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ARIZONA TAX RESEARCH ASSOCIATION

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Census Bureau Correcting Reporting Error in AZ Tax Collections

Whether we like it or not, Arizona's relative ranking with other states on a myriad of bases seems to have a significant impact on policy making decisions in our state. In many instances, the advocates that use these statistics utilize the public finance data published by the U.S. Census Bureau with the assumption of course that the data is accurate. However, after close scrutiny of the FY 2006 tax collections, ATRA determined that Arizona's tax collections were understated by almost $2 billion.

After lengthy discussions with Census Bureau staff, they have agreed that the amount of collections initially reported in sales and vehicle license taxes are understated by at least $1.4 billion. ATRA believes there are other corrections that are warranted and continues to work with Census staff on those changes.

Consequently, the statistics that are currently being disseminated which suggest that Arizona ranks 39th in total tax collections per capita and 34th per $1,000 of personal income significantly understate Arizona's relative tax burden.

See **Census Bureau Statistics,** page 4

What's inside…

Prop 203 Leads to 20% Declines in Tobacco Tax Revenues for Health Care, Education, General Fund

In November of 2006, voters passed the Early Childhood Development and Health Initiative which increased tobacco taxes by 68%. ATRA opposed this tax increase and pointed out that the higher per-pack rate would lead to substantial declines in the revenues received by the existing recipients of the tobacco tax including the General Fund, the Tobacco Tax & Health Care Fund, and the Tobacco Products Fund. The Corrections Fund did not stand to loose any revenue because previous initiatives guaranteed to hold this fund harmless from any future decreases. With fiscal year (FY) 2008 data now available, it is possible to evaluate the actual losses these funds sustained as a result of the higher rate.

Table 1: Change in Tobacco Tax Revenues (FY 2006 to FY 2008)

General Fund	-$7,111,365	-18.0%
Corrections Fund	$0	0.0%
Tobacco Tax & Health Care Fund	-$22,952,580	-21.5%
Tobacco Products Tax Fund	-$29,272,520	-20.1%
Early Childhood Development & Health Fund	$164,805,113	100.0%
Smoke Free AZ Fund	$3,946,308	100.0%

Source: Arizona Department of Revenue

To evaluate the effect Prop 203 had on the previously existing recipients of the tobacco tax, ATRA compared the collections received by each of these recipients in FY 2008 to the amounts collected in FY 2006. The new tax was implemented half way through FY 2007, so the comparison in table 1 measures the first full year of collections at the higher price with the last full year of collections at the lower price. Aside from the Corrections Fund, each of the remaining three recipients of the tobacco tax saw their revenues decline by 18.0 to 21.5 percent. The declines were slightly greater for the Tobacco Tax & Health Care Fund and the Tobacco Products Fund as these funds were required to backfill the declines that the Corrections Fund otherwise would have sustained.

Reviewing the historic tobacco tax collections of the General Fund demonstrates how tax increases have affected trends in tobacco tax collections (figure 1 on page 5). Since FY 1991, the General Fund tax on tobacco has been constant at $0.18 per pack of cigarettes, yet the amount collected has declined significantly since that time. From FY 1991 to FY 1994, for the most part the total amount collected by this $0.18 tax grew at a relatively slow pace. Half way through FY 1995 an additional $0.58 tax per pack was implemented as a result of Prop 200. Despite the previous years' trend of constant or slightly increasing General Fund revenues from the tobacco tax, the collections decreased during FY 1996 and FY 1997. As these were the first two years for which the Prop 200 tax was collected throughout the entire year, the change in the trend of taxed tobacco sales was likely due to the higher price resulting from the new tax.

See **Tobacco Tax Revenues,** page 4

K-12 Cash Balances Could Help Close FY 2010 Deficit

As the Legislature continues its efforts to develop and pass a balanced FY 2010 budget, some have recently noted that school district fund balances could potentially provide much needed funds to help close the gap between planned expenditures and anticipated revenues.

ATRA has long pointed out that using one-time revenues, such as cash balances, to fund ongoing expenditures provides only a temporarily balanced budget that masks an ongoing structural deficit. Budgets that use one-time revenue sources to increase the gap between ongoing expenditures and ongoing revenues imprudently set the stage for a budget crisis as soon as the one-time revenue sources wear thin. For that reason, ATRA has consistently voiced opposition to such budgeting maneuvers. While ATRA opposes using one-time revenues to increase a structural deficit, using cash balances in conjunction with reductions in the existing structural deficit can put the state on a path toward a structurally balanced budget while avoiding a tax increase that could devastate a faltering economy.

