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ARIZONA TAX RESEARCH ASSOCIATION

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Governor Hull Vetoes Sales Tax Fix

June 1 tax increase will apply retroactively

Despite overwhelming bipartisan support in the Legislature, Governor Jane Hull vetoed a fix to the voter approved sales tax hike due to take effect June 1. House Bill 2376 would have ensured that the 0.6% sales tax increase did not apply to transactions and contracts entered into prior to June 1. The veto came just 24 days before the state sales tax is increased.

Grandfathering pre-existing contracts and transactions when the sales tax rate is increased has become common practice in Arizona at the city and county level. Following a verbal commitment from the Legislature last year, most viewed the passage of the grandfathering legislation as a technical cleanup issue that would receive quick legislative approval. Last session, as the Education 2000 legislation was being prepared for debate in the House of Representatives, then Ways and Means Committee Chairman Bill McGibbon attempted to add language to ensure that the new sales tax would not apply retroactively. He was told amendments would not be allowed on the floor and assurances were given that the problem would be addressed during the 2001 legislative session.

The Arizona Tax Research Association (ATRA) was joined by the National Federation of Independent Business (NFIB) and other business groups in the effort to ensure the passage of HB 2376. HB 2376 received the strong support of House Ways and Means Committee Chairman Steve May and Senate Finance Chairman Scott Bundgaard. Senators Jay Blanchard and Ramon Valadez were also strong advocates on the issue.

Governor Hull's veto followed consistent opposition to the bill from her office. Labeling it another "alt-fuels debacle," the Governor's staff created the specter of a rush on long term contracts being entered into prior to June 1 in order to avoid paying the increased sales tax. Worse, the veto message states that the bill provided an "exemption" and that it is the responsibility of businesses to anticipate such tax increases in their contracts.

See **VETO**, page 5

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Small tax cut maintains streak

Corporate rate reduction, sales factor increase in "triggers"

Intent on maintaining its decade-long consecutive streak with some form of tax relief, the Legislature included a small individual income tax reduction in the recently passed biennial budget. This year the Legislature set aside just 0.2% ($15 million) of available revenue for the fiscal year (FY) 2002 budget for tax relief. No additional tax relief was provided in the second year of the biennium.

The estimated $15 million in individual income tax relief comes in the form of a 12.5% increase in the standard deduction. The standard deduction for single filers will climb from $3,600 to $4,050 and married filing jointly or head of household will climb from $7,200 to $8,100. This change will be effective for tax year 2001.

As was the case with the adoption of the state's first biennial budget in 1999, there was considerable disagreement this year regarding the revenue forecast for the biennium. The compromise again was to "trigger" additional spending and tax reductions if revenues exceed budget estimates. While there is little hope that any of the triggers will be met for the FY 2002 budget, there remains a possibility that some could be met in FY 2003. The triggers will be pulled if the ending balance for FY 2001 or FY 2002 exceed forecasts by the following amounts: 1st Priority Tier, $79,708,400; 2nd Priority Tier, $104,131,000; and 3rd Priority Tier, $138,131,000.

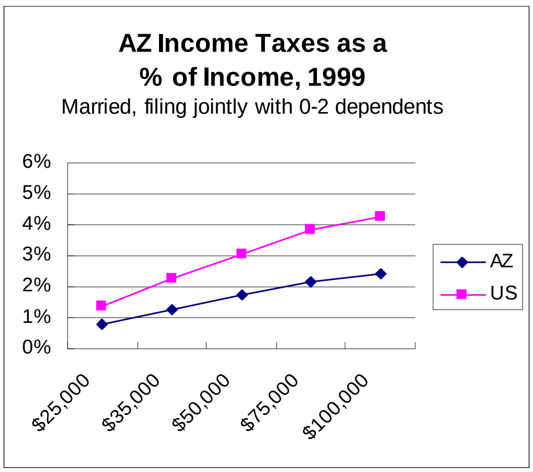
See **TRIGGERED**, page 5

Arizona's individual state income taxpayers compare favorably to those in other states

Arizona residents pay less in state income taxes than their counterparts do in most other states, according to a recent study conducted by the Minnesota Taxpayers Association (MTA).

