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ARIZONA TAX RESEARCH ASSOCIATION

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What Happened to the Sales Tax Base?

It is oft repeated in policy circles that the sales tax base is cratering because consumers are purchasing fewer goods in favor of services and Arizona ought to adopt a broader sales tax base to account for this phenomena. There are two problems with these claims, namely that the sales tax base hasn't contracted and Arizona already has a relatively broad sales tax base.

In a study of Arizona's Transaction Privilege Tax (TPT) using *Department of Revenue* data, Arizona's retail sales tax revenues are up 14% adjusted for population and inflation (P & I) since 1990. Retail sales are the largest category of TPT and represent more than half of all taxable transactions. The

See SALES TAX BASE, Page 2

South Tucson Illegal Property Tax Case Settled

In 2014, ATRA reported on the City of South Tucson's action to illegally levy \$1.8 million in secondary property taxes to repay non voter-approved debt. Although the City Council eliminated the tax in 2014, there was no remedy to return the overpayment of taxes to the city's taxpayers. A class action lawsuit that was filed in October 2014 was recently settled for \$1.1 million.

During the FY 2012 budget process, administrators for the City of South Tucson were looking for ways to alleviate financial pressures from the city budget. One of the major expenses facing the city was the annual debt service for approximately \$7 million in outstanding non voter-approved debt that was backed by city sales tax revenues. To free up those revenues, city administrators recommended city council members begin levying a

See SOUTH TUCSON CASE, Page 7

Inside:

- State Shared Revenues Top \$3 Billion, pg. 4
- Judge Shifts Local Deseg Taxes Back to State Taxpayers, pg. 8
- County/City Tax Update, pg. 9

Save the Date!

ATRA Golf Tournament:

Nov 1, 12:00 pm

Stonecreek GC

ATRA Outlook Conference:

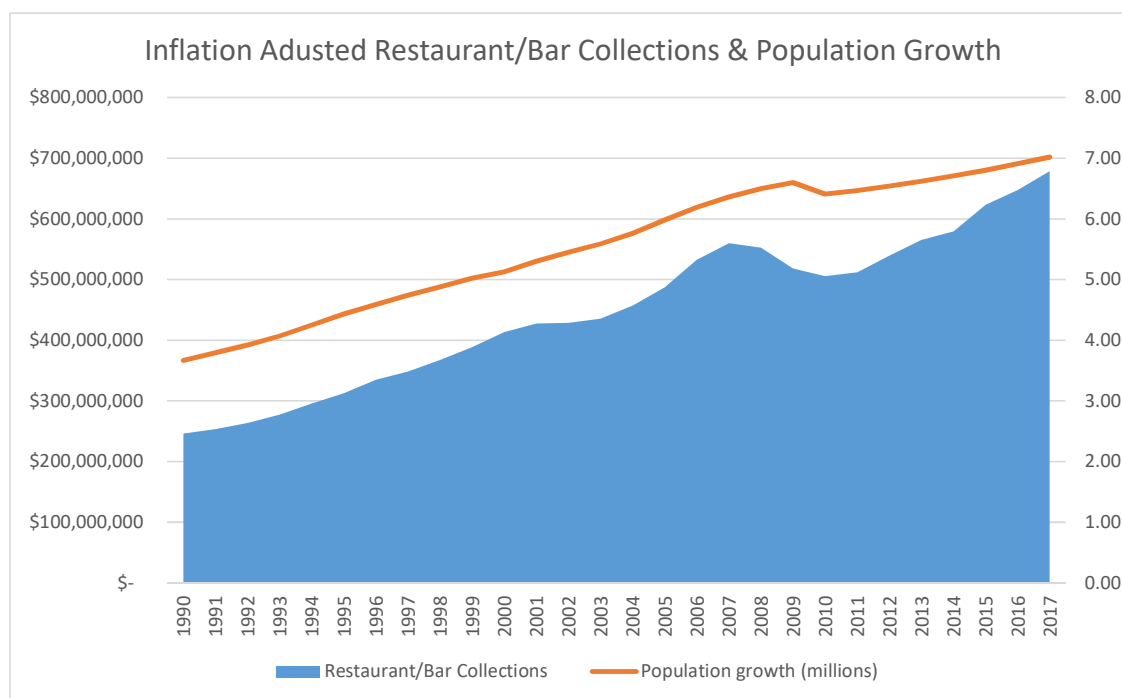
Nov 14, 8:00 am

Embassy Suites Scottsdale

SALES TAX BASE, *Continued from Page 1*

notion that retail sales taxes have cratered doesn't withstand the first policy question: does it provide less revenue to government than it did in the past?

