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Arizona's Special Interest Laundry List

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Last week, Arizona state representatives unveiled a raft of proposed subsidies and special tax breaks for favored industries. Typically, with packages of lobbyist-driven handouts such as these, the actual value to state residents is inversely proportional to the sponsors' soaring language regarding their benefits. So when Arizonans are told that the package's effects will be "bringing in new manufacturing jobs, revitalizing urban areas, attracting tourists, maintaining or expanding the Cactus League and stabilizing the construction market," they should check to make sure they are still in possession of their wallets.

The Arizona State House's press release announcing the proposals grandly reports that "no current general fund money would be used for the projects." Technically, that's true. However, the difference between the government (1) collecting a tax and then cutting a check to a favored business, or (2) exempting that favored business from a portion of its tax liability, is a difference in accounting only. **These programs will impose significant costs on Arizona's general fund in the form of tax revenues foregone.** In many cases, the special tax benefits will go to businesses or projects that would have existed with or without the new laws, representing a true loss of otherwise-collected revenue.

The four main planks of the proposal are:

- Tax breaks for manufacturers of solar energy components. Manufacturers would receive a transferable (and therefore, functionally equivalent to a refundable) credit against income tax for 10% of business investment.
- Expansion of the state's existing Research & Development tax credit. The credit would go from 20% to 24% on expenses up to $2.5 million, and from 11% to 15% on expenses above $2.5 million. This increase is expected to cost the state treasury $11.2 million per year.
- A special 0.75% tax on hotel rooms, restaurants and rental cars in Pima County (Tucson). This tax, subject to approval by Pima County voters, would be used to subsidize spring training facilities used by Major League Baseball teams.

- Exempting certain new developments from various taxes. The exempted taxes would include sales tax for construction goods and city sales tax. Municipalities would be allowed to approve individual developments for tax exemptions on a largely discretionary basis.

This may be a particularly bad time to hand special breaks to certain businesses. Earlier this year, Arizona opted to let expire a temporary suspension of its statewide property tax. This tax will return for 2009, at a $250 million cost to Arizona taxpayers.[1] Meanwhile, Arizona's combined state and federal corporate income tax rate of 39.5% is higher than that of every OECD country in the world except Japan, whose rate is 39.56%.[2] Without spending cuts, tax subsidies for favored industries will increase the need for higher broad-based taxes, like the statewide property tax.

Solar Manufacturing Subsidy

This program would provide preferential tax treatment to manufacturers of solar power generation products. Individuals and corporations would be eligible for a transferable income tax credit up to 10% of a "qualified business investment" in solar manufacturing. This tax credit would not be refundable, but the right to transfer the credit to another taxpayer would make it economically equivalent to a refundable tax credit.

Under a refundable tax credit, a taxpayer whose credit exceeds his taxes due receives net cash from the state. With a transferable tax credit, such a taxpayer can't get a check back from the state, but he can sell his credit to another taxpayer with a net liability. By making this tax credit transferable instead of refundable, supporters can disingenuously claim that their plan has no direct costs to the state's general fund. But because the credit can be sold to taxpayers with net liability, it would reduce general fund receipts.

Sound tax policy means equal economic activities should be treated equally by the tax system. By providing special tax treatment for solar manufacturing, Arizona works to shift business investment from efficient opportunities to tax-favored ones. Many of the advantages cited to make Arizona well-suited for solar manufacturing-including research programs at the University of Arizona and the presence of a strong semiconductor industry-are in fact advantages for a broad range of economic activities. Instead of giving tax credits to politically connected players in a specific industry, Arizona could cut its corporate income tax and draw in more business of all kinds, as determined by the free decisions of individuals in the marketplace.

Research & Development Tax Credit

Arizona, like most states, already has a tax credit for research and development expenses. This proposal would expand the existing credit over two years, ultimately increasing it from 20% to 24% on expenses up to $2.5 million, and from 11% to 15% on expenses above $2.5 million.

[1] http://www.tucsoncitizen.com/ss/local/82727.php.
[2] http://taxfoundation.org/article/us-states-lead-world-high-corporate-taxes.

The theoretical underpinning for R&D tax credits is that research activities produce positive externalities- that is, benefits that do not accrue exclusively to the researcher. R&D tax credits are supposed to compensate investors for the public benefits they create through research. Patents are intended to serve this purpose, though tax credits can fill a gap if patent protections do not sufficiently compensate innovators.

