BILL # HB 2250 **TITLE:** Arizona's job recovery act

SPONSOR: Adams **STATUS:** House Engrossed

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FISCAL ANALYSIS

Description

HB 2250 would provide a number of tax reductions and new business incentives in the state over the next few years. The bill would reduce individual and corporate income taxes and property taxes over a number of years. Additionally, the bill would also create a number of new business incentives including state withholding tax rebates, tax credits, and property reclassifications. More details of the tax reductions and business incentives under the bill are provided below.

Estimated Impact

The bill's tax reductions are estimated to result in a direct General Fund cost of $171.5 million beginning in FY 2012. As shown in *Table 1* below, the cost would increase to $799.0 million in FY 2015 when the main provisions are implemented and would be $941.8 million by the time all provisions are fully implemented in FY 2017.

Table 1 – General Fund Impact of Income and Property Tax Reductions ($ Millions)

Description of Provision	Tax	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17
Phases out state equalization property tax over 4 years, beginning in TY 2011	Property	$(67.5)	$(132.6)	$(202.1)	$(278.3)	$(289.2)	$(301.9)
Reduces business assessment ratio from 20% to 15% over 5 years, beginning in TY 2012	Property	-	(6.4)	(13.0)	(19.6)	(25.7)	(31.0)
Reduces individual tax rates by 10% over 4 years, beginning in TY 2011	Individual Income	(62.8)	(135.4)	(220.7)	(317.5)	(340.1)	(360.8)
Reduces corporate tax rate by 28% over 4 years, beginning in TY 2011	Corporate Income	(35.3)	(77.8)	(124.1)	(176.1)	(187.3)	(199.3)
Increases the corporate sales factor from 80% to 100% over 2 years, beginning in TY 2015	Corporate Income	-	-	-	-	(20.7)	(44.1)
Diverts 100% of state withholding tax on wages of certain new jobs [1/]	Individual Income	(1.7)	(3.2)	(4.2)	(4.9)	(5.5)	(5.9)
Reduces assessment ratio for a qualifying business up to 10 years	Property			Undetermined			
Creates tax credits for new qualifying jobs	Individual & Corporate Income	(4.2)	(7.6)	(3.2)	(2.6)	(0.3)	1.2
Total General Fund Impact		**$(171.5)**	**$(363.0)**	**$(567.3)**	**$(799.0)**	**$(868.8)**	**$(941.8)**

1/ Provision would begin in FY 2011 at a cost of $0.8 million.

By their nature, six-year forecasts are speculative. The dollar value of the tax rate reductions will change if overall economic growth through FY 2017 varies from the underlying baseline revenue forecast. The business incentive provisions will also depend on how many companies will qualify for assistance. The qualification rate is difficult to predict in advance. This note makes assumptions in that regard, but they should be viewed with caution.

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The fiscal note estimates reflect a "static" analysis. The bill will potentially have other impacts that are difficult to quantify, including dynamic revenue feedback effects resulting from an overall change in economic activity related to the tax reductions. REMI, a regional policy simulation model used by many state agencies in the country, including JLBC Staff, typically generates feedback effects that range between 5% and 18%. In other words, for each $1 tax reduction, REMI predicts that the state economy will generate a tax revenue offset of between 5¢ and 18¢.

The bill's repeal of the job training employer tax will not affect the General Fund. This tax, which is levied on 0.1% of taxable wages, is deposited in the Arizona Job Training Fund. Collections of this tax were $14.9 million in FY 2009.

Analysis

HB 2250 includes a number of tax reductions and business incentives that are outlined in the table under the *Estimated Impact* section of this fiscal note. Below is a description of how the tax reductions in the bill were estimated.