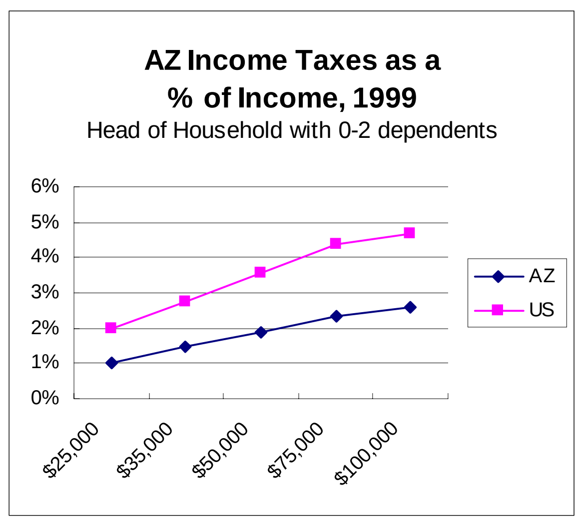
MTA publishes an annual study comparing individual state income tax burdens across states. The most recent study, which compares 1999 income taxes between 41 states and the District of Columbia, reflects that Arizona income taxpayers rank favorably compared to income taxpayers in other states. Taxes were calculated on three different filer types: married filing jointly with 0-2 dependents, head of household with 0-2 dependents, and single filers with no dependents. Several assumptions were made regarding income, deductions, and credits from 1996 income tax returns maintained by the Minnesota Department of Revenue.

	MARRIED-JOINT *0-2 Dependents*		HEAD OF HOUSE *0-2 Dependents*		SINGLE *No Dependents*	
Income	Tax	Rank	Tax	Rank	Tax	Rank
$25,000	$198	28	$258	32	$585	36
$35,000	$443	36	$519	39	$798	40
$50,000	$872	38	$943	39	$1,323	39
$75,000	$1,610	40	$1,743	40	$2,290	38
$100,000	$2,411	40	$2,569	40	$3,690	36



In the study, 42 states are ranked from highest to lowest based on their level of taxes, with rank 1 having the highest tax burden and rank 42 having the lowest tax burden. In all three categories, Arizona income taxpayers ranked within the bottom half, with Arizona taxpayers paying less taxes than most taxpayers in other states as income increases. For instance, taxpayers earning an annual income of $35,000 or more ranked within the bottom 20th percentile, as indicated by the above table. Arizona income taxpayers earning an average income of $35,000 ranked 36th (married filing jointly, 0-2 dependents), 39th (head of household, 0-2 dependents), and 40th (single, no dependents). Even more notable is that as income increases for married and head of household taxpayers, the rankings become even more favorable compared to other states, ranking 40th out of the 42 state ranking.

The accompanying graphs show that the variance in the effective tax rate (taxes as a percentage of income) between Arizona and the U.S. average increases with income, reflecting that Arizona's income tax structure is somewhat less progressive than other states. In other words, as income increases, taxes for Arizona taxpayers also increase but at a slower rate than the U.S. average.



Since 1993, several changes have been made to Arizona's income tax law which have substantially benefited taxpayers, such as reductions in the tax rates, increases in personal, dependent, and senior citizen exemptions, family tax credits, and standard deductions. Included in the FY 2002 and 2003 biennial budget is an increase in the standard deduction from $3,600 to $4,050 for single taxpayers and from $7,200 to $8,100 for married or head of household taxpayers, resulting in an estimated $15 million tax cut each year. Also included as triggers for tax year 2002 is a tax rate reduction for low-income taxpayers earning $10,000 or less, from 2.87% to 2.84% in the first trigger, to 2.81% in the second trigger.

