

ARIZONA'S ECONOMY

ECONOMIC AND BUSINESS RESEARCH CENTER

Arizona's Economic Outlook 2012-13: On the Road to Recovery

By Marshall J. Vest, Forecasting Project Director

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Arizona's economy improved modestly during 2011. Data show that recovery has begun, but the pace is painfully slow. Recent revisions to aggregate measures suggest that growth may be accelerating as 2011 comes to an end, and we expect the pace to quicken as 2012 unfolds. However, remaining imbalances in real estate, depressed population mobility, and severe budget constraints in the public sector will continue to restrain the pace of recovery. It will take another 2-3 years to repair all the damage suffered during the Great Recession.

2011 will go into the economic history books as another forgettable year, as progress continued to be held back by strong headwinds. Hangover from the financial crisis restrained credit growth in the U.S., and the Eurozone's sovereign debt and banking crisis is its most recent manifestation. Housing continued to languish under the burden of distressed sales and falling prices, and population

mobility continued near record lows. Lack of confidence in the ability of governments to set good policies was highlighted by Congress's debacle on resetting the debt ceiling and recent failure of the Congressional "Super Committee" to reach an agreement to reduce the federal budget deficit. With confidence stuck at recession levels, spending and hiring remained restrained.

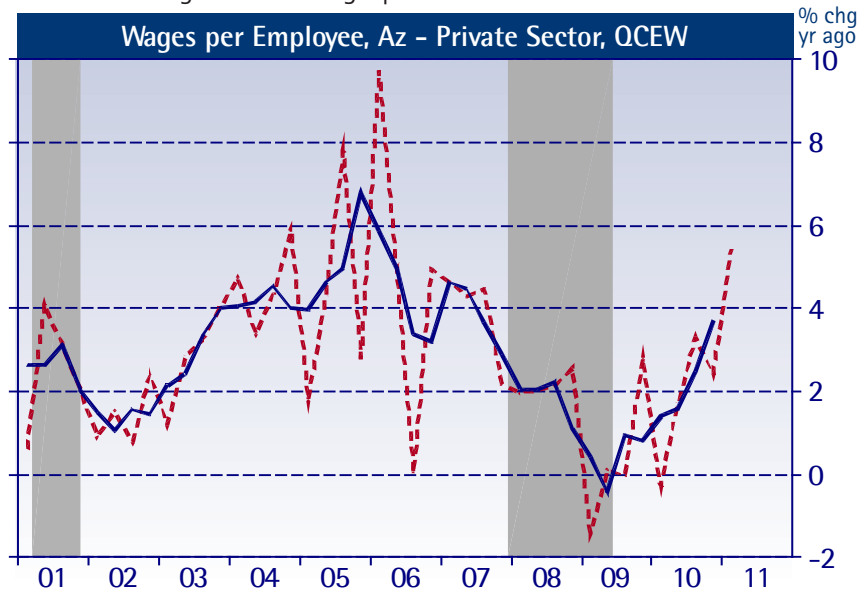
The good news is that all the aggregate indicators of economic activity for Arizona are (finally) improving. Personal income, wages, and employment are growing at increasingly faster rates. Measures of spending are surprisingly robust. Unemployment is declining as are bankruptcies and residential foreclosures.

The Arizona economy is no longer bouncing along the bottom. Recovery is now underway.

Recent revisions to Arizona personal income show much stronger growth in recent quarters than originally reported. On a year-over-year basis, personal income grew 5.7% in the first quarter 2011 and 5.5% in the second. Proprietors income contributed with an annualized gain of 9.1% during the first half, followed by a 6.8% gain for property income. Wage and salary disbursements increased by a disappointing 3.8%.

Wages per employee in the private sector jumped by 5.7% in the first quarter, compared to a year earlier (**Exhibit 1**).

Exhibit 1: Wages Are Moving Up



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Wages have barely kept up with inflation in recent quarters. After adjusting for inflation, wages per employee remain roughly 2% below their pre-recession peak.

Over the 12 months ending in September, nonfarm employment grew by 2.3% from a year ago. That's 48,000 new jobs – all of them in the private sector (Exhibit 2).

Surprises in state revenue collections, especially for income taxes, are thought to be the result of special factors that will not repeat. Indeed, the 18.5% increase in individual income taxes for FY2011 couldn't be explained by the economy's performance; personal income grew only at a 5.5% annual rate in the first half of 2011.

