Study Ranks AZ Business Prop Taxes High

Business property taxes in Arizona remain higher than neighboring states despite past legislative reforms targeting this long standing economic development issue. In conjunction with the Lincoln Land Institute, the Minnesota Center for Fiscal Excellence published its annual report comparing property taxes nationwide for FY 2015, which shows a stark contrast between residential and commercial property tax treatment in Arizona.

For decades, Arizona consistently ranked in the top five in the country for highest business property effective tax rates (ETR). As a result of ATRA-led reform efforts, assessment ratios for businesses have slowly dropped from a

See BUSINESS TAXES, page 2

MIHS Using Bonds to Supplant General Fund

ATRA argued during the 2014 Prop 480 bond election that the Maricopa County hospital system (MIHS) was an outdated health care delivery model and sought $935 million in bonds not just to rebuild facilities but as a last ditch effort to reach fiscal solvency. Following the passage of Prop 480, news reports publicized MIHS’ budget is hemorrhaging red ink. The first planned bond sale certainly reinforces the dire fiscal conditions.

MIHS has drafted a $106 million bond issue, none of

See MIHS BONDS, page 8

Higley Unified Lease Purchased $75 Million Middle Schools

At an uneventful July meeting in 2012, the Higley Unified school board moved quickly through their consent agenda. There were no details provided on the lease purchase agreement for two new middle schools with Education Facilities Development Services (EFDS); it simply passed on a three to zero vote (two were absent) and the board proceeded to the next agenda item. Certainly there were few in Gilbert who understood the school board had just agreed to a 40 year lease-purchase contract for two middle schools for
high of 25% to 18% by FY 2017. By 2008, Arizona’s ranking for major industrial property had fallen to 10th and by 2009, to 15th in the nation.

Although assessment ratio reductions helped Arizona businesses, the recession devastated home values, causing a substantial shift in property tax burdens to businesses, whose values were far more stable through the recession. The ETR for class one property (business/commercial) rose 30% between FY 2010 and 2014 as a result.

One of the measures of differing tax treatment is the Urban Commercial-Homestead Classification Ratio which measures “the degree to which homeowner property taxes are subsidized by commercial property owners.” The nationwide average is 1.710 and Phoenix, Arizona ranks #9 at 2.355. Only Denver ranks higher amongst western neighbors. Colorado commercial property tax ETRs are typically lower than Arizona but their homeowner ETRs are some of the lowest in the nation.

Key competitor cities such as Las Vegas, Denver, Boise, Albuquerque, Los Angeles, Seattle and Salt Lake City all have lower business property ETRs than Phoenix and Tucson. This is largely true in all categories from small to large and commercial to industrial properties.

The study has two components. The Large Urban City category compares the largest urban area in each of the 50 states plus D.C., Buffalo, New York, and Aurora, Illinois (to account for sharp policy differences in Chicago and N.Y.C.). The other comparison group simply ranks the 50 largest cities in America by population.

SMALL BUSINESS

In the Large Urban City category, Phoenix ranks 24th highest in the nation for a $1 million commercial property with $200,000 in fixtures; a 2.3% ETR or $27,536 owed in property taxes.

For the same commercial properties but in the top 50 cities comparison, Tucson, Phoenix and Mesa rank #20, #22 and #29 respectively out of the most populated cities in America. High property tax cities in states like Michigan, New York, Texas and Illinois fill the ranks ahead. Denver and Portland have slightly higher small business ETRs in this category than Arizona cities but most western neighbors have lower rates.

Arizona performs worse for small manufacturers. For a $1 million business with $500,000 in machinery and $400,000 in inventories, Tucson, Phoenix and Mesa rank #13, #16 and #26 out of the largest 50 cities in America. Only states with the highest property tax rates in the country pay higher rates than Phoenix and Tucson.

Amongst a collection of rural cities from the 50 states, Safford, Arizona ranks #27 for a $1 million commercial property. Safford’s FY 2015 total tax rate was $12.11, just under the statewide average of $12.67.
LARGE COMMERCIAL PROPERTY

In the Large Urban City category comparing cities from all 50 states, Phoenix ranks #18 for $25 million properties with $5 million in fixtures and #10 for the category of $25 million industrial properties with $15 million in personal property value such as a manufacturing plant.

