Citizens Finance Review Commission

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Dear Governor Napolitano:

The members of the Citizens Finance Review Commission commend you for your insight into the need for improving Arizona's revenue structure in a way that manages to keep taxes as low, fair and stable as possible. We are transmitting to you this report, which reflects your vision and contains our recommendations to reform our state's revenue system.

The commission hopes that you will endorse our report and convey to the legislature and the public the ongoing need for action on these concepts, which were designed without a political agenda and with the best interests of all Arizonans in mind. It is vital that we put the state back on a sound fiscal foundation and establish a revenue structure that encourages a strong economy. We want to emphasize, too, that these recommendations — presented as a menu rather than as a package — have been structured for the long term. Some of them might be appropriate and well advised at the present time and others can remain available until needed. It will remain essential to carefully analyze any combination of options that ultimately could be incorporated into public policy to fully understand all the complex interactions.

These recommendations are not intended to achieve any particular revenue target. In fact, it would be misleading to aggregate their financial impact because they are not presented as a single package. Some recommendations, in fact, are duplicative of others. The appropriate level of revenues should be established by the expenditures upon which you and the legislature reach agreement. The ability to tax does not equate to a need to tax or spend. Ultimately, taxes are a means, not an end. Arizonans need higher-wage jobs, well-funded education and other public services while keeping taxes simple and low enough to nourish economic growth. We believe you will find that we were true to our original mission in gearing our recommendations to support Arizona's growing economy.

Our commission has no authority to put into practice any of the recommendations in our report. It is up to you and our other elected leaders to select the most effective combination of the individual recommendations that fits best with your long-term fiscal policy. Our commission offers to you the voice of the public. We recognize that this report is only the first step, and we are here to assist, consult and encourage with the realization that the ultimate success of our recommendations will depend on the clear and well-considered action by your administration and our lawmakers.

Sincerely,

Bill Post and Tony Astorga
Co-chairmen

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Summary of Recommendations

WHICH MAY DECREASE REVENUE OR RATES:

No. 1 – The state should move toward reducing overall business property tax burdens.

No. 2 – The state should reduce the business personal property tax on locally assessed business personal property.

No. 12 – The state should not depend on general fund revenues to finance new school construction, but instead should implement a process for new school construction using local school district, county or state property taxes.

No. 33 – In conjunction with eliminating certain exemptions and broadening the transaction privilege tax base, the state should lower the rate accordingly.

WHICH MAY INCREASE REVENUE OR RATES:

No. 12 – The state should not depend on general fund revenues to finance new school construction, but instead should implement a process for new school construction using local school district, county or state property taxes.

No. 19 – The state should have as few corporate and personal income tax credits as possible.

No. 24 – The state should phase out the homeowner's rebate.

No. 29 – The state should broaden the transaction privilege tax base by including "personal" services or "consumer" services.

WHICH ESTABLISH OR RECOMMEND A PROCESS FOR FURTHER ANALYSIS AND STUDY:

No. 5 – The state should carefully examine the effectiveness of the possessory interest tax to determine if it is functioning the way it was intended, i.e., an in-lieu property tax.

No. 11 – The state should establish high-level tax policy guidelines to be used to test the soundness of future proposed transaction privilege tax exemptions.

No. 15 – The state should hire a consultant to examine the fairness and extent of miscellaneous taxes and fees imposed by the state for services.

No. 19 – The state should have as few corporate and personal income tax credits as possible.

No. 30 – The state should broaden the transaction privilege tax base by including certain transactions that currently are tax exempt.

No. 35 – The state should review the effectiveness of private school tuition tax credits and the extracurricular public school tax credit.

Recommendations – continued

WHICH ASSIGN RESPONSIBILITY OR ACCOUNTABILITY FOR PROCEDURES TO EXISTING AGENCIES OR COMMITTEES:

No. 6 – The state should assign specific responsibility for long-term planning to a particular agency or committee.

No. 7 – In addition to its current practice of cost accounting, the state should utilize accrual accounting on a selective basis to provide the state's financial policymakers with long-term planning budget data.

No. 8 – The state should centralize information about federal funds in an effort to increase the federal grant dollars it receives.