The largest increase in the tax base since 1990 is in the restaurant and bar classification, where collections have grown from \$145 million to \$678 million, a 44% increase after adjusting for P & I. Any casual observer would notice Americans eat more at restaurants and quick-service restaurants than they have in previous eras. A variety of studies show grocery purchases (not subject to tax by the State) are declining relative to restaurant spending, which not only are subject to tax on the gross proceeds but have increased in cost by nearly 3% per year since the recession (<https://tinyurl.com/yxodzbdq>). This trend appears to be holding strong with younger generations even as they have families of their own. Whereas food for home consumption is not taxable at all by the State, the cost of the food and the service is subject to TPT for restaurants and bars. This represents a rather substantial tax shift that has been completely ignored by those concerned with base erosion.



There have been several changes since 1990 to the goods and services that constitute the 'TPT' base, with the most significant being the removal of the "commercial lease" tax, known as the rental of real property. This is a sales tax on the gross rent paid by businesses to occupy commercial real estate. Only a few

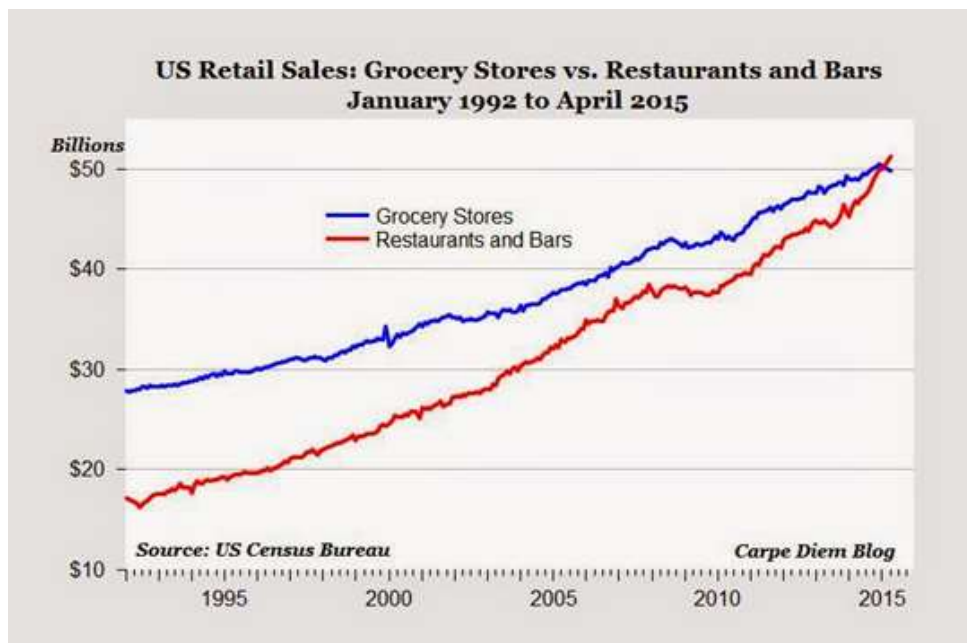
states tax commercial leases, which is viewed by economists as a double tax or "tax on a tax", since property taxes are already owed on the value of a property *before* any revenue is actually generated on the property. The State of Arizona sunset this tax in the early 1990s because it was considered uncompetitive (<https://tinyurl.com/ybzxogi>). It was left in the definition of the tax base with a state rate of zero so counties continue this tax. Cities may elect to levy this tax and most do. If this classification is left in the state base for purposes of historical comparison, the performance of the TPT is diluted. Unadjusted, total TPT is down 0.5% since 1990 adjusted for P & I. After taking the commercial lease tax out of the base, since it was a policy decision and not a system performance issue,

Arizona's TPT produces 5.8% more revenue than in 1990 adjusted for P & I, or \$316 million in 2017 dollars. Policymakers should keep this in mind the next time they're told the sales tax base is crumbling.