Property Tax

The bill phases out the state equalization property tax over 4 years, beginning in TY 2011. In addition, the bill also reduces the Class 1 (business property) assessment ratio from 20% to 15% over 5 years, beginning in TY 2012. These provisions will not affect General Fund revenues since the state property tax was repealed in 1996. (While the Class 1 assessment ratio reduction may result in a reduction in certain property taxes deposited into the General Fund, this revenue loss is believed to be small.) Instead, the two provisions will affect General Fund spending by reducing school property taxes and correspondingly raising the cost for K-12 state aid. Under the Basic State Aid formula, the state pays for the cost of K-12 education not generated by local property taxes. The state also pays 40% of residential school property taxes through the Department of Education's Homeowner's Rebate program.

The phase-out of the state equalization tax is expected to increase the cost for K-12 state aid by $67.5 million in FY 2012 and $132.6 million in FY 2013. By the time the provision is fully implemented in FY 2015, the General Fund cost of this provision will have grown to $278.3 million.

The reduction of the Class 1 assessment ratio will result in a smaller statewide tax base than under current law. By the time the assessment ratio is reduced to 15% in TY 2016, it is estimated that statewide primary net assessed valuation (NAV) will be (1.8)% lower than under current law. Both this estimate and the expected loss in state equalization levies assume that the annual growth in primary NAV will gradually increase from 0% in TY 2011 to 7.0% in TY 2016.

The Class 1 assessment ratio reduction is projected to result in a direct increase of the state share of K-12 funding by $37.7 million in FY 2013 and $78.5 million in FY 2014. By the time the Class 1 assessment ratio reduction is fully implemented in FY 2017, the cost will have grown to $233.5 million. These estimates include the net impact on both Basic State Aid and the Homeowner's Rebate.

The NAV loss resulting from the assessment ratio reduction will also generate savings through state's Truth in Taxation (TNT) program. TNT changes the qualifying tax rate (QTR) each year to offset the annual statewide appreciation or depreciation of existing property. This rate change occurs automatically unless the Legislature decides to forego the TNT adjustment. As a result of the Class 1 assessment ratio reduction, the QTR is expected to be between 2¢ and 12¢ higher than under current law. The higher QTR under the bill than under current law (as a result of the TNT adjustment) serves to offset some of the K-12 cost related to the NAV loss. After this TNT savings is taken into account, it estimated that the net cost of K-12 state aid will be $6.4 million in FY 2013 and $13.0 million in FY 2014. This net cost will grow to $31.0 million in FY 2017.

Individual Income Tax

The bill reduces individual income tax rates by 10% in equal decrements over 4 years, beginning in TY 2011. This provision lowers the range of marginal tax rates to between 2.34% and 4.10% from the current range of between 2.59% and 4.54%. These rate reductions are expected to lower individual income tax collections by $(62.8) million in FY 2012 and $(135.4) million in FY 2013. By the time the provision is fully implemented in FY 2015, the General Fund is expected to incur an individual income tax revenue loss of $(317.5) million. The FY 2012 and FY 2013 estimates are based on the January 2010 4-sector consensus forecast. Estimates after FY 2013 reflect the most recent income tax forecast by the University of Arizona.

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Corporate Income Tax
HB 2250 reduces the corporate income tax rate from 6.968% to 5.0% in equal decrements over 4 years, beginning in TY 2011. Additionally, the bill also increases the sales factor for multi-state corporations from 80% to 90% in TY 2015 and from 90% to 100% in TY 2016. The rate reduction is estimated to result in a revenue loss of $(35.3) million in FY 2012 and $(77.8) million in FY 2013, and would grow to $(176.1) million by FY 2015. The increase in the corporate sales factor is expected to further reduce tax collections by $(20.7) million in FY 2016 and $(44.1) million in FY 2017. The FY 2012 and FY 2013 estimates are based on January's 4-sector consensus forecast. Estimates after FY 2013 reflect the 15-year average annual growth in corporate income tax collections.