No. 16 – The state should decrease revenue loss by increasing spending on revenue enforcement until cost-benefit equilibrium is reached, and by implementing a system that makes tax avoidance more difficult.

No. 18 – The state agencies should maximize the "time value" of money by increasing interest earnings through the use of frequent deposits, longer-term, higher-interest accounts and other fiscal measures.

No. 21 – The cities and state should pursue greater transaction privilege tax uniformity.

WHICH ESTABLISH REVENUE POLICY:

No. 9 – The state should increase the current limit on the budget stabilization fund (the "rainy day fund") to its original 15-percent cap and take measures to make "raids" on the fund more difficult.

No. 10 – The state should utilize capital financing tools (bonding) for long-term capital assets with debt service tied to specific revenue streams.

No. 13 – The state should, where possible, phase in major changes – or phase out changes – to the tax structure over time.

No. 17 – The state should replace unit-based fees and taxes with percentage-based fees and taxes.

No. 20 – The state should follow the federal income tax returns as much as possible.

No. 22 – Each transaction privilege tax exemption should include a sunset provision to periodically compare the public policy supporting the tax exemption against the evolving state of the state.

No. 31 – The state should withhold income tax from non-residents.

No. 32 – The state should retain certain low-income tax credits.

Recommendations – continued

WHICH REQUEST A CITIZENS REFERENDUM:

No. 14 – The state should remove the constitutional requirement that raising tax rates requires two-thirds affirmative vote, reverting to a simple majority requirement.

No. 34 – The state should eliminate the 1-percent constitutional cap on residential property tax.

WHICH REJECT A NEW OR EXPANDED TAXING METHOD:

No. 23 – The state should not adopt a gross receipts or expanded franchise tax as a replacement for corporate income tax.

No. 25 – The state should not reinstate the "throwback rule" in the corporate income tax calculation.

No. 26 – The state should continue to impose the estate tax on the amount that is equal to the state tax credit provided for in the federal tax code even though that credit is scheduled to be phased out.

No. 27 – The state should not adopt a real estate transfer tax.

No. 36 – The state should not adopt a single flat rate for personal income tax purposes.

WHICH ACCEPT A NEW OR EXPANDED TAXING METHOD:

No. 3 – The state should apply a uniform assessment ratio on all future voter-approved property tax-funded bonds and overrides.

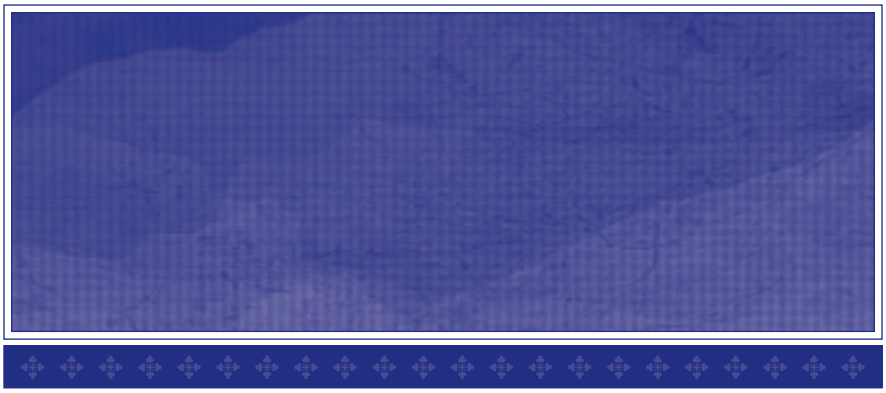
No. 4 – The state should align the transaction privilege tax to more appropriately mirror the state's economy by expanding the tax base.

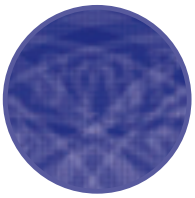
No. 28 – Arizona should re-enact the option of a state property tax, applied on a uniform assessment ratio.

