

*The taxpayer's watchdog for over 60 years*

# ARIZONA TAX RESEARCH ASSOCIATION

## NEWSLETTER

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# ATRA's 2004 LEGISLATIVE PROGRAM

ATRA's Board of Directors announced its program for the 2004 legislative session at its January meeting.

The passage of the fiscal year (FY) 2005 State Budget will again dominate the legislative session. ATRA staff has made specific recommendations to the legislature on options available to reduce spending. While increased economic activity is improving state tax collections, state policymakers' reluctance to restrain

spending will again create pressure to balance the budget through gimmickry and debt financing. ATRA will focus its efforts on ensuring that the FY 2005 budget reduces the State's structural deficit (see commentary below).

## TAX REFORM

Both the Governor's Citizens Finance Review Commission (CFRC) and the Legislature's Tax Reform for Arizona Citizens

(TRAC) Committee have generated proposals for changes to Arizona's tax system. ATRA staff presented recommendations for reform to both committees during the summer and fall. Considerable time and effort will be spent during the 2004 session both in support and opposition to various tax changes.

See **ATRA's 2004 LEGISLATIVE PROGRAM** on page 2.

## CAPITOL CASTINGS:

### *The case that wouldn't die*

by Steven R. Partridge, *Fennemore Craig*

On January 15, 2004, the Arizona Supreme Court heard oral arguments in the case of *Arizona Department of Revenue v. Capitol Castings, Inc.* There are many noteworthy aspects of this litigation, not the least of which is the rare occurrence where the Arizona Supreme Court will even accept a tax case.

Unlike the Court of Appeals, which must accept all appeals of civil or criminal trial decisions, the Supreme Court only accepts cases it wants to hear. Generally, less than 4% of the Petitions for Review filed with the Supreme Court are granted by that court. For calendar year 2002, 400 petitions for review were filed in civil cases. Only about a dozen petitions were selected by the court for review.

Although there are no guarantees in litigation, in most cases, when the Supreme Court accepts a case for review, that generally

See **CAPITOL CASTINGS**, page 4

## STATE BUDGET DEFICIT CONTINUES

*Commentary: Kevin McCarthy*

Arizona's on-going budget deficit remains severe and will not be solved without tough decisions and real leadership from state policymakers. The standard practice in recent years of supporting higher government spending — while at the same time opposing tax increases to fund it — drives the state deeper into debt.

Opposition to raising taxes on a recovering economy is laudable. However, opposition to raising taxes is no assurance that the budget deficit will be closed through spending reductions. The State's FY 2004 budget serves as a perfect example of the extent to which state policymakers will go to meet spending demands. Instead of biting the bullet and bringing spending back in line with revenue, the structural deficit was closed primarily through a combination of debt financing, budget gimmicks, and fund transfers.

This year, the State's improving economy is expected to provide dramatic growth for state revenues. Both the Governor and the

Joint Legislative Budget Committee (JLBC) estimate new base revenues of \$850 million over the FY 2004 budget adopted in June 2003. However, despite dramatic revenue growth, the Governor's budget fails to reduce the overall structural deficit from FY 2004 (see charts on page 5).

Governor Napolitano's FY 2005 budget calls for a dramatic increase in spending with operating budgets up \$772 million (11.9%) over the FY 2004 budget adopted in June 2003. While the initial JLBC FY 2005 budget reduces the deficit, it is also being viewed as an incomplete budget that will likely see ramped up spending as the appropriations process heats up.

## GIMMICKRY & DEBT FINANCING

State policymakers have sidestepped spending cuts or tax increases with a variety of budget gimmicks and debt financing. Even if the Legislature does not incur any more general fund debt obligations than it

See **STATE BUDGET DEFICIT**, page 3

# ATRA's 2004 LEGISLATIVE PROGRAM

## TAXATION

### Property Tax

**Property Tax Increases:** Arizona's top tax problem continues to be high business property taxes. ATRA will oppose increases in property taxes that exacerbate that problem.

