund revenue; however, this percentage is projected to decline to 40% by FY 2006. Individual income taxes are projected to grow by 7% each year. The corporate income tax has been

Analysis (Continued)

extremely volatile historically and is very difficult to predict from year to year, but over the long term, we expect it to grow by 5% each year. Thus, by FY 2005, total income tax collections are projected to grow to $3.4 billion. Since Proposition 107 would repeal the income tax for half of the year in FY 2005, this results in a revenue decrease of $1.7 billion. In FY 2006, the income tax will be fully phased-out resulting in a revenue decrease of $3.7 billion. State income tax revenues are shared with local governments, so the elimination of the income tax will result in a decrease in revenue at the local level. *(See the Local Government section below for further information on local revenue impacts).*

The ultimate impact of the elimination of the income tax depends on whether the Legislature (upon an affirmative public vote) replaces the lost revenue with another funding source, such as increases in the sales tax, or with spending reductions. Currently, the income tax provides approximately 42% of total state General Fund revenue. The rest of state General Fund revenue comes mainly from the sales tax ($3 billion or 47%). All of the other taxes combined provide the remaining 13%. As an example, part or all of the revenue loss could be made up by an increase in the sales tax. Under this scenario, the state sales tax (currently levied at 5% prior to additional local sales tax) would have to increase by about 4.4% to 9.4% to offset all of the income tax (if the elimination of the income tax did not generate new economic activity). Sales taxes are also levied at the local level and local governments would experience a revenue decrease as a result of this initiative as well. Thus, local governments could also increase taxes to offset the elimination of income tax revenues *(See the Local Government section for further information).*

Part or all of the income tax repeal could also be made up with spending reductions. The following table shows the current major categories of General Fund spending. As an example, in order to make up all of the revenue loss with spending reductions, state agencies' budgets would need to be reduced by approximately 40%. A combination of tax increases and spending reductions could also be implemented.

FY 2001 General Fund Budget
(in Millions)

Education (K-12)	$2,488.2	40%
Universities	773.0	12%
Corrections	587.9	9%
AHCCCS	528.9	8%
School Facilities Board	471.2	7%
Economic Security	456.6	7%
Health Services	263.7	4%
Other Agencies	850.2	13%
Total Operating Budget	$6,419.7	100%
Capital Appropriations	35.7	
Total Appropriations	$6,455.4	

Research has shown that lowering taxes can, to some extent, stimulate other economic activity. The only detailed research on the dynamic impact of tax reductions was done by the state of California in 1995. California developed an extensive model to estimate the economic impact of tax reductions. The model provides estimates of the economic impact of a hypothetical $1 billion tax reduction under 3 scenarios: a reduction in the corporate income tax, a reduction in the individual income tax and a reduction in the sales tax. The study found that the corporate income tax reduction would be offset by an 18% increase in economic activity. This means that 18% ($180 million) of a $1 billion tax cut would be offset by revenue growth from other areas, leaving a net revenue loss of $820 million. The offsets for reductions in the other types of taxes were lower at 1% for the individual income tax and 8% for the sales tax. The individual income tax offset of 1% was much lower because California assumed that less than 50% of the tax cut entered the economy. This was due to higher Federal income tax payments since individuals would no longer have state income taxes as a deduction and because higher income groups would save part of the income tax cut. In addition, California assumed that the tax cut was financed by reductions in state spending, including large state employee layoffs.

These results should not be directly applied to Arizona. The model is based on the conditions of the California economy, which is much different from Arizona's economy and, therefore, the results here might be quite different. However, the California model can be used as a general guideline, from which we can conclude that the elimination of the income tax in Arizona may stimulate some offsetting economic growth, but that growth would only offset a proportion of the total cut.

Analysis (Continued)

Thus, the ultimate impact of Proposition 107 depends on whether the revenue loss is replaced. The Legislature could consider an increase in other revenue sources (upon an affirmative public vote), reductions in state spending, or a combination of the two. For further information, we researched other states that do not have an individual income tax. As shown in the table, except for Alaska and New Hampshire, most of these states' revenue is generated by the sales tax.

Federation of Tax Administrators
1998 State Tax Collections by Source
(Percentage of Total)

	Property Tax	Sales Tax	Corporate Income Tax	Individual Income Tax	Other [1/]
Alaska	4.1%	9.8%	23.2%	--	62.8%
Florida	4.4	75.2	5.6	--	14.8
Nevada	2.2	84.9 [2/]	--	--	12.8
New Hampshire [3/]	0.1	49.4	23.4	6.1%	21.0
South Dakota	--	79.3	4.6	--	16.1
Tennessee [3/]	--	76.1	8.7	2.3	13.0
Texas	--	80.7	--	--	19.3
Washington	17.3	73.5	--	--	9.1
Arizona	**3.6%**	**57.7%**	**7.6%**	**26.8%**	

1/ This category includes all other types of taxes, such as taxes on oil, insurance, estate tax etc.
2/ Approximately one-half of Nevada's sales tax revenues are from a gaming and casino revenue sales tax.
3/ These states have a very limited individual income tax on interest income and dividends only.

It is difficult to compare tax rates across states because states differ greatly in how they divide responsibility between state and local government. For example, in some states the entire education system is funded and administered at the local level. In these states, state spending is limited to a very narrow range of services and therefore these states have much lower tax rates at the state level and may have much higher taxes than other states at the local level.

Local Government Impact

Income taxes collected at the state level are shared with local governments through the Urban Revenue Sharing formula. Under this formula, local governments receive 15% of the amount of income tax collected 2 years prior to the current year. For example, during FY 2001, local governments will receive income taxes totaling 15% of the amount collected in FY 1999. Thus, the elimination of the state income tax results in a revenue loss for local governments of $244 million in FY 2005 and $555.4 million in FY 2006 when Proposition 107 is fully phased-in. This amount represents an unknown percentage of city and town revenue.

As discussed above, the ultimate impact of Proposition 107 at the local level depends on whether cities decide to replace the income tax with another revenue source, enact spending reductions, or a combination of the two. The elimination of the income tax may stimulate some additional economic activity, which may offset some of the loss; however, we would not expect this growth to replace most of the revenue loss. Thus, in addition to the possible tax increases and/or spending reductions at the state level, local governments may also raise taxes or reduce government services.

7/14/00

A.R.S. § 19-123 requires the Joint Legislative Budget Committee Staff to prepare fiscal impact estimates for ballot initiative measures. This estimate was prepared by Jennifer Vermeer (602-542-5491).