Another common misunderstanding of Arizona TPT is the scope of the base. Arizona's TPT has 17 classifications ranging from amusements to utilities, covering a variety of goods and services. Arizona is considered to have a relatively wide base of tax, ranked 11th in the country by the *Tax Foundation* with a breadth rating of 43%, which is defined as the ratio of the implicit sales tax base to state personal income (<https://tinyurl.com/yxvb3tql>). Arizona taxes many services, such

as professional photography, printing, gym memberships, and construction services. While Arizona exempts many business inputs to avoid the double taxation of final products, supplies and tools used by businesses are not exempt. Trite comments about "loopholes" and "billions" in exemptions are not often followed by thoughtful efforts to expand the base. While there are policy arguments which support the notion of expanding the base, the concept of taxing services in particular remains deeply unpopular as evidenced by the 2018 ballot initiative Proposition 126, which passed by a nearly 2:1 margin. Prop 126 limits TPT on services in the State Constitution to those in existence as of January 2018.

It's worth noting Arizonans *are* purchasing more services as part of a decade's long nationwide trend. According to a *Tax Foundation* study using Bureau of Economic Analysis data, Americans have been spending more on services

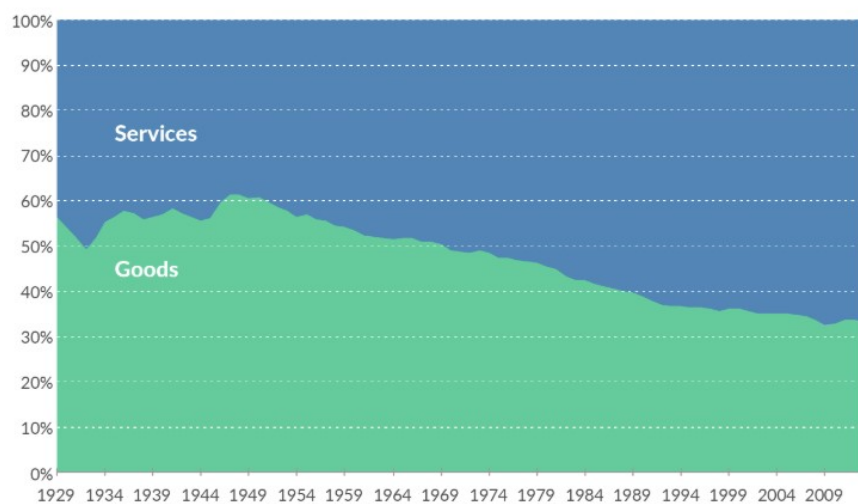


than goods since the 1960's, as part of a trend that began in the 1940's. By 2013, Americans consumed about 1/3 goods to 2/3 services. It stands to reason that as wealth increases, people purchase more services, but it doesn't inherently mean the retail tax base is declining—and it hasn't in Arizona as noted earlier. Naturally, the argument which follows is government should benefit from this increased spending on services.

The premise that the sales tax base is cratering is often supported by a comparison of government expenditures

Percent of Total Personal Consumption Expenditures

Goods vs. Services, U.S. (1929-2013)



Source: Bureau of Economic Analysis, National Income and Product Accounts, "Personal Income and Outlays."

against personal income. America in general and Arizona in particular are wealthier than in previous eras, as measured by personal income. The extent to which government should benefit from that change is a policy choice, not a birthright. Indeed, Arizona's Joint Legislative Budget Committee is asked to routinely produce a document which shows Arizona General Fund expenditures as a percentage of personal income. This document doesn't account for taxes Arizonans chose to add such as Prop 301 for education, because they are not considered General Fund revenues. But that aside, state spending as a percentage of personal income is down over time, hovering at 3.3% the last few years from 4.9% in 1994. The idea that State General Fund spending ought to track the relative value of all personal income in the state does not withstand scrutiny. A rise in wealth will not directly produce more taxable sales or property taxes, which depend on consumer behavior. The income tax is different. An ATRA study on the income tax over the last 30 years shows dramatic growth in personal income taxes in Arizona, which have jumped 145% since 1990 as a result of increased wealth, adjusted for inflation. But should government expand because of this trend? Many state expenditures are for services that theoretically should decline as the wealth of its residents improves, such as Medicaid, social spending, and corrections. It makes even less sense that sales tax collections should have risen by the same level as personal income growth. Any study which attempts to show the erosion of the sales tax base by adjusting for personal income over time is a flawed approach designed to penalize a state for wealth creation.