**Assessment Ratios:** Pursue legislation to address the inequity between business and residential taxpayers for all *future* voter-approved secondary taxes. This measure — HB2264 (Huffman) — reduces the assessment ratio for class one property (business) to 20% while setting the ratio for all other properties at 10%. Another bill, HB2263 (Huffman) reduces the assessment ratio on class one property from 25% to 24% for both primary and secondary taxes.

**State Truth-in-Taxation (TNT) Compliance:** The state TNT law requires the Legislature to adjust the qualifying tax rate (QTR) and county education equalization rate to offset changes in net assessed value (NAV). ATRA staff will work to ensure the FY 2005 state budget adopts the TNT rates for tax year 2004.

**Truth-in-Taxation; Public Vote:** Pursue legislation to require counties, cities & towns, and community colleges to receive voter approval in a May special election prior to levying primary property taxes in excess of the TNT limit. *HB2269 (Huffman)*

**Publication of tax data:** Pursue legislation to require counties to separately state tax rate and levy information for the following: Class A bonds, Class B bonds, M&O overrides, K-3 overrides and capital overrides.

### School Finance

**Desegregation/OCR Spending & Taxation:** Desegregation taxation in 19 Arizona school districts results in major problems for taxpayers in those districts and creates

significant equity problems across school districts. ATRA will pursue legislation to continue the cap that sunsets this year on desegregation budgets and taxation. ATRA will also support further efforts to reform Deseg/OCR laws. (See article on page 4 of this *Newsletter*.) *HB2268 (Huffman) and HB2265 (Huffman)*

**Excess Utilities:** Pursue legislation to continue the two-year cap on excess utilities, which are funded by primary property taxes, that sunsets this year. Pursuant to Prop. 301, school districts the excess utilities statute will expire on June 30, 2009. *HB2092 (Boone)*

**Tax Rate Cap/1% Districts:** Pursue legislation to cap the primary tax rates of school districts with a combination of 50% or more of their residential value at the one-percent constitutional cap on primary taxes and a K-12 primary rate exceeding 150% of the qualifying tax rate (QTR). Enforcement would be given to the Property Tax Oversight Commission (PTOC). *HB2160 (Huffman)*

### Sales Tax

**Sales Tax Exemptions:** Oppose efforts to make wholesale changes to the state's sales tax base through the elimination of exemptions or expansion of the sales tax base.

### Corporate Income Tax

**Sales Factor Allocation:** Support increases in the sales factor allocation provided there is an election for taxpayers to continue paying at the current percentages. *HB2270 (Huffman) and SB1143 (Verschoor)*

## PUBLIC FINANCE

**Students FIRST Reform:** ATRA has made several recommendations to reform Arizona's school capital finance system which remains a serious problem for taxpayers at both the state and local level.

(See article on page 3 of this *Newsletter*.) For more information on ATRA recommendations, contact the ATRA office or visit [www.arizonatax.org](http://www.arizonatax.org).

**Taxpayer's Bill of Rights Clarifications/Reforms:** Pursue legislation making several changes to improve taxpayers' rights, including: the definition of "affected class" in disputed sales tax cases and set time limits on the duration of audits and require documentation of audit results. *(Leff)*

**Community College Revenue Bonding:** Pursue legislation creating accountability for the colleges' use of revenue bonds. Unlike other municipal entities, community college revenue bonds do not require voter approval. Long term debt obligations of this sort impact college districts' general funds and, therefore, property taxes. *HB2161 (Biggs) and HB2254 (Boone)*

**Community College Dual Enrollment:** Support legislation that addresses redundant funding for colleges offering credit to high school students taking courses at high schools from high school teachers. *HB2391 (Gray, C)*

**Study Committee on State Debt:** Support the creation of a legislative study committee on state level debt, state debt financing mechanisms, and possible changes to the state's constitutional debt limit. *SB1150 (Burns)*

