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Tax reform experts provide insight at ATRA luncheon

Two nationally-recognized tax experts and the co-chairman of the Governor's Citizen's Finance Review Commission (CFRC) provided their insights on "The Wave of Tax Reform" at ATRA's luncheon held on June 25, 2003, at the Airport Marriott in Phoenix.

Harley Duncan, Executive Director of the Federation of Tax Administrators; **Robert Cline**, National Director of State and Local Tax Policy for Ernst & Young; and Arizona's own **Bill Post**, co-chairman CFRC and Chairman and CEO of Pinnacle West Capital Corporation, led a timely and informative discussion of tax reform efforts in Arizona against the backdrop of national trends.

Harley Duncan kicked off the event by discussing tax reform drivers, the most popular of which is school finance reform. Other typical factors driving tax reform include state financial crises which, he noted, most states are currently experiencing, as well as arguments that revenue structures are

See **Tax Reform**, page 6

Bill Post reports on tax reform efforts underway at the Governor's Citizen Finance Review Commission (CFRC)

STATE ADOPTS FY 2004 BUDGET

Debt financing and gimmicks used to fund increased spending

State lawmakers and the governor have adopted a budget for fiscal year (FY) 2004 that contains a structural deficit of $432 million. Or rather, that is the structural deficit the Legislature admits to.

That amount ignores another $441 million in ongoing K-12 expenditures that have now been either debt-financed or postponed. Including those items, the total structural deficit going into the FY 2005 budget is closer to $873 million.

The total state budget, approximately $16.5 billion, includes the general fund (38%), federal funds (28%), non-appropriated funds (22%), and other appropriated funds (12%).

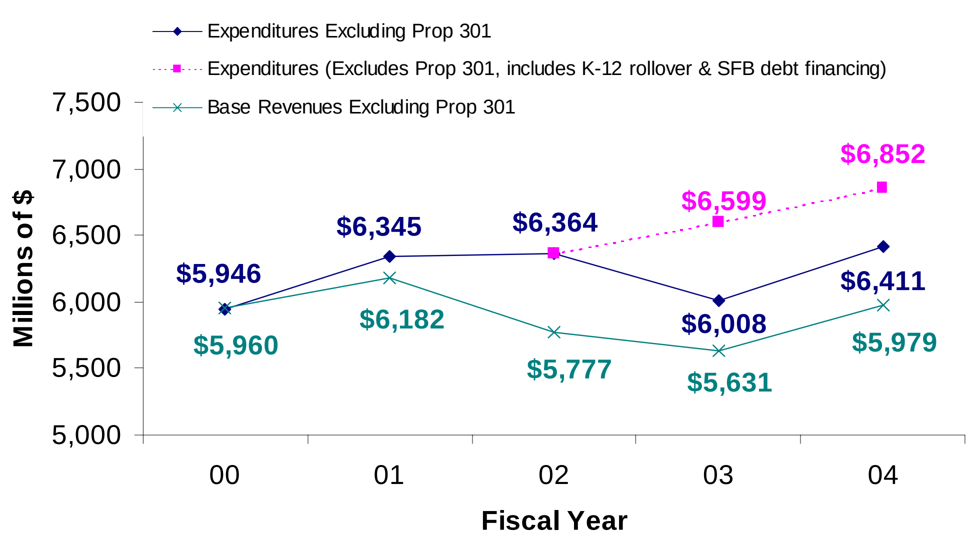
The FY 2004 budget assumes $5.979 billion in general fund revenues, $348 million (6.2%) more than in FY 2003. Meanwhile, the FY 2004 general fund budget includes $6.411 in planned expenditures, creating a gap between revenues and expenditures of $432 million.

Actual general fund expenditures (excluding spending directly attributable to Prop. 301 sales tax revenues) include $250 million for the School Facilities Board (SFB) that was debt-financed and $191 million in K-12 apportionment payments that have been delayed (for the second year in a row) into the next fiscal year.

This brings the total general fund spending commitments this year to $6.852 billion, and the structural deficit to $873 million.

While the K-12 "rollover" is accounted for as a $191 million postponed expenditure, the net effect of the new $250 million debt for SFB (just as it was with last year's $400 million), is that the expenditure simply disappears from the budget. (See article on debt financing decisions made this session on page 2.)