However, state R&D tax credits have almost no research-generating effect. Principally, they move research that would already happen between the states, producing a race to the bottom to see what state can provide the biggest tax incentives. Daniel J. Wilson, an economist with the Federal Reserve Bank of San Francisco, writes:

[T]he setting of R&D tax credits by states (as opposed to only the federal government) is nearly a zero-sum game. For instance, if all states were to lower their R&D user costs, e.g., by raising their tax credit rates, by the same percentage, aggregate private R&D in the nation would rise very little, if at all.[3]

This might mean that, even if Research & Development tax credits have no national effect, Arizona could benefit at the expense of other states by increasing its tax credit. However, to the extent that R&D credits are supporting real spillover benefits from innovation, those benefits will accrue nationally or internationally, not just in Arizona. States that choose to offer generous R&D tax credits (including Arizona) are subsidizing a public benefit that, if it exists, runs far beyond their borders.

Advocates of R&D tax credits will also point to economic benefits beyond innovation, such as the creation of new jobs. However, it is important to consider the effects on a net basis with an eye toward opportunity cost. Much of the R&D tax subsidy will go toward (1) research activities that would have happened with or without subsidy, or (2) research activities undertaken in lieu of more efficient uses of capital. These shifts into R&D do not represent economic growth, just economic change, and will consume tax benefits without accruing value to Arizona.

Finally, it is important to consider tax alternatives. Instead of further complicating its tax code with bigger credits for special activities, Arizona could best increase its competitiveness by simplifying its tax code and cutting rates on its broad-based taxes.

Special Sales Tax on Tucson Hospitality Industry for Spring Training Subsidy

This proposal would give Pima County voters the option to levy a 0.75% sales tax on hotel rooms, restaurant meals, and rental cars. Proceeds from the tax would finance upgrades to spring training facilities in the Tucson area, which are currently used by three Arizona major league teams: the Arizona Diamondbacks, Chicago White Sox (who have announced plans to move spring training facilities to

[3] Daniel J. Wilson, Federal Reserve Bank of San Francisco, *Beggar Thy Neighbor? The In-State, Out-of-State, and Aggregate Effects of R&D Tax Credits* (working paper), 2005-2007, http://www.frbsf.org/publications/economics/papers/2005/wp05-08bk.pdf.

Phoenix) and Colorado Rockies. The hope of the upgrades is to draw a new team or teams to train in Tucson, either from Phoenix or Florida.

High Costs and Fictional Benefits: Proponents cite economic development resulting from tourism as the primary reason for the spring training subsidy. However, researchers across the political spectrum report that sports subsidies tend to disappoint in the economic development department. Research reports published by the Brookings Institution find "that professional sports have been oversold by professional sports boosters as a catalyst for economic development"[4] and that "the additional labor and capital income a community obtains from a sports related facility-whether a stadium, arena, or training center-generally is inadequate to justify public subsidy of that facility."[5]

Consider Tucson's last attempt to attract baseball. In 1998, Tucson Electric Park was built to the tune of $38 million. Just 10 years later, another round of public subsidies is deemed necessary to retain baseball in Tucson. Moreover, modern stadiums are double the price of those from a decade ago. If Goodyear and Glendale are any indication, we can expect a price tag between $75 and $80 million.

Who Pays? Assuming lawmakers and Pima County residents approve the proposal, a three-quarter-cent sales tax will be tacked on to purchases at hotels, restaurants, bars and rental car agencies. The rationale for placing the tax burden on these businesses is that they will benefit from additional spring training-related tourism. However, the Arizona Restaurant and Hospitality Association has already announced its opposition to the proposal.[6]

Who Benefits? If local businesses do not expect to benefit from the tax and subsidy, one should ask who will. An obvious answer is baseball team organizations which, except in the case of the Diamondbacks, lie out of state. While a subsidy benefiting the Chicago White Sox would be a generous gesture on the part of Pima County taxpayers, they should consider whether it is their most preferred use of tax dollars.

