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ARIZONA TAX RESEARCH ASSOCIATION

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GRETCHEN KITCHEL ELECTED ATRA CHAIRMAN



Gretchen Kitchel

Gretchen Kitchel, Senior Public Affairs Representative for Pinnacle West Capital Corporation, was elected chairman of the Board of Directors of the Arizona Tax Research Association (ATRA). Kitchel, who has served on the ATRA Board for several years and as chair of ATRA's Legislative Policy Committee, was elected at ATRA's 64th Annual Meeting on November 19, 2004.

Also elected as ATRA officers were Larry Lucero, *Tucson Electric Power*, first vice-chair; Amy Barron Etkorn, *Advance PCS*, second vice-chair; Barb Dickerson, *Deloitte Tax LLP*, third vice chair; and Dave Minard, *Individual*, secretary/treasurer.

The following ATRA members were elected to seats on the ATRA Board of Directors for terms expiring in 2009: Barbara Dawson, *Snell & Wilmer*; Barbara Dickerson, *Deloitte Tax LLP*; Dick Foreman, *Southwest Gas*; Stephan Newmark, *Brown & Bain*; Kevin Moran, *Cox Communications*; Russell Smoldon, *SRP*; Robert Moroney, *Duke Energy*; Lori Daniels, *State Farm Insurance*; Bas Aja, *Arizona Cattlemen's Association*; Bobbie Sparrow, *Arizona Autodealers Association*; and Jackie Norton, *National Association of Independent Office Properties*. For terms expiring in 2007: Dave Howell, *Wells Fargo Bank*.

Top legislators address ATRA Outlook Conference

ATRA's 2004 Outlook Conference was highlighted by speeches from the chairs of Arizona's two tax writing committees as well as the next Speaker of the House of Representatives.

The morning portion of the conference was capped off by remarks from House Ways & Means Chairman Steve Huffman and Senate Finance Chairman Dean Martin. Representative Huffman made a strong pitch for the Legislature to address Arizona's high business property taxes. In expressing his belief that this is Arizona's top tax issue, Representative Huffman also suggested that the Legislature needed to prioritize tax legislation next session and focus on the reform that will have the greatest impact on Arizona's economy.

Representative Huffman unveiled a new approach he plans to take in the 2005 session to reduce the effective tax rate on business property. Huffman will propose a five-year phased-in reduction from the current 25% assessment ratio for business property to 20%. In an effort to address concerns over shifting taxes to residential property, Huffman will combine the assessment ratio reduction with an increase in the existing homeowner's rebate. Currently, the state rebates 35% of the primary K-12 school taxes on residential property.

Senate Finance Committee Chairman Dean Martin also expressed strong support for reducing business property taxes and offered his own approach for accomplishing it. Martin proposed modeling a business



Jim Weiers

Arizona House Speaker-designate

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Legislative budget director offers optimistic outlook, and warnings

ATRA's Outlook Conference included a briefing on the state budget by Richard Stavneak, director of the Joint Legislative Budget Committee (JLBC).

Stavneak noted that 95% of the state's \$7 billion general fund revenue comes from the "Big 3" taxes: sales and use (51%), individual income (36%), and corporate income (8%). The general fund's reliance on the sales tax, he said, has grown from 44.1% of the total in fiscal year (FY) 1995 to 50.9% in FY 2005.

Growth in personal income in Arizona, Stavneak said, is approaching the growth rates of the 1990s, with the FY 2005 consensus forecast at 7.3%.

He reported that the current consensus of JLBC's finance advisory committee (FAC) is that the "national recovery is strong, and any slowdown is likely to be temporary." Oil prices may be a factor in the national and state economies in the near future. Job growth is slowly beginning to accelerate, although not yet in all sectors. Homebuilding continues to expand, but may slow down if interest rates rise. Stavneak said that the FAC has forecasted a "Big 3" growth rate of 7.7% for FY 2006.

Stavneak warned, however, that general fund revenue remains vulnerable during any recession. He recalled that corporate income tax collections fell by approximately \$200 million during the last recession and that individual income tax collections on capital gains fell by another \$200 million. He said that while the "Rainy Day Fund" is projected to have \$73 million by the end of the year, "it had over \$400 million when the last downturn started."

