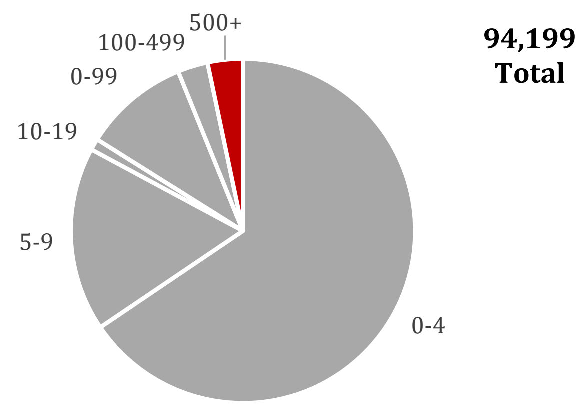
IN SEARCH OF RETURN ON INVESTMENT: HOW ONE ARIZONA TAX CUT BILL DIED WITHOUT IT

Arizona's policymakers have come up with some bad ideas in the name of growing the economy and creating jobs – ideas that, in the end, won't help most of the businesses in Arizona.

HB 2492 was a so-called 2017 "jobs incentive bill" that failed in the Arizona legislature earlier this session. Lawmakers on both sides of the aisle made meaningful arguments in opposing the legislation, arguments that we should apply in the future to other tax cut proposals made in the name of job creation. Here is a deeper look at some of those arguments.

HB 2492 Picks Winners and Losers

Arizona Firms by Employment Size



NOTE: Excludes firms that have no employees.
Source: US Census, Number of Firms,by Enterprise Employment Size for States, NAICS Sectors, 2014

The core provision of HB 2492 would allow corporations to convert unused research and development income tax credits to reimbursements for capital investment expenditures or refunds for any sales taxes associated with those investments. This means that corporations that are already paying nothing in income taxes could get a check for the cost of any capital investments they have made and/or the sales taxes associated with those investments. These provisions apply only to corporations with at least 2,000 employees. In 2014, the US Census Bureau reported Arizona had 94,199 firms that employed staff. Of those, only 3% - 3,113 - employed 500 or more people and two-thirds had fewer than 5 employees. Three years later, the *Arizona Republic's* annual list of the top 100 employers in Arizona listed only 80 businesses with 2,000 or more employees. Without a doubt, incentive programs like those proposed in HB 2492 leave out most Arizona businesses.

Leaving Small Businesses Behind

HB 2492 also expands eligibility for the existing New Employment Income Tax Credit which only benefits businesses with significant capital and business operations. It requires businesses to make multimillion dollar capital investments and create at least 25 new jobs that pay at least the area's median wage. Although the legislation also extends the credit to employers making smaller investments if the new jobs they create have incomes that exceed the area's median wage, the majority of Arizona businesses aren't in the position to make that kind of investment or hire that many employees.

> *"I don't think we need to, in the name of competition, give away the store."*
>
> - ***Rep. Eddie Farnsworth, AZCentral.com, 3/5/17***

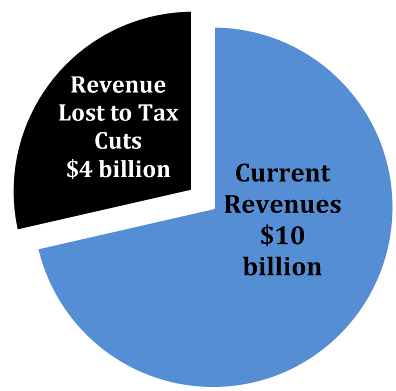
It is the small and mid-sized businesses that did better at retaining jobs during the last recession than the larger businesses.[i] Often lawmakers are focused on creating incentives for a few large corporations or for a very specific industry. For example, the "qualifying facility tax credit" can be claimed only for businesses that expand an existing facility or locate a new facility used for manufacturing or research or for a national or regional headquarters that meets salary and benefits requirements for new positions.

Evidence shows that these types of tax incentives will not help to create the conditions for small businesses to succeed. A study commissioned by the Small Business Administration showed that state tax levels have a negligible impact on small business growth. That is because with nearly nine in ten small businesses making less than $50,000 in annual taxable income, even eliminating the income tax wouldn't come close to paying one full-time worker's salary. Instead, tax cuts take resources away from public investments that help small businesses succeed: investments for schools, transportation, safe communities, and other building blocks of a strong economy that help small businesses grow.

Not Affordable - How Do We Pay the Bill for all of these Tax Incentives?

The Arizona legislature passed two major tax cut bills in 2011 and 2012. When fully phased in, these two bills alone are projected to cost the state's general fund more than $600 million in revenue annually – enough to almost double funding to the state's universities or to completely restore full -day kindergarten and the K-12 funding for school facility maintenance and repair.

How Might Arizona Have Invested the $4 Billion in Tax Cuts Since 1990?



