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# ARIZONA TAX RESEARCH ASSOCIATION NEWSLETTER

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## **JLBC: State Revenues OK Despite COVID**

The 2020 ATRA Outlook Conference was kicked off with a presentation on the state's fiscal health from Joint Legislative Budget Committee Director Richard Stavneak. His presentation explained how and why Arizona's public finances have largely survived COVID related economic disruptions thus far, but the State faces several unknowns in the months and years ahead.

The state budget is rather healthy for two primary reasons: the economy has been particularly resilient through COVID and federal assistance has plowed billions into the Arizona economy and public coffers.

Arizonans received roughly \$32 billion in direct federal assistance, to include \$13 billion in PPP (paycheck protection program), \$10 billion in unemployment insurance (UI), and \$6 billion in stimulus checks. Another \$6 billion went to state and local governments. How the remainder of FY21 proceeds will partially depend on another round of federal COVID relief. One key question is whether the current enhanced Federal Medicaid match will continue in FY22 or expire, which is a \$500 million cost to the state if the state

See STATE FISCAL PICTURE, Page 4

## **Prop 208 Rides Blue Wave to Victory**

In a huge blow to taxpayers and the Arizona economy, a massive income tax increase in Proposition 208 narrowly passed on the November ballot. ATRA served as a leading member of the opposition coalition, working tirelessly to educate Arizonans on the shortcomings of such a measure. In the end, Prop 208 was aided by historic turnout and passed by 3.5 points.

Prop 208 raised the top marginal income tax rate in Arizona by 78%, from 4.5% to 8% for amounts earned over \$250,000 for single filers or \$500,000 for married filers. This change leaves Arizona with a top 10 state tax rate in the country, a most unfavorable position for a state where the wealthy typically choose to live but don't have to. Regrettably, small and medium sized businesses will bear the brunt of this tax, limiting their ability to reinvest in Arizona. For more on the details and the negative national attention received for this proposition, see the ATRA October 2020 newsletter.

Prop 208's success at the ballot was certainly aided by a heated presidential election which drove 80% voter turnout and a record-setting 3.8 million total votes in Arizona. For reference,

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### **INSIDE:**

**ATRA Outlook Wrap Up  
Jim Rounds On The Economy  
Bark Re-Elected Chairman**

## 2020 ATRA Outlook Speakers Round Up



In his remarks, **Governor Ducey** congratulated ATRA on 80 years of service to Arizona taxpayers. He reiterated that he wants to keep the economy as open as possible while avoiding shutdowns. He touted Arizona's relative success through COVID, sporting lower unemployment, faster recovery, and less hits to tax revenues than others. Governor Ducey thanked ATRA for helping pass significant tax reform in 2019 related to income tax conformity and taxation of remote sales. He acknowledged that Proposition 208 passing is a setback but it won't distract him from seeking pro-growth tax reform going forward.

**Arizona Republic** columnist **Bob Robb** spoke at the ATRA Outlook Webinar, focusing his comments on an analysis of the November election. Robb began by reminding that the Republican monopoly of state government is a very recent trend, where historically Arizona has had a mix of partisan leaders. As recently as 2006, Democratic Governor Janet Napolitano and Attorney General Terry Goddard handily won their statewide elections. While Republicans dominated elections from 2010 through 2016, Democrats did much better in 2018 and 2020, marking a course reversal from that period.

Arizona has added one million voters since its last presidential election in 2016 and with it, the electorate has changed. Robb's key takeaway from November is that independents now make up such a large cohort, how they swing will decide statewide elections. In 2016, independents broke slightly for Trump while in 2020, it appears they broke for Biden. He noted the interesting thing about 2020 is that the down-ballot phenomenon did not help other Democrats as much as one would expect: many voters selected Democrats at the top of the ticket and Republicans down ballot, which resulted in Republicans winning Maricopa County row officer seats and the State Legislature remaining largely unchanged.



Robb does not agree that demography or new migrants from others states is the driving force behind Arizona's recent turn towards being 'purple'. He points out that Arizona's demographics haven't significantly changed since 2014. Robb believes Arizona independents are fairly true to their label and are not closeted partisans: they can swing from one election to the next. And since they are now roughly one-third of voters and vote in higher percentages than in the past, how they swing marks the balance of power in Arizona.