**Influencing elections/publicity pamphlets:** Pursue legislation that eliminates the use of pro/con statements in publicity pamphlets as well as require jurisdictions to have pamphlets approved by their respective county attorneys before distribution to the voters to ensure, as required by law, that they contain no bias. All too often, election publicity pamphlets are nothing more than taxpayer-financed campaign mailers. (See article on page 6 of this *Newsletter*.) *HB2111 (Huppenthal)*

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# STATE BUDGET DEFICIT CONTINUES

*Continued from page 1*

has currently, the annual debt service will exceed \$100 million by FY 2008 and \$150 million by FY 2013 (see the bar chart below).

Both the Governor's and JLBC's FY 2005 budgets call for another round of debt financing for new school construction of \$250 million. However, the Governor calls for another \$315 million in debt financing for school deficiency corrections, the Ladewig settlement, prisons, and cash through a state compensation fund sale leaseback. The Governor also generates more one-time "solutions" to the deficit though an increase to the K-12 rollover (\$100 million), a raid on vehicle license tax revenues (\$118 million), and fund transfers (\$33 million).

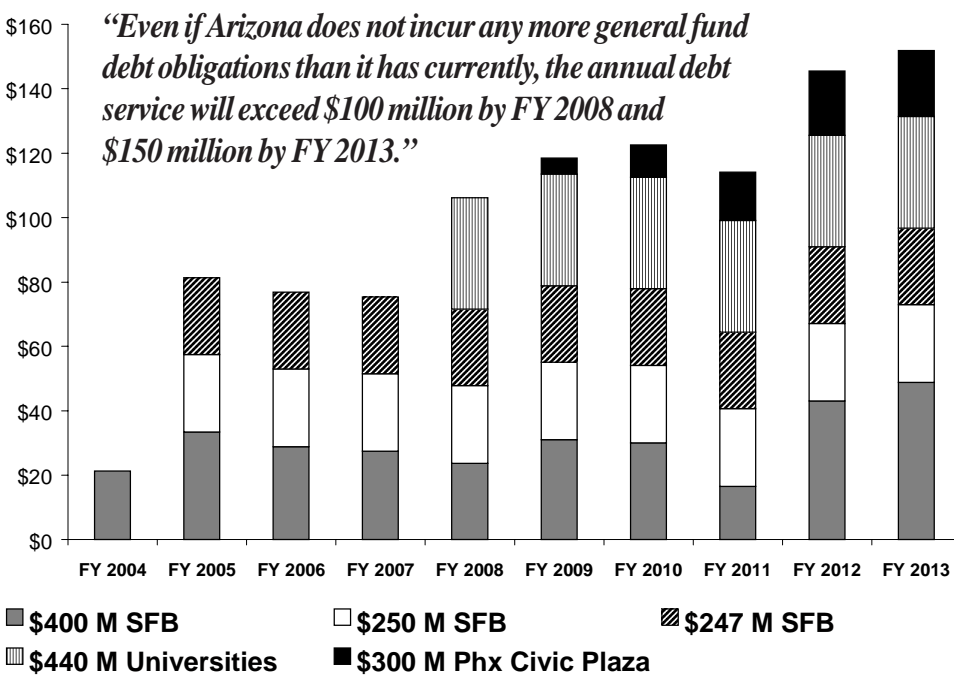
## We now have three mortgages

The debt financing for school construction has been rationalized to the public as being akin to mortgaging a new home. This, no doubt, rings true for many citizens who understand the reasons for debt financing a major one-time capital purchase like a new home. However, there are no similarities between home financing and the

State's current debt financing for school construction. Most notably, new school construction is an **annual** expense that clearly should be financed on a cash basis. The fact that the annual debt service payments will exceed the annual amount being financed in the near future should demonstrate the fiscal insanity of this approach.

In addition, most homeowners secure a home mortgage because they have the income to make the monthly mortgage payments. State government has financed new school construction precisely because they do not have cash. If the State's financing for school construction compares to home financing, we have purchased three homes with no money to pay the three mortgages.