Withholding Tax Rebate
Besides the tax reductions, the bill would also provide a number of new incentive programs for businesses (see page 5). These programs include withholding tax rebates, tax credits and property tax reductions for businesses that meet certain job creation and capital investment requirements. The withholding tax rebate would divert 100% of the state income tax withholding on the wages of certain new employees to the new funds established under the bill. The diversion would occur for jobs with annual wages above 135% of the county "wage offer" along with health insurance benefits. Wage offer by county is neither defined in the bill nor in existing statutes. According to the Department of Commerce, this figure represents the 25th percentile hourly wage in each county. This means that 25% of employees in a county earn a wage that is equal to or less than the wage offer by county.

This diversion would last for 7 years if pay is at least 220% of the "wage offer." The actual threshold will be computed for each county. For this reason, it would vary from a low of $38,200 in Santa Cruz County to a high of $81,400 in Greenlee County. The statewide average wage would be $45,200.

To the extent that new jobs would not have been created in the absence of the incentives, there would be no foregone revenue. It is likely, however, that the state's natural economic recovery would produce some of these new jobs without the tax incentives. These new jobs would be part of the state's General Fund Baseline revenue growth.

To provide some perspective, the University of Arizona forecasts that the state's manufacturing sector will add 2,800 net new jobs in FY 2011. While the withholding provision would not be limited to manufacturing jobs, this industry remains the focus of the incentives package. Moreover, while long-term employment forecasts are available for the manufacturing industry, they are not available for some of the other sectors.

This analysis assumes that 25% of these net new baseline manufacturing jobs (700 positions) will qualify for the incentives under the bill. It is assumed that the remaining 75% of net new manufacturing jobs (2,100 positions) will not be eligible for the withholding rebate due to a failure to meet one or more of the wage, benefit, and payroll requirements of the bill. For example, any new job added to the payroll that would not include employer-paid health insurance (at least 50% of the premium) would be automatically ineligible for the incentive. The 25% estimate is speculative but provides a perspective of the bill's potential impact.

Under the 25% scenario, the 700 net new manufacturing jobs in FY 2011 would qualify for the bill's business incentives and would reduce baseline revenue growth. As noted above, this analysis applies only to manufacturing jobs. Once other sectors of the economy are considered, the impact is likely to be higher.

Based on data furnished by the federal Bureau of Economic Analysis (BEA), the average manufacturing job in Arizona is expected to pay about $60,000 in FY 2011. At this wage level, the average state withholding amount would be approximately 2%, or $1,200 in total. This withholding amount will be diverted to the new funds under the bill. This means that HB 2250 is estimated to result in foregone withholding tax of $(840,000) in FY 2011 as it relates to manufacturing employment. Since a company is eligible for the withholding tax rebate for up to 7 years for net new employment, the amount of foregone revenue will increase over time as reflected in *Table 2* below.

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Table 2 – Foregone Withholding Tax from Net New Manufacturing Jobs ($ Millions)

FY	Cumulative Number of Qualifying Jobs	Average Wage	Average Withholding	Foregone Tax Revenue
2011	700	$60,000	$1,200	$(0.8)
2012	1,400	61,200	1,225	(1.7)
2013	2,525	62,400	1,250	(3.2)
2014	3,275	63,700	1,275	(4.2)
2015	3,775	64,900	1,300	(4.9)
2016	4,125	66,300	1,325	(5.5)
2017	4,375	67,600	1,350	(5.9)

As indicated in the table above, the number of net new jobs that would qualify for the tax incentive would increase over time. Based on the University of Arizona's manufacturing employment forecast, the analysis assumes that the number of qualifying jobs would grow from 700 in FY 2011 to 4,375 in FY 2017. It is further assumed that the average wage will increase by 2% annually and that taxpayers will withhold 2% of their income for state income tax purposes.

The amount of foregone revenue will grow from $(0.8) million in FY 2011 to $(5.9) million in FY 2017. The impact of the incentive is cumulative over time since the withholding tax rebate can be used for up to 7 years for net new employment. The withholding tax rebate will also generate revenues from jobs that would not have been created without the incentive and are therefore not included in the revenue base. As a result, total withholding diverted into the incentive funds will be more than just the amount of foregone General Fund revenue.