In 2021, Robb thinks the "COVID cloud" will hamper the next regular legislative session, which could lead to a shortened session and a skinny budget until a vaccine is widely available. As it relates to the passage of Prop 208, Robb thinks this will allow state lawmakers to focus elsewhere since there will be far less appetite for new revenues

ARIZONA TAX RESEARCH ASSOCIATION  
 Richard Bark.....Chairman  
 Kevin J. McCarthy.....President  
 Jennifer Stielow.....Vice President  
 Sean McCarthy.....Senior Research Analyst  
 Kathleen Farnsworth.....Office Manager

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1814 W. Washington Street  
 Phoenix, Arizona 85007  
 (602) 253-9121  
[www.arizonatax.org](http://www.arizonatax.org)

for K-12 schools. Given the uncertain future of state finances, lawmakers may elect to make fewer budget changes for the next fiscal year in an effort to remain conservative.

**Jared Walzcak of the Tax Foundation** spoke to ATRA Outlook, covering national tax issues resulting from the November election. The Coronavirus Relief Fund act provided massive dollars to states, which were largely supplanted and helped buoy public coffers. Paycheck program and unemployment dollars were taxed as income and therefore helped state budgets. He thinks hits to tax collections may be delayed to FY 2022 as the economy recovers but lacks the significant federal influx.

Walzcak noted Arizona is doing better than most and not only will end the current fiscal year in the black, but should be in a good place for FY 2022. If there is no replacement or other form of relief for the PPP or UI assistance, FY 2022 could be less rosy for all states. He estimates any new federal relief may be directed to states based on unemployment changes which actually could result in less funding for Arizona relative to other states with worse situations.

If there is divided government following the Georgia runoff, he does not expect major changes to federal taxation. If Democrats have unified control, it's likely there will be provisions of the Biden tax plan that could pass. One popular idea is to eliminate the \$10,000 SALT cap while raising the top marginal tax rate to 39.6%, which is mostly a wash from a revenue perspective.

One key item the Tax Foundation is watching is the GILTI provision (Global Intangible Low Tax Income), which is an anti-base erosion provision at the federal level. Before TCJA, under the worldwide tax system, multinational corporations paid on all income earned globally with credits for taxes paid. After the change and under a quasi-territorial system, only profits earned in the United States are taxed except under certain circumstances outlined in GILTI, which is a guardrail provision. Arizona does not tax international profits but some states are attempting or discussing adopting a worldwide taxation system under the banner of adopting a GILTI provision on corporate income, which is quite the reach for a state department of revenue for a number of reasons.

Arizona wasn't the only state to pass a tax increase. States are looking for revenue by taxing capital gains at higher rates, taxing digital services, digital advertising, freezing earned corporate income tax credits, and a host of other changes. He elaborated on the impossibility of taxing unrealized capital gains, such as ownership in stocks, real estate, and businesses; which is essentially a "back door" wealth tax and unlikely to work. In general, Tax Foundation argues that tax increases during recessions are potentially dangerous and can impede recovery efforts. States will have to monitor their unemployment insurance rates which can damage employers if they rise while they are trying to rehire and recover.

Walzcak noted that Arizona has benefitted from sound tax policy in the past and Prop 208 definitely changes that, but overall is still a better option than California and predicted it would not slow overall in-migration. He thinks Prop 208 largely passed because it was paired with a popular spending program. He finds the results of tax questions in other states to be well within normal voter trends, albeit during a particularly unique election cycle, where voters reject broad based taxes but favor small, niche taxes such as on marijuana. He concurred the federal SALT cap will make high-end state income taxpayers more sensitive to state income tax rates, as they are now fully exposed to state taxes and cannot write them off on federal taxes.



**STATE FISCAL PICTURE,** *Continued from Page 1*

chooses to continue to enhanced participation.

Due to strong revenue collections and significant supplanting of state general fund (GF) spending with federal aid, the state looks to end FY21 with more than \$400 million in cash balance. Due to delayed federal income tax filings, which extended payments into FY21, revenues from this source were shifted from last year causing disruptions in year over year growth. After adjusting for these corrections, it appears FY21 state tax revenues dipped a bit at (1.7%) but are estimated to grow 6.3% in FY22.