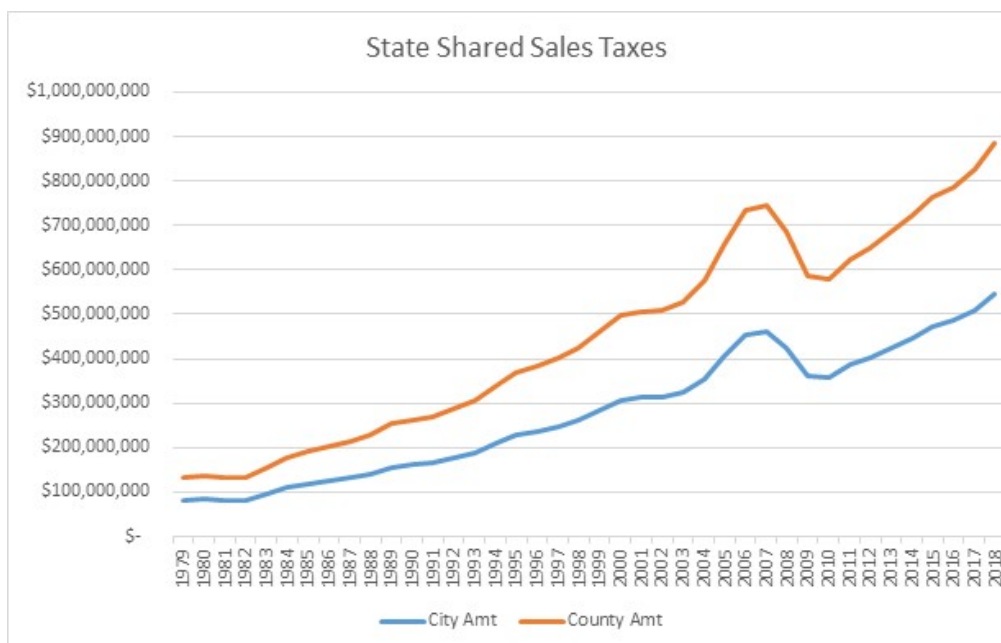
The object of taxation is to efficiently cull money from the private economy to fund government. Government revenues ought to be sufficient to cover what is needed and ideally shouldn't decline simply because the tax base changed; but changes in consumer preferences alone should not drive taxation debates if the overall base has not unduly eroded. If that were the standard, taxpayers should argue for rate reductions to the restaurant and bar classification. The good news is Arizona's sales tax system has fared well over the last 30 years and even made up for some base contraction with the exemption of commercial lease. The bad news is Arizona has some of the highest combined total rates in the nation and does not have much room left for state and local government to raise rates without causing economic harm. Conversations surrounding base expansion should revolve around rate reduction and revenue neutrality, not the false narrative that policymakers have made Swiss cheese of the current system.

-Sean McCarthy

	1990	Inflation Adjusted	Pop + Inflation Adj	2017	Delta	Delta in \$
Retail	\$ 867,217,733	\$ 1,465,518,713	\$ 2,803,253,779	\$ 3,196,120,271	14.0%	\$ 392,866,492
Restaurant/Bar	\$ 145,727,237	\$ 246,265,712	\$ 471,058,665	\$ 678,578,362	44.1%	\$ 207,519,697
ALL TPT w/o Comm Rent	\$ 1,681,247,671	\$ 2,841,154,914	\$ 5,434,579,700	\$ 5,750,798,122	5.8%	\$ 316,218,422

State Shared Revenues Top \$3 Billion

Lost in the annual legislative shuffle are discussions on state shared revenues: tax dollars that are passed along from the state to local governments. Entire committee hearings are dedicated to unfunded mandates levied on local governments or the balance of obligations suffered by the counties instead of the state. Little attention is paid to the record revenues being sent from state coffers in the form of shared taxes. In fiscal year 2020, more than \$3.4 billion will be passed along from state income, sales, vehicle license, and gas taxes to municipalities and counties in Arizona. With total ongoing state general fund revenues this year amounting to an estimated \$11.1

