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ARIZONA TAX RESEARCH ASSOCIATION

NEWSLETTER VOLUME 68 NUMBER 6 AUG 2008

ATRA Opposes TIME Initiative

Summary of key provisions:

The initiative calls for a one-cent increase in the state sales tax beginning January 1, 2010 through December 31, 2039. If passed, the monies will be spent on interstate highway improvements, passenger rail systems, local and regional roads, buses and light rail, transportation enhancements, and preservation of open space and wildlife habitat. The Arizona Department of Transportation (ADOT) estimates the tax will raise $43 billion over 30 years. ADOT's estimate is adjusted for inflation as well as interest associated with borrowing (5% annually). Using ADOT's growth estimates, the nominal dollars actually raised will be almost three times that estimate at $120 billion.

The initiative earmarks the revenue to the following five funds based on the following percentages:

- 55% - Highway Time Fund
- 18% - Rail Time Fund
- 29% - Local Transportation Purposes
- 4% - Transportation "Enhancements"
- 3% - Open Space and Wildlife Fund

The Highway TIME Fund (55%) is estimated to raise $23.42 billion ($66.3 billion in nominal dollars) over 30 years. The revenues in this fund are earmarked for interstate highway improvements, acceleration of state highway projects, improvements to facilitate wildlife movement, funding for public private partnerships, and any other transportation related purpose. TIME Fund monies can also fund additional employees, equipment, services, and facilities necessary to complete projects funded by the tax. The monies in the Highway TIME Fund will be under the control of the Director of the Department of Transportation and earmarked for projects in the following regions:

- 49% for projects located in Maricopa County
- 39% for projects in rural counties
- 12% for projects in Pima County

The Rail TIME Fund (18%) is estimated to raise $7.67 billion ($21.7 billion in nominal dollars) over the life of the tax and the revenues are earmarked for the following purposes: passenger rail systems of statewide significance; freight rail improvements that enhance passenger rail; direct distributions and state matching grants for projects that facilitate passenger rail systems including light rail; direct distributions and grants for programs that provide transportation of passengers along a roadway, including bus, Para transit, carpools, vehicle, rideshare etc. The Rail TIME Fund monies can also fund additional employees, equipment, services, and facilities necessary to complete projects funded by the tax.

The monies in the Rail TIME Fund that are passed through to the Maricopa and Pima County transportation authorities will be spent by those agencies. The remainder of the monies in the Rail TIME Fund is controlled by the Director of the Department of Transportation. The initiative calls for the creation of a Passenger Rail Project Committee for each passenger rail project. The committee of ten members will provide recommendations to the State Transportation Board. The Board will determine the projects designated to

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ATRA Supports Majority Rule Initiative

Summary of key provisions:

The initiative amends the Arizona Constitution to provide the following:

> To preserve and protect the right of the people to fiscal responsibility through true majority rule, an initiative measure that establishes, imposes or raises a tax, fee, or other revenue, or mandates a spending obligation, whether on a private person, labor organization, other private legal entity of this state, shall not become law unless the measure is approved by a majority of the qualified electors then registered to vote in this state.

Currently, any initiative that qualifies for the ballot becomes law if approved by the majority of votes cast on the measure.

ATRA Policy Issues:

Ballot-Box Budgeting

For decades, ATRA has expressed its opposition to ballot-box budgeting. Ballot-box budgeting refers to a variety of different efforts to establish state expenditure and taxation policy at the ballot instead of at the State Capitol.

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What's inside…

ATRA Supports Protect Our Homes Initiative

Summary of key provisions:

The initiative amends the Arizona Constitution to prohibit the following:

> The state, any county, city, town, municipality or other political subdivision of the state, or any district created by law with authority to impose any tax, fee, stamp requirement or other assessment, shall not impose any new tax, fee, stamp requirement or other assessment, direct or indirect, on the act or privilege of selling, purchasing, granting, assigning, transferring, receiving, or otherwise conveying any interest in real property. This section does not apply to any tax, fee, or other assessment in existence on December 31, 2007.