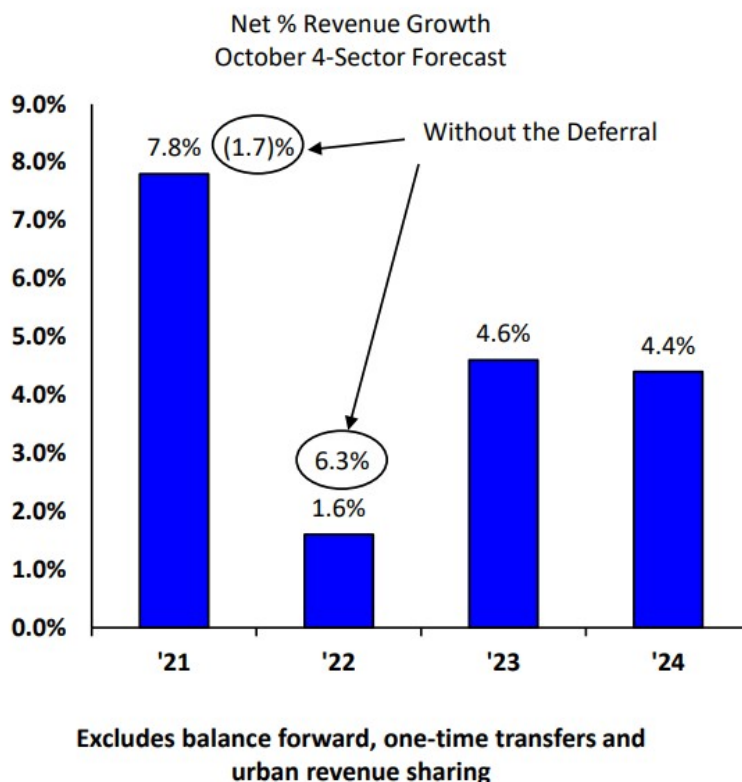
Revenues are buoyed in part by strong growth in remote sales collections following the implementation of the 2019 law (HB2757) which required out-of-state (remote) sellers and marketplace facilitators collect and remit Arizona retail transaction privilege tax (TPT). GF collections of remote sales TPT have far exceeded

the state estimate of \$85 million. ATRA calculates the annualized amount of GF revenues from remote sales is on pace for \$246 million based on ADOR reporting. Stavneak noted that not all remote sale revenues may be new. Lawmakers have asked ADOR to determine whether any major taxpayers switched from paying retail to paying exclusively in the remote sales category.

ATRA surmises this source may continue to increase for several reasons. The threshold for a seller to collect and remit drops to \$100,000 in gross receipts in June (from \$200,000 in FY19 and \$150,000 this year) and more small businesses are beginning to navigate compliance issues. While the pandemic may have encouraged above average online spending, the current returns do not yet include a full holiday season as the law was only just implemented last winter.

TPT from construction services also continues to grow dramatically. They were up 18% year over year in the last quarter of FY20 (Apr-June) and 19% in the first quarter of FY21. Residential construction appears to be headed for continued growth; however according to some experts, the commercial sector could slow in future quarters as ongoing projects are completed and access to debt becomes difficult for businesses to obtain.

On the expenditure front, more than \$400 million in federal coronavirus relief funds were used to supplant state agency spending, resulting in considerable savings to the GF. Roughly \$370 million was set aside for grants to stabilize school districts experiencing enrollment declines or revenue declines associated with more students switching to a dedicated online school. An additional \$277 million in federal aid was dedicated to K-12 schools from the Elementary and Secondary School Emergency Relief (ESSER) which went directly to the Department of





Education for the benefit of public schools. The declines in overall enrollment and increases in online programs will produce an offsetting GF savings for the current fiscal year for state aid.

For the two new propositions that passed, Stavneak noted the amounts collected will not be well known until collections begin to materialize. Excise taxes from recreational marijuana, approved in Prop 207, could generate \$161 million by the third full year of implementation, of which \$53 million would go to community colleges, \$51 million to public safety, \$41 million to transportation, and \$6 million to public health.

