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# ARIZONA TAX RESEARCH ASSOCIATION

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### Richard Stavneak: State Budget Balanced, but Challenges Ahead



Richard Stavneak, Director of the Joint Legislative Budget Committee (JLBC), opened ATRA's 2024 Annual Outlook Conference with encouraging news: unlike last year's projections of deficits, the state's General Fund is forecasted to maintain positive balances through FY 28. However, JLBC expects these balances to decline over time, hitting a low of \$159 million in FY 28. Stavneak cautioned that this modest balance limits the flexibility for future ongoing or one-time spending initiatives.

Stavneak warned that if all \$159 million is used for one-time FY 26 spending, no discretionary funds would remain over the three-year window. Conversely, allocating it entirely to ongoing initiatives would yield just \$53 million per year for FY 26 through FY 28. Stavneak noted that these figures exclude "ongoing" one-time expenses like

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### Steve Trussell Named 2024 ATRA Outstanding Member



Kevin McCarthy presented Steve Trussell with the 2024 ATRA Outstanding Member Award at the Outlook Conference luncheon.

Steve has been a member of the ATRA Board for several years representing the Arizona Rock Products Association (ARPA). In addition to being an active board member, he graciously makes ARPA's facilities available to ATRA for board and committee meetings

Kevin expressed his appreciation for Steve hosting ATRA meetings and acknowledged his staff's hospitality of ATRA members. Importantly, Kevin noted that Steve's impact on ATRA goes beyond graciously opening hosting ATRA meetings, saying "Steve is a great supporter and advocate for ATRA by consistently helping us grow our membership as well as supporting ATRA's legislative efforts at the Capitol."

**Stavneak**, *Continued from page 1*

school building repairs and state health insurance funding, which could push the budget into a shortfall by FY 27 and FY 28 were they to be funded again.

Arizona's FY 24 revenues exceeded projections by \$425 million, largely thanks to a one-time \$145 million gain from Medicaid reconciliation payments. Tax revenue growth also contributed to the gains, with insurance premium taxes up 16%, individual income tax withholding growing by 6.5%, and corporate income taxes rising by 3.3%.



October revenue data painted an even more optimistic picture, with collections growing 21% and exceeding projections by \$127 million, from \$109 million to \$236 million. Stavneak emphasized that the coming months will be critical to determine whether October's growth is sustained, with an updated forecast due in January 2025.

Stavneak stressed that while revenues are currently outpacing expectations, FY 25 revenue growth is forecasted at just 1.8%. Moderate growth in sales tax (3.1%), individual income tax (5.7%), and corporate income tax (3.2%) are expected to be offset by steep declines in non-tax revenues. Medicaid payments are expected to drop from \$174 million to \$32 million, while interest earnings could fall by 33% as the Federal Reserve reduces rates.

JLBC baseline spending projections for FY 26 show both increases and reductions. On one hand, one-time FY 25 spending is reduced by \$683 million, but increases in Medicaid, developmental disabilities services, and K-12 formula funding push total spending up by \$232 million. JLBC forecasts \$180M of supplemental spending increases, with developmental disabilities services accounting for \$76 million of that growth. The remaining \$104 million supplemental comes from K-12 education, which is due to basic state aid recalculations and legal obligations associated with the *Qasimyar* property tax refunds and higher state aid costs.

K-12 spending is set to rise sharply through FY 26, with costs increasing by \$524 million. This includes backfilling the loss of Prop 123 funding, deferred transportation projects, K-12 additional assistance, and low-income weight funding. Stavneak flagged these as significant pressures on future budgets.

Despite these challenges, Stavneak noted that Arizona's budget remains nominally balanced through FY 28, bolstered by the \$1.5 billion Budget Stabilization Fund. However, the inclusion of \$323 million in traditional "ongoing one-time" expenses and potential new initiatives from the Legislature could strain the budget further in coming years.

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# Glenn Farley: US Economy Rebounds Post-Covid, but Arizona Still Feels Strain



Glenn Farley, Director of Policy & Research at the Common Sense Institute (CSI), began his presentation with a review of the US economy since 2020, noting that despite volatility in the covid years, the economy today has mostly returned to pre-covid growth trends. Conversely, Farley noted that federal spending and borrowing reached historic highs at that time and, despite some temperance, have not returned to pre-covid trends.