See **INCOME**, page 3

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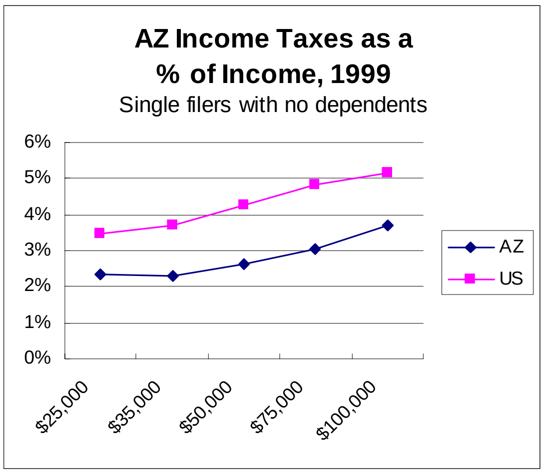
State income tax rankings show higher burdens in most other states

Despite an almost 30% reduction in income tax rates over the last eight years, total state income tax collections have increased 68% from $1.36 billion in FY 1993 to $2.29 billion in FY 2000. While the number of filers increased 29% over that time period, the revenue growth was driven primarily by a 102% increase in reported taxable income.



In comparison to other states within the southwest region, Arizona income taxpayers earning $35,000 or less pay higher taxes than California, Colorado, and New Mexico. However, as income increases, the tax burden on Arizona income taxpayers tends to decrease. For instance, at the $75,000 income level, Arizona taxpayers have the lowest tax burden, paying anywhere from 10% to 54% less in taxes than taxpayers from other southwestern states.

State Income Tax Comparisons for Married Filing Jointly with 2 Dependents

Income	AZ	CA	CO	NM	UT
$25,000	$198	$0	-$96	$115	$458
$35,000	$443	$0	$272	$362	$1,067
$50,000	$872	$314	$918	$1,047	$2,002
$75,000	$1,610	$1,780	$1,919	$2,484	$3,498
$100,000	$2,411	$3,663	$2,834	$4,021	$4,855

THE THREE MAJOR TAXES: PROPERTY, SALES, AND INCOME

The purpose for nationwide tax studies is for states to have the ability to measure their level of competitiveness. The MTA study shows that Arizona income taxpayers have a competitive advantage over other states. However, in order to compare states, the three major taxes, *property*, *sales*, and *income*, must be analyzed collectively.

THE THREE MAJOR TAXES -- FY '97, U.S. Census Bureau

Tax	*per capita* Amount	*per capita* Rank	*% of personal income* Percent	*% of personal income* Rank
Property Tax	655	33	3.12	27
Sales Tax	1,043	12	4.96	11
Income Tax	336	38	1.74	39

Based on fiscal year 1997 census data, Arizona's income tax is highly competitive with other states, ranking 38th per capita and 39th as a percentage of personal income. In contrast, Arizona's sales tax runs high, ranking 12th per capita and 11th as a percentage of income.

Arizona's property tax appears reasonable compared to other states, ranking 33rd per capita and 27th as a percentage of income. However, that statistic masks the inequities within Arizona's property tax system. For example, a different study compiled by MTA showed that the 1998 tax burden between Arizona residential and industrial property taxpayers varied greatly, with residential property taxpayers ranking favorably at 38th and industrial taxpayers picking up the slack, ranking 4th out of 51 states.

Jennifer Schuldt

Don't wait until October . . .

It happens every year. Sometime in October property owners around the state will get their property tax bills. At first they are shocked, then they are angry, then they want to know who's to blame. That's when the calls start coming in and ATRA staff spend the next month or more explaining Arizona's property tax system to yet another set of mystified taxpayers.

Taxpayers often want to blame the county assessor. After all, he probably did just increase the assessed value of your property. We all know that if your assessed value goes up 10% the result is a 10% increase in your property taxes. That is, of course, if the combined rate stays the same.