Nationwide, the story line for consumer spending in recent months has been positive, with spending growing faster than incomes. That's made possible by a lowering of the savings rate.

With data through October, retail sales statewide have grown by 9.9% (12 months compared to prior 12 months). Among major categories, furniture and home furnishings (up 15.5%), clothing/accessories (up 15.1%), building material/lawn & garden (up 12.5%), and motor vehicle dealers (up 11.7%) have

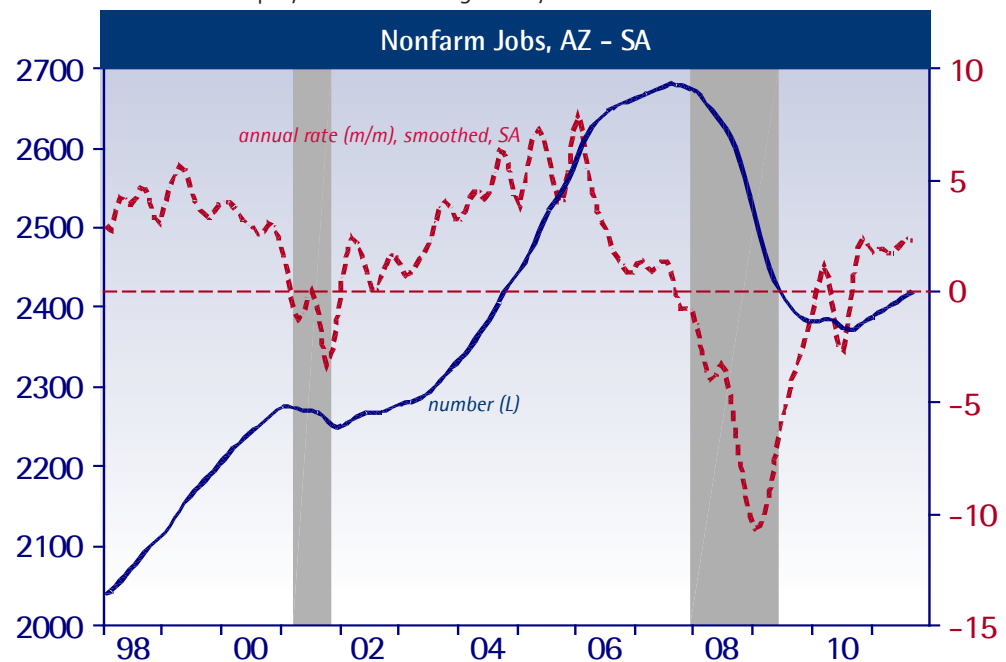
registered the largest increases. Restaurant and bar sales have increased 4.8% and now equal the peak established in early 2007 (however, inflation-adjusted sales remain 11% below the peak).

A more comprehensive picture of spending that includes all sales and use categories shows aggregate spending flattening in recent months and growing at a moderately-paced 5.3% annual rate. That's a significant improvement, however, compared to the declines experienced over the 2008-10 period. This measure includes taxes collected from restaurants & bars, communications, utilities, rentals, hotels/motels, amusements, printing, publishing, contracting, and other smaller categories in addition to retail. (Exhibit 3).

Arizona's housing markets are still depressed, but progress at working through the backlog of distressed properties is encouraging. Foreclosures are still at high levels (Arizona ranked third among states in October) but activity was 36% lower than a year ago. A precursor to foreclosures, delinquency rates on single family mortgages at commercial banks, also remains at very high levels (over 10%), where normal is 2-3%.

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Exhibit 2: Employment is Growing Slowly



