The taxpayer's watchdog for over 80 years

ARIZONA TAX RESEARCH ASSOCIATION

NEWSLETTER VOLUME 83 NUMBER 7 DEC 2023

Richard Stavneak Highlights Budget Deficits

To kick off ATRA's 2023 Annual Outlook Conference, Richard Stavneak, Director of the Arizona Joint Legislative Budget Committee (JLBC), shed light on Arizona's fiscal landscape.

Revenue Projections and Shortfalls:

Stavneak's analysis revealed that the enacted budget, which initially foresaw a $10 million General Fund (GF) balance by June 2024, now faces headwinds. Contrary to the anticipated 1.9% growth in GF revenues for FY24, actual revenues have plummeted by 9.1% since July. The October forecast, even more pessimistic, predicts a 0.6% decline for the entire fiscal year. Consequently, the once projected surplus turns into a potential FY24 shortfall of $400 million, with a looming $450 million deficit expected in FY25. According to Stavneak, however, all hope is not lost as JLBC predicts positive net revenue growth beginning in FY25. Assuming a growth rate of 3-4% in net revenues beginning in FY25, the state's cash balance could move from a $401M deficit in FY24 to a positive balance over $166M by FY27, assuming any prior year shortfall is not carried forward into the following year.

See **STAVNEAK**, Page 2

Chad Heinrich Named 2023 ATRA Outstanding Member

On behalf of the ATRA Board of Directors, President Kevin McCarthy presented Chad Heinrich with the 2023 Outstanding Member Award at the Outlook Conference Luncheon. In addition to serving on the ATRA Board, Chad is a fixture at ATRA's Legislative Policy and Tax Policy Committee meetings.

In presenting the award, Kevin expressed his appreciation for Chad's extraordinary support of ATRA's efforts at the State Capitol each year. Kevin noted "ATRA is not just a research association. We advocate on behalf of taxpayers at the state and local level and we wouldn't be successful without the help of our members. As the National Federation of Independent Business' representative on the ATRA Board, Chad plays a vital role in ATRA's legislative advocacy every year

Stavneak, *Continued from page 1*

Revenue Breakdown - October Year-to-Date:

According to Stavneak, the year-to-date revenue picture is equally grim, with a staggering $331 million loss relative to the forecast. Key contributors to this downturn include a drastic 30.4% drop in Individual Income tax collections and a $59 million shortfall in sales tax growth, despite double-digit gains in contracting. On a positive note, corporate income tax growth remains robust at 11.3%, mitigating some of the overall revenue decline by way of an $84M gain to the forecast.

FY25 Baseline Spending Projections:

Stavneak projects a $1.4 billion decrease in baseline spending in FY25. Though ongoing spending is slated to increase by $830 million for Medicaid and K-12 formula spending, over $2.2 billion in one-time spending from FY24 will not be continued in FY25.

ESA Spending Trends and Considerations:

Stavneak highlighted the evolving landscape of Educational Savings Account (ESA) spending, with the FY24 budget assuming awards totaling $625 million for 68,000 students. Current enrollment, however, stands at 70,000 students with awards totaling $665 million. Future projections anticipate growth to 75,000 students in FY25, with total awards reaching $752 million. Stavneak clarified that the net impact on the Arizona Department of Education (ADE) budget remains contingent on whether new ESA students were "switchers" or were always in private/homeschooled settings. In addition, there does not appear to be an ADE shortfall as current public school student counts are down, though Stavneak and JLBC will continue to monitor.

Economic Monitoring and Fiscal Adjustments:

Stavneak emphasized the dynamic nature of his fiscal projections, acknowledging that the estimate of the FY24 balance may undergo considerable changes throughout the fiscal year. Continued monitoring of economic conditions and the spring 2024 income tax filing season is imperative, as either could significantly alter the fiscal landscape. Despite the challenges, Stavneak explained that the enacted FY24 funding formula spending has not been revised based on current data, though K-12 and Medicaid data will be reviewed in the coming months to validate the accuracy of the original FY24 estimates.