The governor's use of the line item veto resulted in approximately $63 million in increased spending, above what was passed by the Legislature, by postponing into next year a $75 million payment for the Ladewig litigation settlement.



Beg. Balance:	$255	$203	$13	$1	$22

(in millions)

LEGISLATURE CIRCUMVENTS DEBT LIMITS

The Arizona State Legislature took action this session to authorize approximately $1.2 billion in principal debt obligations on the general fund for the School Facilities Board (SFB), state university research facilities, and the Phoenix Civic Plaza.

Adding to the $400 million in debt authorized in FY 2003 for SFB (see article on "lease-to-own" bonds in the June 2002 ATRA Newsletter), the State has authorized another $250 million for FY 2004 earmarked for new school construction.

Another $247 million in debt is intended for correcting school building deficiencies, earmarking the State Land Trust Fund for the debt service payments. Proceeds from the State Land Trust Fund would otherwise offset the general fund's state aid obligation to schools.

This debt financing of ongoing expenditures through the SFB has played a substantial role in "balancing" the state budget in recent years (see article on page 1).

University Research Facilities & Phoenix Civic Plaza

The Legislature also approved two bills further obligating the state general fund for annual debt service payments that were not part of the FY 2004 budget.

House Bill (HB 2529) authorizes $440 million in certificates of participation (COPs) for research facilities in Arizona's three state universities. The debt service payments, beginning in FY 2008, will be approximately $34.6 million annually until it is paid off in FY 2031. The total paid will be approximately $830.4 million, all from the general fund.

HB 2332 authorizes a $300 million debt for an expansion of the Phoenix Civic Plaza. Annual general fund debt service payments lasting from FY 2009 through FY 2039 will total $765 million.

Long-Term Debt Financing

Even if Arizona does not incur any more general fund debt obligations than it has currently, the annual debt service will exceed $100 million by FY 2008 and $150 million by FY 2013.

The combined debt obligations from SFB (FY 2003 and FY 2004), the university research facilities, and the civic plaza expansion exceed $2.75 billion.

It is unrealistic to assume the State will stop piling on more debt, especially in light of the perennial need for new schools.

An analysis by the Joint Legislative Budget Committee (JLBC) demonstrates that, assuming continued use of COPs for new schools, annual debt service payments will increase from $147.5 million in FY 2005 to $380.4 million in FY 2012.

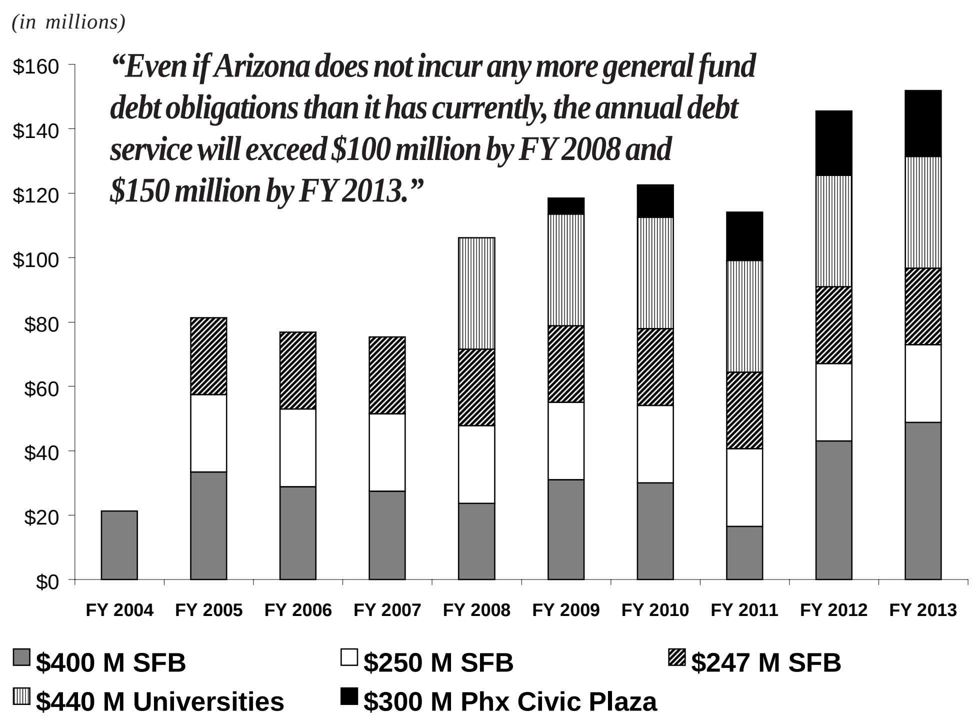
This does not include current outstanding debt for state agencies and universities. The Arizona Department of Revenue's *FY 2001/02 Report of Indebtedness* shows a total outstanding principle of $3.5 billion at the state level, including general obligation and revenue bonds, as well as COPs. Most of this debt, however, is not paid through annual general fund appropriations.

