Date: May 19, 2021

To: Tom Belshe, Executive Director
League of Arizona Cities and Towns

From: Rounds Consulting Group, Inc.

Re: Key Findings: State Income Tax Proposal – Cities and Towns Impact

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Budget summary documents published as of the date of this memorandum estimate the proposed 2.5% flat income tax rate will cost approximately $1.5B when fully implemented. Since cities and towns receive a portion of state income tax collections, the annual reduction in local government revenue distributions from the state would equal $230M compared to current law.

Furthermore, there is an additional listed provision that caps the top marginal income tax rate at 4.5%. This will cost an estimated $370M at full implementation according to the budget documents and will reportedly continue going forward.

> *Synopsis:* *The current revenue sharing percentage of state income tax collections that is distributed to cities and towns would need to increase to 20.6% under a static analysis scenario with the proposed 2.5% flat tax. This means the economic benefits related to a Prop 208 impact offset would be excluded. However, this percentage declines when dynamic impacts are also factored into the equations.*
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> *If an offset of the negative impacts of Prop 208 are factored into the equation, there will be new tax collections from additional spending and investment, but also adjustments for the modest risk of a small number of lost business location projects directly tied to lower quality local infrastructure if revenue sharing declines and local government investment slows.*
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> *In this case, to "hold harmless," the revenue sharing percentage declines from 20.6% to between 17.1% and 17.4%, depending on the level of acceptable risk (explained later). If the 4.5% rate cap is included, the range for the percentage increases to between 18.2% and 18.9%.*

Note: This memorandum does not opine on the return on investment value of the proposed tax cut package as a whole. Instead, it solely relates to identifying the hold harmless local revenue sharing percentage.

Overview and Context

The issues were modeled to identify the extent local government revenues would decline from the proposed state income tax cuts. The RCG model that calculated the original impacts from Prop 208 was modified and used in this analysis. Additionally, assumptions and calculations were modeled and utilized to capture the benefits from additional spending and investment, in addition to any lost business locations from reduced local government investment. The following points are notable.

- There are multiple estimates for the overall cost of the flat income tax proposal. In this review a cost of $1.5B (i.e., the cost estimate of the 2.5% flat tax only) is initially used for the calculations. A cost of $1.9B (i.e., the cost estimate of the 2.5% flat tax plus the 4.5% rate cap) is also calculated.

- At a cost of $1.5B, using a static analysis, cities and towns would lose approximately $230M each year at full implementation. To fully hold cities and towns harmless, the current income tax sharing percentage would have to increase from 15% to 20.6%.

- As previously noted, a static analysis is not appropriate in this case. A portion of the $1.5B cost would be offset since it would help mitigate the negative impacts of Prop 208 and result in additional economic activity.

- RCG previously modeled the negative fiscal impacts of Prop 208 and estimated the state and local government entities would lose $2.4B in tax revenue over just the first ten years, as well as 124,000 jobs. This was the most conservative scenario that was prepared and is also the figure that has been widely published. The baseline impact from Prop 208 was for nearly $5.0B in lost tax revenue and nearly 250,000 lost jobs within ten years.

- Based on this modeling, two separate scenarios/analyses were initially performed: 1) a 50% Prop 208 offset, and 2) a 100% offset. Both scenarios included dynamic economic impacts. However, the most recently released summary documents identify the tax package will include at least a 100% Prop 208 offset. This is the focus of the remaining calculations.

Hold Harmless Revenue Sharing Percentage Calculations - $1.5B Cost

The following analysis is broken down by individual task and translated into hold harmless revenue sharing percentages at each step. These initial calculations are based on the proposed 2.5% flat income tax rate which is estimated to cost $1.5B when fully implemented.

- The income tax measure will likely fully offset the negative impacts of Prop 208 and create additional economic activity.

- This would increase annual tax revenues to the state and local government entities by at least $240M per year and up to $480M (on average; value increases over time; compared to current conditions) plus an additional dynamic revenue value. If the full offset of Prop 208 is included, the hold harmless revenue sharing target is equal to 18.6%.

Additional economic activity was modeled to provide a more dynamic assessment of the proposal. Enhanced spending from the tax rate reduction was modeled along with related local investment increases.

- A broad tax cut would increase taxpayer spending to a certain degree. If additional resident spending impacts are included, the hold harmless revenue sharing target is equal to 17.7%.