Bill Molina Elected ATRA Chairman

At the 2023 ATRA Annual Meeting, Bill Molina, Vice President of Tax for University of Phoenix, was elected Chairman of the ATRA Board of Directors. Bill replaces Michelle Bolton from Intel who completed a two-year term as ATRA Chairwoman. The other officers elected were **Byron Williams**, Southwest Gas Corporation, first vice-chair; **Jeff Mirasola**, Lumen, second vice-chair; **Jason Baran**, Salt River Project, third vice-chair; and **Dave Minard**, Individual, Secretary/Treasurer.

ARIZONA TAX RESEARCH ASSOCIATION
Bill Molina....................Chairman
Kevin J. McCarthy....................President
Jennifer Stielow....................Vice President
Jack Moody....................Senior Research Analyst
Kathleen Farnsworth....................Office Manager

Published by the Arizona Tax Research Association, a nonprofit organization whose purpose is to promote efficient and effective use of tax dollars through sound fiscal policies. Permission to reprint is granted to all publications giving appropriate credit to the Arizona Tax Research

1814 W. Washington Street
Phoenix, Arizona 85007
(602) 253-9121

www.arizonatax.org

The following were elected to seats on the ATRA Board of Directors for terms expiring in 2028: **James Busby**, The Cavanagh Law Firm; **Todd Wynn**, Pinnacle West Corporation; **Carlos Anguaino**, AT&T; **John Worden**, Ernst & Young; **Hugh Donahue**, Freeport McMoRan; **Helen Heiden**, Southwest Gas Corporation; **Jason Baran**, Salt River Project; **Philip Bashaw**, Arizona Farm Bureau; **John Boggio**, Intel; **Mike Levin**, Port of Tucson, LLC; and **Garrett Workman,** South32 Hermosa.

Alan Maguire Provides Comprehensive Review of U.S. and Arizona Economies

Following Stavneak, economist Alan Maguire from The Maguire Company, gave his economic outlook presentation entitled 'The Receding Recession...Maybe!'

Understanding the Economic Landscape:

Maguire began with an overview of the post-COVID state economies reopening. He drew comparisons between the so-called "2020 recession" and previous economic downturns, employing a metric termed the "halfway back point" to measure the speed of the U.S. economy's recovery. Notably, Maguire clarified that the "2020 recession" was distinct, being a planned and intentional suspension of business activity rather than a traditional recession.

Comparative Recovery:

Maguire addressed concerns about a looming recession and highlighted the varying recovery rates across states. He remarked that Arizona, Texas, and Florida were able to recover faster from the pandemic-induced economic challenges compared to states like California, New York, and Michigan. This was due in large part to how quickly the former states were able to lift COVID restrictions in comparison to much of the country. Maguire remarked that Arizona, in particular, demonstrated resilience, refilling lost jobs within a year of the COVID downturn. In comparison, it took most US states two and a half years on average.

Inflation Insights:

Transitioning to the topic of U.S. inflation, Maguire shared data indicating a mixed picture. While inflation persists, certain sectors show improvement. Notably, gas inflation has reduced significantly from the peak in 2022. Maguire attributed different inflation rates to a combination of policy decisions, supply chain changes, and market factors.

Consumer Confidence Analysis:

Maguire touched on consumer confidence indices, noting a small decline in overall consumer confidence from September 2023 to October 2023. Currently, consumers have a far more favorable view of current conditions than

See **MAGUIRE**, Page 4

Maguire, *Continued from page 3*

the future. Maguire contrasted this against 2009, where the opposite was true.

Employment Growth and Economic Challenges:

Discussing U.S. employment growth, Maguire acknowledged post-COVID recovery but highlighted a slower-than-historical trend. He touched on the Federal Reserve's policy of maintaining higher interest rates until inflation subsides. Additionally, he warned of potential challenges such as increasing credit card debt, stunted student loan repayments, and heightened delinquency in auto loans due to high-interest rates and continued reckless federal spending.