Fund	FY 2008 Ending Cash Balance	1-year Change	% Change
Maintenance & Operations (M&O)	$442,720,510	$32,934,688	8.0%
Classroom Site Fund and Instructional Improvement Fund	$178,538,096	$35,350,552	24.7%
Unrestricted Capital Outlay	$272,979,868	$23,155,262	9.3%
Soft Capital Allocation	$145,558,916	$14,686,585	11.2%
Deficiencies Correction	$566,922	-$725,891	-56.1%
Building Renewal	$76,043,624	-$25,656,080	-25.2%
New School Facilities	$2,821,374	-$4,092,321	-59.2%
Adjacent Ways	$70,778,233	$23,435,223	49.5%
Debt Service	$539,894,149	$77,181,552	16.7%
School Plant	$42,977,604	-$2,158,899	-4.8%
Federal Projects	$47,797,370	-$10,274,758	-17.7%
State Projects	$17,592,515	-$3,028,827	-14.7%
Food Services	$58,339,105	$9,518,470	19.5%
Other	$434,566,352	$70,685,668	19.4%
Total	**$2,331,174,638**	**$241,011,224**	**11.5%**
Bond Building	$732,122,450	-$10,248,168	-1.4%
Intergovernmental Agreements	$6,160,840	-$22,379,826	-78.4%
Indirect Costs	$34,938,879	$4,128,055	13.4%

Source: Arizona Department of Education, Annual Report of the Superintendent of Public Instruction

Fund sweeps accounted for $583.7 million of the revenue used in the FY 2009 budget fix that passed earlier this year, and most expect several hundred million dollars in additional balance transfers to be part of the FY 2010 budget. Notwithstanding the several rounds of fund sweeps, school district cash balances have remained untouched. The Annual Report of the Superintendent of Public Instruction indicates that school districts began the current fiscal year with more than $2.3 billion in the bank (see above table). So the question naturally arises whether some of these funds might be used to lessen the spending cuts or the tax increases necessary to balance the FY 2010 budget.

Much of the $2.3 billion cash balance could not be used to close the state's budget deficit. For example, this total balance includes $539.9 million in school districts' debt service accounts. This revenue was raised by secondary property taxes that were authorized by voters specifically for the debt service requirements of voter-approved bonds. School districts, therefore, have an obligation to the voters as well as the bond holders to spend this revenue on nothing other than the debt service payments of the voter-approved bonds. Similarly, $47.8 million of the balance is found in funds for federal projects such as Title I grants. The federal requirements associated with these funds limit the state's ability to require districts to use this cash balance to offset a reduction in state aid.

But a substantial portion of the total cash balance could be used to help balance the FY 2010 budget by transferring the cash into the county aid for equalization assistance fund or by using some other similar method. This money would then reduce the amount of state revenues needed to fund the equalization formula. Of the cash balances that are available for such a sweep, transferring the

See **K-12 Cash Balances**, page 3

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K-12 CASH BALANCES, *Continued from page 2*

balances of some of the funds would have an impact on school districts while other revenues could be transferred with virtually no affect to the schools. This difference stems from the districts' authority, or lack of authority, to spend the cash balances.

Cash balances result from one of two reasons: 1) because a district did not spend all of the funds they were authorized to spend in a given fiscal year or 2) because the district overestimated the property tax levy it would need to fund its authorized expenditure limit. In either case, A.R.S. § 15-991 (A)(3) requires school districts to use the cash balances remaining at the end of a fiscal year to decrease the next year's property tax levy. And A.R.S. § 15-992 (A) prohibits districts from including a delinquency factor for estimated uncollected taxes in the computation of the district's primary tax rate. Regrettably, in recent years these statutes have been largely ignored, and many school districts have amassed larger and larger cash balances. In many cases, the higher tax rates necessary to build up these cash balances have offset the property tax relief that otherwise would have resulted from the state's continued compliance with truth-in-taxation laws. In meetings with school district representatives, the justification for ignoring this law was that the cash balances were a request of the investment banking industry conducting bond ratings.

In situations where a cash balance resulted from a district not spending every authorized dollar, the district, in most cases, is allowed to increase the next year's budget. This budget increase results in a higher property tax levy which offsets the levy decrease that would otherwise result from the portion of the cash balance pertaining to the unspent budget capacity. Cash balances that correspond to a budget balance carryforward, therefore, cannot be swept without cutting school district budgets.

If, however, a cash balance exceeds a district's unexpended budget capacity then a cash balance will remain even if the district spends every authorized dollar. The cash balance that remains after subtracting a district's carryforward results because the district levied more property taxes in the previous levy than the district was authorized to spend.

