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A VICTORY FOR TAXPAYERS *Supreme Court decides Capitol Castings case*

By Steven R. Partridge, *Fennemore Craig*

On April 21, 2004, the Arizona Supreme Court filed its decision in the case of *Arizona Department of Revenue v. Capitol Castings, Inc.* It was a complete victory for taxpayers.

The Supreme Court overturned two previous Court of Appeals' decisions in this same matter, the first one being issued in 1998. The Court also affirmed the holding of the *Duval Sierrita Corp. v. Ariz. Dept. of Revenue* decision, upon which business has relied since 1977. Most ATRA members are probably aware of the potentially devastating impact on the machinery and equipment exemption if the Court of Appeals' decisions were permitted to remain law.

In this author's opinion, this decision has gone even further than the original *Duval Sierrita* decision in providing guidance to industry. In summary, this decision held that courts should apply "flexible and commonly used definitions of machinery and equipment within the relevant industry." It also held that the courts should examine the

nature of the item and its role in the operations. "Items essential or necessary to the completion of the finished product are more likely to be exempt." The court referred to a "harmonious integrated synchronized system." The court also directed that other factors be considered, such as 1) whether the item physically touches the raw materials or work in progress; 2) whether the item adds value to the product or; 3) whether it affects or manipulates the work in progress.

The court also acknowledged that the goal of tax exemptions was "promoting economic development."

This acknowledgment, on its own, is extremely valuable and a recognition that our Supreme Court is aware of the economic implications of its decisions. The Court's published opinion is available on the ATRA website: www.arizonatax.org.

Steve Partridge, an attorney with Fennemore Craig, was formerly an Assistant Director for the Arizona Department of Revenue. Steve is currently serving on ATRA's Board of Directors.

Statewide debt up 6% to nearly \$22 billion

Total statewide debt increased \$1.2 billion (6%) to nearly \$22 billion, from fiscal year (FY) 2001-02 to FY 2002-03, based on the Department of Revenue's (DOR) latest annual report on state and local indebtedness.

Over the last five years, total statewide debt has risen \$4.9 billion (28.7%).

The DOR report is a compilation of data provided by the state's cities and towns, counties, community colleges, school districts, and other political subdivisions throughout Arizona. The debt reported includes principal amounts only, excluding all interest payment obligations.

State and University debt, by far, had the largest increase overall in total outstanding debt, up \$754.1 million (21.8%) over the one-year period. Cities and towns held the largest level of debt at \$7.6 billion after borrowing an additional \$406.9 million in FY 2002-03, representing 34.7% of total statewide debt.

See STATEWIDE DEBT, page 2

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Statewide Debt

Jurisdiction	FY 1997-98	FY 2001-02	FY 2002-03
County	\$662,747,210	\$735,118,470	\$714,430,302
Cities/Towns	\$5,491,251,513	\$7,197,608,359	\$7,604,551,505
Comm Colleges	\$323,985,000	\$514,880,000	\$488,800,000
Schools	\$4,191,390,200	\$4,134,971,264	\$4,019,381,000
Special	\$359,282,598	\$973,542,496	\$1,053,304,378
State & Univ.	\$2,302,390,417	\$3,466,248,100	\$4,220,320,579
Other	\$3,695,813,842	\$3,654,246,677	\$3,815,548,736
TOTAL	\$17,026,860,780	\$20,676,615,366	\$21,916,336,500

STATEWIDE DEBT *Continued from page 1*

The financial instruments used to fund the approximate \$22 billion in statewide debt, which may or may not require voter approval, are listed and described below.

VOTER APPROVED DEBT

General obligation bonds (G.O.)

G.O. bonds are secured by the issuer's taxing authority, usually property taxes, require voter approval, and are subject to constitutional debt limits in most cases.

Revenue bonds

Revenue bonds are debt secured by an identified revenue source, usually other than property taxes, and are not subject to constitutional debt limits. These bonds may or may not require voter approval.

Special assessment or special district bonds

These bonds are used to fund projects that benefit a specific group of property owners within a specified area or "district" and are secured by taxes levied against property located within the district.

NON-VOTER APPROVED DEBT

Municipal property corporation (MPC) bonds

MPC bonds are debt issued by nonprofit corporations set up by and acting on behalf of a political subdivision of the state to build or acquire projects that are leased back to the political subdivisions. The lease revenues of the nonprofit are used to secure the bonds. This type of debt is not subject to constitutional debt limits because it is viewed as not being the debt of the political subdivision and does not require voter approval.

Certificates of Participation (COPs)

COPs are proportional shares in annually appropriated long-term leases. COPs are not subject to constitutional debt limits and do not require voter-approval.