Overall since 1990, tax cuts and credits have cost the general fund $2.2 billion – double that if you account for inflation.[ii]

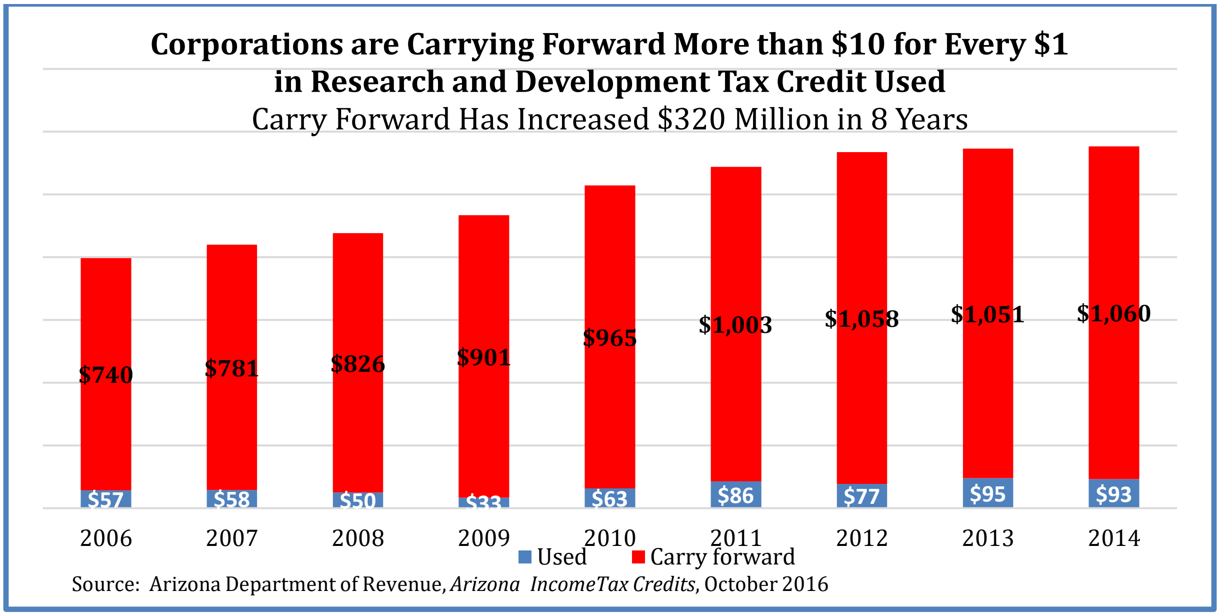
> *"This does nothing to help small business, unless, of course, trickle-down reaches them."*
>
> ***- Rep. Pamela Powers Hannley, AZCentral.com, 3/5/17***

If it had been enacted, HB 2492 would have drained another $16.2 million annually from the General Fund. Without a return on investment analysis, we have no way of knowing whether these tax incentives are delivering the promised jobs or whether they are just giveaways to companies for which taxpayers are paying the bill.

We are Giving Away the Store

Arizona's research and development tax credit is a subtraction from the state income taxes for businesses that make qualifying expenditures. The original R&D tax credit was created in 1993. Arizona lawmakers have already made a number of changes to expand it over the past decade, all in the name of creating more jobs.

First, the legislature removed the cap on the R&D tax credit which enabled some companies to claim an unlimited amount of tax credits to offset their corporate tax liability. Then, when a corporation's tax credit is greater than its tax liability, lawmakers allowed those corporations to carry the unused portion forward to use in future tax years. The main research and development tax credit allows an unused credit to be carried forward for 15 years, while the university research and development credit allows a 5-year carry forward. And, of course, corporations can start a new credit whenever they make an investment, which results in them wiping out their tax bills into the foreseeable future. For tax year 2014 (the latest data available), corporations used $93 million in research and development tax credits and carried over to future tax years more than $1 billion. HB 2492 would have enabled corporations to convert those unused tax credits to another type of reimbursement or credit with no way of knowing whether the expanded subsidies are creating jobs and growing our economy.



Some Companies May Never Have to Pay Corporate Income Tax in Arizona

Tax incentives typically generate economic growth only when the existing tax burden is high. That is not the case in Arizona. Three out of four corporations that filed income taxes in Arizona in 2013 had the minimum tax liability of $50 before applying tax credits. Arizona's corporate income tax rate was reduced from 6.968% to 4.9% over a 5-year period ending in tax year 2017 – a 30% reduction. A corporation with $1 billion in taxable income would pay $20.7 million less in 2017 than they would have in 2013. This reduction to Arizona's corporate income tax rate is contributing to larger corporations using less of their available tax credits to wipe out their income tax liability and carrying forward larger amounts of unused credits.

The large carryforward balances creates a problem for fiscal stability in our state – the $1 billion can hit the budget at any time and makes projecting revenues difficult.

The increasing number of corporate tax cuts and subsidies also means some companies may never have to pay corporate income tax in Arizona. This raises the question of whether Arizona should be looking at other strategies to make the state more economically competitive.