Ending Cash Balances in Districts' M&O Funds

FY 2003	$218,653,828
FY 2004	$299,660,656
FY 2005	$381,687,642
FY 2006	$427,890,899
FY 2007	$409,785,822
FY 2008	$442,720,510

Source: Arizona Department of Education, Annual Report of the Superintendent of Public Instruction

Property taxes are levied in August based on estimates of both revenues and expenditures for a fiscal year that is only 30 days old. As the fiscal year develops, the actual revenues and the finalized expenditure limit may divert significantly from the estimates used to determine the authorized levy in August. If a district overestimates its authorized expenditures or underestimates its revenues then the district will have levied too much in its property tax. The district, therefore, is required to refund the excess levy to the property taxpayers by using the cash balance to offset the next year's levy as mentioned above. Conversely, if the district underestimates the authorized amount of property taxes, the district will end the year with a negative cash balance. The negative balance will increase the next year's levy, thereby, charging the taxpayers for the amount that should have been levied in the previous year.

Over the last five years the ending cash balances in school districts' maintenance and operations (M&O) funds have increased an average of 16.1% each year (see nearby table). The fact that school districts have consistently ended each fiscal year with cash balances substantially greater than the budget balance carryforward indicates that districts regularly overestimate the authorized property tax levy in order to maintain a larger cash balance. On paper the districts technically refund the balance back to the property taxpayers each year; but, as the next year's levy is also overestimated, the balance remains with the schools. As school districts are not permitted to spend these cash balances, the state could transfer these balances into the county equalization fund to decrease the state aid required to fund the FY 2010 equalization formula. Alternatively, the state could transfer these funds directly into the state's general fund. Such a transfer will have virtually no effect on school districts because the districts are not permitted to spend these balances.

The amount of the unspendable cash balances that school districts held in their M&O funds at the end of FY 2008 is easily calculated by subtracting the total budget balance carryforward of all districts from the total of the ending cash balances. At the end of FY 2008 school districts' M&O funds held $442.7 million. The adopted FY 2009 school district budgets, as of February 9, 2009, included a total of $112.9 million in the general budget balance carryforward as well as the carryforward of budget balances for special programs such as career ladder and performance pay programs. This means schools held $329.8 million in their M&O funds which they were not authorized to spend. Since history has demonstrated that districts have consistently overestimated their property tax levies, the districts likely overestimated their 2008 property tax bills by a similar amount as they did the previous year. This means the districts will likely end the current fiscal year with at least the same $329.8 million of unspendable revenue in their M&O funds.

Unspendable cash balances will also exist in the districts' unrestricted capital outlay funds and their soft capital allocation funds. The Department of Education estimates that school districts ended FY 2008 with $388 million more in cash than they had in unexpended budget capacity.

Justin Olson

TOBACCO TAX REVENUES, *Continued from page 1*

By the end of FY 1997, the market seemed to have fully absorbed the impact of the higher price on tobacco and a new trend in tobacco sales set in. For the next five years, sales of taxed tobacco remained relatively constant as demonstrated in the total collections of the $0.18 General Fund tax. In 2002, Voters passed Prop 303 and added another $0.60 to the tobacco tax, which again shifted the trend in sales of taxed tobacco. The new rates were effective for only the last half of FY 2003 and still the effect on sales and corresponding General Fund revenues is apparent. In FY 2004, the decrease is even greater as this was the first year in which the sales of every month were affected by the Prop 303 tax.