ATRA Policy Concerns/Issues:

During a time when the state is looking for creative ways to raise revenues, this constitutional provision would proactively prevent state and local governments from imposing such a tax. Arizona is one of 13 states that do not currently levy a real estate transfer tax.

Additionally, this initiative would limit government from increasing the existing tax burden on real property owners that are already required to pay property taxes annually, impact fees on new construction, sales tax on the construction and materials under the transaction privilege tax (TPT) prime contracting classification, and the speculative builder tax under the Model City Tax Code.

Property Taxes

Arizona businesses rank 5th in the country in the amount they pay in property taxes. According to a recent study published by the Minnesota Taxpayer's Association, an industrial property owner paying taxes in Arizona with $25 million in real property value and $25 million in personal property carries a tax burden of approximately $1.3 million. This annual tax liability results in a 2.529% effective tax rate (ETR), which is 1.039% higher than the national average of 1.490%.

Residential properties fare better than business properties in the same study. For a residence that is valued at $300,000, the annual property tax liability is $2,638 (ETR of 0.879%), ranking Arizona 38th. The national average ETR is 1.327%.

Development Fees

In state statute, counties and cities have the authority to assess development fees to offset the capital costs for water, sewer, streets, parks, public safety facilities or the cost of any service identified in an infrastructure improvements plan that is necessary for public services provided by the jurisdiction.

The only limitation on the amount of fees that may be assessed is that the fee must bear a reasonable relationship to the burden of capital costs imposed upon the county or municipality to provide additional necessary public services to the development. Fees are typically paid when construction permits are issued unless otherwise specified in a development agreement. The total revenue collected from development fees is unknown.

Transaction Privilege Taxes (TPT)

In addition to paying property taxes and impact fees, taxes are collected under the TPT prime contracting class. According to the prime contracting class, taxes are imposed on 65% of the prime contractor's gross receipts from a construction project.

The combined average TPT rate levied under the prime contracting class is 9.1%, with rates ranging from a low of 7.6% to a high of 11.3%. In FY 2007, total state tax collections under the prime contracting class amounted to $1.1 billion, representing 20% of total TPT collections of all the classifications. Collections by classification are not available at the city level but assuming the same percentage relationship as the state, collections under contracting at the city level are estimated at $477 million.

Speculative Builder Tax

The speculative builder tax is applied to the sale of "improved real property" that is sold prior to the completion of improvements or before the expiration of 24 months after the improvements are substantially completed.

The rate levied under the speculative builder tax is the same as the TPT retail rate levied by the city unless otherwise specified. The speculative builder tax is triggered by the sale of the improved property and the rate is applied to 65% of the gross income from the business activity as a speculative builder.

The total amount collected under the speculative builder class is not known; however, the average city retail rate is 2.4%, with rates ranging between 1.5% and 4%.

Other Policy Considerations:

Proponents of the real estate transfer tax no doubt see it as an effective and simple way to garner significant tax revenue from taxpayers who are unable to avoid or escape the tax. From an administrative standpoint, the tax could probably be implemented with minimal fiscal compliance and administrative costs. However, ease of administration, coupled with the opportunity to raise significant revenue on major real estate transactions, are not the criteria that should lead to the implementation of the tax.

One of the key criteria for judging a state and local fiscal system is

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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 Arizona Tax Research Association.

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efficiency, which is defined as follows:

> Avoid causing changes in economic behavior by keeping tax bases broad and marginal tax rates low. Tax individuals and businesses in relation to public services received, where appropriate.

Clearly, a real estate transfer tax in Arizona would be a new tax that is narrowly focused on a major transaction that has little relationship to public services received. In fact, any political attraction to the tax would be grounded in the fact that most citizens would not be impacted by the tax.

Another criterion for judging a state fiscal system is **stability,** which is defined as follows:

> Employ a system that does not produce wide swings in expenditures or revenues in response to economic cycles.

