Citizens Finance Review Commission

An Examination of Personal Income Tax Credits

Prepared for the Citizens Finance Review Commission

by

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1. What They Are

Tax credits are dollar for dollar reductions off of a personal income filers tax bill. For example, someone with a $500 tax liability and a $200 tax credit would only owe $300 in personal income taxes. Arizona has over 20 tax credits available to personal income tax filers (first time claimants). These taxes fall into four[1] main categories/goals: alleviating tax on low-income or disabled individuals; promoting economic development; encouraging environmentally-responsible behavior; and encouraging certain contribution or purchasing behavior. This paper proposes eliminating all tax credits except those designed to alleviate taxes on low-income or disabled individuals[2] or credits that are voter-protected[3]. Please see Appendix A for a list of all current personal income tax credits by category, with data on number of filers who claimed the credit and amount of general fund revenue lost.

2. How It Would Be Administered

The Department of Revenue currently monitors tax credits. If there were fewer credits, there would be less for DOR to monitor.

Most credits were created to encourage certain behavior, such as donating to charities that help working poor families or taking actions that improve the environment. However, such credits generally lack accountability measures to ensure that the provisions attain the stated goal. Furthermore, many credits are used by relatively few individuals. For example, in 2000 fewer than 10 taxpayers claimed credits for agricultural pollution control equipment, alternative fuel delivery systems, defense contracting, employment of TANF recipients, environmental technology, military reuse zone, recycling equipment and underground storage tanks.

Tax credits represent an expenditure of state funds as much as programs that receive a general appropriation. However, only recently have tax credits become subject to any review or evaluation. Tax credits that do not achieve desired goals should be eliminated, just as programs that do not achieve desired goals should be eliminated. Arizona's three tax credits targeted to reducing the tax burden of low-income or disabled taxpayers have resulted in poorer or disabled families paying less in taxes. However, other credits do not demonstrate similar effectiveness. Additionally, tax credits that advantage a relatively narrow segment of the population (less than 10,000 taxpayers) should be eliminated.

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[1] Currently, there is also a state personal income tax credit for taxes paid to other states or countries. The purpose is so that taxable income won't be taxed by Arizona and by another state or country. In 2001, this credit reduced state revenues by $53 million; however Arizona also received some funds because of this credit in other states. The Department of Revenue is working on a report looking at this credit in more detail. This paper does not address this credit.

[2] Specifically, the property tax credit (refundable credit for property taxes accrued or rent paid by seniors with income less than $5000), the family income tax credit (a non-refundable credit of up to $40 per person for taxpayers with income below $31,000) and the increased excise taxes paid (a refundable credit of $25 per person against income tax imposed to mitigate the $0.006 increase in state TPT rate dedicated to education spending.)

[3] The clean election credit which is a non refundable credit for donations made to the Clean Elections Fund. This was passed on the ballot and is protected by the voters (e.g., subject to Prop 105).

3. Impact on Existing Revenue Stream

Because income tax funds run directly to the state and the tax is administered and collected by the state, we expect that localities' own revenues will not be affected by changes in the income tax system. However, state law directs a certain percentage of state income tax revenues be distributed to cities and towns. Therefore, if income tax changes increase or decrease state revenue collections, the amount of funds shared with cities and towns would increase or decrease accordingly (unless the state urban revenue sharing law were changed – ARS 43-206).

4. Cost

Reducing the number of tax credits would reduce the work of the Department of Revenue, resulting in low or no cost to the agency. Indeed, it may reduce staff time for auditing personal income tax returns.

5. Policy Considerations

A. Equity
Currently, income tax credits favor certain activities and charities over others. For example, it costs a family with federally adjusted gross income of $50,000 about $192 (after adjusting for state personal income taxes) to donate $200 to a nonprofit health clinic or advocacy organization but $0 (after adjusting for state personal income taxes) to donate that $200 to a charity that helps working poor families or schools. Also, pollution control devices or solar hot water plumbing stub outs are treated differently than fuel efficient cars or electric lawn mowers. Therefore, eliminating these credits and subjecting similar activities to consistent tax treatment is high in horizontal equity.