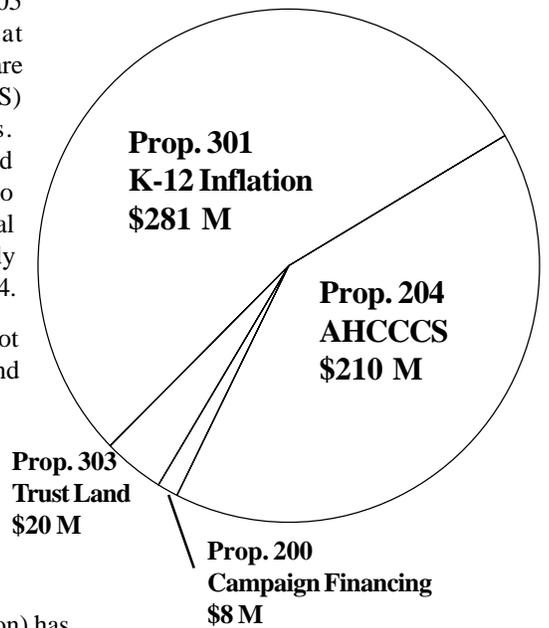
On the spending side, Stavneak said that K-12's share of the \$7.3 billion state general fund has increased since FY 1995, from 40.3% to 43.1% in FY 2005.

One area of concern in the FY 2005 budget, Stavneak said, is that enrollment in the Arizona Health Care Cost Containment System (AHCCCS) is exceeding budget projections. While the adopted FY 2005 budget had anticipated AHCCCS enrollment to reach 745,795 by the end of the fiscal year, actual enrollment has already reached 779,689 as of September 2004.

Stavneak said that four recent ballot propositions have cost the general fund \$519 million. Two measures that passed in 1998, Propositions 200 (campaign financing) and 303 (urban trust land purchases) have cost the general fund a total of \$28 million. Proposition 301 (K-12 inflation) has cost \$281 million and Proposition 204 (AHCCCS expansion) has cost \$210 million since they were approved by voters in 2000. These propositions have become a significant factor in the budget process because Proposition 105, passed in 1998, requires a three-fourths vote of the Legislature to change ballot-required funding. Any legislative change must also "further the purposes" of the original ballot measure.

The impact of any future ballot measures will be quite different, Stavneak pointed out, with the passage of Proposition 101 in November, 2004. A legislative referendum, Proposition 101 amended the Arizona Constitution to require any initiative or

"Recent ballot propositions have cost the general fund \$519 million." — JLBC



referendum to designate a non-general fund source for any new spending and restores the Legislatures ability to adjust funding levels to match the designated revenue.

Answering what he said was a frequently asked question, Stavneak reported that the average annual general fund spending growth between FY 1996 and FY 2005 was 5.2%, compared to the average annual growth in population and inflation of 4.9%. For FY 2005, general fund spending grew by 13.2%.

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Conference panel provides updates on issues in Arizona's tax system

Participants at ATRA's Outlook Conference heard from a panel comprised of ATRA staff and members that provided an update on issues in Arizona's property, sales, and income taxes.

Jennifer Schuldt, senior research analyst for ATRA, led off the tax panel presentations with an overview of Arizona's property tax system. Schuldt provided a ten-year snapshot of the performance of the property tax system.

Over the past 10 years, secondary net assessed values (NAV) have more than doubled, with the growth in primary NAV just under that. On the levy side, Schuldt noted that secondary levies, most of which require voter approval, have grown 117.3% over the past decade, whereas primary levies have grown 67.1% over that same period. Schuldt pointed out that K-12 schools levy the majority of property taxes out of total statewide property taxes.

Schuldt noted that Arizona's property tax system has long been considered one of the most complicated in the country. One such complexity, the classification system, has led to significant policy problems such as high business property taxes and accountability of the system.

Arizona's property tax system was the primary focus of two recent tax reform groups—the legislature's Tax Reform for Arizona Citizens Committee (TRAC) and the governor's study committee, Citizens Finance Review Commission (CFRC). Schuldt addressed the fact that although the CFRC recommended an increase in property taxes by reenacting the statewide property tax, the TRAC committee, on the other hand, did not recommend a tax increase.

Michael Hunter, vice president of ATRA, continued the property tax discussion by reviewing what ATRA's focus on property tax reform has been—to decrease inequities

in the current system, as well as control the growth in property tax levies.