For a variety of reasons, Arizona's state and local fiscal system has been volatile over the last decade. Some of that volatility is the result of predictable fluctuations in the economic cycle. However, Arizona's reliance on tax revenues from the real estate industry certainly adds to the degree of instability in our system. As noted above, state and local governments receive a considerable amount of revenue from the real estate industry. With the exception of property taxes, most of these sources of revenues show significant fluctuation depending upon conditions in the real estate market. The addition of a real estate transfer tax would undoubtedly add to the volatility in our revenue system.

MAJORITY RULE, *Continued from page 1*

History has certainly vindicated ATRA's policy concerns with ballot-box budgeting. Regrettably, too many of the ballot-box budgeting efforts that ATRA has opposed have become law. The result is a state budget that has been complicated by initiatives and referendums that raise taxes, earmark funds outside the appropriations process, and prescribe and guarantee funding levels for a multitude of programs. Since 1998, the negative consequences of ballot-box budgeting were heightened by the passage of Proposition 105, the measure that limits the Legislature's authority to modify a voter approved initiative.

The following are the major efforts at ballot-box budgeting that ATRA has opposed:

- 1990 – Proposition 103 (ACE Initiative) guaranteed funding for K-12 schools
- 1990 – Proposition 200 (Heritage Fund) guaranteed funding for open space and parks
- 1992 – Proposition 108 (It's TIME) 2/3 vote to increase general fund revenue
- 1994 – Proposition 200 (Tobacco Tax and Health Care Act) raised the tobacco tax 40 cents and created guaranteed funding for health care
- 1996 – Proposition 200 (Drug Medicalization Act) earmarked luxury taxes on liquor to drug treatment programs
- 1998 – Proposition 200 (Clean Elections Act) diverted existing revenues and earmarked them for candidates for statewide office
- 2000 – Proposition 301 – half-cent sales tax increase for K-12 and mandatory spending obligations for student growth and inflation
- 2000 – Proposition 107 (Income Tax Repeal) would have eliminated state individual and corporate income taxes
- 2002 – Proposition 303 (Tobacco Tax/Health Care) referred by the Legislature, increased tobacco taxes 60 cents and earmarked funds for health care
- 2006 – Proposition 203 (Tobacco Tax/Early Childhood) increased tobacco taxes 80 cents and earmarked funding for early childhood programs
- 2006 – Proposition 106 (State Land) earmarked trust fund monies to the State Land Department

ATRA has supported several different efforts that attempted to reform the initiative process and restore some sanity to fiscal policy development at the state level. In 2004, ATRA supported two reforms, Proposition 101 and 104 that made small steps toward initiative reform. Fortunately, Proposition 101, which required a dedicated funding source for required expenditures, passed. ATRA also supported the more comprehensive initiative reform effort advanced by Rep. Kirk Adams in the last two legislative sessions. That experience left most participants very cynical about the prospects for comprehensive initiative reform. ATRA believes Majority Rule prescribes a specific initiative reform in the area that is most problematic for Arizona taxpayers.

Further, the fact that Majority Rule will limit future use of the initiative process for ballot-box budgeting and raising taxes is entirely consistent with the current constraints placed on referendums by the Constitution and the Arizona courts. While the Arizona Constitution provides citizens the power to both propose laws and refer acts of the Legislature to the polls, it specifically limits the authority of the citizenry from referring the annual budget. The framers of the Constitution, while clearly reserving the citizen's right to both enact and reject laws, obviously did not want that power extended to laws "for the support and maintenance of the Departments of the State and of State institutions." In fact, the Arizona Court of Appeals (*Wade v. Greenlee County, 1992)* interpreted this provision to also prohibit citizens from referring a tax increase that was necessary to "support" the state budget.

It is clear that both the Constitution and the courts draw a distinction between policy issues that the citizens can exercise control over through referendum versus budget and tax policy that are best developed through elected representatives at the Capitol.