There's the rub. The assessor has a constitutional obligation to adjust assessed values to reflect changes in the market. But that doesn't mean tax rates have to remain the same. In fact, some taxpayers want to blame the Legislature, but the fact is they have reduced the property tax rates they set for the last three years to offset increases in statewide assessed values.

If you want to find out why taxes keep going up, or better yet, if you want to exercise some influence over your property taxes, **NOW IS THE TIME**. For the next couple months, counties, cities and towns, community colleges and school districts will be adopting budgets and tax rates for the fiscal year starting July 1. Look in your local paper for notices of budget meetings and tax increases. Of course, being plugged in at ATRA can greatly facilitate access to this information. Call ATRA staff to see if a taxpayer meeting has been scheduled. Get involved.

Your participation can make a difference.

Just don't wait until October.

Governor signs ATRA's "liabilities in excess" bill

Governor Jane Hull signed legislation proposed by ATRA that reforms the way in which emergency school district facility repairs are funded. The bill passed both the Senate and the House without a "no" in the final vote.

HB 2037, sponsored by Representative Linda Gray, is one of the most significant school finance and property tax reforms to emerge from this legislative session and represents the culmination of ATRA's three-year effort to bring closure to an oversight in the Students FIRST laws enacted in 1998.

The current "liabilities in excess" law (A.R.S. §15-907) allows school districts to petition their county government to override their budget and access local property taxes without voter approval in the event of facility damage or to mitigate a health and safety hazard. HB 2037 will instead require school districts to petition the School Facilities Board (SFB) for funding in the event of an emergency. The district may go to the county *only* if the SFB has insufficient funds to cover the emergency.

The bill defines emergency as "a serious need for materials, services or construction or expenses in excess of the district's adopted budget for the current fiscal year and that seriously threaten the functioning of the school district, the preservation or protection of property or public health, welfare, or safety."

ATRA has focused considerable attention on inequities in per-pupil spending and taxation resulting from laws like the current "liabilities in excess" statute. In addition, ATRA has brought to light very serious abuses of the current "liabilities" law (see the *ATRA Newsletter* for May, June, September 1999 and February 2001).

ATRA's work on this issue during the last three years has resulted in county school offices and governing boards giving considerably more scrutiny to, and in some cases denying, school district requests under the "liabilities in excess" statute.

The SFB voted unanimously to support HB 2037. The bill was also supported by Arizona School Administrators, the Arizona School Boards Association, the Arizona Education Association, and the Maricopa County School Superintendent.

School District Levies Outside Budget Limits

The enactment of HB 2037 is the latest in a series of successful efforts by ATRA to eliminate unequalized property tax levies outside school district budget limits. ATRA's legislative activity resulted in the five-year phase-outs during the 1990s of levies for both "excess insurance" and so-called "energy saving devices." Recently, ATRA's efforts to educate legislators and the public about inequities and other problems associated with levies for "excess utilities" resulted in the voter mandated termination of levies for excess utilities after the year 2009.

Not insignificant is the fact that ATRA's defensive efforts at the legislature have consistently prevented any new spending categories from being pushed outside district budget limits inequitably onto local property taxes.

However, three highly problematic spending categories remain. Statutes authorizing unlimited levies for desegregation, small school districts, and adjacent ways are still on the books. These levies are responsible for most of the highest school district tax rates and spending inequities in Arizona.

Michael Hunter

Other good news from 2001 session

Of the 1,252 bills, memorials, and resolutions introduced during the First Regular Session of the 45th Legislature, 389 were enacted into law. As always, some of the best news for taxpayers can be found in proposed legislation that *did not* become law.

Among the bills defeated with the help of ATRA's opposition were several proposals to eliminate several sales exemptions and income tax credits. Characterized by the Department of Revenue as "tax expenditures" and in some media accounts as "loopholes" much of the controversy surrounding these exemptions and credits results from a misunderstanding about the data in the Department's *Tax Expenditure Report*, which misleadingly reports that the state loses well over $4 billion in exemptions from the sales tax.