For the categories which focus on industrial property with high personal property value, it bears mentioning that Arizona is ranked higher than reality. The study does not capture Arizona’s accelerated depreciation laws which substantially decrease the value of personal property over time. ATRA’s estimation, after factoring accelerated depreciation, is that Arizona’s rank for the previous category drops from #10 to #20.

Tucson has the unfortunate distinction being #10 out of the largest 50 cities in the country for Commercial Property Taxes for a $25 million property with $5 million in fixtures, owing $871,933 in net property taxes for a 2.9% ETR. Phoenix is #14 and Mesa is #26. Suburban Arizona cities tend to have lower tax rates than Phoenix or Tucson.

Arizona again fares particularly poorly in large industrial property valued at $25 million with half of its value in personal property, such as manufacturing plants. Tucson, Phoenix and Mesa rank #12, #13 and #20 respectively.

HOMEOWNER

Arizona remains a low property tax state for homeowners. In the Large Urban City category comparing cities from all 50 states, Phoenix ranking #37 out of 53 for a $150,000 value home paying $1,462 net property tax, a .974% ETR. A $300,000 home in Phoenix ranks #39 in the same category, paying $2,923 net property tax, a .974% ETR.

In the largest U.S. cities category, Mesa ranked #44 for property taxes on a $150,000 home and #46 for a $300,000 home.

WHY PHOENIX AND TUCSON?

Phoenix and Tucson rank particularly high in business property taxes against other American cities in part because they have high effective tax rates even for Arizona.

In FY 2015, taxpayers in Tucson Unified paid a total property tax rate of $16.77 per $100 of assessed value, $4 over the statewide average. Taxes are particularly high in Tucson due to the $64 million in Desegregation money levied by Tucson Unified which adds roughly $2 to the primary school tax rate. Additionally, Pima County raised their primary rate $.61 for a primary rate of $4.28 in FY15, more than double the statewide average county government rate.

In Phoenix, property taxpayers also pay rates higher than the statewide average. For example, taxpayers in Phoenix Elementary/Phoenix Union paid $17.04 per $100 this year. Phoenix Elementary and Phoenix Union both take advantage of Desegregation/Office of Civil Rights levies, adding $3 to their total rate. Many Phoenix school districts have similar property tax circumstances, keeping the average rate high.

-Sean McCarthy
an unbelievable $150 million. These two $75 million schools are certainly the most expensive middle schools Arizona has ever built.

Higley Unified encompasses a rapidly growing part of south Gilbert. The district wanted to relieve pressure from growth in its K-8 elementary schools by opening two new middle schools. The problem was they had already maxed out their debt limit for bonding. They could have waited for the state to build them via the School Facilities Board but they disputed the state demographer’s projected pupil growth timeline. It’s worth noting that SFB was correct and Higley’s pupil growth slowed dramatically in recent years.

EFDS is a consulting firm of sorts well versed in Arizona school finance, providing “creative financing solutions” to districts. They convinced the district two middle schools could be lease-purchased and have “little to no impact on the District’s balance sheet or debt capacity,” according to their RFP submission. Constitutional debt limits in Arizona technically only apply to General Obligation (G.O.) bonds so local governments can circumvent the constitution with a variety of debt instruments such as Municipal Property Corporations and Lease Purchase agreements.

The timeline of the Higley Lease Purchase deal raises an eyebrow. The RFP from Higley, which uses nearly the same language as the EFDS response, was sent out June 20, 2012. Phase 1 selection was just 19 days later, when the superintendent-led “evaluation committee” reviewed four generic submissions describing the firms experience and qualifications. The following day they whittled the candidates from four to two. The next day the two selected groups presented their phase two proposal which supposedly required specific financial details and EFDS was selected as the winner. The following day was July 12, when the board approved the Lease Purchase at the aforementioned board meeting.