While Majority Rule does not extend

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TIME INITIATIVE, *Continued from page 1*

be funded through the Rail Time Fund.

Rail TIME Fund monies are earmarked for distribution as follows:

- 8% to the Maricopa County transportation authority (RPTA)
- 5% to the Pima County transportation authority (RTA)
- 87% for any purpose authorized under the Rail Time Fund

The Local Transportation Purposes "Fund" (20%) is estimated to raise $8.52 billion ($24.1 billion in nominal dollars) and the revenues are earmarked for the following purposes: local roads; light Rail; bus; Para transit, carpool, vehicle, transportation enhancements; transportation safety; and other transportation related projects.

The monies in the Local Transportation Purposes "Fund" are passed through to the local governments and Indian tribes as follows:

- 60% to Maricopa County, cities and towns in Maricopa County, and Indian tribes according to population
- 38% to all other counties and cities and towns in those counties based on current HURF distribution formula
- 2% to Indian tribes outside Maricopa County based on population of tribe

The Transportation Enhancements "Fund" (4%) is estimated to raise $1.7 billion ($4.8 billion in nominal dollars) and the revenues are earmarked for the following purposes: acquisition of scenic enhancements; development of safe school routes; environmental mitigation (water pollution, wildlife mortality, habitat connectivity); landscaping and scenic beautification; neighborhood mitigation; preservation of rail corridors; facilities for pedestrians and bikes; transit oriented development; and other enhancements determined by the Department.

The monies in the Transportation Enhancements "Fund" are passed through to counties (unincorporated population), cities and towns, and tribes according to population.

Open Space Conservation & Wildlife Habitat Fund (3%) is estimated to raise $1.3 billion ($3.6 billion in nominal dollars) and the revenues are earmarked for the following purposes: protect, maintain or recover wildlife habitats and open space that is affected directly or indirectly by transportation projects.

The Director of the Department of Transportation will administer the fund in consultation with the State Game and Fish Department and select projects based on priorities set by Arizona State Wildlife Action Plan and Arizona Game and Fish. The Department may issue grants to a political subdivision of the state, Indian tribe or 501(c).

ATRA Policy Concerns/Issues:

Earmarking Revenue

For decades, ATRA has expressed concerns about earmarking revenues outside the appropriations process through what is commonly referred to as "ballot box budgeting." Earmarking revenues and creating dedicated funding requirements does significant damage to the state's ability to do comprehensive budgeting and handcuffs state policymaker's ability to do comprehensive budgeting over time.

History has certainly vindicated ATRA's policy arguments against ballot box budgeting. Regrettably, determining state budget priorities at the ballot box has become so commonplace in Arizona that much of the flexibility needed to annually adopt a state budget has been stripped of the Legislature.

The TIME initiative will not only earmark billions of dollars outside the scrutiny and flexibility of the appropriations process for 30 years, it will also divert a large portion of the state's tax base that has supported the general fund away from that potential use for the next 30 years.

Impact on State & Local Tax System

The majority of Arizona's state and local tax revenue comes from three major taxes: sales tax; property tax; and income tax. Arizona relies most heavily on the sales tax and has consistently ranked in the top ten nationally in sales taxes per capita. In the near term, TIME would add an estimated $1.2 billion in annual sales tax collections – pushing Arizona into the top five nationally.

The sales tax has always been the most important revenue source for the State of Arizona, accounting for 49% of the state's general fund revenue in Fiscal Year (FY) 2008. While there are no current specific proposals to raise taxes to support the state general fund, recent events (Prop. 301) suggest that if there were, they would be directed at the sales tax. The state's recently adopted FY2009 budget contains a structural deficit of $1.3 billion. With most budget gimmicks used up, the options available for closing the FY2010 budget deficit without increasing taxes are significantly decreased. Ironically, the TIME initiative proposes an increase in a state tax in an amount that is roughly equivalent to the current state deficit.