Arizona's Economic Landscape:

In his Arizona Economic Outlook section, Maguire provided a historical perspective on job recovery, comparing the state's performance in 2009 to recent years. He acknowledged Arizona's robust recovery post-2021 but cautioned about slowing job growth compared to historical standards. Maguire noted that slowed population growth and an older population are expected in recessionary periods, and that Arizona's younger than average population help keep recession concerns at bay. However, Arizona continues to face growing challenges related to housing affordability, wherein only 15.6% of available housing is affordable for median-income households. This is down from 33% in the fourth quarter of 2021 and 50+% in 2019. Maguire argued that in order to remain competitive with states like Texas and Florida, housing affordability must remain a key consideration for lawmakers.

Pertinent Observations and Future Outlook:

Maguire concluded with observations on excessive federal stimulus running out, the persistence of inflation, and the Federal Reserve's efforts to catch up. He noted the shifting predictions of an impending recession, emphasizing the need for caution. Despite potential challenges, he commended Arizona's strong pre-pandemic position, job creation resilience, and its status as a leading state for business and quality of life.

ATRA Briefs Major Tax Issues for 2024

ATRA staff focused on the major public finance trends, problems, and policy recommendations that the organization plans to pursue in the coming legislative session.

ATRA President, Kevin McCarthy, began by noting that Arizona has moved from a high tax/low growth state to a low tax/high growth state over the last several decades. Although much progress has been made to address the property tax burden on businesses through reductions in the assessment ratio and reducing the tax on newly acquired personal property to 2.5%, there's more to be done to improve Arizona's business climate.

McCarthy kicked off the property tax discussion by noting that the historic 25% spike in Full Cash Values (FCV) this year which added $25.6 billion in value went virtually unnoticed. He credited Prop 117 for the lack of taxpayer outcries since the FCV (market value) is no longer taxable. Prior to Prop 117, Arizonan's experienced two similar spikes in values, both of which led to significant efforts that would have upended Arizona's property tax system with Prop 13-type systems. After successfully opposing those measures, ATRA led the effort on Prop 117 in 2012 that moved Arizona's property tax system to a single taxable value and limited its annual growth to 5%.

McCarthy dug deeper into the details of this year's dramatic growth in FCV, pointing out that residential property accounts for 69% of total FCV and nearly 80% of this year's growth. He explained there are two reasons why it's important to understand where the growth is occurring: First is to recognize that the current tax system is very reliant on growth from residential property taxes and that growth should continue with the low flat income tax; Second, there will be significant and broad implications associated with slower growth, whether it is associated with the economic cycle or other pressures like water shortages. Reinforcing Arizona's growth trend, McCarthy referenced a recent analysis from the Tax Foundation that shows Arizona ranking 8th nationally with a net gain in interstate migration of residents, even outpacing Texas.

Despite the skyrocketing full cash values, this year was a relatively normal year from a levy growth standpoint. In contrast to the average levy growth of 8.3% during the five-year period during the real estate boom (2003-2008), levies increased an average 3% over the last five years. The good news is that Arizonan's are finally off the roller coaster under Prop 117. One of the chief criticisms from the detractors in the Prop 13 camp was that a failure to put a hard and fast cap on taxes would simply push tax rates up under the Prop 117 valuation cap, but the record shows that clearly didn't happen. In the eight years since Prop 117 has been in effect, the statewide average tax rate has dropped $1.80 (14%).