Other types of debt instruments that state and local governments enter into are lease purchase and third-party contracts. Although these instruments are not included in the totals for bonded indebtedness, there are many similarities that exist between lease purchase agreements and COPs. Therefore, a brief discussion of statewide lease-purchase debt is included at the end of this article.

COUNTIES

Total county debt decreased from \$735.1 million in FY 2001-02 to \$714.4 million in FY 2002-03, a 2.8% drop. However, the last five years show that county debt has increased nearly \$51.7 million, or 7.8%. The majority of county debt consists of \$343.8 million in revenue bonds.

Pima County, by far, has accumulated the most debt of all the counties. After tacking on an additional \$20.5 million, Pima County's total debt of \$444 million translated into the highest debt per capita of all the counties at \$499. In comparison, Maricopa County carried only one-third the debt of Pima County at \$130.3 million, or \$40 per capita, after reducing the county's debt by \$39.6 million in FY 2002-03. Cochise County had the largest percentage increase, with the county's debt rising from \$1.7 million in FY 2001-02 to \$9.5 million in FY 2002-03. Graham County, on the other hand, is the only county in the state that reports no debt.

County Per Capita Debt

FY 2003

County	Outstanding Debt	Per Capita Debt
Pima	\$443,974,350	\$499
Pinal	\$38,675,000	\$201
La Paz	\$4,035,000	\$198
Coconino	\$23,700,000	\$189
Greenlee	\$1,455,000	\$169
Yuma	\$25,115,000	\$148
Apache	\$9,510,000	\$136
Cochise	\$9,500,000	\$77
Navajo	\$6,670,000	\$66
Mohave	\$8,605,000	\$52
Yavapai	\$8,812,500	\$49
Gila	\$2,585,000	\$49
Maricopa	\$130,273,452	\$40
Santa Cruz	\$1,520,000	\$38
Graham	\$0	\$0

Source: Department of Economic Security, Arizona Department of Revenue

CITIES

The debt of cities and towns makes up the largest share of local government debt at \$7.6 billion, or 34.7%. City debt rose \$406.9 million (5.7%) since FY 2001-02 and \$2.1 billion (38.5%) since FY 1997-98. The majority of city debt is in revenue bonds, which accounts for \$3.4 billion (44.3%) of total city debt.

See STATEWIDE DEBT, page 3

Top 10 Outstanding Debt FY 2003

City/Town	Outstanding Debt
Phoenix	\$3,375,512,875
Tucson	\$782,730,171
Mesa	\$728,538,000
Scottsdale	\$542,651,737
Glendale	\$385,660,463
Chandler	\$302,697,500
Tempe	\$271,000,000
Gilbert	\$164,920,000
Peoria	\$148,046,868
Avondale	\$83,052,252

Source: Arizona Department of Revenue

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STATEWIDE DEBT *Continued from page 2*

Of the 73 cities currently reporting outstanding debt, Sedona carried the highest per capita debt of \$6,334 in FY 2002-03, followed by Williams at \$4,373, and Winslow at \$4,358. Phoenix held the highest level of debt at \$3.4 billion (\$2,472 per capita), utilizing 43.1% of the city's debt limit, which considers only G.O. debt. The second highest portion of debt was held by the city of Tucson, with total debt at \$782.7 million (\$1,544 per capita), 45.3% of the debt limit. The city of Mesa carried the third largest level of debt, holding \$728.5 million in total debt (\$1,704 per capita), 34.1% of the city's debt limit.

Between FY 2001-02 and FY 2002-03, there is an apparent shift in the debt instruments used by cities from revenue bonds to non-voter approved MPC bonds, which accounted for \$1.6 billion in total city debt after jumping \$1 billion, or 186%, over the previous fiscal year.

Top 10 Per Capita Debt FY 2003

City/Town	Per Capita Debt
Sedona	\$6,334
Williams	\$4,373
Winslow	\$4,358
Tolleson	\$3,187
Page	\$3,070
Cave Creek	\$2,944
Scottsdale	\$2,535
Phoenix	\$2,472
Show Low	\$1,865
Safford	\$1,841

Source: Arizona Department of Revenue

COMMUNITY COLLEGES

Total community college outstanding debt dropped \$26.1 million (5.1%), from \$514.9 million in FY 2001-02 to \$488.8 million in FY 2002-03. The \$430.5 million in G.O. debt accounted for 88.1% of total community college debt. Total community college debt has grown \$164.8 million (50.9%) since FY 1997-98.

