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ARIZONA TAX RESEARCH ASSOCIATION

NEWSLETTER VOLUME 71 NUMBER 2 FEBRUARY 2011

Recession drove down tax collections, not public payrolls

Arizona has struggled through historic budget challenges at the state and local level for the last three years. ATRA has offered a myriad of recommendations to balance budgets through eliminating unnecessary programs, streamlining services, as well as changing the many formulas that drive the current services budgets of Arizona governments.

Many have called for state and local governments to simply adopt the spending plans that were in effect before state and local revenues skyrocketed in the middle of the decade. On-going state revenues for Fiscal Year (FY) 2011 are close to on-going spending in FY05. While that type of roll back sounds easy from a conceptual standpoint, there are complications that stand in the way. However, it is important to understand where the majority of the tax revenue was appropriated as the Arizona economy roared back after the recession following 9-11.

In Arizona, total state and local tax revenues skyrocketed between FY04 and FY07. Total tax revenues climbed $6.8 billion over that period, a 42% increase. While that revenue growth funded new policy initiatives and some tax relief, the largest single beneficiary of the boom times were public employees. Over those three years, state and local payroll climbed $2.2 billion or 24%. In addition, employer contributions to the various retirement programs also jumped dramatically, climbing $503 million (111%) over that same period.

Regrettably, the three years of explosive tax revenue growth between FY04 and FY07 was followed by a historic decline in the following three years. Unbelievably, between FY07 and FY10, state and local tax revenues fell $3.6 billion (15%). Interestingly, state general fund revenue losses of $3.4 billion actually account for all of the state and local decline during that time period as many local governments raised taxes to

See **Public Payrolls,** page 3

Governor Signs Arizona Competitiveness Package

Provides Business Tax Cuts/Reforms

Last week, the Governor signed the Arizona Competitiveness Package (HB2001) into law, which is designed to trigger economic growth in Arizona by providing tax incentives to certain qualified businesses and tax cuts to all businesses, Most of the benefits associated with the tax cuts won't be realized for a few more years since the cuts are phased-in upon the expiration of the temporary sales tax (Prop 100).

HB2001 replaces the Department of Commerce with the newly created Arizona Commerce Authority (ACA). The ACA is funded with $35 million from the state general fund, $25 million of which is provided to the Arizona Competes Fund to provide "deal-closing funds" to qualifying businesses. Additionally, the bill allows the Enterprise Zone Program to sunset; however, new income tax and premium insurance tax credits are created in the amount of $3,000 for net new jobs created, which can be claimed for three years, capped at 400 jobs in each year. The legislation also provides for an additional tax credit for research and development (R&D) of 10% for university-related research, subject to an annual aggregate cap of $10 million.

Business Property Tax Assessment Ratio Reductions

The Governor's Competitiveness Package includes an ATRA legislative proposal (SB1163) that was sponsored this year by Senator Steve Yarbrough to reduce the assessment ratio on class 1 (business) property to 18%. Whereas SB1163 would have reduced the assessment ratio by one percent each year beginning in tax year 2012, HB2001 requires that the assessment ratio be reduced by a half percent each year beginning in tax year 2013 to 19.5%, which continues to drop until it reaches 18% in tax year 2016. Additionally, the assessment ratio in class 2 (agricultural property) is reduced from the current assessment ratio of 16% to 15% in tax year 2016. Furthermore, the bill requires the Department of Revenue to annually adjust the homeowner rebate between tax years 2013 and 2016 in order to offset the shift in tax liability to owner-occupied homeowners.

Business Personal Property

Arizona statutes provide additional depreciation on business personal property, which is commonly referred to as "accelerated" depreciation, for the first five years. In an effort to encourage businesses to purchase new equipment, the bill increases the additional depreciation by 5% in each of the five years.