Farley then addressed the disconnect between public sentiment and economic reality. Despite easing inflation, which dropped to 2.4% year-over-year as of September, the average household still feels the strain. High borrowing costs, including credit card rates topping 28% and mortgage rates near 7%, have deepened consumer fatigue. Farley noted that this “sentiment gap” underscores a broader challenge—an economy struggling to maintain momentum without tipping into recession.

Farley noted that Arizona’s economic growth over the last decade has far exceeded the national average. Farley highlighted a doubling of per-capita personal income from \$33,774 in 2010 to \$62,543 in 2023, propelling Arizona to the 20th highest income rank nationally. The state’s Real GDP grew by 40% during the same period alongside 75,000 new residents arriving each year, primarily from California, Florida, Oregon, Texas, and Washington. As one of Arizona’s biggest growth engines continues to be interstate migration, Farley noted tradeoffs. In 2023, 54,000 Californians moved to Arizona, bringing with them higher-than-average incomes and home-buying power, fueling disparities in the Phoenix Metro market.

Farley touched on the state’s continued reputation as a destination for business relocations. However, inflation has hit Arizona harder than most states, with the Phoenix metro standing out for its unusual upward leap in housing costs compared to the national average. Housing costs alone have driven what Farley calls Arizona’s “homebuyer misery index” to troubling levels, a metric which captures both rising home prices and borrowing costs.

Arizona’s job market is showing signs of cooling according to Farley. After robust 4.5% annual job growth in 2021-2022, growth slowed to just 2.4% for 2023-2024. Though Arizona’s job market continues to outperform the US average, Arizona remains about 100,000 jobs below its pre-pandemic trend. According to Farley, Arizona will never return to that pre-pandemic trend given current growth rates. Farley also noted that Arizonans in the private sector work more hours for less pay than they did pre-pandemic.

Arizona’s housing market continues to struggle under the weight of limited supply and rising costs. Farley criticized policy interventions like rent control, which he argued disincentivize new construction and exacerbate affordability challenges. Instead, he called for policies that lower barriers to new residential construction, which he argued is among the root causes of Arizona’s housing crisis.



**Farley**, *Continued from page 3*

Farley also highlighted water as one of Central Arizona's most pressing long-term issues. He argued that it isn't a climate or drought problem, as other water sources like the SRP are just as strong today as they were at the beginning of the drought in 2000. The problem, he argues, lies in over allocation of the Colorado River. With Central Arizona heavily reliant on the Colorado River, prolonged drought conditions pose a significant risk to the growth and sustainability of urban Arizona communities. He emphasized the need for proactive policy solutions to ensure water availability for future generations.

Farley concluded by reiterating the importance of maintaining Arizona's competitiveness. From reducing housing barriers to protecting school choice and modernizing infrastructure, he called for the defense of Arizona's Empowerment Scholarship Accounts and new residential construction efforts.

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## Bill Molina Re-Elected ATRA Chairman

Bill Molina, Vice President of Tax for the University of Phoenix, was re-elected Chairman of the ATRA Board of Directors at the 2024 ATRA Annual Meeting. The other officers elected were **Byron Williams**, Southwest Gas, first vice-chair; **Jason Baran**, SRP, second vice-chair; **Gaylord Gagnon**, APS, third vice-chair; and **David Minard**, Individual, Secretary/Treasurer.

The following were elected to seats on the ATRA Board of Directors for terms expiring in 2029: **John Malloy**, Core Civic; **Kelley Wilson**, Deloitte Tax; **Byron Williams**, Southwest Gas; **Rachel Aja**, Cox Communications; **Lori Daniels**, State Farm Insurance; **Bas Aja**, Arizona Cattle Feeders' Association; **Bill Molina**, University of Phoenix; **Heidi Thomas**, Early Warning Services; **Tait Rudd**, Grand Canyon Education; **Michael DiMaria**, Valadez & Associates; and **Matthew Hinck**, Cal Portland. For terms expiring in 2028, **Pattie Theis**, South32; in 2027, **Shelby Stults**, The AES Corporation; and for terms expiring in 2026, **David Martin**, Arizona General Contractors.