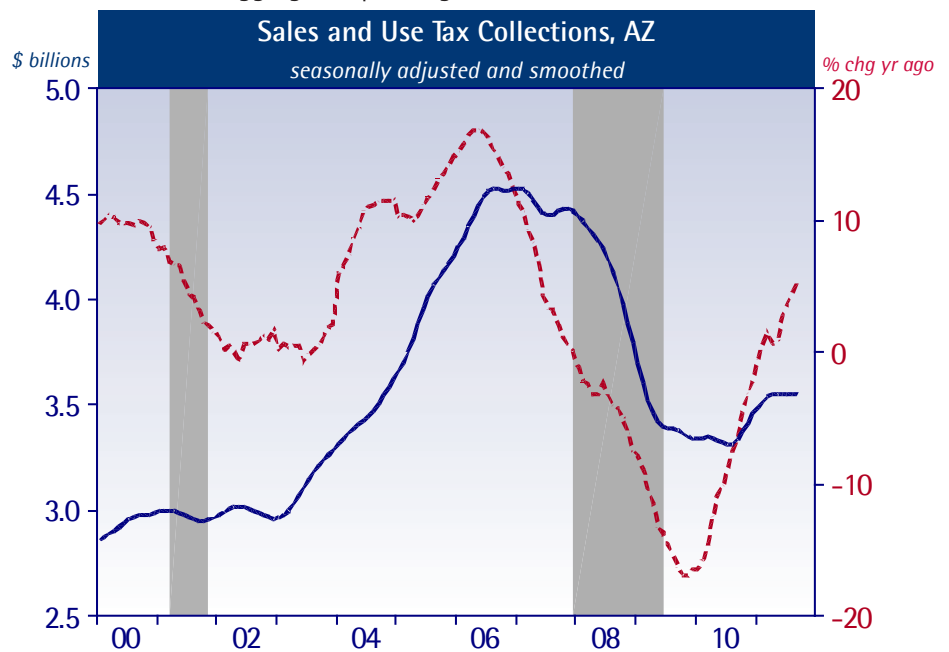
Fortunately, demand remains high for residential properties, driven by strong investor interest. In the resale housing market, active listings have been reduced significantly to what might be considered normal. Coupled with current large number of sales, the months supply now stands at only three months in metro Phoenix and less than five months in metro Tucson. Four to six months is considered "normal" (Exhibit 4).

Unfortunately, a large portion of sales are distressed and that continues to put downward pressure on prices. Prices are perhaps the best single indicator of market conditions, and until housing prices stabilize, the distress flag flies high.

Is Population Declining?

When results from the 2010 Census became available showing a count that was fully 1/4-million short of expectations, we raised the notion that Arizona's population had declined during the Great Recession. This is a question that will never be answered with certainty, since a (supposedly accurate) count is performed only once per decade. But it makes a huge difference in our

Exhibit 3: Aggregate Spending Shows Slow Growth



understanding of how population flows vary over the business cycle.

Originally, before the results of the Census enumeration were known, the Census Bureau estimated that Arizona's mid-year 2010 population approached 6.677 million (release

Exhibit 4: Active Listings Are Reduced Swignificantly



date early March 2011). The Census now believes the number (released in September 2011) to be 6.414 million, which is consistent with the April 1, 2010 count. The new Census estimates show population continuing to grow by 1-plus percent during the recession

Implications for net migration are dramatic. The current estimates show net migration remaining positive in the 20,000-35,000 range.

For Metro Phoenix, the Census Bureau originally estimated a mid-year 2010 population of 4.435 million and currently shows 4.211 million. Net migration is a positive 23,000 in the current estimates.

For metro Tucson, the 1-million mark is no longer a reality. The current Census estimate is 982,000 compared to the pre-Census estimate of 1.027 million. Net migration for 2010 is a positive, but weak, 2,300.

So, the recent estimates from the Census Bureau say that population in Arizona did not decline during the Great Recession and that population is currently growing by roughly 1% annually.

The Outlook

The recovery remains in its infancy and it will take years to repair the damage suffered by the Arizona economy during the Great Recession.

We continue to look for another year or

two of slow growth for Arizona's economy. Assuming that the nation's economy avoids recession (a 40% change of another dip in the next 6-12 months), recovery in Arizona will continue to gain momentum. The pace will be modest due to drag from the real estate and public sectors, and reduced mobility of the nation's population. It will be mid-decade before Arizona's economy will get back to "normal."

For 2012, we expect increases in average annual growth of 3.9% for personal income, 1.3% for nonfarm employment, 0.5% for population, and near 5% for retail sales. In absolute numbers, that's 30,000 new residents, and a similar number for nonfarm employment. The following year will bring 64,000 new residents and 54,000 new jobs. By 2015 the numbers will be near "normal" at 135,000 and 120,000, respectively. The accompanying forecast tables provide additional details.

By mid-decade, we will have regained all the jobs lost and repaired the damage suffered during the recession. At this point, after all we've been through, that sounds pretty good. ■



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The Flat Income Tax in Arizona: Shift in Tax Burden from High to Low and Middle Income Households

Alberta Charney, Ph.D., Research Director

Introduction

A flat income tax bill was proposed during the 2011 Arizona legislative session and, although the measure failed, some version of a flat tax bill is expected to be back during the 2012 legislative session. A flat tax imposes the identical tax rate on all taxpayers, regardless of income and personal circumstances. This is in contrast to the existing increasing block rate structure that taxes higher income taxpayers at higher rates and lower income taxpayers at lower rates. This article assesses the impacts of the proposed 2011 flat tax bill. Although the flat tax bill anticipated to be presented in 2012 may be somewhat different, any flat tax bill if passed will cut income taxes for highest-income Arizonans and substantially shift tax burden to low- and middle-income households. Such a shift will most certainly dampen economic activity in Arizona through reduced demand.