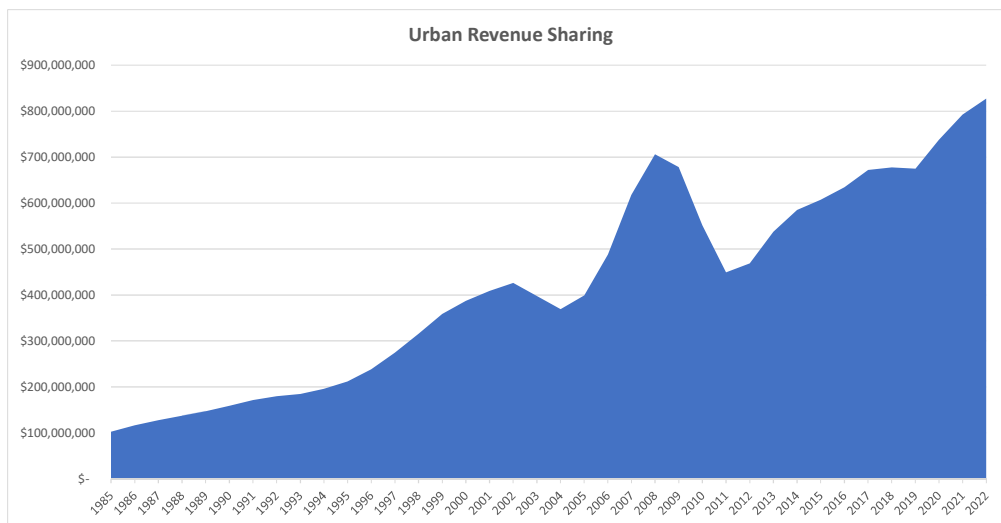


billion, these appropriations are considerable.

Almost every state shares revenues with local governments in some fashion. There often are rigorous policy debates over the amounts and formulas. It's been some time since Arizona has revisited its sharing policy. The National League of Cities "estimates states' share of annual operating revenues for municipalities was 20-25 percent" averaged over the last twenty years. For the

City of Phoenix, state shared revenues of \$463 million this year represent 36% of their general fund revenues.

Inclusive of all revenue sharing, Arizona ranked second in the nation in percentage of intergovernmental transfers to local governments from the state in a 2010 survey of states by The Lincoln Land Institute. The study reported Arizona shipping 55.4% of state revenues to local governments, including state aid to K-12 schools. This comparison across states reflects the varying relationships states have with local governments as well as the intricacies of their K-12 funding formula.



Arizona does not typically share precise amounts of money but percentages of revenues collected, which means local governments typically benefit from a rising economy. (See below for simplified explanations on how the State shares different revenues with localities.)

These shared revenues are a critical part of the state budget and yet they are not well understood. Scores of lobbyists

representing sub-jurisdictions of Arizona inundate the State Capitol with financial requests, almost exclusively focused on their needs and costs. Policymakers should bear in mind that before they address any of their priorities, they've already cut a check to local governments in amounts higher than last year as these revenues increase with nary a discussion. The formulaic and automatic increase in state funding to counties and cities is an interesting contrast to the appropriations to state agencies. State agencies, K-12 public schools, corrections, and universities,

among others, are funded largely based on services provided or flat appropriations.

Adjusted by population and inflation, urban revenue sharing is up 31% since 1990, despite significant reductions in both the personal and corporate income tax rates. Since 2010, revenues are actually down 0.7% adjusted for population and inflation. This is mostly because the historic downturn years in income tax collections were in 2011 through 2013. Going back to the pre-boom year of 2004, adjusted urban revenue sharing is up 18%.

TPT shared revenues have increased from \$425 million to roughly \$1.4 billion since 1990. Inflation and population adjusted amounts are down 3% since then. The sales tax article on page one discusses historical TPT collections in further detail. Since 2010, adjusted TPT shared revenues are up 16%. This analysis only accounts for the shared portion of the state's 5% rate. This sets aside possible economic impacts from other rate changes such as the addition of the 0.6% Prop 301, city, and county rate increases.