Arizona's toleration for the sales tax has resulted in a dramatic increase in sales tax rates of state and local governments over the last two decades as evidenced by the following average tax rates:

Average Retail Sales Tax Rates (1980-1990-2008)

1980
- State Rate = 4%
- Avg. City Rate = 1.2%
- **Total Avg. Rate = 5.2%**

1990
- State Rate = 5%
- Avg. City Rate = 1.6%
- Avg. County Rate = 0.5%
- **Total Avg. Rate = 6.8%**

2008
- State Rate = 5.6%
- Avg. City Rate = 2.4%
- Avg. County Rate = 0.7%
- **Total Avg. Rate = 8.7%**

Clearly, if the TIME initiative passes, the average state and local rate will be just shy of 10% – well above the national average of 8.5%. As a result, it is obvious that a significant increase in the state sales tax rate would affect both state and local governments for the foreseeable future. From a practical

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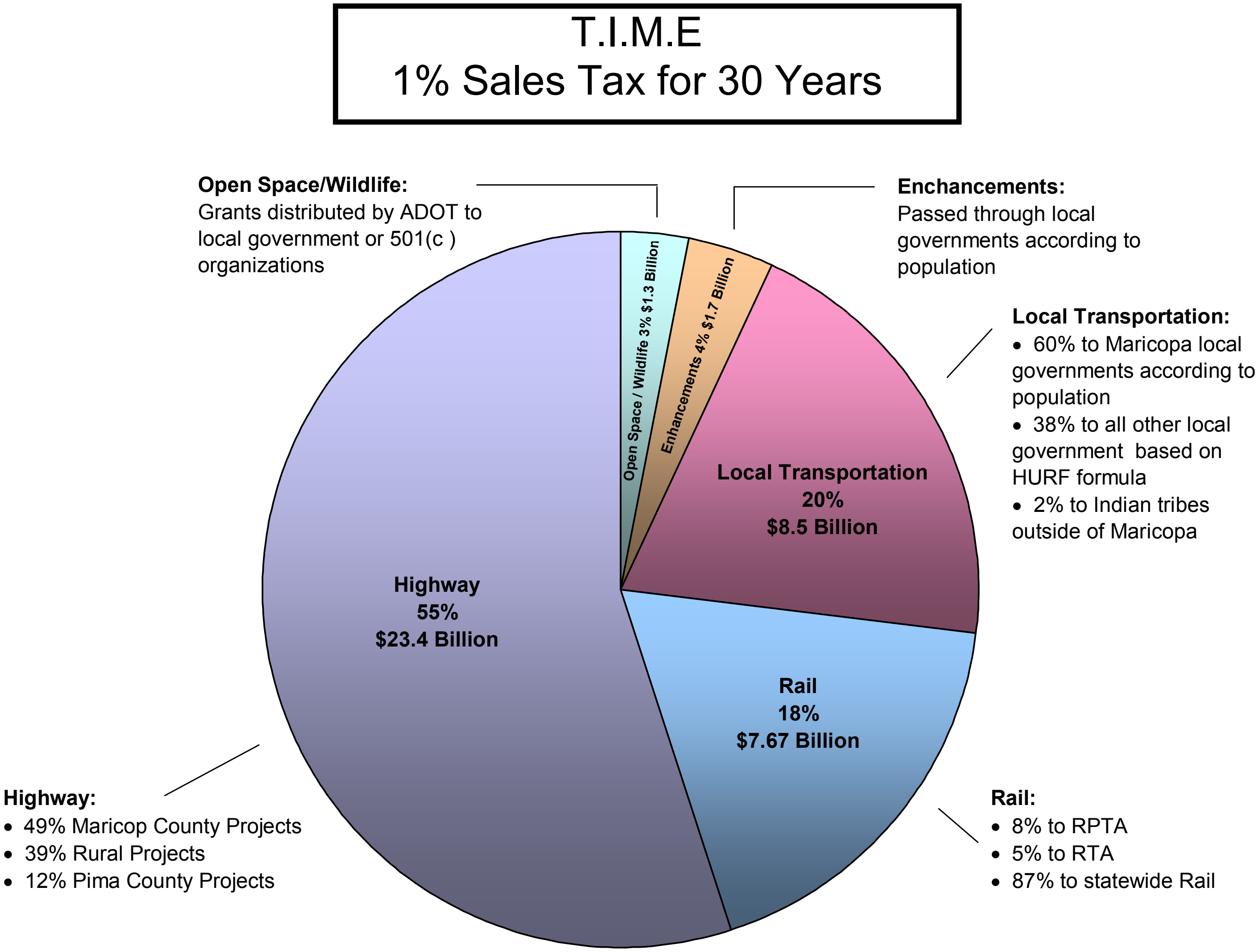