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## Robert Robb & Matt Benson Provide Election Update



*Pictured: Substack Columnist Robert Robb, Matt Benson of Veridus, and Rebecca Hudson-Nuñez of Freeport-McMoRan and Chair of the ATRA Legislative Policy Committee engage in a lunch discussion panel concerning state and national political issues.*

# ATRA Highlights Major Public Finance and Taxation Issues

ATRA President Kevin McCarthy kicked off the ATRA panel with a discussion on the performance of Arizona's tax system. McCarthy explained that after many studies and reforms to Arizona's tax code over the last several decades, the system performs quite well. Adjusting for population and inflation, Arizona's tax system generates over 50% more than it did in 1980. He warned that if there isn't enough money for state and local government to spend, it's likely not a tax problem.



McCarthy explained how policymakers often refer to the concept of the "Three legged stool" of property, sales and income, when judging state and local tax systems. Despite the extraordinary changes that have occurred over the last 40 years, the relationship between sales, property, and income, Arizona's tax system has virtually remained unchanged.

McCarthy pivoted to ATRA Vice President Jennifer Stielow to provide an analysis of Arizona's property tax system. Stielow explained that despite the \$55 billion hyper growth in market values over the last two years, Arizona isn't experiencing a crisis like many other states. She credited the protections provided by Prop 117 as the reason since the Limited Property Value (LPV) is capped at 5% annual growth and the Full Cash Value (FCV/market value) is no longer taxable. The spike in market values coupled with the limited growth in LPV since Prop 117 has been in place has created a \$70 billion gap between statewide FCV and LPV. Meaning, if the real estate market were to crash, it likely won't have an impact since we are not taxing the real estate bubble as we did prior to 117.

Stielow explained how well Arizona's property tax system has performed since 117 has been in effect. She explained that the average annual growth in total levies has been cut in half: From over 8% per year on average prior to the crash in the real estate market and the passage of Prop 117, to less than 4% over the last nine years. As a result, the statewide average tax rate has decreased \$2.10 to \$10.67. Breaking down the total rate between primary and secondary, the primary rate is down \$2.13 to \$6.61, which is mainly due to the \$1.15 decrease in the K12 primary rate. As much as the school districts would like to take credit, it's solely the result of the Legislature's continued adherence to Truth in Taxation (TNT) that requires an adjustment to the Qualifying Tax Rate (QTR) that is levied to fund school district budgets to offset growth in values. The secondary statewide rate, on the other hand, increased \$0.04 to \$4.07 since tax year 2015. In this case, the K12 rate has moved in the wrong direction, with an increase of \$1.15 since 2015.



**ATRA**, *Continued from page 5*

Jack Moody, ATRA Senior Research Analyst, informed that during the last two election cycles, school districts statewide asked voters to approve a combined total of over \$6 billion in new bonding, with almost \$4 billion passing. The passage rate of these bonds notably declined this year: Last year, voters approved almost \$3 billion in bonding, or roughly 80% of the total request; and this year, voters approved \$950 million, or just 40% of the total request.



He continued with a discussion on school district override requests over the same time period, in which voters approved levies totaling \$335 million (approximately 68% approval). Moody stressed that the overrides and bonds are largely an urban phenomenon, as four counties in particular – Coconino, Graham, Greenlee, and La Paz – didn’t have any school districts go out for overrides or bonds this year.

Moody made the point that in many instances, voters don’t get to say “no” to these requests. That’s to say that when some districts don’t receive approval, they continue to go out until they do. He referenced Gilbert Unified, Payson Unified, and Queen Creek Unified, which all went out for overrides but failed in 2023, yet passed after going out again in 2024. Deer Valley Unified, in contrast, went out for a bond and override, both of which failed in 2023 and 2024.

Moody stressed that these secondary levies create great inequities across districts, particularly with the general obligation (G.O.) bonds. Considering the top ten districts in total bond requests per pupil, Agua Fria Union had the greatest disparity with almost \$34k in bond requests per student. In contrast to Agua Fria, voters in Laveen Elementary approved almost \$7k per student.