How Do We Know If These Incentives are a Good Investment of Our Tax Dollars?

Access to high-quality data is essential for determining a tax incentives' return on investment:

- How have these incentives lead to more jobs in Arizona?
- How many companies have decided to expand, remain or move to Arizona because of these incentives?

Arizona lawmakers play an integral role when considering these incentives measures to ensure that data are collected and available to make informed decisions. Here are three approaches that lawmakers in other states have employed:

- **Require businesses to provide data as a condition of getting the benefit.** This approach requires businesses claiming a tax incentive to provide the state with a report detailing how the additional investments they are making are a result of the incentive and how it will be used to boost the state's economy. For example, to evaluate the impact of a film tax credit, Massachusetts required companies claiming the credit to provide detailed budgets that distinguished between spending that benefits residents of other states, like the salaries of actors and directors, and spending that boosts the local economy. The data enabled the state to determine that the tax credit was costing the state more jobs than it created.[iii]

- **Create access for evaluators to gather existing, otherwise confidential, information.** Assessing incentives often involves using tax data that are subject to restrictive confidentiality rules. Lawmakers, though, can make exceptions and Arizona does have a law (A.R.S. 42-2003) allowing such confidential information to be shared with the Joint Legislative Committee on Tax Credit Review to evaluate the effectiveness of tax credits. However, those who are provided access to such confidential information must then also have the ability to cross reference other relevant information to inform their analysis. For example, lawmakers in one state authorized a research team to access confidential tax data from its Department of Revenue. The researchers showed that in most recent years, companies receiving tax credits under the state's largest incentives program were adding jobs more slowly than companies that had not received the incentives.[iv]

- **Ensure agencies are working together to collect and analyze comprehensive information.** Iowa lawmakers established a collaboration between its Department of Revenue and agencies that award tax credits, such as the state's commerce department. The agencies created a tracking system that catalogues when agencies award tax credits and keeps tabs on whether companies have claimed credits on their taxes yet. The system was instrumental in enabling the state to understand the impact of its R&D tax credit by enabling the Iowa Department of Revenue to compare research spending, the number of patents granted, and the number of Ph.D. scientists and engineers between states, including those with and without such credits. The report found that the credits did not appear to increase the level of research activities in the state, relative to other states.[v]

Arizona Businesses Want Investments in Education and a Trained Workforce, Not Lower Taxes

For the past two years, Alliance Bank has conducted an annual survey of 400-500 of Arizona's top CEOs and in both surveys they identified improving Arizona's public education system and improving the quality of our workforce as the highest priorities for the state. Similarly, in 2016 the Tucson Chamber of Commerce asked business leaders to compare whether tax cuts for their businesses or increased funding for education were the best way to improve our state's economy. Seventy-three percent said improving education and the quality of our workforce was the best way to encourage economic expansion.

Making the right targeted investments of our tax dollars can build a strong foundation for Arizona's economic growth and create more high-paying jobs. But lawmakers need to make those decisions with a clear budget roadmap that leads us to where we want to be in the next five to ten years and a realistic look at what it will take to get us there. It is within the context of that long-term planning that a return on investment analysis will enable lawmakers to weigh the costs and benefits of their decisions and decide whether Arizona businesses <u>and</u> workers would be better served by giving tax credits to create a few jobs or by investing in our public education system, job training programs, infrastructure and other priorities.

Visit our website at AZEconCenter.org. Reach us by email at DLujan@AZEconCenter.org.

---

[i] *Eric Jay Toll, Phoenix Business Journal "Hesitant No More: Arizona small businesses poised to flex hiring muscle," July 2015,*
http://www.bizjournals.com/phoenix/news/2015/07/31/hesitant-no-more-arizona-small-business-poised-to.html

[ii] *Joint Legislative Budget Committee staff, Tax Handbook 2016; Tom Rex, Center for Competitiveness & Prosperity Research, W.P. Carey School of Business, Arizona State University, Tax Reductions in Arizona: Effective on Economic Growth and Government Revenue, October 2016.*

[iii] *Massachusetts Department of Revenue, "A Report on the Massachusetts Film Industry Tax Incentives," November 2011,*
http://www.mass.gov/dor/docs/dor/news/2011filmincentivereport.pdf

[iv] *University of North Carolina Center for Competitive Economies, "An Evaluation of North Carolina's Economic Development Incentive Programs: Final Report," July 2009,*
http://www.ncleg.net/documentsites/committees/JSCEDI/UNC%20C3E%202009%20final%20report%20to%20NCGA%20Joint%20Select%20Committee%20on%20Economic%20Development%20Incentives.pdf

[v] *Iowa Department of Revenue, "Iowa's Research Activities Tax Credit – Tax Credits Program Evaluation Study," December 2011,*
http://www.iowa.gov/tax/taxlaw/RAC2011.pdf