Dramatic revenue growth provides the State an excellent opportunity to grow its way out of the current fiscal crisis. However, making easy short-term decisions and punting tougher ones to the future will be a huge missed opportunity.



# School district bond debt since Students FIRST hits \$1.2 billion

*Voters in eight districts approve \$403 million this November*

School district elections last November resulted in voter approval for \$403,010,000 new general obligation (G.O) bonds. This brings to \$1,179,928,000 the total G.O. bonds approved since Students FIRST legislation adopted in 1998 placed school construction and repair responsibilities at the state level.

\$205 million of the bonds approved in 2003 were in the Phoenix Union High School District. The next highest amount approved was in the Glendale Union High School District where voters passed \$80 million in bonds. Voters in Cave Creek Unified rejected a \$15 million bond question.

Of the 11 school districts holding capital override elections last November, voters in six districts approved a total of \$12.7 million in annual property tax override levies. The remaining five districts rejected \$38.3 million.

This recent bond activity yet again brings into question the claims that passage of Students FIRST would result in the "biggest property tax cut in Arizona history." The \$403 million in G.O. bonds is only 11 percent less than the 10-year bond building expenditures average between FY 1991 and FY 2000.

## G.O. Bond Election Results, November 2003

Cave Creek Unified	\$15,000,000	Fail
Fowler Elementary	\$10,000,000	Pass
Glendale Elementary	\$24,725,000	Pass
Glendale Union	\$80,000,000	Pass
Higley Unified	\$31,300,000	Pass
Phoenix Union	\$205,000,000	Pass
Snowflake Unified	\$6,300,000	Pass
Stanfield Elementary	\$1,685,000	Pass
Tolleson Union	\$44,000,000	Pass
<b>Total Passed</b>	<b>\$403,010,000</b>	

## CAPITOL CASTINGS

*Continued from page 1*

means they are going to alter the decision of the Court of Appeals. The other noteworthy aspect of the case was the excellent preparation all five justices demonstrated during the proceedings.

Capitol Castings was represented by ATRA board member Barbara Dawson and Charlie Pulaski from the law firm of Snell and Wilmer.

The *Capitol Castings* case relates to an extremely important provision of Arizona's tax code: the exemption from the transaction privilege tax for machinery or equipment used directly in manufacturing. A.R.S. § 42-5061(B)(1). This issue has been relatively quiet since the Court of Appeals decision in *Duval Sierrita Corp. v. Arizona Department of Revenue* in 1977. There has been very little controversy over what a machine is, what is manufacturing or what is direct use. That all changed in 1998, when the first *Capitol Castings* decision was handed down by the Court of Appeals.

For the sake of brevity, I will not detail the facts or findings of that court. Suffice it to say, the court held that certain sand molds used by *Capitol Castings* were expendable and therefore not subject to exemption as machinery. In response to this decision, in 1999 the Arizona Legislature amended these statutes to make it clear that exempt machinery would retain its exemption, "regardless of the cost or useful life of that property." This legislation was passed as a direct result of the efforts of ATRA on behalf of the business community. If you thought this was the end of the controversy, you would be wrong.

Here is where things get confusing. The original *Capitol Castings* decision was sent back to the Tax Court to resolve several procedural issues. The case bounced around the Tax Court for several years, and spanned the occupancy of the Tax Court bench by two different judges. When the case proceeded back to the Court of Appeals, ATRA, recognizing the significance of the case, filed an *amicus* brief supporting the position of Capitol Castings.

In what can only be described as one of the more bizarre judicial twists, instead of

clarifying or reversing the original *Capitol Castings* decision, the second panel of judges issued a decision that was, at the least, convoluted, and at the worst, a complete nightmare for the taxpayers. It is difficult to even summarize the decision.