See **Package,** page 3

Avg. Annualized Payroll of Public Employees

State	2009 Avg. Salary	Avg. Salary Rank	State	Avg. Salary as % of per capita income	Rank
California	$65,604	1	California	169.0%	1
New Jersey	$62,298	2	Michigan	167.7%	2
Connecticut	$59,845	3	Nevada	160.7%	3
New York	$59,387	4	Utah	159.4%	4
Alaska	$59,219	5	**Arizona**	**158.9%**	**5**
D.C.	$59,132	6	Washington	153.3%	6
Washington	$58,688	7	Oregon	152.8%	7
Maryland	$58,040	8	Alaska	151.6%	8
Nevada	$56,872	9	Rhode Island	149.8%	9
Massachusetts	$56,626	10	Ohio	146.6%	10
Rhode Island	$56,325	11	South Carolina	142.5%	11
Illinois	$52,888	12	Iowa	142.3%	12
Michigan	$52,331	13	Idaho	142.0%	13
Minnesota	$52,169	14	Wisconsin	142.0%	14
Hawaii	$52,146	15	Illinois	139.2%	15
Colorado	$50,060	16	New York	137.9%	16
Oregon	$49,988	17	Indiana	137.6%	17
Delaware	$49,868	18	Florida	137.5%	18
Pennsylvania	$48,476	19	North Carolina	137.5%	19
Arizona	**$48,008**	**20**	New Mexico	137.2%	20
Iowa	$47,950	21	Minnesota	136.9%	21
Wisconsin	$47,941	22	D.C.	136.6%	22
Florida	$47,647	23	Georgia	135.8%	23
Ohio	$47,580	24	Hawaii	135.3%	24
Wyoming	$46,515	25	New Jersey	135.0%	25
Virginia	$46,446	26	Alabama	134.9%	26
Vermont	$46,070	27	Montana	134.1%	27
New Hampshire	$45,225	28	Arkansas	133.7%	28
Utah	$45,147	29	Kentucky	133.7%	29
Nebraska	$43,632	30	Pennsylvania	133.5%	30
North Carolina	$43,440	31	Mississippi	133.3%	31
Texas	$43,235	32	Colorado	132.0%	32
Indiana	$42,569	33	Maryland	131.1%	33
North Dakota	$42,369	34	Vermont	130.5%	34
Maine	$42,285	35	Tennessee	130.3%	35
Louisiana	$42,213	36	West Virginia	130.1%	36
Georgia	$42,066	37	Louisiana	129.6%	37
Montana	$41,822	38	Texas	129.2%	38
South Carolina	$41,557	39	Maine	125.5%	39
New Mexico	$41,516	40	Nebraska	124.9%	40
Idaho	$41,206	41	Massachusetts	123.8%	41
Alabama	$40,941	42	Missouri	123.4%	42
Kansas	$40,760	43	Oklahoma	121.4%	43
Tennessee	$40,736	44	Connecticut	119.6%	44
Missouri	$40,387	45	Kansas	117.2%	45
Oklahoma	$39,285	46	North Dakota	116.9%	46
Arkansas	$39,187	47	Virginia	115.4%	47
Kentucky	$39,089	48	New Hampshire	115.1%	48
West Virginia	$38,444	49	Wyoming	111.0%	49
South Dakota	$37,307	50	South Dakota	110.1%	50
Mississippi	$36,816	51	Delaware	97.7%	51

Source: U.S. Census Bureau

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Published 10 times annually by the Arizona Tax Research Association, a nonprofit organization whose purpose is to promote efficiency and economy in Arizona government and reductions at all levels. Permission to reprint is granted to all publications giving appropriate credit to the

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PUBLIC PAYROLLS, *Continued from page 1*

offset their revenue losses.

However, the relationship that existed between revenue and salary growth between FY04 and FY07 failed to repeat when revenues plummeted between FY07 and FY10. In fact, as the recession dried up tax revenue, public payrolls actually continued to climb between FY07 and FY08, and again in FY09. It was not until FY10 that there was a small (3.5%) decrease in public payroll. Over the three-year period between FY07 and FY10, payroll climbed $534 million (5%) as revenues fell $3.6 billion.

For the last three years, ATRA has repeatedly reminded policymakers that state and local government budgets are largely composed of the salaries and benefits of public employees. As ATRA's research demonstrates, when the economy expands and tax revenues increase, salaries and benefits climb as well. However, when the economy contracts, or worse when we experience a historic recession, those payrolls remain and even expand in some instances.