ATRA dedicated significant energy toward a successful effort to explain to policy makers that many of the items characterized as exemptions have either never been subject to tax or resulted from clarifications of tax liability, as opposed to exemptions for activities that were clearly taxable.

Other successful ATRA efforts dealt with defeating numerous bills enhancing government employee retirement systems and establishing or enhancing the authority of various taxing jurisdictions.

ATRA also worked to have bills favorably amended. Two note-worthy bills ATRA originally opposed that did make it to the finish line in a much more acceptable form include HB 2440 and HB 2183.

HB 2440 (Norris) allows school districts to leverage their federal impact aid to service revenue bonds for capital projects above the state standards. An ATRA amendment, sponsored by Representative Linda Gray, ensures that districts that use the provisions of HB 2440 cannot simultaneously use general obligation bonds.

HB 2183 will provide small but growing school districts with a limited override that decreases as the district's student population grows. ATRA's opposition resulted in a voter-approval requirement being amended onto the bill.

Legislature, Governor give taxpayers a few hard knocks this session

In addition to the veto of HB 2376, ATRA's bill that would have averted a retroactive sales tax (see page 1), there were a few other bills indicating this was not the most taxpayer friendly session in recent memory.

JAIL DISTRICT BILL PASSES

In 1989, ATRA worked with the counties in a concerted effort to pass the current jail district law which allows counties the ability to levy a secondary property tax up to $0.20 per $100 assessed value or a countywide ½ cent sales tax for the purpose of acquiring, constructing, operating, maintaining, and financing county jails.

While drafting the jail district law, the Legislature demanded that if counties were going to increase taxes for the sole purpose of financing county jails that the tax revenues collected must be used for that purpose only.

Since the passage of the jail district law, several efforts have been made to undermine the agreement reached with ATRA and the counties in 1989. Up until this year, those attempts have failed.

This year the counties sought authority to tap jail district funds for "services" rendered by the county. Over ATRA's opposition, HB 2092 narrowly passed the Legislature and was signed by the Governor.

ENTERPRISE ZONE PROGRAM EXTENDED

In an effort to save a few manufacturing businesses from the impact of Arizona's high business property taxes, both city representatives and the Arizona Department of Commerce (ADOC) supported HB 2527 which extends the current Enterprise Zone Program. Interestingly, at the same time, the cities opposed a bill that would help reform inequities inherent within Arizona's property tax system.

HB 2527 extends the Enterprise Zone Program another five years and broadens the criteria in qualifying businesses, which provides a 50% to 80% property tax break for approximately 35 companies.

ATRA testified before the House and Senate in sole opposition to HB 2527.

While agreeing with the proponents that Arizona's high business property taxes are an impediment to economic development, ATRA argued that targeting relief to select companies is not the answer to the problem. In fact reducing the assessment ratio on select companies actually makes the tax burden ***higher*** on existing business.

Senator Jay Blanchard supported ATRA's position and successfully removed the property tax break from the bill in the Senate Finance Committee. However, Senator Ramon Valadez amended the property tax provision back into the bill on the Senate floor. Demonstrating that it is easier to affix band-aids than to deal with the underlying causes of a severely ailing property tax system, HB 2527 received overwhelming legislative approval.

EXCESS UTILITIES LEVIES FOR JOINT TECH DISTRICTS

The Governor allowed to pass into law, without signature, HB 2560, allowing the East Valley Institute of Technology (EVIT) and other joint technological education districts to levy unlimited property taxes in excess of their budget limits for utility costs.

With Proposition 301 last November, voters agreed to an increase in their sales tax burden for education with the understanding that property tax levies outside school district budget limits for excess utilities would ultimately be eliminated. Expanding excess utilities to include joint tech districts goes contrary to the policy direction embarked upon with the passage of Prop. 301.

The excess utilities provision was amended onto HB 2560 late in the session. Over ATRA's opposition, the bill passed by the narrowest of margins: 16 votes in the Senate and 31 in the House.