## Is the Sales Tax Collection Bubble About to Burst? - \$145 M First Quarter Growth over Prior Year

	% Change over Prior Year	
	4 <sup>th</sup> Qtr FY 20	1 <sup>st</sup> Qtr FY 21
Retail/Remote Sales	5%	19%
Contracting	18	19
Restaurant/Bar	(32)	(12)
Lodging	(67)	(34)

☐ US durable goods spending up 15% in September

☐ US services spending down 5%

☐ In Az retail, auto sales up 12%; building materials gained 23%

☐ Wayfair/Remote stronger than expected

**JLBC**

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For Prop 208, JLBC estimates remain the same as their summer estimate, with \$827 million generated for K-12 education. They noted that because the surcharge in Prop 208 is based on tax year 2021 liability, the returns won't be finalized until October of 2022. While revenues will likely begin to be distributed to school districts and charters by the end of 2021, they likely will not be budgeted for by schools until FY 2023 because they will already be halfway through FY 2022. Revenues from these tax brackets are notoriously volatile and how the pandemic will impact them is uncertain at this point.

## Richard Bark Re-Elected ATRA Chairman

At the 80th Annual Meeting following the Outlook Conference, **Richard Bark**, Director of Governmental Relations for Freeport McMoRan was re-elected Chairman of the Arizona Tax Research Association's Board of Directors. The other officers re-elected were: **Michelle Bolton**, Cox Communications, first vice-chair; **Bill Molina**, University of Phoenix, second vice-chair; **Byron Williams**, Southwest Gas Company, third vice-chair; **Dave Minard**, Individual, Secretary/Treasurer.

The following members were elected to seats on the ATRA Board of Directors for terms expiring in 2025: **Steve Barela**, APS; **Jim Brodnax**, Individual; **Jeff Mirasola**, Lumen; **Jack McCain**, American Airlines; **Otto Shill**, Jennings Strouss & Salmon; **Michael Green**, Law Offices of Michael Green; **Pat Irvine**, Fennemore; **Janna Day**, AZ Policy Connect; **Chad Heinrich**, NFIB; **Matt Clark**, Verizon Wireless; and **Elizabeth Shipley**, Intel. **Michael DiMaria**, Total Spectrum, was elected to the Board for a term expiring in 2024.

**PROP 208 PASSES**, *Continued from Page 1*

just 2.6 million Arizonans voted in 2016. It was a particularly good year for Democrats at the statewide level, securing the top vote for the President, U.S. Senate, and Corporation Commission. In a year that saw endless political advertising, messaging voters about down ballot issues proved difficult.

There are likely many reasons for Prop 208's passage. What is certain is the consistent drum-beat of Arizona's supposed underfunding of K-12 schools—and that broad acceptance as fact by a variety of groups and outlets, played a central role. While public education advocates have always argued they are limited by a lack of resources, it has only been more recently that politicians across the spectrum have stipulated to it. Local media consistently prints it as fact. And importantly, some in the business community have regurgitated these narratives, even if they follow the claim with different resolutions. For many voters, the idea that Prop 208 was a bad tax increase may never have entered their minds because they've been trained that any new money for education must be positive under the circumstances.

For decades, taxpayers and the business community wrestled with the challenges of funding public education while also focusing on operational efficiency, equity in spending, parental choice and a host of other policy issues outside of financial inputs. Of late, the focus has been limited to increasing per-pupil revenues. The largely unmovable statistic of state ranking in per-pupil spending dominates. For voters not versed in tax policy, anything that might save them the embarrassment of the near daily barrage of headlines suggesting Arizona's miserly government underfunds students was attractive.

It's worth remembering that more than 60% of resident adults weren't born in Arizona per the Census Bureau. For many, they may only know a few things about public education generally in Arizona. Arizona's low per-pupil spending ranking is often confused with its ranking in performance—which is certainly not the case. You won't see *The Arizona Republic* cite the Cato Institute's #4 ranking for Arizona's K-12 education system, which measures performance outcomes adjusted for socioeconomics and expenditures.