McCarthy noted that one of the biggest drivers in the overall performance of the system is sometimes not well understood because it happens each year with little fanfare and that is the state's adoption of the Truth in Taxation (TNT) rate for the Qualifying Tax Rate (QTR), which generates billions annually to fund K12 schools. Although the state has consistently adhered to TNT, there are K12 formula inequities that drive primary tax rates up higher. McCarthy pointed to Red Mesa Unified as a prime example how property taxpayers can be negatively impacted through inequities in the school finance system. Red Mesa imposed a $31 primary tax rate this year through a very flawed and outdated transportation formula (transpo delta) that allows a district to levy at its historical highest miles rather than the actual miles traveled. McCarthy stressed that other formula inequities like desegregation and the small school adjustment are also driving tax rates above the QTR.

Shifting gears, McCarthy focused on the record number of G.O. bond requests voters and taxpayers faced this November. Including overrides, 83% of the questions passed. He stressed that the most concerning element in nearly every campaign was the common theme that passage of the bond and/or override would not result in a tax increase.

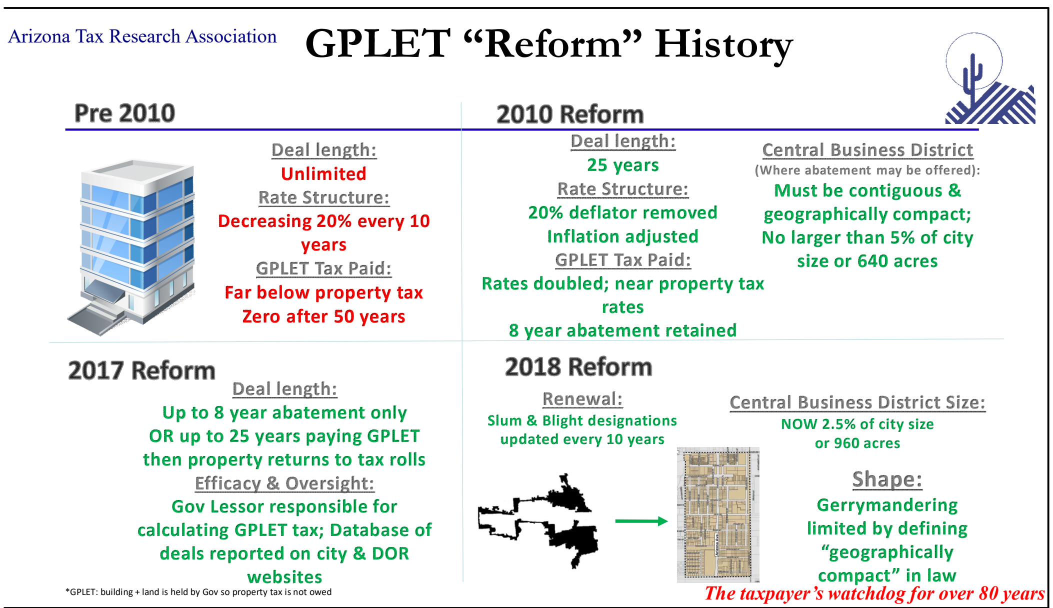
McCarthy closed with a list of recommendations, which he began by encouraging policymakers to fix the flawed K12 finance

See **ATRA BRIEF**, Page 6

ATRA Brief, *Continued from page 5*

formulas that drive very high and inequitable tax rates. Additionally, he encouraged lawmakers to improve the transparency for bond elections. Lastly, policymakers should make personal property taxes more equitable by reducing the tax burden on property acquired prior to 2022.

ATRA Vice President, Jennifer Stielow, began her discussion on the Government Property Lease Excise Tax (GPLET) by explaining the decades of chaos surrounding the controversial tax, which began in the early 80's when the cities began to aggressively use their tax exempt status for economic development. The Legislature responded by creating a mechanism under the property tax to tax private concerns on certain government property but exempted existing deals from the property tax. Lawsuits were filed by the early 90's and the court struck down the property tax exemptions as unconstitutional. Rather than repeal the exemptions, the Legislature responded by creating an excise tax under GPLET for which the exemptions would theoretically be legal. GPLET is limited to property owned by a city, town, county or county stadium district and not the state and most special taxing districts.