Constitutional Issues

In addition to the policy and economic problems associated with a package of handouts to favored groups, such bills may violate a number of constitutional provisions specifically designed to keep lawmakers from giving special privileges to benefit a person or class. Arizona's Constitution is strong in these protections, with three distinct provisions:

- *Gift Clause* (Art. 9, Sec. 7), barring laws that "give or loan [the state's] credit in aid of, or make any donation or grant, by subsidy or otherwise, to any individual association or corporation . . . ." The framers of Arizona's constitution inserted this clause as a result of serious misuse of government

[4] Robert Baade and Allen R. Sanderson, "Employment Effect of Teams and Sports Facilities,"*Sports, Jobs & Taxes: The Economic Impact of Sports Teams and Stadiums*, Brookings Institution Press, 1997.
[5] Dennis Zimmerman, "Subsidizing Stadiums: Who Benefits, Who Pays," ibid.
[6] http://www.azstarnet.com/sn/fromcomments/244661.php.

funds in speculative railroad investments with little or no public benefit. Subsidies or other gifts benefiting private actors can violate this Clause.

- *Privileges or Immunities Clause* (Art. 2, Sec. 13), stating that "[n]o law shall be enacted granting to any citizen, class of citizens, or corporation other than municipal, privileges or immunities which, upon the same terms, shall not equally belong to all citizens or corporations." Forcing individual and business taxpayers to subsidize the special benefits provided to other individuals and businesses could violate this Clause.

- *Special Laws Clause* (Art. 4, Sec. 19), barring non-general laws in the area of tax assessment and collection (Subsec. 9); granting exclusive privileges or franchises to corporations, associations, or individuals (Subsec. 13); and "when a general law shall be made applicable" (Subsec. 19). Taxes levied on some but not others can violate this Clause.

These clauses have been described as intending to "limit the exercise of government power to truly public purposes and that prevent unjust enrichment of favored interests to the detriment of the taxpaying public."[7] Arizona's Goldwater Institute has been active in challenging lobbyist-driven handouts that may violate these constitutional provisions.

Singling out hotels, restaurants, and rental cars for a punitive tax merits particular concern, not only because it inequitably shifts tax burdens to non-voting visitors. The Special Laws Clause bars the state from enacting laws not generally applicable to all within a rationally defined class. Pima County thus could not be singled out by name for the establishment of a taxing district. Instead, drafters designed a "class" of all counties with population between 500,000 and 2 million-set up to ensure that it would include Pima County and no other. A state appellate court narrowly accepted a similar "class of one" legislative design in 2002, but past cases indicate such legislation may not be entirely permissible.[8]

Such an end-run around a constitutional taxpayer protection presents serious problems. Residents of other parts of the state who visit Pima County would pay taxes to support that county, but would not have a say in how the funds are used. Excluding other counties from the legislation means baseball subsidies are supported by a funding source only authorized in one county. The Special Laws Clause is meant to "prevent the enactment of statutes bestowing special favors on preferred groups or localities."[9] Many of the provisions in the legislative laundry list do precisely that.

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[7] Complaint, *Turken v. Gordon*, Superior Court of Arizona, Maricopa County, CV-2007-013766, *at* http://tinyurl.com/63c5tl.
[8] *See Long v. Napolitano*, 203 Ariz. 247, 253-61 53 P.3d 172, 178-86 (App. 2002). *See also State v. Christi*, 149 Ariz. 323, 324, 718 P.2d 487, 488 (App. 1986) ("A [prohibited] local law arbitrarily singles out one locality in the jurisdiction for special treatment."); *Id.* ("Local or special laws are laws plainly intended to apply to an arbitrarily defined spectrum of cases."); *In re Marxus B.*, 199 Ariz. 11, 15, 13 P.3d 290, 294 (App. 2000) ("[W]here the prospect [for a class of one becoming a class of more than one] is only theoretical, and not probable, we will find the act special or local in nature.").
[9] *City of Tucson v. Grezaffi*, 200 Ariz. 130, 138, 23 P.3d 675, 683 (App. 2001), *quoting City of Tucson v. Woods*, 191 Ariz. 523, 529, 959 P.2d 394, 400 (App. 1997).

Exempting certain new developments from various taxes

This proposal would allow municipalities to create special "Commercial Enhancement Zones," where developers would be exempted from certain taxes. It contains two layers of micromanagement: the state sets criteria that areas must meet if municipalities wish to designate them, and then municipalities may approve tax credits on a discretionary basis, considering such nebulous criteria as whether a development is "appropriate for the area" and will "contribute to the long-term vitality of the zone." This smacks of central planning of development, with the government using the tax code to push development toward favored locales and developers, instead of the places where it is most economically demanded. Arizona should instead push for a neutral and simple tax system that treats all economic actors alike.

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