Maintaining credits to lower the tax burden of low income taxpayers further improves the vertical equity of Arizona's tax system. Most other PIT credits are used by families with federally adjusted gross incomes of $50,000 or more.

B. Economic Vitality
Credits are designed to encourage specific economic behavior, not overall economic vitality. In the given time frame, we could not find relevant analyses focused specifically on tax credits for personal income taxes. The impact on partnerships or sole proprietorships is unknown.

C. Volatility
Eliminating most tax credits will make the income tax base broader and will modestly decrease the volatility of personal income taxes.

D. Simplicity

Fewer tax credits will improve the simplicity of Arizona's overall personal income tax system.

6. Economic Impact

Eliminating tax credits (other than those designed to alleviate the tax burden of low-income taxpayers or protected by voters) would increase state revenues an estimated $49 million.

7. Other

Tax credits designed to alleviate the tax burden on poor Arizonans have been effective. For example, a family of four (2 parents, 2 children) does not begin to owe state income taxes in Arizona until their income reaches $23,600 and this compares favorably to other states. *(State Income Tax Burdens on Low-Income Families in 2002*, Johnson, Zahradnik and Llobrera, Center on Budget and Policy Priorities, April 2003, www.cbpp.org/4-11-03sfp.htm)

The clean election credit is voter protected.

While the education credits are popular and used by over 10,000 taxpayers, research from the Arizona State University Education Policy Studies Laboratory found that education tax credits do very little to improve educational options for low-income children. Specifically, the research concludes "Arizona's private school tuition tax credit program is expensive and does relatively little to help poor students" and that the public school credit is five times more likely to benefit the wealthiest school districts than the poorest school districts. (Glenn Y. Wilson, The Equity Impact of Arizona's Education Tax Credit Program: A Review of the First Three Years (1998-2000), Education Policy Research Unit, ASU, March 2002, www.asu.edu/educ/epsl/EPRU/documents/EPRU%202002-110/epru-0203-100.htm)

Overall, we believe that the proposal analyzed here will improve the vertical and horizontal equity and progressivity of Arizona's tax system. It will also improve simplicity and raise additional revenues.

Appendix A CURRENT INDIVIDUAL INCOME TAX CREDIT BY CATEGORY

All Data is for 2001 unless otherwise noted (NDA = no data available)

Personal Income Tax Credit	Refundable?	Number of Claims	Total Value of Credit
ALLEVIATING TAX ON LOW INCOME OR DISABLED INDIVIDUALS			
Family Tax Credit		402,094	$7,356,939
Increased Excise Taxes Paid (Prop 301 off-set)		428,189	$22,612,548
Property Tax Credit for Low-Income Seniors	YES	15,143	$4,999,419
PROMOTING ECONOMIC DEVELOPMENT			
Construction Materials (1998)		0	0
Defense Contracting (2000)		0	0
Enterprise Zone		97	$1,182,868
Environmental Tech Facility (2000)		0	0
Military Re-use Zone (2000)		0	0
Research and Development		NDA	
Technology training		NDA	
ENCOURAGING ENVIRONMENTALLY RESPONSIBLE BEHAVIOR			
Agricultural Pollution Control Equipment (2000)		9	$17,562
Agricultural Preservation District		NDA	
Agricultural Water Conservation (1999)		121	$922,072
Pollution Control Device (1996)		0	0
Recycling equipment (2000)		6	$4,605
Solar energy (2000)		2,238	$805,586
Solar water heater pluming stub outs/electric vehicle outlets (2000)		34	$11,416
Underground storage tanks (2000)		0	0
ENCOURAGING CERTAIN BEHAVIOR			
Contributions to charities that provide assistance to the poor (2000)		5,288	$934,904
Employment of TANF recipients (2000)		0	0
Private school tuition organization		46,546	$24,838,082
Public school extra curricular activity fee		166,468	$20,004,715
School Site Donation		NDA	
Clean Elections		26,757	$599,485