Stielow discussed the recent court decisions that have made all the reforms potentially moot due to Arizona's Gift Clause, which provides that a municipality may not "give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise, to any individual, association, or corporation." Stielow advised that taxpayers have won on two recent Gift Clause challenges. Under *Schires v. Carlat* in 2021, the court ruled that payments made by the City of Peoria to a private university violated the Gift Clause. In its determination, the court relied on the *Wisturber* two-pronged test that requires first, the expenditure to have a public purpose, and second, the consideration received by the government cannot be grossly disproportionate to the amount paid to the private entity. The court gave broad deference to the city in determining a public purpose, however, the court ruled that the benefit provided to the private concern was grossly disproportionate to the amount received by the government. Stielow emphasized that the court came to this conclusion by considering only those direct payments that were bargained for and not the indirect benefits (See *ATRA March 2021 Newsletter*).

Prior to *Schires* was the *Englehorn v. Stanton* case in 2020, which was the most significant and only judicial review of the GPLET structure. Under *Englehorn* (Derby), the Court again relied on *Wisturber* and determined that an agreement between the City of Phoenix and developer to build a high-rise apartment tower in the downtown area violated the Gift Clause (See *ATRA July 2020 Newsletter*). The court specifically stated that "if payments under a future GPLET agreement must more closely approximate the amount of ad valorem taxes, does the GPLET have any remaining usefulness to incent redevelopment? In other words…this judicial officer questions whether the death knell for the GPLET's usefulness has rung."

In detailing how the problems go well beyond any constitutional infirmities, Stielow questioned the legitimacy of city planners picking winners and losers. Moreover, the original intent behind GPLET was to revive slum and blighted areas, but its use has gone well beyond that as these deals continue to be made in the thriving areas of downtown Phoenix and Tempe. She further reinforced how these GPLET deals adversely impact the state general fund, by tens of millions in increased state aid payments to school districts, and also results in higher tax rates in areas that have a high concentration of GPLET deals, such as in Phoenix and Tempe.

ATRA firmly believes that if policymakers can't repeal GPLET entirely following the court decisions, then they should reduce the taxpayer subsidy. ATRA's recommendations include reducing the current 8-year abatement period to 4 years or less, which would depend on the project size and investment in order to not violate the Gift Clause.

McCarthy followed by explaining how University Leasing arguably remains a bigger issue since state land is not even subject to GPLET. Absent a legislative fix, taxpayers had some hope for success while awaiting review by the Supreme Court that was slated to consider the Gift Clause in the *Omni* case. Consequently, all hope was quashed when Attorney General Kris Mayes surprisingly dropped the case last spring (See *ATRA Special Report "ABOR Tax Free Zones," 2017*).

ATRA staff wrapped up with a brief discussion on some of the unresolved sales tax issues following TPT Simplification in 2013 that centralized the audit function under DOR to minimize differences in interpretations and audit results. Unfortunately, that reform has been undermined by a successful end run by the cities through the latest intergovernmental agreement with ADOR. ATRA will seek legislation to expand the statutory authority of the Unified Audit Committee (UAC) and to reinforce DOR's authority regarding TPT audits.

Tax Litigation Continues To Impact Arizona Public Policy

ATRA Board Members and tax lawyers, Pat Derdenger, James Busby, and Otto Shill briefed attendees at the Outlook Conference on several important tax cases impacting Arizona. Each noted that important tax policy is often decided in the judicial system instead of at the State Capitol.

James Busby kicked off the presentations with a review of the *ADP, LLC v. Arizona Department of Revenue* sales tax case and the Supreme Court's decision to not hear an unfavorable Court of Appeals decision. James had authored an amicus brief on behalf of ATRA encouraging the Supreme Court to hear the appeal. James noted that Arizona is the only state that has not amended its statutes to specify whether software is tangible personal property or whether it is taxable for another reason. ATRA made a strong effort in 2018 and 2019 to create such a statutory framework for digital goods and services. He noted with frustration that the Court of Appeals relied on a 1943 Supreme Court Case involving jukebox's to rule against ADP.