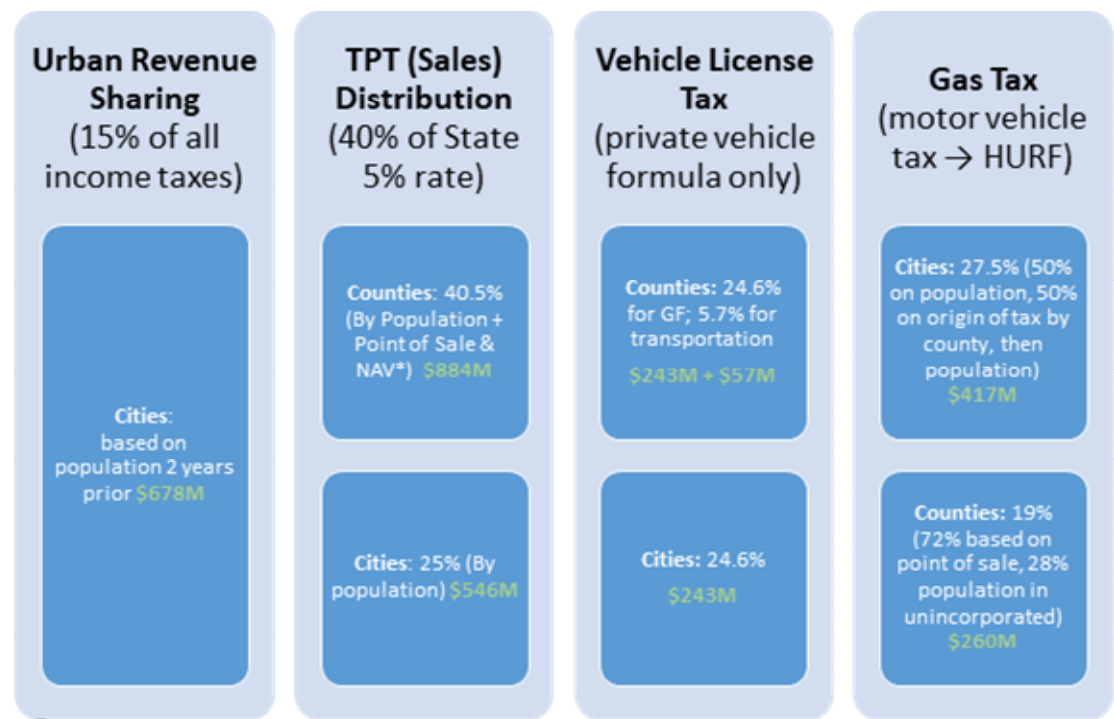
Transaction Privilege Tax (Sales): Of the state's 5% rate, 60% of the amount heads to the state GF while 40% is moved to the distribution formula, per state law. Of that distribution amount, 34.49% goes to the state GF, 38.08% to counties (based on population and point of sale), 2.43% to counties (based on net assessed value and point of sale), and 25% to municipalities (based on population).

Urban Revenue sharing (Income tax): 15% of all income tax collections from two years prior are distributed only to municipalities based on population.

Vehicle License Tax: VLT distribution is a complex formula split between private and public vehicles. Of private vehicles registered, 45% is designated for HURF, 24.6% goes to Counties for GF operations and 5.7% for transportation purposes, and 24.6% to cities for any purpose.

Motor Vehicle/Gas Tax (Transferred to HURF): The state distributes \$10M to the Department of Public Safety and keeps 50.5% of the remainder for the State Highway Fund. Then, 19% goes to counties (72% based on

point of sale, the rest on population in unincorporated areas). 27.5% goes to municipalities (50% based on population and 50% based on county of origin of gas sales to cities and towns in those counties based on population). Finally, 3% goes to cities with a population of 300K or more.



-Sean McCarthy

SOUTH TUCSON CASE , *Continued from Page 1*

secondary property tax to repay the debt, despite it not being voter approved General Obligation bond debt. The justification that such a levy would be considered legal was based on a 1990 letter by the League of Arizona Cities and Towns. However, that letter was addressed to a different city in response to the question as to whether a budget is subject to referendum, not a secondary property tax.

Taking the administrator's advice, the council adopted a secondary tax rate of \$2.4338 to produce a levy of \$600,850 for tax year 2011. To provide perspective, the city's primary tax rate to fund its general operations was only \$0.2265 at the time and generated just \$53,486. The council levied the secondary property tax over the next two tax years for a total of \$1.8 million through tax year 2013.