Existing Structure

Arizona's current income tax structure can best be described as a progressive block rate structure. After deductions and exemptions are subtracted, the remaining taxable income is taxed at higher rates for each incremental block of income. Single taxpayers are taxed at the following rates:

- 2.59% on the first \$10,000 of taxable income
- 2.88% on the next \$15,000 of taxable income
- 3.36% on the next \$25,000 of taxable income
- 4.24% on the next \$100,000 of taxable income
- 4.54% of taxable income over \$150,000

For married couples filing jointly, the same rates apply, but the income ranges double (\$20,000 to \$300,000).

Arizona's Tax Structure Has Been Getting Flatter

Arizona's rate structure has been getting flatter for the past 20 years. Since 1990, there were seven income tax cuts that have both reduced total revenue and shifted relative tax burden from high-income individuals to low- and middle-income individuals. In 1990, the income blocks were as described above, but the rates were 3.8%, 4.4%, 5.25%, 6.5% and 7%.

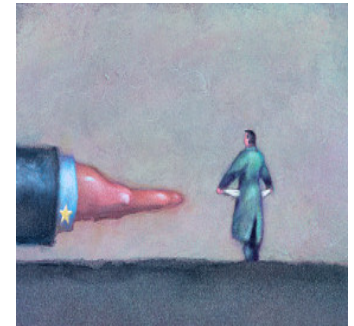
Through seven different tax cuts, each of the rates was cut by a total of approximately 35%, resulting in the current rates shown above. Cutting each rate by the same percentage had the effect of reducing the rates for the highest brackets more than the bottom rates were reduced. The highest 1990 rate was reduced 35% from 7% to 4.54%, a reduction of 2.46 percentage points in the rate. The lowest 1990 rate was also reduced approximately 35% from 3.8% to 2.59%, a reduction in the tax rate of 1.21 percentage points. The rate cut for those in the highest bracket was more than double for those in the lowest bracket.

Each of the seven cuts since 1990 shift some of the tax burden from the highest-income groups to low- and middle-income groups for a given amount of taxes collected. The proposed flat tax reduces the rate to a flat 2.13% for all groups. In order to maintain an equal amount of revenue, this relatively low tax rate is accomplished by eliminating exemptions, many deductions, exclusions, etc., which results in a massive shift of the income tax burden from high- to low- and middle-income households.

Winners and Losers

The Arizona Department of Revenue computed the taxes that will be paid by each income group under the flat tax and compared them to taxes paid under the current tax structure (Table 1). The DOR calculations are available on the Joint Legislative Budget Committee's website at

<http://www.azleg.gov/legtext/50leg/1r/fiscal/hb2636.doc.pdf>. The impact is based



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on DOR's estimated 2011 tax liability for residential filers. Additional computations were made by the author.

Based on these figures, 88% of Arizona taxpayers will pay more in taxes with the flat tax and 12% will receive tax cuts. Almost \$400 million in tax burden (\$395.7 million, the sum of the tax increase above the line) will be shifted from taxpayers with Federally Adjusted Gross Incomes (FAGI) above \$100,000 to those with FAGI below \$100,000. Taxpayers with FAGI above \$100,000 will receive an average tax decrease of 27% while those with FAGI below \$100,000 will see an average tax increase of 43%.

Taxpayers in the very lowest bracket (under \$10,000 in FAGI) will pay almost \$57 million more than their current liabilities, an increase of more than 9,000 percent!