The financing scheme is necessarily complicated (see graphic). In order to avoid the district technically having any connection to the sale of the debt to finance the schools, there must be a “bridge” corporation. The general concept is EFDS creates a non-profit corporation (The James Megellas Foundation) who holds the debt and makes the loan payments to the bond issuer. Higley makes lease payments to Megellas. EFDS takes a management fee walks and away after construction is complete.

“The bonds are not a direct financial obligation of the District” reads the RFP from EFDS. Of course, the lease payments most certainly will be a direct financial obligation for years to come. Unbelievably, Higley didn’t know exactly how much they were in for when they approved the RFP in 2012; they were told “preliminary proforma data suggests that a lease rate, with the incorporation of Adjacent Ways would be within your budget” (see graphic). The actual lease rates became known in 2013 after the contract was finalized.

The EFDS plan included going to the ballot to renew an M&O override and increase a capital override in November of 2012 in order to afford the annual lease payments, which started at $3.2 million and will grow to $4.15 million in FY2017. They also had to get approval from their voters to enter into a lease-back contract for the land which Higley already owned. The 10% capital override request laid out how the additional funds would be used without any mention of lease payments or new school facilities. Project spokesman Justin Greene told The Arizona Republic in October 2012: “A positive outcome in the election gives the district stable financial standing.”
The capital override failed to mention that as the Lease Purchase funding stream, it would need to be successfully renewed at the ballot five times over the life of the loan. The capital and the M&O override both failed.

The ballot pamphlet for the lease authorization stated it would allow the district to lease schools “at a low interest rate... without debt or a tax increase.” It passed. The same news article mentioned Core Construction and Hunt & Caraway, the construction and design companies awarded the contract, provided the majority of the funding for the campaign committee ‘Yes Yes Yes for Higley Schools.’ The lease agreement could proceed but the payment mechanism had failed. Enter the Adjacent Ways levy.

Per state law, a school district governing board may levy additional property taxes to pay for public infrastructure such as sidewalks, sewers and road ways adjacent to their property. They specifically “shall not use any portion of the monies generated from the special assessment for any construction, maintenance or other improvements to the school district’s property...” except for emergency vehicle lanes.
It’s particularly common for growing districts to access the Adjacent Ways levy to pay for public infrastructure. Beginning in 2011, Higley began levying substantial amounts of Adjacent Ways funds and carrying forward much of it. On average, they levied $3.1 million for five years through FY 2015.

To date, all project related payments for the Lease Purchase of the two middle schools appear to have been made from the Adjacent Ways fund. The first payment was $1.5 million in December of 2012. The first two years of lease payments were made on June 30, 2014 totaling $6,000,000 and a $420,000 “prepaid use fee.” Higley has admitted to using the Adjacent Ways fund but says the decision “was made by a previous CFO” and going forward will pay for the lease out of the General Fund.

The “Evaluation Committee” who approved the 40 year deal was three district employees which included Dr. Denise Birdwell (Superintendent), Dr. Jim Lockwood (CFO), and Justin Greene (Director of System Services).

Dr. Lockwood resigned in November of 2012 after less than a year on staff. Dr. Lockwood told ATRA the plan had been in motion well before he arrived and although he was technically on the committee, he had no part in the contract negotiations. An East Valley Tribune report from February 2011 quotes Higley district officials considering “creative” solutions to address growth and the possibility of one or two new middle schools.

Kevin Hegarty, the CFO who replaced Lockwood, left after just eighteen months. Minutes from 2013 meetings demonstrate Mr. Hegarty planned to pay for the leases out of the capital fund leveraging new money from student growth and converting them to district sponsored charters. He left before the $6 million lease payments were made in June 2014. Both CFOs indicated they left the district due to philosophical differences with leadership.

Justin Greene no longer works for the district and appeared to be the project coordinator. Before working for Higley, Mr. Greene was the Superintendent of Union Elementary in Tolleson before resigning after it went into receivership in 2007. The financial consulting group working on behalf of the State Board of Education described finding “numerous indicators of gross financial mismanagement by the previous administration” at Union. Greene had negotiated a 24% pay increase when Union was found to be overspending their budget by more than $2.5 million over a two year period, a large amount for a small district.