Three years after the secondary property tax was implemented and following turnover in the city administration, the City Council sought a legal opinion regarding the legality of the tax. The Council was advised that a secondary property tax may only be levied by the city "for debt retirement of voter-approved, bonded indebtedness." In a memo to its taxpayers, the city vowed to immediately eliminate the tax and called it "much needed relief" for its homeowners. Although the memo stated that the previous City Council and administration "erroneously or intentionally imposed an improper secondary tax," the city was silent as to how or if taxpayers would be refunded the \$1.8 million in illegally levied taxes.

Five years after the class action was filed, the parties have agreed upon a \$1.1 million settlement. However, with a general fund budget of only \$5.3 million, the City doesn't have the funds to repay a settlement of that magnitude. Since Pima County is also named as a defendant in the case, the County Board of Supervisors agreed to carry a 19-year loan for the City. With a 3.5% interest rate, the annual debt service payment the city will be required to pay the county amounts to approximately \$80,000.

The Property Tax Oversight Commission (PTOC) is responsible for reviewing the property tax rates and levies of all local taxing jurisdictions. However, at the time, that oversight only applied to primary property taxes, not secondary property taxes. The South Tucson debacle prompted the Legislature to pass a bill in 2015 to broaden PTOCs review process to include secondary property taxes in order to prevent a similar situation from occurring again in the future.

ATRA reported on a similar situation as South Tucson's in its *May 2019 Newsletter* in which Paloma Elementary failed to receive voter approval to spend \$10.5 million on construction projects as required by law. In this case, the district was warned by its auditors as far back as March 2016 that it needed voter approval, but those warnings were ignored until recently. After receiving new legal advice earlier this year, the board voted to refer a measure to the November ballot to ask its voters for retroactive approval.

Adding \$1.1 million to its existing \$19 million in existing debt (including \$12 million in PSPRS debt) may be the least of South Tucson's problems. According to a recent memo from the city's financial director to councilmembers, the city is in a fiscal crisis and is proposing to increase its sales tax rate to 5% on retail purchases, which is already the highest of all other cities at 4.5%. With just 5,600 residents and a tiny tax base, the notion that they can tax their way out of a fiscal crisis is a painful gamble. If Arizona had a receivership statute for failing cities similar to that for school districts, South Tucson would be a worthy candidate.

-Jennifer Stielow

Judge Reverses Legislature: Deseg Taxes Back to a State Obligation

In a late June decision at the Arizona Tax Court, Judge Whitten sided with Pima County and Tucson Unified School District in their lawsuit against the State, who had made Desegregation taxes a secondary property tax. In the 2018 state budget, the Legislature demanded these taxes be collected only as secondary property taxes, which made them ineligible for Constitutional 1% Cap protection for homeowners and relieved the State from subsidizing these taxes in areas like Tucson and the City of Maricopa, where these rates contributed to high total primary rates. However, Pima County homeowners did not pay their full share of Deseg taxes this year because the County ignored the law change in light of their legal challenge.

The court agreed with Pima County that taxes for Desegregation are not defined as secondary property taxes in A.R.S. §15-101 (25) and therefore must be viewed as primary property taxes. Ergo, they are deserving of the 1% Cap protection for homeowners. The inference is if the state had better defined Desegregation, or created a special taxing jurisdiction, it could have been allowable.

The opinion adds a new legal theory at the end of the judgement which is rather unhelpful. While explaining that Deseg taxes must be similarly accounted for like other primary property taxes in accordance with the 1% Cap payment (or, recovery) mechanism in A.R.S. §15-972, the judge slips in this statement without context: “Since the ‘secondary property tax’ levy for desegregation expenses is not a voter-approved ad valorem tax, it is still subject to the constitutional 1% Limit and must be included in the calculation...” (emphasis added). This passing reference to a requirement for voter-approval was not used as a justification when the judge reasoned that they must be considered a primary property tax and the summary does not attempt to untangle the mess of nonvoter approved levies which are presently collected as secondary property taxes. There are no references to existing case law in this area or further explanation. Confusingly, the statement was entirely unnecessary as that portion of the summary was simply explaining that the funding recovery mechanism in A.R.S. §15-972 still applied, which was rather simple once one had already concluded Deseg taxes are primary property taxes.