- A reduction in local tax revenues could lead to reductions in business attraction as the quality of services that are provided by local governments (e.g., infrastructure, public safety, etc.) diminishes due to budget constraints. If the risk of lost business attraction is included, the hold harmless revenue sharing target is equal to 18.5%.

- A broad tax cut would increase investment to a certain degree. If additional investment impacts are included, the hold harmless revenue sharing target is equal to 17.1%.

- If there is concern related to the uncertainty of the investment benefits, a 25% reduction in the benefit figure can be applied. This would result in a more conservative estimate with the hold harmless revenue sharing target equaling 17.4%.

In this scenario, which is based on the estimated $1.5B cost of the proposed 2.5% flat income tax rate, the revenue sharing percentage to hold cities and towns harmless declines from 20.6% to between 17.1% and 17.4% (see above bullet points). This can also be used as a range to debate.

Hold Harmless Revenue Sharing Percentage Calculations - $1.9B Cost

A second sequence of calculations were performed to also capture the impacts from the proposed 4.5% rate cap. These are highlighted below.

The overall cost of the tax cut proposal would equal the estimated $1.5B plus an additional value that is roughly estimated at $369M at full implementation. A rounded $400M value is used to adjust for estimation risk and error.

The $400M modeling input is lowered from the initial cost of more than $800M. This is lowered over time since a portion of the Prop 208 offset will be shifted to the 2.5% flat tax. The related sequence of hold harmless calculations are displayed below.

- If additional resident spending impacts are included, the hold harmless revenue sharing target is equal to 19.2%.
- If the risk of lost business attraction is included, the hold harmless revenue sharing target is equal to 20.0%.
- If additional investment impacts are included, the hold harmless revenue sharing target is equal to 18.2%.
- Again, if there is concern related to the uncertainty from the investment benefits, the hold harmless revenue sharing target is equal to 18.9%.

In this scenario, at an estimated cost of $1.9B, the revenue sharing percentage to hold cities and towns harmless is between 18.2% and 18.9% (see above bullet points).

Summary of Hold Harmless Revenue Sharing Percentages

The dynamic revenue impacts will indeed occur, but there is uncertainty on the extent the benefits will be realized over an uncertain period. Prop 208 offsets are highly likely to occur as are the impacts from additional local spending. Additional investment and growth will also occur, but the degree of certainty in the estimates is lower compared to the other items.

If only considering the $1.5B cost of the 2.5% flat tax (i.e., excluding the 4.5% rate cap), the dynamic analysis identifies that the lower threshold for the revenue sharing percentage is 17.1%. If a portion of the investment and growth considerations are excluded from the calculation (i.e., slightly lower induced activity), the hold harmless revenue sharing percentage increases to 17.4%.

If the analysis includes the cost of both the flat tax proposal (i.e., $1.5B) as well as the 4.5% rate cap (i.e., $400M). At a combined cost of approximately $1.9B, the estimated annual reduction in local government revenue distributions from the state would equal $285M. At a cost of $1.9B at full implementation, to hold harmless, the revenue sharing percentage declines to between 18.2% and 18.9%.

Additional Considerations

The term “dynamic analysis” is currently being misused in many calculations. A dynamic analysis captures the effects when there are changes in behavior related to changes in the economic environment.

This is not the same as a calculation that simply estimates how many years of future economic growth will be needed for revenue collections to reach some previous level. Analyses of that kind do not compare current law with proposed law. Under current law the cities and towns are already set to receive a portion of the related revenues under the existing economic base and statute.

There also exists a complication related to distributions and a portion of the projected dynamic revenue growth. While the distribution formula is based on community size, the enhanced economic activity and the majority of the related dynamic revenue collections will occur in the more urban parts of the state, with concentration in Greater Phoenix. Therefore, impacts will vary by community and these calculations would require a review of each individual city or town which is beyond the scope of the analysis.

Additional issues relate to the argument that cities and towns are to receive a *Wayfair* case windfall due to additional remote sales now being taxable. However, a large portion of the sales are already taxable and do not represent net-new tax revenue. The volume of net-new sales activity would need to be in excess of any reasonable calculation to offset the local government losses previously calculated.

A similar argument is being made based on Prop 207 revenue distributions (recreational marijuana sales). These monies also do not represent a windfall of tax collections and are part of the current economic and revenue base. The inclusion of any discretionary revenue after the Prop 207 intended uses has a minimal impact on the calculations.

Let us know if you have additional questions.