standpoint, it is clear that the state would be precluded from looking to the sales tax to raise revenues to meet general fund obligations. City governments, where sales taxes are the largest own source revenue, would also be impacted by the state taking a full one cent of capacity out of the system. Simply put, if successful, this 17.9% increase in the sales tax rate will ensure that future pressure for increased revenues at the state or local level will be directed at property or income taxes.

The revenue estimate

Some confusion regarding the TIME initiative relates to the estimate that the new tax will garner between 2010 and 2039. The proponents estimate that amount at $42.6 billion; however, that estimate is derived by discounting future sales tax collections back to FY2010 dollars, as well as backing out the costs of bonding. (ADOT staff discounted collections 5% over each of the 30 years.) The actual amount of sales taxes in nominal dollars collected over that time, using ADOT's growth estimates, will actually be in the neighborhood of $120 billion.

Accountability

A new tax that will garner an estimated $120 billion over the next 30 years naturally generates questions regarding the accountability for those revenues. Interestingly, the initiative provides no information on the specific transportation projects that will be funded. ADOT and the Governor have produced a planning document titled *Statewide Transportation Investment Strategy* that provides estimates of the projects that will be funded by county. The breakdown of the estimated expenditures for each fund, by county, is attached. It is important to note, however, that the *Statewide Transportation Investment Strategy* is not in the initiative nor is it even referenced. Further, the document doesn't indicate priorities for project funding.

Despite the fact that ADOT and the State Transportation Board have existed for decades and current statutes outline their duties and responsibilities, the

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the same limitation on voters' initiative rights that exist for referendums, the practical effect will be similar. Put simply, Majority Rule will significantly decrease the number of initiatives placed before the voters that propose raising taxes and spending. While some will argue that Majority Rule is a clever attempt to limit the citizenry's initiative powers, and ATRA may have preferred a more straightforward approach, ATRA believes its ultimate effect promotes a sound public policy and an initiative reform that is desperately needed.

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initiative provides the ADOT director sweeping new powers separate from the control of the Board. For example, while the board is given the power to determine projects funded by the Highway Fund, the Director is given the authority to "receive, allocate, control, and disburse all monies designated for state transportation systems by federal or state law or rule." In addition, the Director is given the power to negotiate contracts on behalf of the state with federal or local governments as well as enter into contracts for the "design, construction, operation, or maintenance of state transportation systems facilities or state public transportation systems."

Most surprising is the fact that the Director is granted the sole power (with only *consultation* with the State Game and Fish Department) to dole out the estimated $3.6 billion in open space funds. In addition to local governments, any 501(c) organization qualifies to receive the funds.

Finally, also of major concern, the initiative exempts the Director, ADOT, and the State Transportation Board from the rule making procedures and requirements in state law for five years after the effective date.

MARK YOUR CALENDARS

ATRA's Annual

GOLF TOURNAMENT

at McCormick Ranch Golf Club, Friday, November 7, 2008, 12:00pm

&

OUTLOOK CONFERENCE/ANNUAL MEETING

at The Buttes Resort, Friday, November 21, 2008, 8:30am to 2:00pm

More Information:
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