Certificates of Participation (COPs)

COPs are similar to revenue bonds, except that they circumvent Arizona's constitutional debt limits through statutory language requiring annual appropriations for the debt, or *lease purchase*, payments.

The interest rate runs approximately a quarter-percentage point higher than bonds would cost because investors have to settle for buildings as collateral rather than the "full faith and credit" of a government that issues bonds with a voter-approved tax to service the debt.

On June 9, ATRA and a handful of representatives from the business community signed a letter outlining some of the most important concerns about the State's recent use of debt financing. The text of the letter, which was sent to each member of the Legislature, is reprinted on page 3.



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June 9, 2003

Dear Legislator:

The undersigned organizations have all expressed opposition to closing the state's on-going gap between revenues and expenditures through the use of budget gimmickry and debt financing.

Make no mistake, the most important responsibility of the Legislature is to adopt a budget each year that balances spending demands and available revenue. This in not only the most important responsibility of the Legislature — it is its constitutional obligation.

Specifically, the Arizona Constitution provides, in Article 9, section 3, that "The Legislature shall provide by law for an annual tax sufficient, with other sources of revenue, to defray the necessary ordinary expenses of the State for each fiscal year." Article 9, section 4, goes onto say that, "Whenever the expenses of any fiscal year shall exceed the income, the Legislature may provide for levying a tax for the ensuing fiscal year sufficient, with other sources of income, to pay the deficiency, as well as the estimated expenses of the ensuing fiscal year."

As budget negotiations continue, it is important to reflect on the profound duty imposed by these constitutional budgetary directions. Clearly, the pressure placed on legislators to meet the demands of spending advocates is significant. However, what is at issue here is not whether the state of Arizona supports or opposes such spending in specific examples. Rather, the budget must reflect the burden required by the Constitution as well as the basic fundamentals of fiscal responsibility.

The Constitution provides one minor exception to the legal requirements discussed above. Article 9, section 5, provides a $350,000 debt limit for the state to "contract debts to supply the casual deficits or failures in revenues, or to meet expenses not otherwise provided for.» For the past several years, we have watched with increasing concern the apparent disconnect between the vital constitutional limitations on state debt and the growing use of debt financing mechanisms to "balance" the state budget. For example, the state has outstanding debt service payments through the School Facilities Board that now exceed $1.3 billion over the next 16 years. The annual debt service obligations climb from $21 million in Fiscal Year 2004 to over $100 million annually in ten years. Surprisingly, similar measures that further exacerbate our structural deficit through major debt financings are still under consideration before the Legislature.

It is clear that state policymakers have taken legal cover under a very loose definition of constitutional debt. However, from the standpoint of fiscal responsibility, it is the debt, not its legality, that is most important. It is the reality of the financing that matters to both taxpayers and future legislatures saddled with increasing debt service payments.

It has been suggested on more that one occasion that taxpayers do indeed have options if the Governor and Legislature ignore these constitutional prescriptions. We hope you would agree that it should not require litigation by taxpayers to enforce the Constitution. Rather, we ask you to consider carefully the duty you have been sworn to uphold and bring the spirit, intent, and letter of the law to fiscal policy discussions.

Many recommendations have already been made to address Arizona's budget deficit. These include reform of the budget process to ensure that it creates an accurate, visible budget inclusive of taxpayer input and tax reform specifically designed to grow Arizona's economy by encouraging business expansion, relocation, and retention. Revenues from economic expansion and growth remain the best prescription for faltering revenue streams. Such actions remain critical as we move forward into next year's budget process.