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The mentality that our schools must be bad because of a spending statistic is aided by our populist taxation regime in Arizona. Historically, Arizona's system of tax was designed to hide the cost of government to average citizens and tax them indirectly through businesses. Arizona had one of the nation's highest corporate income tax rates at 9% and some of the nation's highest business property tax rates. Conversely, Arizona has a progressive personal income tax system that offered very low rates on most Arizonans and higher rates on the wealthy with a top marginal rate of 7% before the reforms of the 1990s and 2000s, plus low residential property taxes. Sales taxes in Arizona were far more modest before 1990 but have been raised by both state and local entities over the last 40 years. Arizona has made significant strides in bringing down the corporate income tax rate (from 9% to 4.9%) and some success in the property tax arena. However, when one of the many adults who moves to Arizona sees their personal income and property tax bill, it's not surprising they may conclude the reason for our low spending in education is because of low tax rates. The truth is

their low rates have always been subsidized by higher business rates. Even despite reforms over the last few decades, commercial property tax rates are roughly double the effective rates of most metro areas west of the Mississippi.

Prop 208 is yet another reminder of the tragedies of ballot-box budgeting. Instead of having a rich debate over the merits of higher personal income tax rates in Arizona as a stand-alone issue, the debate centered on a sympathetic recipient of the revenues. California and Illinois both rejected populist ballot initiatives this November that would have made their tax code worse, but were not tied to specific spending. It is not evident that Arizonans wished to make their state less attractive for economic development or future migration of high-end filers. But for proponents, it was the tax increase they could cynically sell as “free to you and me;” not one developed based on robust study and analysis. Tax policy is a critical part of a state’s identity and deserves to be analyzed on its own. That outside interests can spend more than \$20 million on an initiative to sacrifice Arizona’s reputation as taxpayer friendly is a most troubling trend.

## Jim Rounds’ Economic Forecast

Economist Jim Rounds presented at ATRA Outlook, breaking down how policy changes will influence Arizona’s economic landscape. Following the JLBC presentation, Rounds explained that personal income growth skyrocketed in the second quarter of 2020 due to the federal stimulus package, which helped stabilize income tax receipts, as much of that stimulus resulted in taxable income.

Regarding the economic bounce back post-COVID, Rounds is predicting a ‘V’ shaped recovery curve, which will be marked by the timing of the wide distribution of the vaccine. With vulnerable adults being prioritized, COVID death rates should slow in the first quarter of 2021, allowing more of the economy to open and recover. He thinks employment should more fully recover by the second to third quarter of 2021. While the Great Recession of 2008 took 101 months to recover all jobs lost in Arizona, he thinks it will be 16 to 24 months for the COVID recession with 65% already recovered. “It’s going to look like one of the worst recessions we’ve ever had that also didn’t last very long.”

### Arizona Job Losses

Seasonally Adjusted; **Peak to Trough**  
Source: U.S. Bureau of Labor Statistics

**Note: 170,000 of 300,000 lost jobs have been recovered.**

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|---|--|
| <ul style="list-style-type: none"> <li>• <b>1990-1991 Recession</b> <ul style="list-style-type: none"> <li>- Lost Jobs: 12,400</li> <li>- % of Jobs: 0.8%</li> <li>- Job Recovery: 10 Months</li> </ul> </li> <li>• <b>2001 Recession</b> <ul style="list-style-type: none"> <li>- Lost Jobs: 30,600</li> <li>- % of Jobs: 1.3%</li> <li>- Job Recovery: 20 Months</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• <b>Great Recession (2008)</b> <ul style="list-style-type: none"> <li>- Lost Jobs: 314,500</li> <li>- % of Jobs: 11.7%</li> <li>- Job Recovery: 101 Months</li> </ul> </li> <li>• <b>COVID Recession (2020)</b> <ul style="list-style-type: none"> <li>- Lost Jobs: 294,600</li> <li>- % of Jobs: 9.9%</li> <li>- Job Recovery: 16-24 Mo?</li> </ul> </li> </ul> |
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Rounds pointed out the areas hardest hit tended to be lower wage jobs in the leisure and hospitality and other service sectors. This partially explains why state income taxes have been less impacted, because Arizona has low rates on lower incomes.

Following the recovery, Rounds expects strong

growth in retail and other taxable sales leading to growth in government coffers. He argues that the travel industry and other hospitality sectors will recover sharply however people can only consume so many services at the same time so growth may not be as dramatic as some might hope given the expectation that households are sitting on cash savings.

Rounds reminded that percentages of growth can be deceiving and if an economic or revenue category drops by 50%, it has to grow by 100% to fully recover. This is an important reminder for lawmakers looking to get the state budget back on track.