Coconino Community College has the highest per student debt of \$14,009, almost twice that of Yavapai Community College, which has the second highest per student debt at \$7,874. Maricopa Community College had the largest community college debt at \$285.6 million, followed by Pima College with \$103.4 million. Graham County's Eastern Arizona Community College reported no debt at the end of FY 2002-03.

College Per Student Debt FY 2003

College District	Outstanding Debt	Per Student Debt
Coconino	\$23,115,000	\$14,009
Yavapai	\$25,315,000	\$7,874
Yuma/La Paz	\$20,110,000	\$5,528
Pima	\$103,355,000	\$5,328
Maricopa	\$285,615,000	\$4,839
Mohave	\$11,980,000	\$4,608
Navajo	\$9,955,000	\$4,192
Pinal	\$7,860,000	\$2,312
Cochise	\$1,495,000	\$434
Graham	\$0	\$0

*The student population counts used to calculate per student debt are provided by the State Board of Community Colleges for FY 2001-02 for the expenditure limitation calculation.

Source: Arizona Department of Revenue

SCHOOL DISTRICTS

Total debt for K-12 school districts was \$115.6 million (2.8%) less in FY 2002-03 than in FY 2001-02, dropping the total to approximately \$4 billion, making up 18.3% of Arizona's total debt. Over the last five years, total debt for schools has dropped \$172 million, or 4.1%. However, the decrease may not be an indication of a trend as eight districts gained approval for \$403 million in November 2003. Those new debt levels will begin showing up in next year's report.

The majority of debt for K-12 is in G.O. bonds, accounting for \$3.9 billion of the \$4 billion in total school debt.

Maricopa County school districts ranked 1st in per student debt at \$5,303 and Pima schools were not far behind at \$5,257. Maricopa County's Saddle Mountain Unified per student debt amounted to \$39,281, ranking 1st out of the 146 school districts that carry debt. Paradise Valley Union High School District carried the largest amount of outstanding debt once again at \$318.1 million in FY 2002-03, ranking 19th with per student debt of \$9,151.

SPECIAL DISTRICTS

An increase of \$79.8 million (8.2%) in special district debt is the result of 132 districts reporting outstanding debt at the end of FY 2002-03. Total debt in this category reflected an increase from \$973.5 million to \$1.1 billion, accounting for 4.8% of total statewide debt. DOR cautions in the debt publication that due to poor reporting by special districts, comparing the level of debt from year to year may not reflect the true level of outstanding debt.

See STATEWIDE DEBT, page 4

School District Debt by County FY 2003

County Total for School Districts	Outstanding Debt	Per Student Debt*
Maricopa	\$2,828,791,000	\$5,303
Pima	\$661,715,000	\$5,257
Pinal	\$103,095,000	\$4,345
Coconino	\$72,650,000	\$4,041
Navajo	\$37,725,000	\$3,627
Yavapai	\$65,930,000	\$3,525
Greenlee	\$5,640,000	\$3,492
Mohave	\$80,880,000	\$3,362
Gila	\$18,695,000	\$2,688
La Paz	\$6,370,000	\$2,531
Cochise	\$34,935,000	\$2,354
Graham	\$10,740,000	\$2,324
Santa Cruz	\$19,125,000	\$2,301
Yuma	\$58,825,000	\$1,825
Apache	\$14,165,000	\$1,540

*Arizona Department of Education's 100th day average daily membership student count for FY 2002-03.

Source: Arizona Department of Revenue

STATEWIDE DEBT

Continued from page 3

SPECIAL DISTRICTS

Debt Instrument	FY 2002	FY 2003	Difference	% Difference
COPs	\$38,430,000	\$30,090,000	-\$8,340,000	-21.70%
G.O.	\$133,512,379	\$165,817,821	\$32,305,442	24.20%
MPC	\$0	\$0	\$0	0.00%
Revenue	\$629,866,167	\$645,238,762	\$15,372,595	2.44%
Special Assmt	\$171,603,950	\$212,157,795	\$40,553,845	23.63%
TOTALS	\$973,412,496	\$1,053,304,378	\$79,891,882	8.21%

Out of the 13 counties that reported special district debt, Maricopa County districts held the most debt at \$444.4 million, followed by Coconino with \$220.9 million, and Pima with \$207.1 million. The majority of debt held by special districts is in revenue bonds, which account for \$645.2 million (61.3%) of the total debt acquired by special districts.

The DOR report notes that the 427 special districts that filed reports is significantly less than the number of special districts required to report.