Moody closed by highlighting ATRA’s concerns regarding potential election law violations. In particular, a number of school districts this year argued in the official district statement section in the voter information pamphlets that their bond sales would not increase taxes. He provided examples in Roosevelt Elementary and Agua Fria Union, both of which stated that the issuance of bonds “will not” increase the tax rate. He warned that such erroneous statements undermine the primary benefit to investors who will purchase these bonds. Specifically, these bonds are backed by the full faith and credit of the district, and to that end, the ability of the district to raise secondary property tax rates to the extent necessary to pay the debt service is unlimited. Moody quoted the prospectus from Liberty Elementary’s 2019 bond sale that stated **“All of the taxable property within the District is subject to the levy of a direct, annual, ad valorem tax to pay the principal of and interest on the bonds without limit as to rate or amount.”** Districts would never be able to sell these bonds if there were any limits on the tax rate and misleading voters with untruthful claims about the tax implications of these bonds is undoubtedly done to influence their vote.

McCarthy completed the K12 discussion by pointing out the broader impacts that declining enrollment is having

**ATRA**, *Continued from page 6*

on districts- on what is supposed to be a generally uniform system. McCarthy referenced the inequitable features of the K12 formula that have been capped rather than eliminated, like levies for desegregation and the Transpo Delta, as factors increasing per pupil spending as student counts have dropped.

McCarthy switched gears to discuss the property tax reform measure that passed in 2021 to reduce the assessment ratio on business (class 1) property from 18% to 15%. ATRA annually calculates the effective tax rates (ETR) for each of the nine classes of property through its property tax model. Comparing the ETR on businesses in 2005 when the assessment ratio was 25%, the ETR has dropped nearly 48% by tax year 2023 when the assessment ratio was 17%. As a result of assessing business property at a higher rate, McCarthy explained that nearly \$929 million in property taxes is shifted to businesses from all other property types with lower ratios, which is mainly primary residences and residential rental.

McCarthy handed it off to Stielow to explain how Arizona's business property tax ranking has improved over the last 20 years as a result of the property tax reforms. She explained that ATRA participates in an annual study published by the *Minnesota Center for Fiscal Excellence* that compares the tax burden on a large industrial property located in the largest city in each state using actual tax rates and assessment ratios. She explained that where we were in 2005 when businesses were assessed at 25%, Arizona ranked 4<sup>th</sup> highest. With the reduced ratio of 17% in tax year 2023, Arizona's ranking improved to 11<sup>th</sup> and further improves to 15<sup>th</sup> once the ratio reaches 15%. Coupling the reduced assessment ratio with the 2.5% assessment on all newly acquired business personal property, Arizona's ranking improves immensely to 35<sup>th</sup>. Stielow cautioned that one of the challenges with the study is that Phoenix has an above average tax rate of more than \$14 compared to the statewide average rate of \$10.67. There are a number of factors at play, including K12 levies for desegregation in Phoenix Elementary and Phoenix Union, as well as the City of Phoenix's abundant use of abating taxes under the Government Property Lease Excise Tax (GPLET). While on the subject of GPLET, Stielow informed that although ATRA's legislative effort last year to reduce the abatement period under GPLET was vetoed, another effort will be made during the 2025 session to end the state general fund subsidy. Doing so will save millions each year in state aid to schools.

Stielow closed with a brief discussion on sales taxes, explaining that the state is benefitting from dramatic growth. Over the last five years, sales tax collections have grown over 59%, or nearly \$7 billion. Much of that is attributed to the 2019 legislation that allowed Arizona to begin collecting TPT from out of state retailers. In fact, nearly \$4 billion in revenue has been collected from remote sales and marketplace facilitators since collections began in FY 2020. In response to some at the city level who claim it's not new revenue but a mere shift from the retail to remote seller class, ATRA disagrees for two reasons: Prior to Wayfair, there was no legal mechanism to require remote sellers or marketplace facilitators without a physical presence to collect and remit the tax; and it's just not reflected in the numbers, as retail sales growth remained strong following Wayfair.

McCarthy wrapped up the segment with a briefing on personal income taxes. He said that although lawmaker's passage of the historic 2.5% flat tax cut has been the target of considerable attention, the system has absorbed that cut and revenues are rebounding. In closing, he stressed that the static analysis done to hold cities harmless under urban revenue sharing was shortsighted and will clearly make the cities big winners over the long haul.



# Thomas & Gabel Talk Tax Compliance and Litigation Impacts on Arizona Taxpayers

Heidi Thomas of Early Warning Services and Chairwoman of ATRA's Tax Policy Committee kicked off the segment with a discussion on current issues with tax compliance. Heidi provided a historical perspective on nexus and how the standard has evolved from one of physical presence under *Quill* to the current day economic nexus standard under *Wayfair*.