Last year, ATRA pointed out that the extraordinary growth Arizona experienced in the last thirty years drove huge increases in state and local tax revenue, the majority of which went to fund public payrolls and benefits. In fact, after controlling for population and inflation growth, Arizona state and local taxes climbed 36% from 1980 to 2010. As a result, the average salaries for Arizona public employees rank high in comparison to other states. The most recent data from the U.S. Census Bureau pegs Arizona's average salary for 2009 at $48,008. At the average salary of $48,008, Arizona ranks 20th nationally. However, as the table on page 2 shows, when each state's average annual salary is expressed as a percentage of the state's per capita income, Arizona ranks 5th nationally.

Regrettably, when state and local policymakers debate budget reductions, they often focus first on services that are important to the general public. Rarely are across-the-board reductions in payroll considered. If they are finally considered, it is usually only in reaction to extraordinary budget deficits like the State of Arizona has experienced. Clearly, reducing payroll is rarely a popular or easy decision for elected officials. However, if Arizona is truly going to meet its on-going budgetary challenges at both the state and local levels, we have to at least be honest about where all the money is.

PACKAGE, *Continued from page 1*

In addition, HB2001 changes the inflation index that is currently used to adjust the existing $50,000 exemption for personal property used for business or agricultural purposes. Instead of adjusting the exemption by the GDP Price Deflator, the Department of Revenue will be required to use the Employment Cost Index (ECI). The current inflation-adjusted exemption is $67,268, and according to a fiscal note prepared by the Joint Legislative Budget Committee, changing the inflator to the ECI is expected to increase the exemption $600.

Corporate Income Tax

Arizona ranks 26th out of the 45 states that have a corporate income tax. Included in HB2001 is a phased-down reduction in the corporate income tax rate over four years that will improve Arizona's average ranking. Beginning in tax year 2014, the existing corporate income tax rate of 6.968% is incrementally reduced until it reaches 4.9% in tax year 2017. The significance of reducing the corporate income tax rate to 4.9% is to bring the corporate income tax rate in line with the highest individual income tax rate of 4.54%. Once fully implemented, Arizona's corporate income tax rate will be more comparable to its border states: Colorado (4.63%); Utah (5%); New Mexico (4.8%-7.6%); and California (8.84%) (Nevada does not have a corporate income tax).

In addition to the reduction in the corporate income tax rate, the elective sales factor for multistate corporations is increased to 100% over a four-year period. The current structure under the corporate income tax apportions income for multistate corporations between property (25%), payroll (25%), and sales (50%). However, corporations have the option to elect a super-weighted sales factor in which the corporation may allocate 80% to sales, with 10% each to property and payroll. HB2001 increases the current elective 80% sales factor 5% each year beginning in tax year 2014 until it reaches 100% in tax year 2017. The purpose of allowing multistate corporations the option to elect a single sales factor is to encourage business to expand plant and payroll in Arizona.