STATE AGENCY & UNIVERSITY DEBT

State and university debt reflected the largest dollar and percentage increase, with total outstanding debt increasing from \$3.5 billion in FY 2001-02 to \$4.2 billion in FY 2002-03, a \$754.1 million jump (21.8%). Total debt for these agencies accounted for 19.3% of total statewide debt. Over the past five years, debt in this category has increased \$1.9 billion (83.3%).

The dramatic increase in state and university debt is mainly the result of increased borrowing by the SFB in FY 2002-

03. The net increase in outstanding debt for SFB climbed from \$439.1 million at the close of FY 2001-02 up to \$1.1 billion at the end of FY 2002-03.

OTHER JURISDICTIONS

Other jurisdictions include special districts that cross county lines, such as the Central Arizona Water Conservation District and Salt River Project. The total outstanding debt for other jurisdictions increased \$161.3 million (4.4%) to \$3.8 billion in FY 2003, making up 17.4 % of total statewide debt.

LEASE PURCHASE/THIRD PARTY CONTRACTS

Not included in the total statewide debt are the lease purchase agreements reported by political subdivisions and state agencies. Total outstanding contracts amounted to \$512 million at the end of FY 2002-03. In comparison, the debt in this category is up \$125.3 million (32.4%) from FY 2001-02, in which political subdivisions reported lease purchase debt totaling \$386.7 million.

Jennifer Scholdt

COMPARISON OF STATE AND LOCAL DEBT, FY 1998 AND FY 2003

FY 2003

Debt Instrument	County	Cities/Towns	Comm Colleges	Schools	Special	State & Univ.	Other	TOTALS
COPs	\$95,373,452	\$95,070,000	\$2,710,000	\$65,615,000	\$30,090,000	\$901,237,579	\$0	\$1,190,096,031
G.O.	\$225,360,000	\$2,475,955,501	\$430,515,000	\$3,932,371,000	\$165,817,821	\$3,100,000	\$0	\$7,233,119,322
MPC	\$49,880,000	\$1,559,626,220	\$0	\$0	\$0	\$0	\$0	\$1,609,506,220
Revenue	\$343,816,850	\$3,368,142,938	\$55,575,000	\$21,395,000	\$645,238,762	\$3,315,983,000	\$3,815,548,736	\$11,565,700,286
Special Assmt	\$0	\$105,756,846	\$0	\$0	\$212,287,795	\$0	\$0	\$318,044,641
TOTALS	\$714,430,302	\$7,604,551,505	\$488,800,000	\$4,019,381,000	\$1,053,434,378	\$4,220,320,579	\$3,815,548,736	\$21,916,466,500

FY 1998

Debt Instrument	County	Cities/Towns	Comm Colleges	Schools	Special	State & Univ.	Other	TOTALS
COPs	\$130,704,463	\$98,848,388	\$22,190,000	\$79,180,000	\$0	\$345,140,804	\$0	\$676,063,655
G.O.	\$311,465,000	\$2,122,585,828	\$261,720,000	\$4,112,210,200	\$74,974,798	\$29,965,456	\$0	\$6,912,921,282
MPC	\$16,543,212	\$460,352,246	\$0	\$0	\$10,575,000	\$0	\$0	\$487,470,458
Revenue	\$204,034,535	\$2,637,445,368	\$40,075,000	\$0	\$116,252,418	\$1,904,966,769	\$3,695,813,842	\$8,598,587,932
Special Assmt	\$0	\$172,019,683	\$0	\$0	\$157,480,382	\$22,317,388	\$0	\$351,817,453
TOTALS*	\$662,747,210	\$5,491,251,513	\$323,985,000	\$4,191,390,200	\$359,282,598	\$2,302,390,417	\$3,695,813,842	\$17,026,860,780

*Does not include \$5.2 billion in Industrial Development Authority revenue bonds.

TOTAL COUNTY OUTSTANDING DEBT

Debt Instrument	FY 2002	FY 2003	Difference	% Difference
COPs	\$98,603,834	\$95,373,452	-\$3,230,382	-3.28%
G.O.	\$228,350,000	\$225,360,000	-\$2,990,000	-1.31%
MPC	\$53,080,000	\$49,880,000	-\$3,200,000	-6.03%
Revenue	\$355,084,636	\$343,816,850	-\$11,267,786	-3.17%
Special Assmt	\$0	\$0	\$0	0.00%
TOTALS	\$735,118,470	\$714,430,302	-\$20,688,168	-2.81%