In 2019, Arizona lawmaker's enacted legislation to require remote sellers and marketplace facilitators that do not have a physical presence in this state to collect and remit TPT that exceed \$100k in Arizona gross sales. Basing the \$100k threshold on "gross" sales rather than "net" disregards any deductions that Thomas argued could be administratively costly and burdensome for ADOR and taxpayers. She also warned that any retroactive claims of physical presence prior to the 2019 legislation is an inefficient use of valuable ADOR resources that may inhibit out of-state taxpayers from coming forward to comply. Heidi cautioned that some municipalities have utilized alternative interpretations of sourcing and nexus rules to shift revenue into their jurisdictions from other cities. Furthermore, she explained the inconsistency in sourcing transactions can be confusing and cause disparities between similarly-situated taxpayers.



Dawn Gabel of Dickinson Wright discussed recent legislation that may have broad implications for taxpayers. In *RockAuto*, ADOR conducted a retroactive audit for the period between 2013 and 2019 and determined the out-of-state taxpayer had sufficient physical nexus with this state. *RockAuto* is a Wisconsin-based company that sells automotive parts online through its website. The company has no physical connection to Arizona except for contracts with its suppliers who fulfill orders placed by *RockAuto*'s customers. *RockAuto* employees visit the state approximately four times a year for a couple days, and when its suppliers would ship orders, they would include

*RockAuto* magnets and seal the shipping boxes with *RockAuto*'s name. The Court of Appeals determined that *RockAuto* established physical nexus in this state by maintaining a market through its suppliers- even though the suppliers were not affiliates of *RockAuto*. The broader implications, Dawn warned, is that any person in a supply chain can establish physical presence. The case has been appealed to Arizona Supreme Court.

Another case with potentially broad implications is *Mesquite Power v. ADOR*. The main issue was to





**Litigation**, *Continued from page 8*

determine if the income from a power purchase agreement (PPA) should be included in the income approach to value for ad valorem tax purposes. For context, *Mesquite* is a power generation plant that has a PPA in which the owner of the plant receives fixed payments for guaranteed capacity to its buyers. *Mesquite's* expert relied on the income approach to value using anticipated market revenue but without regard to the PPA. Conversely, ADOR's expert also used the income approach but included the PPA, contending that it must be included to value the plant based on its "current usage."

The Arizona Supreme Court concluded that although the PPA "is not automatically and entirely irrelevant" under the income approach, the PPA may be considered if it is relevant to the calculation of income derivable from the property itself. The case was remanded to tax court, in which the Court directed the trial court to weigh several factors including whether the PPA has independent value, if the plant operates independently of the PPA, and whether comparable plants typically operate with or without a PPA. From Gabel's perspective, a PPA does not restrict or change the way the property is used or what activities can occur on the property, and therefore, consideration of the PPA is not required by the "current usage" standard.

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## Walczak Provides National Tax Perspective



Jared Walczak, Vice President of State Projects at the Tax Foundation, began with a focus on President-elect Trump's campaign promise to implement across the board tariffs, warning that doing so would push the average tariff rate on all imports to levels not seen since the Great Depression. He also noted that although there's a good potential to extend the key provisions of the TCJA, there is some uncertainty of the SALT cap's future. He highlighted other federal policies that may be considered, including a reduction to the corporate income tax rate, and the tax exemption on tips, overtime pay, and social security income.

Walczak shifted focus to homeowner effective tax rates (ETR) across the states, specifically illustrating that nearly all other states have higher ETR's than Arizona's 0.45%. According to Census Bureau data, assessed values are rising faster than inflation, by 26.6% in real terms since 2020. He acknowledged that while such swift growth may be the cause for crises in some states, he warned of the consequences of implementing assessment limits akin to California's Prop 13. In particular, Walczak noted that Prop 13 shifts tax burdens onto newer and younger homeowners who may be the most income-restricted and discourages existing owners from relocating or renovating, which ultimately worsens housing affordability for first-time homebuyers.

Walczak closed by referencing the ongoing taxpayer confusion and uncertainty surrounding taxation of digital products, specifically in regard to scope and sourcing, and the legal challenges surrounding the internet tax freedom act (ITFA) and other constitutional challenges.