Sincerely,

Kevin J. McCarthy
President
Arizona Tax Research Association

Valerie Manning
President, CEO
Greater Phoenix Chamber of Commerce

Richard Foreman
Chair, Education Committee
Greater Phoenix Chamber of Commerce

Russell Bowers
Executive Director
Arizona Rock Products

Michelle Bolton
State Director
NFIB, Arizona

Michelle Ahlmer
Executive Director
Arizona Retailer's Association

Maricopa Hospital District Bill Passes

Reacting to threats from Maricopa County officials that they would close the Maricopa Integrated Health System, the state legislature provided the opportunity for the county to seek voter approval for a new taxing jurisdiction to fund its hospital operations.

ATRA opposed the measure, House Bill 2530, on the grounds that current county finances already provide Maricopa County with the means to solve the financing issues without creating yet another special taxing district.

In November, Maricopa County Supervisors will ask voters to approve a new property tax to fund the creation of a special health care district (SHCD).

This will be the second year in a row that Maricopa County will approach the voters for the purpose of creating or extending a tax for county operations. Last November, voters approved a 20-year extension of the sales tax for the construction and maintenance of county jails.

A board-appointed citizen's task force had determined that the county hospital faced a financial crisis that necessitated a greater taxpayer subsidy for both capital and operating purposes. In addition, Maricopa County officials have expressed concerns about the impact of increasing hospital expenditures on the county's constitutional expenditure limit.

Despite having every available tool to address both the operational and capital financing needs of the hospital, as well as the county expenditure limit, the Maricopa County Board of Supervisors opted for creating a new taxing jurisdiction with five new elected officials to oversee its operations.

This new SHCD, made available only to Maricopa County, will allow the county to impose a new secondary property tax not to exceed $40 million in the first year. A $40 million secondary levy for tax year 2003 would require a tax rate of approximately 16 cents per hundred dollars of assessed value. That levy limitation will be increased each year by the growth rate of the county's constitutional levy limit on primary property taxes. In the last five years that limit has risen over 50%. The annual growth in the county's levy limit has averaged 8.7%.

Maricopa County currently subsidizes the hospital with $13 million in general fund revenues in fiscal year (FY) 2003, less than half the amount the county requested in new taxing authority for the SHCD.

The county also plans to finance the debt service for capital projects with the $40 million in tax capacity. The legislation provides multiple mechanisms for the SHCD to debt finance projects. While voter approval is required to sell general obligation bonds, it is not required to issue revenue bonds or revenue anticipation notes.

ATRA argued that all of the debt mechanisms should require voter approval because ultimately all the debt service payments will effect the property tax, the district's only source of taxation.

COUNTY GOVERNMENT: DOING LESS WITH MORE

Since the constitutional levy and expenditure limitations were approved by voters on 1980, the creation of special districts has been a popular approach for not only raising taxes for specific areas of county government but also for relief of the general fund. (See exhibits A and B.)

The Legislature has created flood control districts, library districts, jail districts, health service districts and now special health care districts.

In the most recent special district legislation (jails and health service), in order to negate any general fund windfall, the Legislature required an on-going maintenance of effort payment to eliminate the incentive to create the district simply for general fund relief.

In addition to the guarantee of general fund relief by not requiring the county to make a maintenance of effort payment, the Legislature amended the law to allow the county to charge the new district for "services." Maricopa County currently taps the flood control and library districts for about $2 million annually for reimbursement for services provided by county management.

Although the legislation arrived very late in the session, the Legislature cooperated with its passage, relying heavily on the fact that the creation of the district required voter approval. In fact, so few amendments were made to the bill that the only objective of the State Senate was to keep the bill identical to the House version in order to expedite its final passage.

Exhibit A

County Funding Structure 1980

Primary Property Taxes
(limited by constitution)
State Shared Revenue

<u>Special Districts</u>
- FLOOD CONTROL -
(secondary property tax)

Exhibit B

County Funding Structure 2003

Primary Property Taxes
(limited by constitution)
State Shared Revenue
Half-cent Sales Tax

<u>Special Districts</u>
- FLOOD CONTROL -
- LIBRARY -
(Secondary Property Tax)

- JAIL -
- HEALTH SERVICES -
(Sales or Property Tax)

- FIRE DIST. ASSISTANCE -
- COLLEGE TUITION -
(From primary to secondary tax)

Tax experts discuss reform efforts around country

Continued from page 1

inadequate to sustain current spending levels.