In a nutshell, the courts ruling would limit the machinery or equipment exemption to machines that were purchased from a retailer and were brought into Arizona in one piece. If a machine was constructed by a business because it was not otherwise available or if it was so large it needed to be shipped in several pieces, the application of the decision would have rendered that machine taxable.

Another example of the illogical consequences of the decision was the acknowledgment by the Attorney General representing the Arizona Department of Revenue that a machine is, indeed, composed of its component parts. Nevertheless, the Department of Revenue stated that the component parts were not the machine. It is hard to conceive of a machine without its component parts. The potential result of this decision would be a substantial increase in litigation over this issue and its new variations.

The only recourse was to file a Petition for Review with the Arizona Supreme Court. ATRA filed an *amicus* brief with the Arizona Supreme Court in September. If the Supreme Court was happy with the two attempts by the Court of Appeals, over a five-year period, to resolve this issue, it is unlikely the court would have granted the Petition for Review. It is also hard to imagine that the Supreme Court could make the decisions of the Court of Appeals worse. The optimistic conclusion is that the Supreme Court is going to correct these decisions. Hopefully, it will be in support of the taxpayers of Arizona and ATRA, and will create a degree of stability in this issue for the future. However, with courts, like gambling, you never know until the dice stop rolling.

**Steven Partridge, an attorney with Fennemore Craig, was formerly an Assistant Director for the Arizona Department of Revenue. Steve is currently serving on ATRA's Board of Directors.**

## Sunset review panel recommends extension of deseg/OCR freeze

A legislative sunset review committee of reference voted on November 6 to recommend extending the current two-year cap on school district property taxes for desegregation (deseg) and agreements with the U.S. Department of Education's Office for Civil Rights (OCR).

The current cap, established by HB 2550 (Huffman) in 2002, froze deseg/OCR levies at FY 2001-2002 levels until FY 2003-2004. Unless the Legislature takes action to the contrary, the cap sunsets June 30, 2004. The 19 school districts currently using this levying authority would again have unlimited access to property taxes. Other districts with OCR agreements would also be allowed such authority.

The Joint Legislative Budget Committee had estimated that the two-year freeze in HB 2550 would save the general fund approximately \$15 million in costs associated with the 35% homeowner rebate and the constitutional one-percent cap.

Meanwhile, primary property tax rates decreased in nearly all the 19 deseg/OCR districts, in large measure attributable to the two-year freeze.

Any such continued relief to taxpayers or the general fund is likely to disappear if the cap is not extended.

Legislators on the committee of reference voting to extend the cap were Representatives Linda Gray, Tom Boone, and Warde Nichols, and Senators Mark Anderson and Jim Waring.

Voting against the recommendation were Senators Slade Meade, Richard Miranda, and Harry Mitchell, and Representative Ted Downing.