Arizona Enterprise Development Program

The bill would repeal the existing Enterprise Zone program and in its place establish the Arizona Enterprise Development program. This new incentives program, which would be effective through FY 2016, would not be limited to certain geographical areas within the state, unlike the current Enterprise Zone program. The program would continue to provide both property reclassifications (either to class 6 or class 9 with an assessment ratio of 5% and 1%, respectively) and income tax credits for net new employment. The premium tax credit for insurers would also continue although under more stringent wage requirements than currently.

The length of the property reclassification would depend on the location (city of 50,000 inhabitants or other location) and the amount of capital investment and number of new jobs created by the business. The individual and corporate income tax credits would be increased to either $3,000 or $1,500 per new employee per tax year depending on whether the business is in an Arizona basic industry or not. Additionally, the maximum number of credit claims by a taxpayer would be raised from 200 to 400 and the credit carry-forward would increase from 5 to 15 years. While the Arizona Enterprise Development program would have the same health insurance requirements as the other proposed incentives programs, its wage requirement would be higher. Specifically, it would require that all qualified employees are paid at least 175% of the "wage offer by county" compared to a minimum of 135% under the other incentives programs of the bill.

The fiscal impact of the property reclassifications under the program cannot be determined in advance. This would require an estimate of both the amount of new capital investment that companies would make and the number of new employees that they would hire under the expanded new job tax credit incentive.

According to DOR, individual and corporate taxpayers used $4.5 million in enterprise zone tax credits in 2007, the last year for which data is available. The same taxpayers reported unused credit carry-forwards of $3.7 million. Although the current Enterprise Zone program is effective through FY 2011, the program would be allowed to continue under HB 2250 for qualified businesses that have employees in the second and third year of employment. By FY 2014, the grandfathered program and its estimated $4.5 million annual cost would have expired. It is assumed that under current law, or baseline forecast, that the enterprise zone credit would have continued at this level in future years.

Under the proposed Enterprise Development program, a business in an Arizona basic industry, such as manufacturing, would be eligible for a $3,000 income tax credit per new employee per year for a period of 3 years. This analysis assumes that employers that used the withholding tax rebate above would also qualify for the enterprise development tax credit.

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(The enterprise development wage threshold is lower than the threshold for the 7-year withholding rebate.) It is estimated that the first year cost (FY 2011) of this incentive would be $2.1 million (700 new employees x $3,000 credit). This cost would increase over time as more new employees would qualify for the credit. However, as noted above, the credit could only be claimed for 3 years for new employees and would be capped at 400 claims per taxpayer.

To estimate the net impact of the new $3,000 tax credit, its cost is compared to the savings incurred from the repeal of the current enterprise zone credit. As noted above, the baseline cost of the expiring enterprise tax credit is $4.5 million. The expiring credit savings begin in FY 2014 when the grandfathering of the credit would no longer apply. The net impact of the new tax credit under the Arizona Enterprise Development program is summarized in *Table 3* below.

Table 3 – Net Impact of the $3,000 Tax Credit Associated with Net New Manufacturing Jobs ($ Millions)

FY	Cumulative Number of Qualifying Jobs	Foregone Revenue of New Credit	Saving from Repeal of Old Credit	Net Impact
2011	700	$(2.1)	N/A	$(2.1)
2012	1,400	(4.2)	N/A	(4.2)
2013	2,525	(7.6)	N/A	(7.6)
2014	3,575	(7.7)	4.5	(3.2)
2015	2,375	(7.1)	4.5	(2.6)
2016	1,600	(4.8)	4.5	(0.3)
2017	1,100	(3.3)	4.5	1.2

As noted above, the net cost of the new credit (in terms of foregone revenue) would be an estimated $2.1 million in FY 2011 and would grow to $7.6 million by FY 2013. Beginning in FY 2014, the cost would be offset by the expiring tax credit savings. Forgone revenue is less after FY 2014 due to the combined effect of both declining rate of growth in manufacturing employment and the credit's 3-year cap. These estimates are speculative for at least 2 reasons. First, the impact will vary if the qualification rate is higher or lower than the 25% assumption used in the withholding diversion analysis. Second, the analysis was limited to manufacturing employment while the credit is available to a broader set of jobs.

