BILL # SB 1545 | **TITLE:** omnibus tax relief act

SPONSOR: Martin | **STATUS:** As Amended by Senate FIN

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FISCAL ANALYSIS

Description

This bill, as amended, would provide the following changes to Arizona tax law: (1) reduce individual income tax rates by 25% over 5 years, beginning in calendar year (CY) 2006, (2) reduce the corporate income tax rate by 25% over 5 years, beginning in CY 2007, (3) repeal the membership camping classification of the transaction privilege tax, the rental occupancy tax, and the severance tax on timber, (4) set the county equalization assistance for education tax rate to $0.2179 for FY 2007 and $0 for each fiscal year thereafter, and (5) increase the tax exemption for business and agricultural personal property from $50,000 to $150,000.

Estimated Impact

Relative to current law, SB 1545 would reduce income tax and transaction privilege tax (TPT) revenues by between $(165.7) and $(195.9) million in FY 2007. The bill would also increase the state's K-12 education formula cost by $101.4 million in FY 2007. Thus, the total General Fund cost for SB 1545 would be an estimated $267.1 to $297.3 million in FY 2007. In FY 2012, when the bill is fully phased in, the total General Fund cost is estimated to be $1.6 billion. The table below shows the estimated General Fund impact (in millions of dollars) of all the provisions in the bill for each year between FY 2007 and FY 2012.

	General Fund Revenues:			General Fund Expenditures:		
FY	Ind. Income Tax Rate Reductions	Corp. Income Tax Rate Reductions	Repeal of Certain TPT Categories	County Equalization Phase-Out	Bus. Pers. Prop. Exemption	Total General Fund Cost for All Provisions
			(Millions of Dollars)			
2007	$(155.5)	$(10.0) to $(40.2)	$(0.2)	$101.4	$0.0	$267.1 to $297.3
2008	$(333.8)	$(47.4) to $(85.3)	$(0.2)	$224.7 to $232.1	$0.9 to $5.7	$607.0 to $657.1
2009	$(536.1)	$(92.3) to $(131.2)	$(0.2)	$239.6 to $255.6	$0.9 to $6.3	$869.1 to $929.4
2010	$(766.5)	$(139.2) to $(181.6)	$(0.2)	$255.5 to $281.4	$0.9 to $6.9	$1,162.3 to $1,236.6
2011	$(1,025.2)	$(189.9) to $(234.9)	$(0.2)	$272.4 to $309.7	$0.9 to $7.6	$1,488.6 to $1,577.6
2012	$(1,097.0)	$(231.3) to $(241.9)	$(0.3)	$290.3 to $340.9	$0.9 to $8.3	$1,619.8 to $1,688.4

These estimates are based on a static model and do not incorporate "dynamic" estimates. Dynamic forecasting goes beyond the static approach and attempts to predict changes in the economy brought about by changes in tax policy. For example, the income tax reductions would lead directly to significant increases in households' disposable income and after-tax corporate profits. These increases would stimulate increased consumer and capital spending that would lead to higher levels of employment, construction, personal income, and additional revenue from sales, property, and insurance premium taxes. In addition, an even broader dynamic model would evaluate the impact of reductions in the growth in state spending resulting from the changes in tax policy. This spending impact, however, is difficult to evaluate until the specific reductions are known.

Dynamic estimates are based on complex econometric models. Based on national research, these models typically generate dynamic revenue feedbacks ranging from 2% to 20% of the static revenue impact within 5 years. In other words, up to 20% of the static revenue loss would be offset by revenues generated by greater economic activity. The specific feedback will depend on the type and magnitude of the tax reduction.

Due to time constraints, this analysis does not include a dynamic forecast for SB 1545. The impact, however, can be expected to fall within the typical dynamic feedback range.

The follow link posted on JLBC's web site contains a document that provides a description of recent developments in dynamic revenue forecasting, including some results reported in other states: http://www.azleg.gov/jlbc/m-RevForecasting.pdf

Analysis

Individual Income Tax
Arizona uses a graduated tax system for the individual income tax, under which the tax rates vary from 2.87% to 5.04% of a taxpayer's taxable income. Under SB 1545, the rates for the state's 5 tax brackets would change as follows:

Current Law	CY 2006	CY 2007	CY 2008	CY 2009	CY 2010
2.87%	2.73%	2.59%	2.45%	2.31%	2.17%
3.20%	3.04%	2.88%	2.72%	2.56%	2.40%
3.74%	3.55%	3.36%	3.17%	2.98%	2.79%
4.72%	4.48%	4.24%	4.00%	3.76%	3.52%
5.04%	4.79%	4.54%	4.29%	4.04%	3.79%

According to the Department of Revenue (DOR), the first 5% rate reduction in CY 2006 would reduce individual income tax collections by an estimated $(155.5) million in FY 2007. DOR further assumes that each incremental rate reduction will decrease tax collections by an additional $(155.5) million, so that when this provision of SB 1545 is fully phased in CY 2010, the General Fund will receive $(777.5) million less in tax revenues in FY 2011 than under current law.