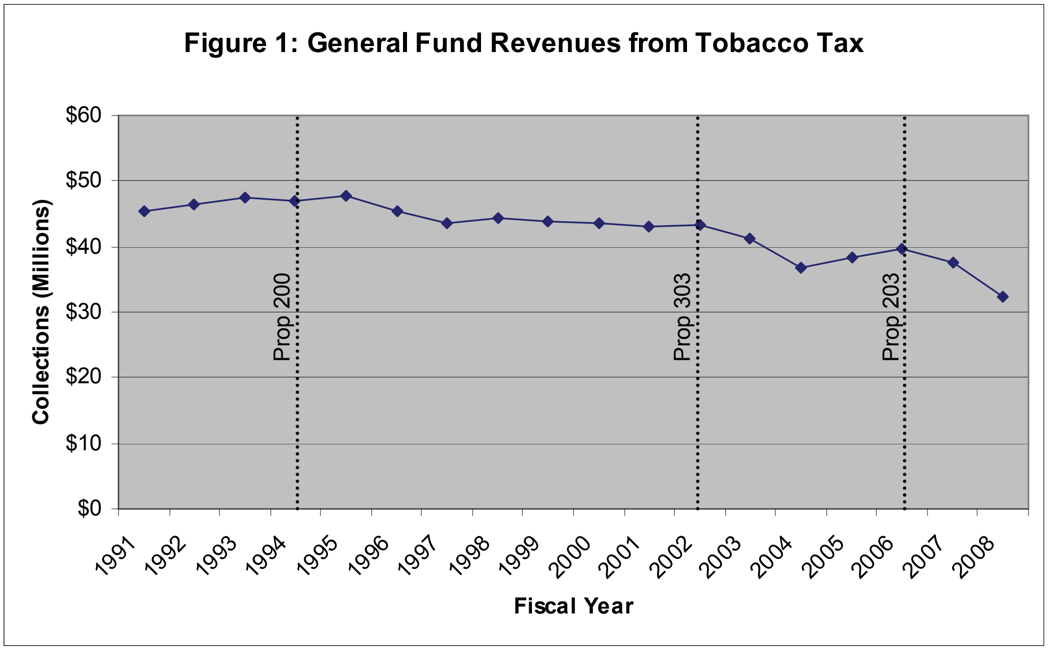

Figure 1: The above chart depicts the revenues that Arizona's General Fund received from the constant $0.18 per-pack tobacco tax according to the Arizona Department of Revenue. Dashed lines indicate the last fiscal year of collections prior to the implementation of new taxes on tobacco resulting from the indicated propositions. A decline in General Fund revenues follows each tax increase.

The market again adjusted to the new price and then collections actually increased from FY 2004 to FY 2006. The 2003 increased appropriation to the Tobacco Enforcement Unit of the Department of Revenue, which allowed the department to hire ten new investigators and four new auditors, likely contributed to an increase in tax compliance that influenced this increase in collections. But regardless of the reasons for the increased collections leading up to 2006, Prop 203 clearly had the predicted effect of decreasing the trend in taxed tobacco sales. This decrease in sales resulted in the decrease in General Fund revenues seen in figure 1. Taxed tobacco sales dropped in both FY 2007 and FY 2008. The decline was smaller in FY 2007 as the Prop 203 tax increase was only effective during the last half of the year. Based on the sales trends leading up to Prop 203, one might reasonably assume that tobacco sales would have at a minimum remained constant at the FY 2006 level had the price per pack not increased. Such an assumption implies that Prop 203 resulted in a General Fund loss of at least $7.1 million (see table 1 on page 1).

Recently, Arizona's over reliance on a declining revenue source has become more problematic as the federal government imposed a new 61.66 cent increase in the tobacco tax per pack as of April 1st of this year. This tax increase will undoubtedly drive down Arizona tax collections for FY 2010 for all of the current recipients.

Justin Olson

CENSUS BUREAU STATISTICS, *Continued from page 1*

In FY 2006, the Bureau reported that the total state and local general sales taxes for Arizona amounted to $7.5 billion, when in fact total collections were actually more than $8.7 billion. After much analysis by ATRA and the Bureau, it was found that the $628 million collected from the education sales tax was entirely omitted from the reported state level tax collections. Excluded from the local sales taxes was the $246 million generated from the Maricopa County road tax and approximately $60 million levied by the city of Phoenix that is dedicated to the Phoenix Civic Plaza. Still in question is approximately $320 million in local sales taxes, which is currently being researched by the Bureau.

In addition to excluding almost $1.3 billion in sales taxes, a substantial amount of revenue collected under the vehicle license tax (VLT) was not reported to the Bureau. According to the FY 2006 tax data reported by the Census Bureau, Arizona ranked 48th in the amount it levies in VLT compared to other states. ATRA found that of the $831 million in VLT that was actually levied in FY 2006, approximately $485 million (60% of the total) was not reported.

The reason for the inaccurate numbers reported by the Bureau is that unlike most states that consider the numbers reported by the Census to be important, the data collection and reporting process for Arizona is not taken as seriously. Reportedly, when the Census

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CENSUS BUREAU STATISTICS, *Continued from page 4*

Bureau began collecting state and local finance data, no state level entity in Arizona agreed to take on the responsibility to annually report the data. By default, that responsibility fell to Arizona State University where one ASU professor and a few assistants attempt to report Arizona's complicated web of tax and expenditure data to the federal government.

In the meantime, the Census Bureau has adjusted the FY 2006 state level tax collections by $1.1 billion to account for the missing VLT and Education Sales Tax. Although the Bureau is continuing to research the omission of the $320 million in taxes at the local level, the adjustments to account for the missing Maricopa County road tax and City of Phoenix sales tax should be reflected in the Census Bureau state and local reports by this summer.

As a result of the corrections made by the Census Bureau solely at the state level (VLT and education sales tax), Arizona's state and local ranking rises from 39th to 34th in total tax collections per capita and 22nd per $1,000 of personal income. The per capita ranking climbs even further to 32nd upon recognizing the missing tax revenues at the local level (Maricopa County road tax and Phoenix sales tax) and 19th per $1,000 of personal income. Adjusting for the $320 million that remains in question causes Arizona's ranking for total tax collections to jump up to 15th per $1,000 of personal income.

ATRA believes that if lawmakers and policy advisors are going to rely on the Census Bureau reports when making decisions concerning Arizona's tax policy, it is necessary that the data be as accurate as possible. The Legislature should assign the responsibility to the Joint Legislative Budget Committee or a similar agency to work closely with the Bureau in providing accurate data so that the information reported in the future can be used with a greater level of confidence.

Jennifer Schuldt