For policymakers, Rounds argued that a variety of factors impact economic development to include competitive tax rates, workforce issues, infrastructure, and good governance. Any policy change should balance these demands. He hopes the federal government institutes stimulus packages in each of the next three years to support the recovery. For what the state can do, he thinks government spending policies should be able to show with evidence that they result in a dollar for dollar return on investment.

Overall, Rounds remains bullish on Arizona, suggesting we'll be a top five growth state overall in the years to come, benefitting from a wide variety of indicators from population to wage growth.

## ATRA Staff Talks Property Tax Issues

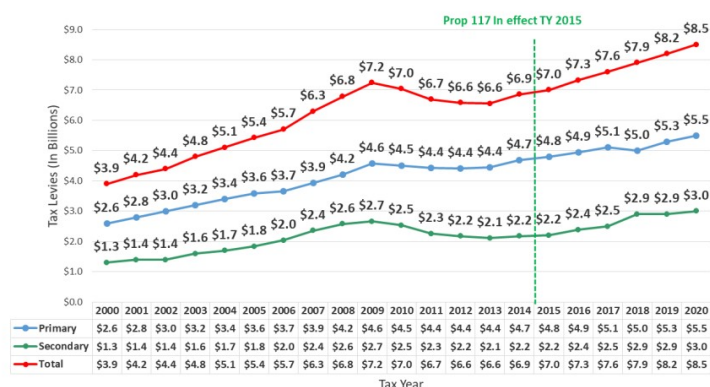
ATRA staff covered trends in property taxes at the 2020 ATRA Outlook Webinar, focusing on the constitutional property tax reform in Proposition 117 and secondary levies for K-12 school districts.

Jennifer Stielow began by comparing the periods between 2000 to 2005 and 2015 to 2020, where full cash values grew by 52% and 44% respectively. The difference is during the first period, secondary taxes were exposed to the full growth in values and primary taxes were exposed to valuation growth of 52%. By contrast, in the last five years, the newly created limited property value (LPV), which applies to primary and secondary taxes, has grown by just 28%.

Because of the slower growth in values, tax levies also grew slower, since many jurisdictions are in the habit of

leaving their rate at the same amount regardless of value changes. From 2000 to 2005, levies grew 38.5% whereas in the last ten years they grew just 21%—a considerable win for taxpayers and a far more sustainable path. 2015 is a useful starting point because it was the first year Prop 117 was implemented.

### 20-Yr Property Tax Levies



- 2000-2005: Secondary & Primary Levies grew 38.5% (7.7%/YR)
- 2015-2020 (Post 117): Total Levies up 21% (4.3%/YR) - Secondary up 36% (7.3%/YR); Primary up 15% (2.9%/YR)

The limitations in the growth of taxable property value passed by voters in Prop 117 were designed to



stabilize the system and prevent rapid growth from slamming taxpayers with explosive growth in property taxes. That property taxes grew by less half the amount in the last five years over a comparable period before the change is proof it has worked.

Sean McCarthy continued with a discussion on secondary property tax levies for K-12 school districts, which fund bonds and overrides for districts who pass them. Sean discussed how bonds and overrides are key contributors to inequity in school spending as some districts have more access to bonding than others, and like overrides, some have none at all. Areas with high property value tend to have higher spending and lower taxes on bonds and overrides. As the state is being sued on an equity challenge to its funding of capital spending in K-12 school districts, these inequities, which are growing, are a big policy problem. As policymakers think about fixing school finance, there should be less local funding based on property value as state funding increases.

Bonds and override levies have grown 18% in the last three years, from \$1.2 billion to \$1.45 billion. M&O override levies have grown 24% in the last three years mostly as a result of significant increases in formula funding to schools. These overrides are additional general fund monies and are based on a percentage of budget up to 15%.

Bonding is up significantly because access to debt is growing as property values grow in Arizona and voters approve them. Historically, bond spending is unrelated to overall pupil growth or the amount of capital money the state has delivered to schools. Doubling the debt limitations in 2014 opened considerable capacity. Bond debt service has grown from \$625 to \$825 per pupil for districts with bond debt in the last three years.

For more information on both of these topics, the slides are available on the ATRA website as well as the video of the webinar.