TOTAL CITY & TOWN OUTSTANDING DEBT

Debt Instrument	FY 2002	FY 2003	Difference	% Difference
COPs	\$126,740,000	\$95,070,000	-\$31,670,000	-24.99%
G.O.	\$2,275,690,174	\$2,475,955,501	\$200,265,327	8.80%
MPC	\$546,167,967	\$1,559,626,220	\$1,013,458,253	185.56%
Revenue	\$4,136,007,398	\$3,368,142,938	-\$767,864,460	-18.57%
Special Assmt	\$113,002,820	\$105,756,846	-\$7,245,974	-6.41%
TOTALS	\$7,197,608,359	\$7,604,551,505	\$406,943,146	5.65%

TOTAL COMMUNITY COLLEGE OUTSTANDING DEBT

Debt Instrument	FY 2002	FY 2003	Difference	% Difference
COPs	\$3,080,000	\$2,710,000	-\$370,000	-12.01%
G.O.	\$465,295,000	\$430,515,000	-\$34,780,000	-7.47%
MPC	\$0	\$0	\$0	0.00%
Revenue	\$46,505,000	\$55,575,000	\$9,070,000	19.50%
Special Assmt	\$0	\$0	\$0	0.00%
TOTALS	\$514,880,000	\$488,800,000	-\$26,080,000	-5.07%

K-12 SCHOOL DISTRICT OUTSTANDING DEBT

Debt Instrument	FY 2002	FY 2003	Difference	% Difference
COPs	\$68,510,000	\$65,615,000	-\$2,895,000	-4.23%
G.O.	\$4,053,356,264	\$3,932,371,000	-\$120,985,264	-2.98%
MPC	\$0	\$0	\$0	0.00%
Revenue	\$13,105,000	\$21,395,000	\$8,290,000	63.26%
Special Assmt	\$0	\$0	\$0	0.00%
TOTALS	\$4,134,971,264	\$4,019,381,000	-\$115,590,264	-2.80%

TAX REFORM BILLS KILLED IN SENATE

The hopes for two important tax reform bills appear to have been dashed in the Arizona State Senate. House Bill (HB) 2263 and HB 2160, which were introduced pursuant to recommendations from the Tax Reform for Arizona Citizens (TRAC) Committee, appear to be dead for this session.

ASSESSMENT RATIO REFORM

The disparity between business and residential property taxes is one of the most problematic features of Arizona's tax system, resulting in some of the highest business property taxes in the nation. A system that intentionally shifts tax burdens from homeowner/voters to other classes of taxpayers also results in a lack of transparency and accountability in local government decisionmaking.

Introduced by Representative Steve Huffman, **HB 2263 (assessed valuation; class one property)** was a modest proposal reducing the assessment ratio on business property from the current 25% to 24%. The League of Arizona Cities and Towns even announced their support of HB 2263, referring to it "as a reasonable and limited approach to addressing the disparity."

Having passed Ways & Means (9-1), HB 2263 passed the House 35 to 25. The measure did not survive the Senate Finance

Committee however, where it was held without having been heard.

ONE-PERCENT CAP DISTRICTS

Another bill stemming from a TRAC Committee recommendation and introduced by Rep. Huffman was **HB 2160 (schools; maximum property tax rate)**. This legislation would have capped the primary property tax rate in school districts in which homeowners with 50% or more of the value in the district are at the 1% cap and the primary tax rate is 150% of the qualifying tax rate (QTR), as determined by the Property Tax Oversight Commission (PTOC). There are currently nine districts meeting the criteria to be affected by this proposal.

Passage of this legislation would have resulted in a savings to the state general fund which picks up the costs of homeowner taxes in excess of the cap.

HB 2160 received a "do pass" recommendation from Ways & Means, 9 to 1, and was then approved by the House, 38 to 22.

The Senate Finance Committee approved the measure 6 to 3 but ran into trouble on the Senate floor when Senators Marsha Arzberger, Pete Rios, and Jorge Luis Garcia each ran amendments to exempt their school districts from the provisions of the bill,

effectively gutting the legislation. Ensuring the legislative vehicle was dead, HB 2160 was then voted down on Third Read by a vote of 12 to 16.

Voting against taxpayers on HB 2160 were:

Linda Aguirre, D - Phoenix
Carolyn S. Allen, R - Scottsdale
Marsha Arzberger, D - Wilcox
Timothy S. Bee, R - Tucson
Bill Brotherton, D - Phoenix
Jack A. Brown, D - St. Johns
Robert Cannell, D - Yuma
Ken Chevront, D - Phoenix
Jorge Luis Garcia, D - Tucson
Gabrielle Giffords, D - Tucson
Albert A. Hale, D - Window Rock
Slade Mead, R - Phoenix
Richard Miranda, D - Tolleson
Harry E. Mitchell, D - Tempe
Pete Rios, D - Hayden
Victor Soltero, D - Tucson