DOR's estimated incremental revenue loss of $(155.5) million for each year between FY 2007 and FY 2011 was calculated based on the expected taxable income for the current calendar year (2006). While this is a reasonable approach for FY 2007, it will understate the revenue loss in FY 2008 and even more so in subsequent years. For example, DOR's FY 2011 estimate of $(777.5) million was derived by applying the proposed 2010 tax rates to the 2006 baseline taxable income. In other words, DOR's estimates assume no growth of taxable income after 2006.

A more realistic estimate, however, would be obtained if taxable income were adjusted each year. To this end, it was assumed that taxable income would grow by an average annual rate of 7.1% between CY 2007 and CY 2011, or 41.1% in total. After this adjustment, it is estimated that the rate reductions under SB 1545 will decrease individual income tax revenues by $(155.5) million in FY 2007, $(333.8) million in FY 2008, and $(1,097.0) million in FY 2012.

Corporate Income Tax
Under current law, the Arizona corporate income tax rate is 6.968% of a corporation's net Arizona taxable income or $50, whichever is greater. SB 1545, as amended, would reduce the corporate tax rate to 6.65% in CY 2007, 6.30% in CY 2008, 5.95% in CY 2009, 5.60% in CY 2010, and 5.25% in CY 2011.

Based on the JLBC FY 2007 Baseline forecast, the maximum static impact of the proposed rate reductions would be about $(40.2) million in FY 2007, $(85.3) million in FY 2008, and $(241.9) million in FY 2012.

However, due to variability in corporate income tax filing deadlines, the full impact of corporate income tax reductions typically occurs over 3 fiscal years. For purposes of this analysis, 25% of the revenue impact would occur in year 1, 65% in year 2, and 10% in year 3. This means that for the first rate reduction in CY 2007, the full revenue impact of $(40.2) million would only partially occur in FY 2007. Instead, the total impact would be distributed over 3 years (FY 2007 to FY 2009), as specified by the percentages above. Using this approach, the estimated static impact at the lower end of the range would be approximately $(10.0) million in FY 2007, $(47.4) million in FY 2008, and $(231.3) million in FY 2012.

Transaction Privilege Tax (TPT)
SB 1545 would eliminate the TPT on membership camping contracts, the rental occupancy tax, and the severance tax on timber, which would result in the following General Fund revenue reductions:

TPT Categories	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Membership Camping	$(122,100)	$(130,700)	$(139,800)	$(149,600)	$(160,000)	$(171,300)
Rental Occupancy	$(46,400)	$(49,700)	$(53,200)	$(56,900)	$(60,900)	$(65,100)
Timber Severance	$(22,100)	$(23,700)	$(25,400)	$(27,100)	$(29,000)	$(31,100)
TOTAL	$(190,600)	$(204,100)	$(218,400)	$(233,600)	$(249,900)	$(267,500)

Tax Exemption for Business and Agricultural Personal Property
Under current law, business (Class 1) and agricultural (Class 2) personal property is exempt from taxation up to a maximum amount of $50,000 in full cash value per taxpayer. The amount is adjusted annually for inflation and is currently $57,632. SB 1545 would increase the maximum amount of this exemption to $150,000.

According to DOR, if this bill had been in effect for FY 2005, the statewide property tax base would have been reduced by 0.26%. For FY 2008, when the $150,000 exemption would first become effective, a 0.26% reduction would correspond to a statewide NAV loss of $(147.1) million. By FY 2012, the NAV reduction under SB 1545 would have grown to $(215.2) million.

DOR noted that their NAV loss estimate was somewhat uncertain owing to some database limitations. Under state law, each business is allowed only one exemption regardless of whether that company owns one or more locations in Arizona. For example, although there are several hundred Circle K convenient stores in the state, the corporation still receives no more than one $50,000 exemption. Each of a company's business locations is assigned a tax account. Thus, for DOR to provide an accurate estimate of the NAV impact of the proposed $150,000 exemption, they would need to match up all the accounts in their database with the corresponding taxpayers. However, such database queries cannot currently be performed.