Dynamic Impact

According to economic theory, taxpayers typically respond to a change in tax policy, such as a reduction in marginal tax rates, by either working more or less hours and saving more or less of their after-tax income than previously. In the aggregate, such decisions affect both labor supply and capital formation, and thus the economy's output over time. Such supply-side effects are often referred to as "dynamic impacts" since the change in output attributable to the tax policy change will also affect tax revenue collections over time. Such dynamic feedback effects vary depending on the tax policy change that is implemented. The REMI dynamic forecasting model typically generates feedback effects of between 5% and 18%.

The withholding tax rebates, income tax credits, and property reclassifications under the incentives programs of the bill may influence an out-of-state company's decision to move its operations to Arizona, or an in-state firm's decision to expand its existing presence in Arizona. However, the number of companies using such incentives and the resulting increase in net new employment and capital investment cannot be determined in advance. Additionally, it is also uncertain how the state would address any foregone revenue from the incentives programs. To the extent that foregone revenue requires the state to reduce spending that supports both public and private sector jobs, there would be some potential offsetting effect on the overall economy.

Business Incentive Funds

The bill provides for the creation of these programs:

Arizona Job Training Program

This program, which is effective through FY 2020, is managed by the Arizona Department of Commerce (ADOC) for employers in "Arizona basic industries" that provide new jobs in conjunction with certain job training programs. Arizona basic industries refer to businesses primarily engaged in manufacturing, mining, research and development, and for which at least 65% of revenue is derived from out-of-state sales.

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Businesses that meet all the requirements of the program are entitled to a rebate (for up to 7 years) equal to 50% of the state withholding tax on wages earned by new employees. The remaining 50% of the tax is deposited in the new Impact Program Fund. If certain capital investment and job creation thresholds are met, the rebate could increase to as much as 100% of new employees' state withholding tax

Arizona Quality Jobs Program
The Arizona Quality Jobs program, which would also be administered by ADOC and end in FY 2020, has the same payroll, wage, and health insurance requirements as the Arizona Job Training program. The main difference is that the Arizona Quality Jobs program would apply to new jobs created as a result of out-of-state businesses relocating their operations to Arizona, or in-state businesses expanding their existing operations in Arizona. Unlike the job training incentive, the Arizona Quality Jobs program would not be limited to "Arizona basic industries." Companies that qualify for the program would receive a rebate (for up to 7 years) equal to 50% of the state withholding tax imposed on the wages of new employees. The remaining 50% of the tax would be diverted to the new Arizona Quality Jobs Fund.

Arizona Opportunity Fund
The monies in the Arizona Opportunity Fund would be used to award grants for the express purpose of "attracting Arizona basic enterprises, economic development, infrastructure development and community development." The fund sources would be derived from legislative appropriations, interest earnings, gifts, grants, donations, available monies from the federal government (including monies from the American Recovery and Reinvestment Act of 2009), and 50% of state withholding tax on the wages earned by new employees in the Arizona Job Training and Arizona Quality Jobs programs. To be eligible for a grant, a business would have to be in an Arizona basic industry and meet the same wage and health insurance requirements as in the two aforementioned incentives programs.

Local Government Impact

Each year, incorporated cities and towns receive 15% of income tax collections from 2 years prior. This bill would reduce local government distributions by $(14.7) million in FY 2014, $(32.0) million in FY 2015, $(51.7) million in FY 2016, $(74.0) million in FY 2017, $(82.2) million in FY 2018, and $(90.6) million in FY 2019.

The assessment ratio reduction and property reclassifications under the bill will have the effect of reducing the local property tax base. Local governments will likely respond by increasing their property tax rates and/or decreasing tax levies. Any rate increase will result in a tax shift from owners of commercial property to other owners of residential and other property.

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