See **TAX LITIGATION**, Page 8

Tax Litigation, *Continued from page 7*

Pat Derdenger followed James with a discussion of recent important property tax cases. First was *Qasimyar v. Maricopa County* where the court ruled that a property tax reclassified from owner-occupied residential (Class 3) to rental residential (Class 4) required a Rule B calculation for the limited property value. Maricopa County had argued that the property should not receive a Rule B calculation because the property was not a change in use. According to Maricopa County, this case impacted thousands of parcels – some receiving increases in LPV and some decreases.

Pat also addressed *Mesquite Power v. Arizona Department of Revenue* where the dispute centers on the incorporation of intangibles into the value of a gas powered electric generation facility. The Court of Appeals overturned a Tax Court decision and agreed with Mesquite Power that a Power Purchase Agreement (PPA) was an intangible and could not be included in the valuation of the property. ATRA Board member Dawn Gabel authored an amicus brief on behalf of the Association urging the Supreme Court to accept this case for review, which they have done.

Otto Shill wrapped up the session by addressing the ongoing challenge to bring closure to the *Vangilder v. Arizona Department of Revenue* case that the Supreme Court invalidated in March 2022. Since that time, taxpayers have awaited guidance from the Arizona Department of Revenue regarding the process that will be used to refund monies to Pinal County taxpayers.

Otto also addressed the U.S. Supreme Court decision out of Minnesota (*Tyler v. Hennepin County)* where the court invalidated Minnesota's tax foreclosure statutes. The court ruled that a Minnesota homeowner who lost her home to a tax foreclosure was entitled to the surplus from the home's sale. In response to this problem, Arizona passed a statute in 2020 requiring Arizona counties to return surplus monies in a tax lien sale. However, following the Minnesota court decision, Arizona will likely have to extend that protection to include tax liens that are purchased at auction.

Legislative Leaders Address Outlook

Speaker of the House Ben Toma and Senate President Warren Petersen addressed the ATRA Outlook Conference with their thoughts about the upcoming legislative session. Speaker Toma first addressed the current state budget deficit and the grumbling about the historic 2.5% flat tax that reduced income taxes almost $2 billion. Toma said he was proud of the tax cut and didn't regret the large reduction in revenue. Senate President Petersen addressed the state's housing crisis and expressed frustration with the amount of time it takes to get a new home built in Arizona. He also said concerns about Arizona's water crisis should not be used to choke off residential development. Both leaders agreed the current budget deficit will create challenges but the size of the deficit is manageable particularly following historic budget increases in recent years.

Stephanie Do Addresses National Tax Issues

Stephanie Do, Senior Tax Counsel for the Council on State Taxation (COST), began her presentation by illustrating the volatility of state tax revenues nationwide. She noted that current state tax revenues are considerably more volatile than the U.S. economy.

Stephanie briefly highlighted some of COST's studies and publications including the *State and Local Business Tax Burden Study* that shows businesses made a considerable contribution of over $951 billion in U.S. state and local taxes during FY21, marking a 13.6% increase from the previous year. Arizona experienced an 80% increase in corporate income tax revenue from FY20 to FY21.

She also highlighted COST's annual *Sales Tax Scorecard* where Arizona's complex state and local sales tax system was given a "D" grade by COST. To improve its rating, Stephanie recommended Arizona streamline the current complex system, centralize audits and eliminate contingency audit practices, and provide a clear state stature if the state wants to tax digital products.

She concluded her presentation with an analysis of property tax trends and legal cases, highlighting postponed audits, increasing tax rates, and delays in updates and settlements. Lastly, she reviewed the increasing efforts of state and local governments to expand assessments to include intangible assets.