In the end, the court decision is not particularly helpful to anyone. State taxpayers remain liable for subsidizing local taxes in areas like Tucson and Pinal County. Deseg districts and other high tax rate jurisdictions could be made liable for all their local taxes if the State makes simple tweaks to the law in light of the court’s opinion. While the judge may have suggested secondary taxes must be voter-approved, that is not clear. Naturally, the repayment or recovery mechanism is a statutory consideration only and the State can make changes to how the unpaid taxes resulting from the 1% Cap are managed. If the State appeals, an appellate court could theoretically make clear the bright line for what constitutes a secondary property tax, which could threaten the many nonvoter-approved secondary property taxes, such as library, flood control, and fire district assistance taxes.

-Sean McCarthy

Proposed Local Government Tax Increases

County Tax Increases

ATRA reported in its June 2019 newsletter the various local governments that are proposing property tax increases this year. Four more counties have adopted their tentative budgets, and of those, two are proposing to increase taxes over 4%.

La Paz County is proposing a 4.04% increase in primary property taxes, which if adopted, would place the county at its constitutional maximum limit. Santa Cruz County is proposing a 4.09% tax increase by increasing its primary tax rate \$0.1564 over its Truth in Taxation (TNT) rate to \$3.9815. Santa Cruz is also increasing its Flood Control District (FCD) taxes 4.3% by raising the tax rate to its statutory maximum of \$0.7963, which is \$0.0328 above its TNT rate. TNT laws require the state and local governments to notify taxpayers of potential tax increases; however, both counties could choose to adopt lower levies at their final adoption hearings in August.

Graham and Greenlee Counties are not proposing to increase taxes this year. Graham County is reducing its primary and FCD tax rates in adherence to TNT. Greenlee County is able to increase its primary rate two cents to \$0.7333 to counterbalance the 4.2% decrease in the value of existing property. Although the county could have

County	2018	2019	TNT Rate	TNT Req.	% Chg.	MAX TR
Graham						
Primary	2.9920	2.9644	2.9644	NO	0.00%	3.0873
FCD*	0.1379	0.1299	0.1299	NO	0.00%	
Greenlee						
Primary	0.7026	0.7333	0.7333	NO	0.00%	1.1442
PHSD	0.2500	0.2500	0.2500	NO	0.00%	0.2500
FCD*	0.2500	0.2500	0.2704	NO	0.00%	
La Paz						
Primary	2.3607	2.5890	2.4884	YES	4.04%	2.5890
Santa Cruz						
Primary	3.8815	3.9815	3.8251	YES	4.09%	4.9994
FCD*	0.7763	0.7963	0.7635	YES	4.30%	0.7963

*The FCD maximum tax rate is the greater of 50 cents per \$100 of assessed value or 20% of the county primary tax rate.

chosen to increase its FCD rate to the TNT rate of \$0.2704, it is proposing to maintain last year's rate of \$0.2500. The 25-cent tax rate for the Public Health Services District (PHSD) could not be increased because it is at the statutory rate cap.

properties, the city would need to reduce the tax rate approximately 13 cents to the TNT rate of \$1.7454 to offset the tax increase. The cities of Bisbee and Sierra Vista are both increasing taxes this year. Bisbee is increasing its primary tax rate to \$2.9152, which is approximately 6 cents over its TNT rate of \$2.8581. Sierra Vista is maintaining the same tax rate this year of \$0.1136, which is just slightly above the TNT rate.

Final decisions regarding tax increases must be made before the third Monday in August when all county boards of supervisors are required to formally adopt the property tax rates and levies for the state and all its local taxing jurisdictions.

-Jennifer Stielow

City Tax Increases

The City of Coolidge is proposing a 7.5% tax increase by keeping its primary tax rate the same at \$1.8759. Due to the significant growth in the value of existing locally assessed

City/Town	FY 2019 Primary Rate	FY 2020 Proposed Rate	TNT Rate	% Increase	Max Rate
Coolidge	1.8759	1.8759	1.7454	7.50%	1.9400
Bisbee	2.8261	2.9152	2.8581	2%	2.9152
Sierra Vista	0.1136	0.1136	0.1124	1.11%	0.1827