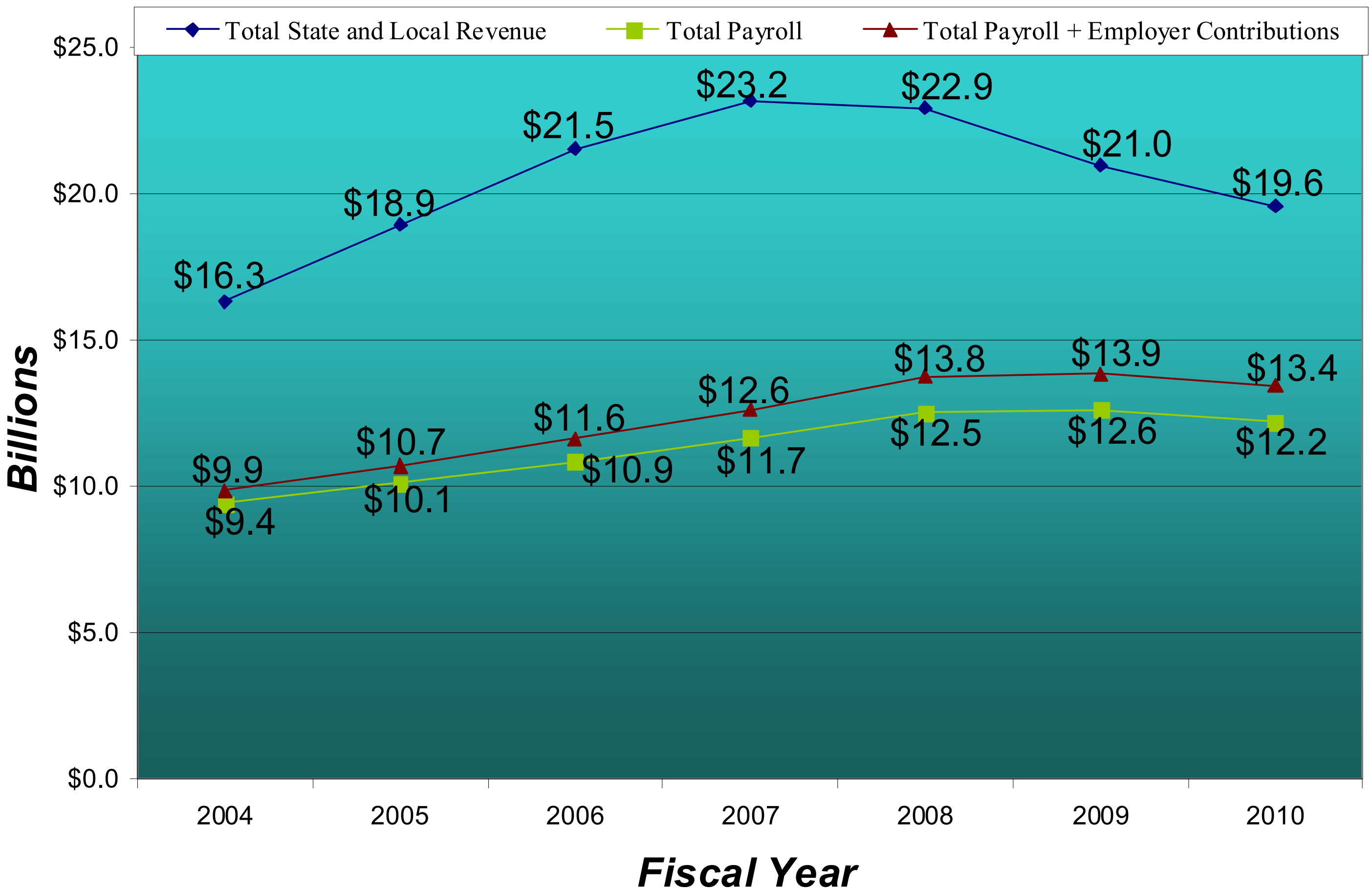
Residential Property

The bill also includes a reform to the state's current practice of subsidizing owner-occupied homeowner property taxes. Over the past two years, there has been much debate regarding how to reduce the state general fund impact of the homeowner rebate. Property assessed under class 3 consists of owner-occupied residential property and residential property not listed under any other class, which receives a 40% rebate on school district primary property taxes, not to exceed $600 for any property. Residential property that is rented is classified under class 4 and does not receive the homeowner rebate. As a result of residential property defaulting to class 3, the state general fund subsidizes residential properties that were never intended to receive the homeowner rebate, such as bank-owned property.

In an attempt to control the costs associated with the homeowner rebate, HB2001 limits property that may be included under class 3 to an owner's primary residence or a residence that is rented to the owner's relative and used as the relative's primary residence. Beginning in tax year 2012, the county assessor is required to send an affidavit with the notice of valuation to every residential property owner in each even-numbered year and the owner must declare, under penalty of perjury, whether the residence should be listed under class 3. Property that does not meet the criteria is reclassified under class 4.

Total State & Local Revenue, Payroll, & Employer Retirement Contributions

(FY 2004 * FY 2010)



FY '04 - FY '07
- Total taxes increased $6.8 billion (42%)
- Payroll increased $2.2 billion (24%)
- Total payroll and employer contributions increased $2.7 billion (28%)

FY '07 - FY '10
- Total taxes decreased $3.6 billion (15%)
- Payroll increased $534 million (5%)
- Total payroll and employer contributions increased $819 million (6%)