Duncan pointed out that discussions about broadening the sales tax base to include services are occurring in several states. Some states are adding only a selective group of services to their tax base while other states are adding all services. He warned policymakers of the need to be cognizant of providing a system that is both stable and equitable during any tax reforms.

Duncan also discussed the volatility of business taxes and the need for systems to be characterized by stability, adequacy, and neutrality. He suggested a need to combine reporting requirements and warned lawmakers to be aware of "pass-thru" entities in developing an equitable system.

Duncan also identified some of the different ways that states calculate their net income base, such as gross receipts, factor taxes, and value added taxes. Most states, he said, underutilize personal income taxes.

Duncan closed his presentation with three suggestions for a successful tax reform effort: 1) the need for executive leadership; 2) the importance of solid background research to make sound decisions; and 3) the need to involve many people in the process in order to understand why change is necessary.

Robert Cline began his presentation by informing attendees that the total budget deficits for all states in fiscal year 2004 amounted to over $86 billion, 15% of total state taxes. He explained that the deficits are in large part a result of short-run economics, such as weak economic growth and disappearing capital gains, as well as a long-run structural imbalance between taxes and spending.

Harley Duncan, Executive Director of the Federation of Tax Administrators

Emphasizing Harley Duncan's earlier point, Cline discussed the fact that many states are interested in expanding the sales tax base as a result of the growing service sector. He also noted growing recognition of the need to reform business taxes, especially on multistate companies, and that some states are reconsidering the level at which they tax personal income.

Cline addressed some of the potential problems involved in taxing business and professional services, providing examples like pyramiding, distortions, and the noncompetitive implications, such as "sale-for-resale" exemptions.

Robert Cline, National Director of State and Local Tax Policy for Ernst & Young

Conversely, however, Cline suggested that broadening the sales tax base can have the positive affect of lowering existing high rates, assuming that any changes would be revenue neutral.

Cline drew attention to the misconception in labeling exemptions as "loopholes" since they are usually basic features of tax laws. As a result, some states are using the concept of "loophole closing" to justify *ad hoc* changes to raise short-run revenues.

On property taxes, Cline pointed out that business property taxes are three times higher in Arizona than are residential property taxes. He explained that the inequity in property taxes between business and individuals creates growing competitive pressure and typically results in property tax exemptions and targeted incentives.

Cline addressed Arizona's current corporate income tax structure and the national trend toward increasing the sales factor weight as an attempt to offset high business taxes. He reported that eight states are already at a 100% sales factor weight and an additional five states have sales factor weights greater than 50%.

Cline ended his presentation by advising reform-minded legislators and administrators that, to build a case for reform, one should explain what is broken, identify the winners and losers, and then measure the economic impacts of such reform.

See **Tax Reform**, page 6

Tax reform experts discuss national trends

Continued from page 5

Bill Post provided a report from the Governor's Citizen Finance Review Commission (CFRC) and identified research proposals currently under consideration.

Post said that proposed research relating to the income tax includes determining the effects of implementing a 100% sales factor in the corporate income tax formula, replacing the current corporate income tax with a gross receipts or franchise tax, and reinstating a throwback provision in the corporate income tax statutes.

The Commission also plans to evaluate all of the existing tax credits, deductions, and additions under both the individual and corporate income tax structures.

Post also discussed property tax research proposals, which will include reviewing the implications of eliminating the 1% cap on residential property and the 35% homeowner's rebate, along with the effects of reinstating a statewide property tax. In addition, the Commission will study the impact of eliminating the different assessment ratios and the distinction between full cash and limited property values.

"States are using the concept of "loophole closing" to justify *ad hoc* changes to raise short-run revenues, resulting in increased complexity, redistribution of taxes, and more uncertainty for taxpayers."
— *Bob Cline*

Some of the sales tax issues that the Commission plans to research include establishing criteria for creating new exemptions, expanding the tax base to include services, evaluating the application of the Streamlined Sales Tax Agreement, and the implications of instituting a real estate transfer tax.

According to the official timeline, the Commission will report its final recommendation and report to Governor Napolitano at the end of October 2003.

Jennifer Schuldt