

Reforming State Taxes: Arizona Issues and Lessons from Other States

Arizona Tax Research Association Luncheon

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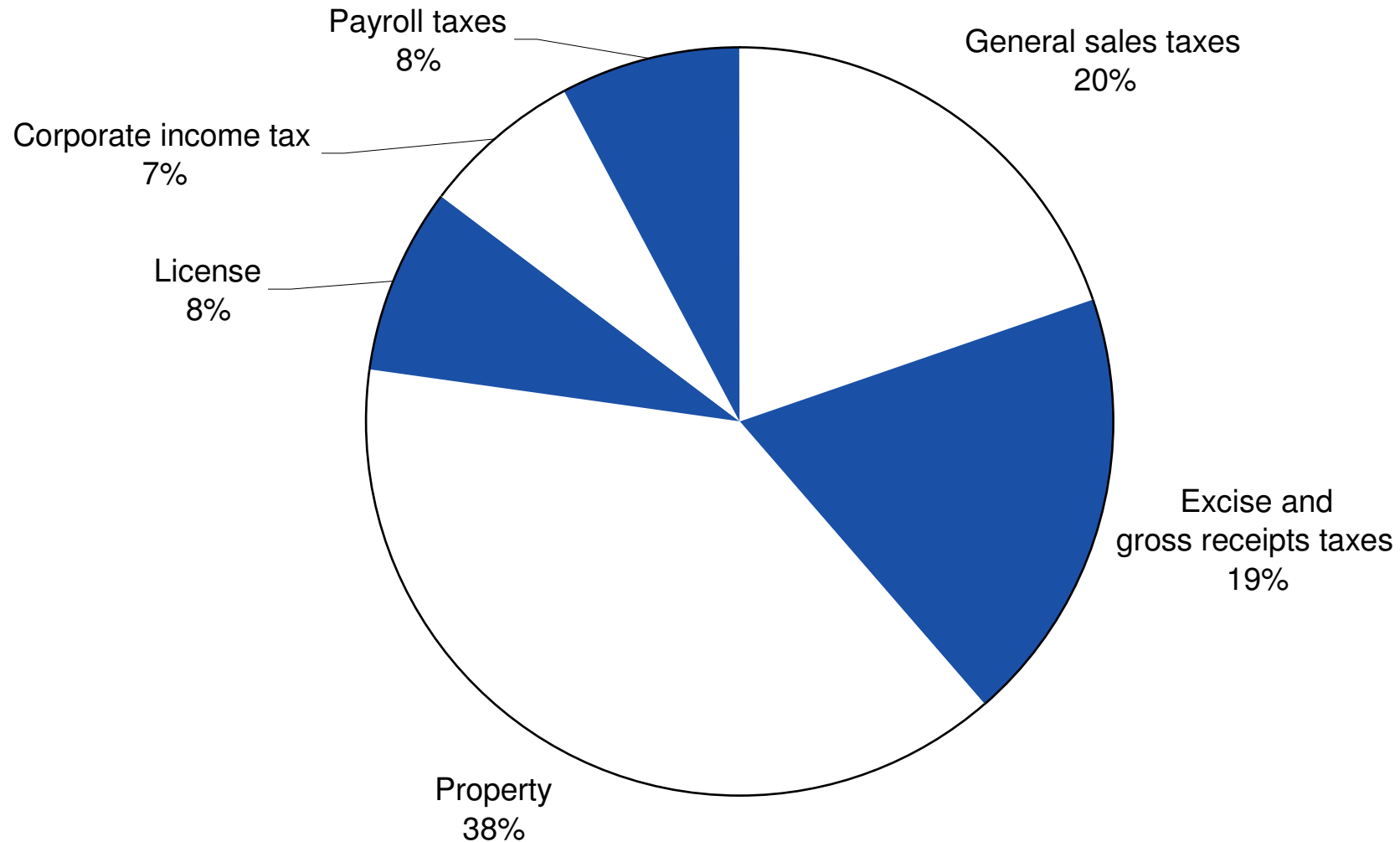
Introduction: The State Fiscal Storm

- State's were dealing with budget deficits for FY 2004 that total at least \$86 billion (15% of total state taxes)
- In January, Arizona was facing a \$1.5 billion “structural” shortfall in FY2004 (25% of budget) vs. \$500 million deficit for FY2003
- Deficits due to short-run economics (weak economic growth & disappearing capital gains) and long-run structural imbalance between taxes and spending
- Concerns over corporate taxes: corporate governance and financial reporting concerns, problems of cyclical volatility and long-run growth in corporate taxes
- Are businesses paying their fair share of taxes?