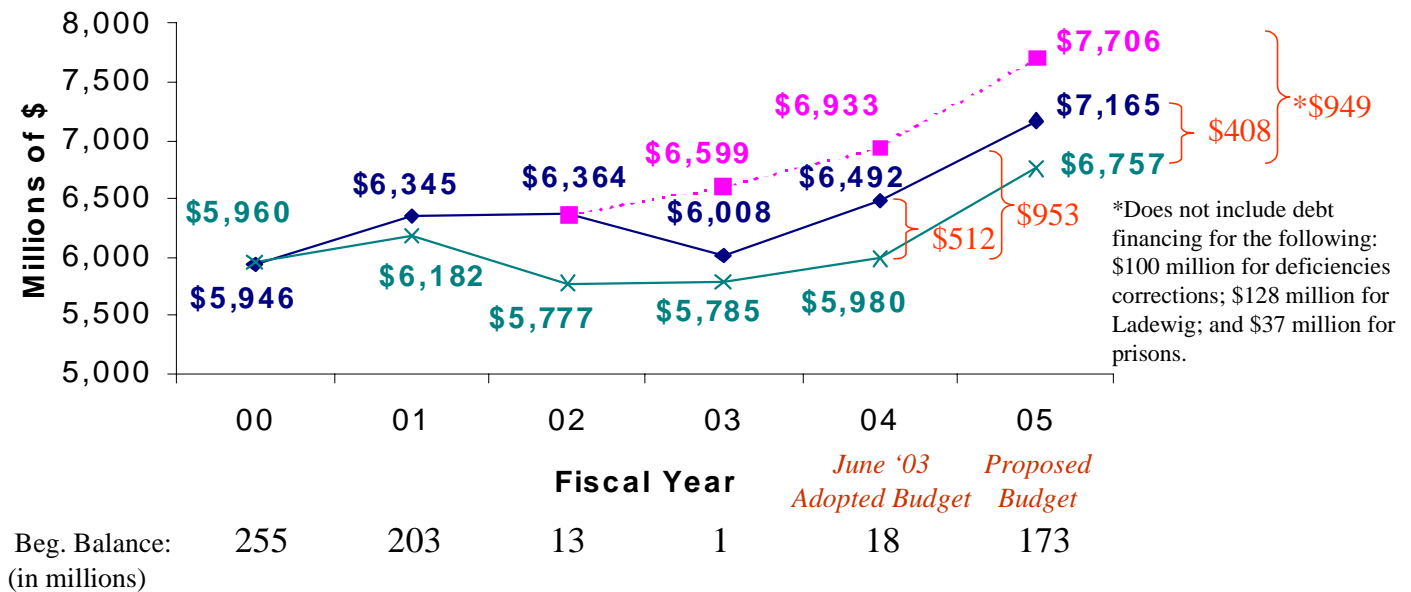
Representative Steve Huffman has introduced HB2268 this session to extend the cap for another two years. In addition, he has introduced three other bills to reform deseg/OCR spending authority and reporting requirements.

# Arizona's Ongoing General Fund Deficit

*Excludes beginning balance, one-time revenues & expenditures, & Prop. 301*

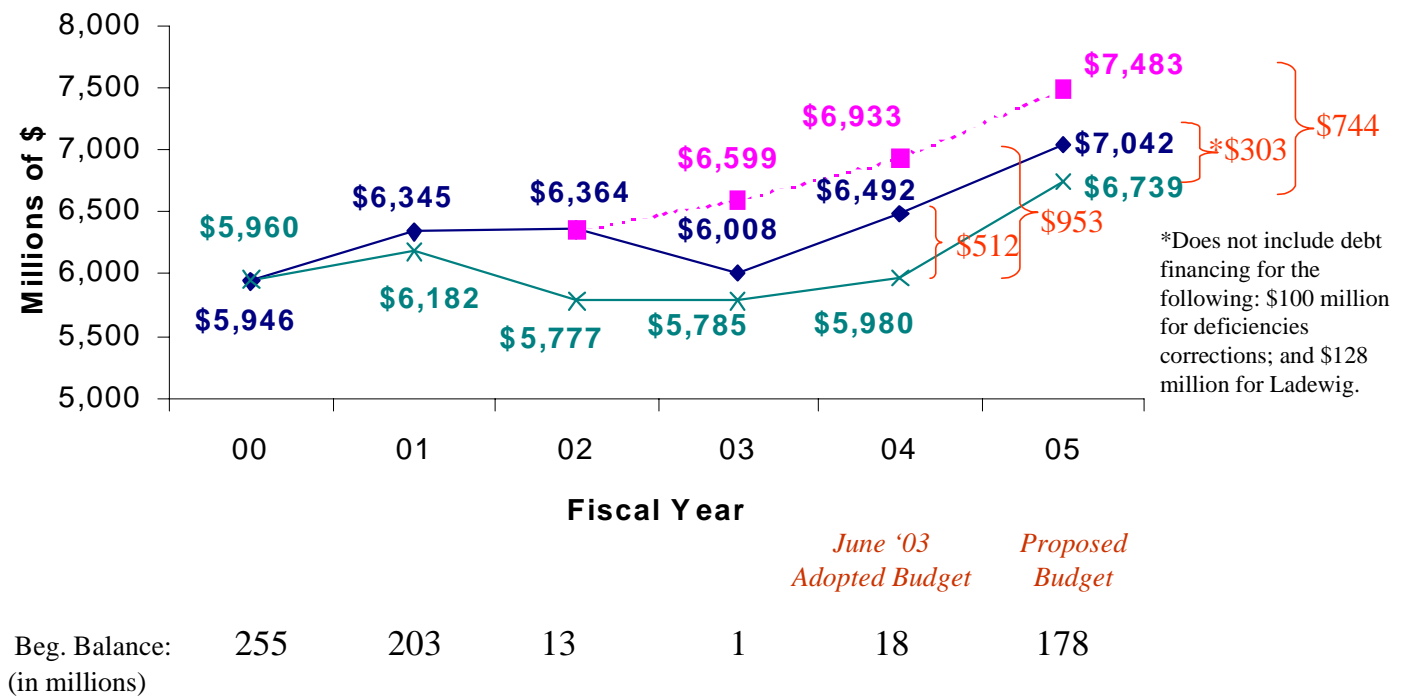
- ◆ Expenditures
- Expenditures (Includes K-12 rollover & SFB debt financing)
- × Base Revenues