Veto ensures tax hike retroactive

Continued from page 1

Governor Hull's veto causes all sales tax payments made to the state after June 1 to be subject to the 0.6% rate increase regardless of the date of contract or when the transaction occurred. For businesses that remit sales taxes to the state on a cash basis (when the money is received), they will be exposed to higher tax liabilities than legally existed at the time of the transaction.

Unfortunately, this issue will now shift to the Courts where businesses will be forced to use their own resources to force the State to provide what the Legislature felt was a simple, fundamental principal that the state should adhere to.

Triggered tax cuts included in budget

Continued from page 1

The triggers included the following additional $47.1 million in tax reductions:

1st Priority Tier: Reduces the lowest individual income tax rate from 2.87% to 2.84%. This rate reduction would reduce individual income taxes by an estimated $6,570,000.

2nd Priority Tier: Reduces the lowest individual income tax rate from 2.84% to 2.81%. This is also estimated to reduce income taxes by another $6,570,000.

3rd Priority Tier: Reduces the corporate income tax rate from 6.968% to 6.8% for an estimated tax savings of $12 million. In addition, the corporate apportionment formula for allocating multi-state income is changed by providing an election for corporate taxpayers to choose the current formula of double-weighted sales or a new formula with a more heavily weighted 65% sales factor. The estimated tax savings for the apportionment change is $22 million.

April 29 marked Arizona's *Tax Freedom Day* in 2001

According to the *Tax Foundation*, the average American taxpayer worked the first 123 days of this year to pay all federal, state, and local taxes, until "tax freedom" was finally earned on the 123rd day, May 3.

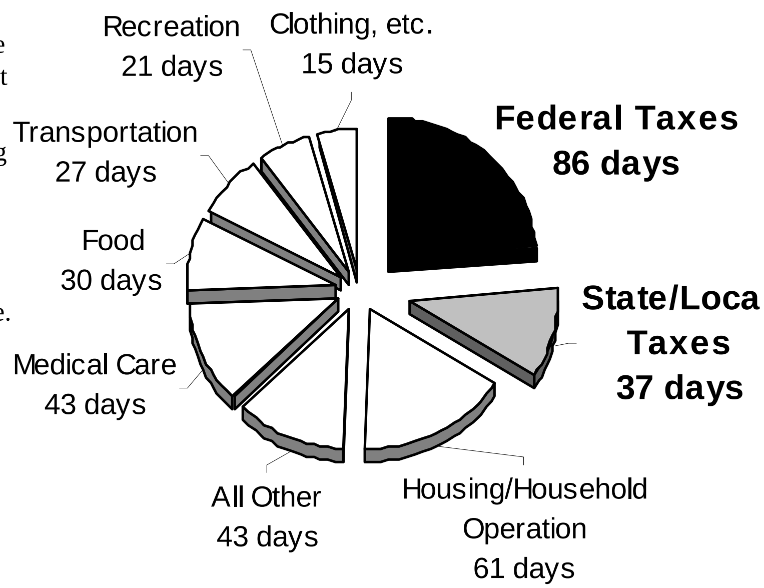
The average Arizonan, in comparison, worked 119 days before celebrating "tax freedom day" on April 29, one day later than last year.

The *Tax Foundation*, a Washington, DC government watchdog organization, calculates Tax Freedom Day by determining per capita federal, state and local taxes for everyone in the U.S. and then divides that by the per capita U.S. income. This percentage is then translated into days by multiplying it by 365 days. The same method is used to compute Tax Freedom Day for each state.

Arizona has ranked 24th for the past two years. Based on the report, a typical taxpayer in Arizona can expect 32.8% of their income to go toward taxes: 23.4% to the federal government and 9.4% to state and local government.

The report also measures the price of government against the price of other important categories of consumer spending. The pie chart to the right shows that Americans will work longer to pay for government (123 days) than they will for food, clothing, and shelter combined (106 days).

How Long Americans Work to Pay Taxes Compared to Other Major Spending Categories



Source: Tax Foundation calculations using Department of Commerce consumption data.