Exemptions and Deductions Lost

The following is a list of exemptions and deductions that can no longer be subtracted from FAGI to get to Arizona's taxable income:

Personal exemptions and exemptions for dependents

Exemptions for the blind and elderly

Military pay exemption and \$2500 military pension exemption

Standard deduction

Itemized deductions, including:

Charitable contributions

Mortgage interest deductions

Moving expenses deductions

Un-reimbursed medical expenses

Table 1: Winner and Losers Under a Flat Tax

Federal Adjusted Gross Income (FAGI) Bracket	% of Total Tax Filers	Income Tax Liability under current Law (\$Mil)	Income Tax Liability under Flat Tax (\$Mil)	Tax Increase (Decrease) with Flat Tax (\$Mil)	% Increase (Decrease) in Income Tax Liability
\$0 - \$10,000	15.00%	\$0.60	\$57.50	\$56.90	9,483 %
\$10,000 - \$20,000	16.40%	\$27.30	\$123.90	\$96.60	354 %
\$20,000 - \$30,000	14.40%	\$69.60	\$134.80	\$65.20	94 %
\$30,000 - \$40,000	11.40%	\$107.40	\$158.30	\$50.90	47%
\$40,000 - \$50,000	8.40%	\$116.50	\$150.30	\$33.80	29 %
\$50,000 - \$75,000	14.00%	\$299.90	\$359.40	\$59.50	20 %
\$75,000 - \$100,000	8.50%	\$289.60	\$318.70	\$29.10	10 %
\$100,000 - \$200,000	9.50%	\$596.80	\$521.80	(\$75.00)	(13%)
\$200,000 - \$500,000	2.10%	\$350.60	\$246.60	(\$104.00)	(30%)
\$500,000 - \$1,000,000	0.30%	\$158.40	\$92.40	(\$66.00)	(42%)
\$1,000,000 - \$5,000,000	0.10%	\$183.90	\$100.40	(\$83.50)	(45%)
Over \$5,000,000	0.01%	\$148.60	\$81.40	(\$67.20)	(45%)
Total	100%	\$2,349.20	\$2,345.50	(\$3.70)	(0%)

Fairness in Taxation

A common argument for applying the same tax rate to all income brackets is that it is "unfair" to tax higher incomes at higher rates and lower incomes at lower rates. But fairness is something that should be evaluated on the basis of Arizona's tax structure as a whole – not on the basis of a single tax.

Arizona relies very heavily on the sales tax, which is widely considered a "regressive" tax, meaning the share of income paid is lowest for highest income individuals and highest for low income individuals. In Fiscal Year 2010, before the addition of the temporary sales tax, sales taxes comprised 56% of the state's general fund and income taxes represented only 36% of general fund receipts. A major reason why income tax rates are "progressive" is to offset the regressive nature of other state taxes, especially the sales tax.

Many of the changes in Arizona's tax structure since 1990 have had the effect of shifting the relative burden of state tax collections from the highest income groups to low- and middle-income groups, specifically, the repeal of the estate tax in 2006, the increased reliance on sales taxes, the reduced reliance on income taxes, and the repeated flattening of the income tax.

Macroeconomic Effects of the Shift in Tax Burden

During the recession of 2001, Peter Orszag (former Head of the Office of Management and Budget) and Joseph Stiglitz (a Nobel Prize winning economist) released a policy paper entitled "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?" Recognizing that both general tax increases and spending cuts can have detrimental effects on the state economy, they concluded that as long as the economy is suffering from insufficient aggregate demand, then "if anything, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits..."

The converse is also true. Shifting tax burden from high-income households to low- and middle-income households will have negative consequences on the state's economy by reducing aggregate demand. During weak economic conditions, reducing aggregate demand will have a negative impact on jobs as low- and middle-income households have to reduce spending in order to pay the increase in taxes. Low- and middle-income households already spend almost all of the money they earn; high income families can save a portion. When taxes are raised on lower income taxpayers, they must pay for the tax by cutting spending and the corresponding tax cut for high-income individuals is likely to result in offsetting spending increases. As a result, as tax burden is shifted from the highest to the lower income groups, aggregate demand (total spending) in the state decreases.

The Myth of Flat Taxes and State Growth

Having a flat tax does not guarantee a healthy state economy nor does it indemnify a state from severe economic downturns and recessions. Some of the worst performers during the 2004–2009 period (most recent BEA data) had flat taxes throughout the period, e.g., Michigan (-7.14% employment growth), Indiana (-2.05%), Illinois (0.26%), Tennessee (0.56%), Pennsylvania (1.66%), and Massachusetts (2.16%)..... compared to Arizona's (5.85%) and the US as a whole (2.83%). The only state with a flat tax during this period that grew faster than Arizona was Colorado (6.67%).

Conclusion

The proposed flat tax will shift almost \$400 million in tax burden from taxpayers making over \$100,000 to taxpayers making less than that. The shifting of tax burden to low- and middle-income households will have a dampening effect on total demand and hence on economic activity in Arizona. ■

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