Hunter noted that ATRA's equity efforts have been met with limited success, with some class consolidation, but that ATRA has been successful at the same time in defeating several efforts to further erode equity within the system. Hunter addressed the major inequity between business and residential tax burdens, with businesses being assessed at 2.5 times that of residential taxpayers.

Reviewing ATRA's success in controlling levy growth, Hunter pointed to the elimination of the state's 47-cent property tax rate as well as the 32-cent reduction in the qualifying tax rate (QTR). During that same time, the truth in taxation (TNT) law was enacted, saving taxpayers an estimated \$687 million since 1999, and ATRA has continued its efforts ever since to limit non-voter-approved K-12 district levies.

Barb Dickerson, Director of Multi-State Tax at Deloitte Tax LLP, gave the group an overview of Arizona's transaction privilege and use tax system (TPT), noting that the system is just as complex, if not more complex, than Arizona's property tax system.

Dickerson reported on the streamlined sales tax project (SSTP), which is a project that was created by the National Governors Association and the National Committee of State Legislators (NCSL) in March 2000. Dickerson noted that one positive aspect of SSTP would be the simplification and uniformity of the TPT tax code. However, SSTP has also raised a concern as all states would have to adopt uniform definitions and an identical tax base, and states can only levy a single tax rate, aside from the allowance for a second rate for food and drugs. In Arizona, the state has a different tax base and rate than the cities. Adopting SSTP would cause problems for cities that

have a broader tax base than the state and would also be problematic for city revenues unless the rate is set at the highest level currently being levied.

Dickerson concluded her presentation by noting that there are no easy solutions to achieve simplification within the system, and while some groups have recommended adoption of the SSTP to be in the best interest of Arizona, such action could further complicate an already complex system if not thoroughly planned and studied by all parties.

Steve Shiffrin, Senior Manager of the state and local tax division at Ernst & Young LLP, concluded the tax panel segment with a discussion on recent developments in the corporate and individual income tax laws.

Shiffrin began his presentation on the sales factor, which is used to compute corporate income tax liability, discussing the arguments for and against the inclusion of overnight sales of securities in the computation. Arguments for complete inclusion mainly rest on one method of thought that since stocks and bonds represent business income, they are no different from any other item of business inventory. However, the historical argument remains that the definition of what constitutes business income is ambiguous and therefore must be interpreted reasonably within the context of the law.

Shiffrin also reported about the many multistate companies that established intangible holding companies in the 1990s and the treatment of isolated income of those companies. Shiffrin closed by giving a brief overview of the American Jobs Creation Act, starting with the repatriation of foreign income on a one-time only basis in 2005 and 2006 and the parameters of reinvesting that income.

Jennifer Schuldt

McCarthy, Stein, focus on politics of tax reform

ATRA President Kevin McCarthy and Public Policy Consultant Randie Stein combined for a discussion on the challenges of passing major tax reform.

Randie Stein, a former analyst for the Senate Finance Committee and member of the Citizens Finance Review Commission (CFRC), led off the program with her assessment of Arizona's tax system as well as a practical overview of the politics of changing state tax systems.

While suggesting that she wasn't at all bothered by the fact that none of the CFRC tax reform proposals had been implemented, Stein said the process itself was both necessary and important.

Further, she noted, "Arizona's tax structure is really not that out of whack. That's not to say we would not benefit from some improvements, it is just naïve to believe a perfect system can be achieved. Tax reform means considering and weighing the benefits of a proposed change against the 'costs' of getting there."

Stein also pointed out that the nature of the legislative process decreases the likelihood of major tax reform. Legislators tend to spend the first year studying the system and the second year focusing on re-election – hardly good timing for major tax reform.

Kevin McCarthy followed with his own overview of Arizona's tax system as well as advice on how to successfully make changes to tax systems. McCarthy said, "When you consider the practical and political difficulties of major tax reform, ATRA has recommended that state policymakers focus on targeted reforms in areas where change is most needed." McCarthy pointed out that, for better or worse, state policymakers tend to not make major changes in tax policy unless they are faced with a crisis. Although certainly in need of improvement, most policymakers do not view Arizona's tax system to be on the verge of collapse. In referencing an ATRA study that showed real per capita tax growth of 52% between 1980 and 2000, McCarthy

suggested that, as a revenue producer, the overall state and local tax system has fared well over the last two decades.