Instead, DOR is only able to match one account to each taxpayer. Because of the limitation of this method, the true NAV impact is likely to be understated to some degree. For example, assume that a company owns 2 business locations in the state each with personal property valued at $100,000, for a total of $200,000. If the exemption were increased to $150,000, DOR's method would only show a NAV impact of $100,000 for this company since only one of its 2 accounts would be matched to the taxpayer. In other words, this method would understate the NAV loss by $50,000 since this company in reality would be able to claim $100,000 for one tax account and $50,000 for the other account.

Under the Basic State Aid formula, the state pays for the cost of K-12 education not generated through local property taxes. The state also pays a percentage (between 36% and 40%) of residential property taxes through the Department of Education’s Homeowner’s Rebate program. By reducing NAV by $(147.1) million in tax year 2007, the bill will result in a direct increase of the state share of K-12 funding by $5.7 million in FY 2008. This estimate includes the net impact of both Basic State Aid and the Homeowner’s Rebate.

The NAV reduction under SB 1545 will also generate savings in the cost of the state’s Truth in Taxation (TNT) program. TNT reduces the QTR and county equalization tax rate to offset growth in existing property values. This reduction occurs automatically unless the Legislature decides to forego the TNT adjustment. For FY 2008, the school tax rate is expected to be reduced by 11¢ under existing statutes. However, the lower NAV under SB 1545 would result in the tax rate reduction being 0.9¢ less than under current law. The higher QTR under the bill will reduce the net General Fund cost increase from $5.7 million to $0.9 million in FY 2008, which constitutes a TNT saving of $(4.8) million. By FY 2012, the higher QTR under SB 1545 than under current law will reduce the net General Fund cost increase from $8.3 million to $0.9 million.

The proposal will also affect state General Fund revenues. Although the state property tax was repealed in 1996, the General Fund still receives property tax revenues from unorganized districts and school districts that levy the minimum qualifying tax rate. The impact on state revenues could not be determined but is expected to be small.

As noted above, the fiscal impact of this bill depends on whether the TNT impact is included or not. In the absence of a TNT adjustment, it is estimated that the cost to the General Fund would be $5.7 million in FY 2008 and $8.3 million in FY 2012. However, if the QTR is adjusted to account for TNT, the bill’s General Fund cost would be limited to about $0.9 million in each year between FY 2008 and FY 2012.

County Equalization Assistance for Education Tax

For FY 2007, the county equalization tax, which is levied on the primary net assessed value (NAV) of all property in the state, is expected to generate $213.8 million. SB 1545 would reduce the FY 2007 county equalization tax rate from $0.4220 to $0.2179 per $100 NAV, which would result in a statewide property tax reduction of $(103.4) million.

Under the Basic State Aid formula, any reduction of the county equalization tax would result in a commensurate increase of state funding for local schools. Thus, SB 1545 would increase General Fund expenditures by $103.4 million in FY 2007.

The impact in FY 2008, and in subsequent years, when the tax rate would be set at $0, depends on whether the TNT impact is included or not. In the absence of a TNT adjustment, it is estimated that the cost to the General Fund, relative to current law, would be $235.1 million in FY 2008 and $343.9 million in FY 2012. However, if the county equalization tax rate is adjusted to account for TNT, the General Fund cost would be reduced to $227.7 million in FY 2008 and $293.3 million in FY 2012. Thus, the lower county equalization tax rate under TNT would have the effect of reducing the cost of this provision of SB 1545.

Phasing out the county equalization tax over 2 years may have the effect of reducing the General Fund cost for the “1% Cap.” Under the Arizona constitution, the total amount of primary property taxes levied on owner-occupied residential property (Class 3) is limited to 1% of a parcel’s full cash value. If the combined primary tax bill exceeds the 1% Cap, the state pays the difference in the form of additional state aid to schools. It is estimated that SB 1545 will reduce the General Fund cost for the 1% Cap by $(2.0) million in FY 2007 and $(3.0) million in each subsequent fiscal year. This would reduce the net cost of this provision to $101.4 million in FY 2007 and between $290.3 and $340.9 million in FY 2012.

Local Government Impact

Each year incorporated cities and towns receive 15% of individual and corporate income tax collections from 2 years prior. This bill would reduce local government distributions by between $(24.8) and $(29.3) million in FY 2009 and by between $(199.2) and $(200.8) million in FY 2014.

TPT revenues are shared with local governments and any reduction in these collections would result in decreased funding for local governments. SB 1545 would reduce the city and county share of the state sales tax by $(104,100) in FY 2007 and by $(146,000) in FY 2012.

SB 1545 would also shift the tax burden to property owners not affected by this legislation and/or result in property tax losses for local governments.

2/22/06