State-Local Business Taxes: All States

- E&Y study for the Council on State Taxation (IL,MA)
- In fiscal year 2002, businesses paid \$378.9 billion in state and local taxes (liabilities of businesses): *41% of total state and local taxes*
- Includes property, sales/excise taxes on inputs, corporate income, gross receipts, payroll taxes
- Corporate income taxes account for only 7% of total S&L business taxes; business property taxes are 5-times higher; 2/3 of taxes fall on capital investment
- State and local business taxes are rising, not falling – jumped by \$17b in calendar year 2002 vs. \$6b fall in non-bus. taxes

National State-Local Business Taxes, FY 2002



Tax Issues States Are Trying to Resolve

- Balancing the use of the big three taxes: broadening the sales tax base to include services, reforming business taxes, rethinking the personal income tax
- Increasing challenge of taxing income of multistate companies: nexus, apportionment, P.L. 86-272 (NJ)
- Need for more stable business taxes minimum fees, net worth taxes, gross receipts taxes, factors tax, value-added taxes
- Uniform taxation of all forms of businesses, both C-corporations and pass-through entities
- Interaction of business tax and sales tax issues: Simplified Sales Tax Project linking sales tax remote collection and bright-line nexus test for business taxes

Arizona State-Local Business Taxes

- E&Y estimates of AZ 2002 state-local business taxes:
 - ▶ \$6.1 billion of business taxes, 45% of all S/L taxes
 - ▶ property taxes (\$2.8b) are 45% of all business taxes
 - ▶ sales taxes (\$2.1b) are 35% of total business taxes
 - ▶ corporate income taxes (\$0.3b) are only 5.4% of total
- 1998 business tax competitiveness study for ATRA: AZ effective tax rates on new investments for 8 manufacturing and service industries
 - ▶ 1st or 2nd highest for sales taxes on inputs and income taxes – 32 to 38% higher than 10 state average
 - ▶ 1st or 2nd highest for property taxes – 100% higher
 - ▶ 1st or 2nd highest for total taxes – 66% above average

AZ Reforms: Broaden Sales Tax Base

- Taxing the growing service sector: Are businesses tax collectors (sales tax) or taxpayers (gross receipts taxes (NM) or value-added taxes (MI, NH))?
- In theory, retail sales tax should not be applied to business purchases – in practice almost 40% of AZ sales tax come from business purchases
- “Loopholes” are different from exemptions and basic tax features
- If business and professional services are taxed you have problems of pyramiding, distortions, non-competitiveness – “sale-for-resale” exemptions
- Expanded base can be used to lower high rates (helps households and business), fund low-income credits

AZ Reforms: Out-of-Line Property Taxes

- ATRA 2000 figures show impact of classification system:
 - ▶ tax burdens on commercial/industrial property (3%) are three times higher than residential property (1%)
- MTA study found that AZ effective urban property tax rates were:
 - ▶ 6th highest in U.S. for large commercial properties – 65% *above* national average
 - ▶ 3rd highest for large industrial properties – 78% above average
 - ▶ 31st in property taxes on higher value homes – 23% *below* national average
- Classification system results in growing competitive pressure for property tax exemptions, targeted incentives, significant complexity, and accountability issues

AZ Reforms: Business Taxation

- Continued shift to more heavily weighted sales factor for apportioning multistate corporate income
 - ▶ 8 states have a 100% sales factor weight (MA, IL); 5 others with weights greater than 50%
 - ▶ More states greater than 50% than evenly weighted
 - ▶ Analysis of economic development benefits
- Increasing stability of corporate income taxes:
 - ▶ minimum fees (AZ \$50)
 - ▶ gross receipts taxes (NJ alternative minimum tax – not limited by P.L. 86-272); telecom, energy, insurance
 - ▶ net worth taxes, factors tax, value-added taxes (WA, WVA)
- Federal non-conformity – bonus depreciation (3/7ths)
- Taxation of pass-through entities – rate differentials

Reform Efforts in Other States

- Pennsylvania's 21st Century Tax Policy Project
- KY's proposal for a business activity tax (tax on in-state sales and payroll) on all businesses
- Washington State study recommendation to replace B&O tax with a value-added tax
- Michigan's unknown replacement for the Single Business Tax; VAT discussion in Texas
- West VA's 1998 study recommending VAT proposal
- New Jersey's after-the-fact business tax study
- New Mexico's Tax Reform Commission – GRT
- Nevada

Summary

- States are using the concept of “loophole closing” to justify *ad hoc* changes to raise short-run revenues – increased complexity, redistribution of taxes, more uncertainty for taxpayers
- Focus reform on balanced package of changes
- Expect continued convergence of business income and consumption taxes – 100% sales factor, sales taxes and gross receipts taxes
- Watch out for the property tax – market value growth, falling state aid, rising nominal tax rates
- *Build the case for reform – explain what is broken, identify winners/losers, measure impacts on economy, work with legislators and administrators*