McCarthy said ATRA's recommendations on tax reform have been consistent: the top priority should be addressing the high business property taxes that result from Arizona's property tax classification system.

Recognizing that a property tax system that shifts taxes from the homeowner/voter to the non-voting business taxpayer is grounded in politics, McCarthy said reversing that political construct, even a little, is a major challenge.

Nonetheless, policymakers are faced with two options to try bring down the effective

property tax rates on business property that are some of the highest in the country.

First, they can try to decrease the inequity in the distribution of property taxes caused by the assessment ratios.

Second, the overall amount of property taxes levied can be reduced over time, thereby bringing down effective tax rates on all properties.

McCarthy closed his remarks by cautioning against the view of tax reform as an isolated one-time event that once achieved can be forgotten. "Taxpayers need to be ever vigilant in their efforts to ensure that taxes are fairly collected and efficiently spent."

Kevin Kinsall recognized for dedicated leadership



Outgoing Chairman Kevin Kinsall was recognized at ATRA's Annual Meeting Luncheon for his dedicated leadership during his three years at the helm of ATRA's Board of Directors. Presenting Mr. Kinsall with a plaque, past-chairman Russell Smoldon (right) said "Kevin's chairmanship was one of the most successful in ATRA's long history." Manager of Governmental Relations for the Phelps Dodge Corporation, Kinsall was elected to chair the association at the Annual Meeting in November 2001.

Good Gov Award goes to Alhambra official

Doug Virgil recognized for saving energy and taxpayer dollars

The Arizona Tax Research Association selected Dr. Doug Virgil, Assistant Superintendent for Business Services for the Alhambra Elementary School District, as its 2004 recipient of the ATRA Good Government Award. The award was presented during ATRA's Annual Meeting luncheon on Friday, November 19, 2004 in Scottsdale.

For the last 14 years, ATRA has taken the occasion of this annual luncheon to recognize an outstanding individual whose work in the public sector is characterized by strong, continuing, and consistent efforts to spend taxpayer dollars wisely and to promote government that is efficient, open, and accountable. ATRA solicits nominations from local governments and state agencies, which are then reviewed by ATRA members and staff.

Presenting the award, ATRA vice president Michael Hunter said "What caught ATRA's eye was Dr. Virgil's implementation

of a highly successful energy conservation program that has realized a savings of over \$250,000 in the past 18 months, and the district has estimated that the program will save taxpayers more than \$290,000 annually."

Hunter noted that ATRA is not the first organization to recognize these efforts. The Alhambra district received an *Award of Excellence* in the Governor's Awards for Energy Efficiency sponsored by the Arizona Department of Commerce and Dr. Virgil himself was the sole recipient of the Governor's *Energy Advocate of the Year Award* for 2004.

Presenting the award, Hunter concluded that "Dr. Virgil's concerted effort to increase efficiency in energy consumption benefits everyone in the Alhambra community, including, from our standpoint, taxpayers."



Alhambra Elementary's Doug Virgil

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Continued from page 1

property tax rebate after the existing rebate for residential property. Suggesting that the real problem is the actual amount businesses pay in taxes, Martin said the real problem is not the assessment ratios. Martin also argued that his approach sidestepped any concerns about shifting taxes to homeowners.

The Outlook Conference luncheon program was highlighted by an address from House Speaker-elect Jim Weiers. Mr. Weiers also spoke favorably about the need for the Legislature to address high business property taxes. A small businessman, Mr. Weiers has consistently advocated for more equitable treatment of business property in Arizona's property tax system.



Steve Huffman
House Ways & Means Chairman



Dean Martin
Senate Finance Chairman

Lyn White named ATRA's Member of the Year

The ATRA Board of Directors recognized Lyn Harry White with ATRA's Member of the Year Award at their 2004 Annual Meeting Luncheon. Lyn, manager of state and local government relations for Phelps Dodge Corporation, is one of ATRA's most active members.

"The success of any association is directly linked to the energy and commitment of its membership. Lyn's energy and commitment to ATRA is truly unparalleled," said Russell Smolden in presenting the award.

Lyn has worked tirelessly for many years organizing a variety of events. In addition, Lyn has played a very active role in advocating ATRA's initiatives at the Arizona Legislature.

"No one in ATRA's membership is more deserving of this recognition than Lyn," said ATRA President Kevin McCarthy.



Lyn White