August, 2018 – Proposition 207 Small Business Impacts Part 1

Supporters of Proposition 207 argue that it is a tax only on the wealthy. This is inaccurate. The initiative will have a sizeable impact on small businesses for the following reasons:

- *The near doubling of individual income taxes for certain tax brackets will directly impact a significant portion of the small businesses in the state since the owners pay the individual income tax and not the corporate income tax.*

- *The initiative will also result in economic losses that will disproportionately impact the smaller, local market operations that provide support to the larger corporations and their employees.*

- *To add insult to injury, the initiative will make it difficult for business owners to reinvest and expand their own companies.*

<u>A Tax on Small Businesses – By the Numbers</u>

The target of the initiative's tax increase is the upper brackets of the individual income tax. The near doubling of the tax rate begins at $250,000 in taxable income for individual filers and at $500,000 for joint filers. The proposed tax rate goes up even more for those individual filers with taxable income above $500,000.

Initiative proponents argue that this is a very small group of wealthy people and that no economic harm will arise. This argument is dangerously incorrect. To understand the initiative's impact were it to pass, we analyzed tax data for incomes over $200,000 and over $500,000, which is consistent with current law.

Thus far, initiative advocates have incorrectly characterized how the proposed tax rates will impact individuals and the local economy. The following is an accurate summary of where the tax increases will do the most harm.

In 2015, there were 166,000 small business filers in the state that were established as LLCs or S Corps. More than 40,000 had taxable income over $200,000. This means that nearly 25% of all small business filers in the state would be impacted by the initiative. If we remove the businesses that produced losses, 27% of revenue-generating and taxpaying businesses would be impacted by the initiative.

It has also been argued the small business component represents an insignificant percentage of the targeted "wealthy individuals." There are just over 100,000 tax returns that fall into the higher income brackets. Thus, these 40,000 small business filers represent almost 40% of all filers that will be impacted.

Furthermore, these same 40,000 small business filers produced nearly 90% of all small business taxable income. This means that not only does the initiative impact far more small businesses than has been described, but specifically targets the small business filers that contribute the most tax revenue to the state. This money supports education, public safety, roads, etc. These same filers are the most at risk of leaving the state. They are also the group most likely to not locate to Arizona in future years. This will add to the significant forecast of revenue losses that is being produced.

A Tax on Small Businesses – Follow the Money

There has been much written on the initiative removing inflation indexing. This will eliminate inflation protection and will result in an estimated $30M tax increase on all taxpayers, and will grow each year at the rate of inflation. However, an even bigger problem is how future job losses and depressed economic growth will impact small business development and viability.

Research is being conducted on the extent the initiative will cause any of the current population or business base to flee the state (physically or for tax purposes), how it will impact future job and population growth rates, the extent new business recruitment will be weakened, and if future wage growth will become more stagnant. Multiple approaches are used as checks on the other calculations and to avoid the possibility of including an outlier.

A preliminary "best case" scenario identifies a loss of 40,000 jobs from the initiative and a cumulative $1.0B in state and local tax collections by year ten. The most severe case analyzed thus far identifies a loss of over 100,000 jobs and a cumulative $3.0B in lost tax collections by year ten. Note: In the case of major changes in public policy (i.e. significant tax law changes, highway infrastructure, utility infrastructure, communications infrastructure, etc.) impact calculations can extend well beyond a ten-year timeframe. The ten years was purposely selected to provide conservative economic impact estimates.

The preliminary economic and fiscal impact values are provided for perspective on the following point that has yet to be addressed: When the state adds base sector jobs, many other jobs are also created because these businesses spend money throughout the community, as do the employees. However, when the state loses business development opportunities, the state *loses* these same jobs. Many of these jobs are in small business categories like restaurants, bars, retail shops, dry cleaners, real estate agents, etc.

A Tax on Small Businesses – Basic Business Development

This last point may seem small by economic and fiscal impact standards, but may be one of the greatest flaws in the initiative. The proponents' argument ignores how small businesses develop and expand. Lending by banks remains very tight after the last economic downturn, but has always been tight for small businesses. Owners save, take risk, and open small businesses under LLC or S Corp status.

A couple of weak revenue years may be followed by a strong year. This income is later put back into the company and then the cycle continues. Business owners bet on themselves when the banks will not. Growth is in steps and not everything can be planned. This initiative and accompanying tax increase will impact small business expansion and a fundamental right to prosper.