The constant through the entire deal is Dr. Denise Birdwell, the Superintendent since December 2008 who retired last month. Both the $1.5 million payment in December 2012 and the $6 million lease payments in June 2014 appear to have been made during a CFO transition. Ultimately, the buck stops with the elected school board members who voted for the lease-purchase in 2012: former Board President Greg Land, current President Vanessa Whitener and Kim Anderson. Future district leaders will be forced to deal with rising lease payments through 2053. Long term leases with rising costs appear to be part of a trend. The Arizona Auditor General reported in a
2012 performance audit the district had entered into an unfavorable lease agreement for solar power where above market charges were set to elevator each year, resulting in a net monetary loss to the district.

The Higley exercise highlights two important issues. First, it demonstrates the significant impact financial blunders can have on future elected officials. Depending on the interest rate, the most a middle school should cost is between $30 and $40 million. Higley will pay double that over the life of the agreement because the district chose a “creative debt instrument,” with debt payments stretched over 40 years. Though they technically could break the lease, they would face financial penalties, the pain of closing schools and a massive hit to their credit rating.

It is clear Higley attempted to use the “charter model” to finance these schools, but unlike a school district, the risk for a charter school is entirely on the charter operator. If a school district creates a financial obligation, it ultimately falls on the jurisdiction’s taxpayers to finance the debt. Lease Purchase agreements, as currently constructed, allow a school board and administration to severely handcuff future boards for decades.

Second, it demonstrates that unlimited access to money outside of the Revenue Control Limit lacks true oversight and encourages abuse. Higley’s use of the Adjacent Ways levy to fund debt service was clearly illegal. Currently, a school board must hold a truth in taxation hearing to publicly explain their levying for Adjacent Ways. The explanations are brief and public understanding is low. There is no limit to how much a board can levy from year to year. School district performance audits do not review the purchases made with Adjacent Ways. After this episode Higley has indicated it will continue to levy $3 million for Adjacent Ways in FY16, presumably for statutorily approved expenses.

Even if the district had not inappropriately leveraged the Adjacent Ways levy to pay for nearly $8 million in lease related costs, this setup is bad for taxpayers. Lawmakers should ensure state statutes do not encourage future abuses of the Adjacent Ways levies and Lease Purchase agreements.

-Sean McCarthy
which is for the items advertised during the election, which focused on the burn unit and building a new hospital. The first goal of the bond issue is to relieve pressure on the general operating budget. The district went into debt in 2013 and will leverage $36 million in bonds to refinance debt which is currently being paid through the general fund. The district has at least a $43 million structural deficit for FY15 according to district budget documents. Refinancing is allowed because it was written in the legal text of the bond but voters were told this bond sale was about new projects- not improving their general fund balance.

So in addition to the tax increase property taxpayers will pay next year for MIHS’ operating costs- the board approved its maximum tax increase for a total of a $67 million levy for FY16, the bond will be used to supplant general fund dollars.

The rest of the bond sale is predominantly for soft capital. ATRA has long encouraged local governments to use to “pay as you go” approaches for soft capital items such as computers, technology, furniture and other items with short useful lives to avoid interest costs. MIHS would likely argue these technology “refreshes” or upgrades are vital to ongoing operations (and they likely are) but ATRA wonders why these critical components were apparently not prioritized in the budget. The “useful life” measure of most of the items in the first bond issue is five to ten years with some as short as three years. This for a bond package which taxpayers will be paying for the next 27 years with interest. MIHS’ estimates the total cost of the bond including interest will be roughly $1.6 billion. Sound business principals suggest one should only debt finance projects that will have a useful life longer than the bond repayment. Long term financing for soft capital is a tell-tale sign of an entity that is operating on a weak fiscal foundation.

ATRA continues to argue that in the context of a declining market share, fewer patients and a ballooning structural deficit, none of the bonds should be sold until policymakers determine a clear vision for MIHS. Rebuilding the hospital and new paint on their regional outpatient clinics won’t fundamentally change their position in the health care market in Maricopa County. A rigorous and open review could determine a future niche role for MIHS which properly matches their capacity with public demand. If not, taxpayers can be sure this won’t be the last time MIHS will need an infusion of money to remain afloat.

-Sean McCarthy