## Governor's Proposal



Beg. Balance:	255	203	13	1	18	173
(in millions)						

## JLBC's Proposal



Beg. Balance:	255	203	13	1	18	178
(in millions)						

Data source: JLBC

## Cities to taxpayers: “Let them eat cake”

That government leaders can sometimes demonstrate a bit of arrogance in their attitude toward taxpayers will likely come as no surprise. However, even the most experienced government watchdogs among ATRA’s staff and membership were given momentary pause by some very telling statements made recently by prominent municipal leaders.

Arizona’s **League of Cities and Towns**, in a newsletter article expressing opposition to a bill supported by ATRA, let taxpayers know in no uncertain terms how little regard they have for those who pay their bills.

The bill that is causing the League so much consternation, HB 2111, is a response to the fact that, all too often, election publicity pamphlets are nothing more than taxpayer-financed campaign mailers.

Sponsored by Representative John Huppenthal, HB2111 would simply require county attorneys to ensure that the information in the taxpayer-funded pamphlets is, as required by law, unbiased.

After noting that ATRA is behind the legislation, the League asks:

*“Are they perhaps just really upset at the approval rate of bond elections which cost their members property tax?”*

Another communication from a city leader also demonstrates that the cities have a system that works very well for them and that they will oppose any reforms that benefit taxpayers.

In response to a tax reform proposal to equalize assessment ratios between business and residential properties for *future* voter-approved bonds and overrides, Glendale Mayor **Elaine Scruggs**, who is also currently serving as president of the League, made clear she prefers a system that obfuscates the link between voters and the impact of their taxing decisions at the polls.

On behalf of both the City of Glendale and the League of Cities and Towns, she said that “Although we sympathize with the arguments of the business community on the assessment ratio issue, we cannot support the changes proposed.”

Mayor Scruggs continued:

*“Although we all recognize that in the final analysis the tax is passed down to the consumers of the business or industrial product or service, my constituents are saying that they prefer to pay these indirect taxes through their use of the product or service rather than directly.”*

Finally, Gilbert Mayor **Steve Berman**, who made a campaign promise not to raise taxes, gave taxpayers a peek at his hand when he told an *Arizona Republic* reporter about his desire to raise taxes once the town has successfully recruited several businesses, including dealers for a new auto mall.

The Republic quotes Mayor Berman saying:

*“Once we got them we can crank up the sales tax, and there’s nothing they can do about it. We’re in the courting stages.”*

Sound public policy development, and certainly tax reform, requires both leadership from all interested parties and statesmanship from policymakers. Taxpayers won’t hold their breath waiting for such virtues from the cities’ lobby.