A FISCAL TOOL BOX

TOOLS FOR A MORE FAIR AND EFFECTIVE REVENUE POLICY FOR ARIZONA

RECOMMENDATIONS OF THE CITIZENS FINANCE REVIEW COMMISSION





DEAR FELLOW ARIZONANS:

Public participation in government of the people and by the people is perhaps the most powerful tool available to society in formulating policy that ultimately and profoundly impacts the daily lives of us all. We are proud to report that it is the voice of the public at work in the most fundamental of ways that can be heard in these final recommendations of the Citizens Finance Review Commission, and it is that public voice that offers to our leaders these suggestions that can help bring about better and more fair and effective long-term revenue policy for Arizona.

Our mission was to create a series of recommendations that could be used by the Governor and the legislature in developing a course to stimulate Arizona's economy for the long term and position the state to compete effectively for business against other regions of the West and of the nation. In particular, we developed recommendations — separate from expenditures — that address tax policies that are simple, low and fair and support our state's growing economy. The framework we used for making decisions was based on four working principles:

- Economic Vitality
- Equity
- Volatility
- Simplicity

You will find that these principles provide the underpinnings of our final report, and each of the six themes they encompass relates directly to these principles.

This report is the work of 21 independent-minded business and community leaders, five highly respected economist technical advisors and more than 40 volunteer researchers. Approximately a year ago, the commissioners came together at the request of the Governor to begin in earnest work on this important assignment.

We solicited input from stakeholders across the state and evaluated and considered studies of every kind with diverse views on the economy and the future of Arizona, as well as the present state of affairs. The process took place in full view of the public, and all of our work, including reference material and core studies, is available on the commission's website at www.azcfrc.az.gov. Cost to the state: less than $15,000. The result, however, is worth far more. We offer a strong work product produced by highly talented volunteers who came to the commission either with substantial understanding of the issues in hand or a high capacity and great enthusiasm to learn. Overall, we conservatively estimate that more than 4,000 volunteer hours by the commissioners, advisors, staff and researchers went into creating this report. We now offer to our elected leaders an uncommon opportunity to take advantage of an array of ideas that can improve the lives of our citizens. These ideas were developed without regard for politics and driven by the philosophy that taxes should support the economy rather than shape it.

In the end, we settled on 36 recommendations. It is important to understand that this committee has no authority to implement any of these recommendations. That is appropriately up to the Governor, the state legislature and other elected leaders. We urge them to consider each recommendation, keeping in mind that what we offer is a menu and not a single package. The recommendations must be selectively utilized to provide the most benefit for the most people in a way that fosters long-term fiscal health and

builds a stronger economy. Likewise, the recommendations are not intended to raise revenues to any particular level. Expenditures — set by the legislature and the Governor — should determine the level of revenues, not the ability to tax. Recommendations where the primary benefits are simplicity, efficiency and expanding the knowledge base should be implemented as soon as practical. It will take committed, real and long-lasting leadership to take advantage of what we offer here, but the long-term benefit will be a stronger, simpler and less volatile revenue structure.

It became clear early in the process that the impacts of tax changes are not always those we expect and, further, that decisions have been made through the years with too little information. There is what we call an "analysis deficit" in Arizona. Information important to fiscal decision-making is not readily available or in useful form. Our report stresses that this problem must be remedied. As much as anything, our work is an endeavor to raise the bar — to enhance the knowledge base of our revenue structure — and provide our legislators and Governor with access to information that is essential in the difficult and challenging process of establishing the appropriate state fiscal policies. Along the same lines, you will find that our report advocates a more flexible system for enacting changes to the tax code in the form of reducing the constitutional requirement from a two-thirds vote in the legislature to a simple majority.

It also became clear early on that our revenue structure needs to mirror our economic structure. Our economy has changed over time, and the dynamics of competitive pressures placed on our state by other economies have also changed. In order to achieve a revenue system that benefits us all, we must map our revenue structure appropriately to our economy and consider our competitive position with other states and cities.

There is broad agreement on two major problems. First, the structure of our economy has been and is continuing to change. There is less manufacturing, and business and personal services make up a much larger part of our economy. Yet, our tax system has not changed to match the changing economic structure. Second, we place significant tax burden not only on individuals but also on all business. In most cases, these taxes are passed on to the consumer in higher prices, and in the end the consumer pays most if not all of the taxes. If this compound collection process reduces the state's ability to attract those firms that improve the overall standard of living – those firms that build a knowledge-based economy — the overall tax burden on citizens increases in the end.

No one believes this will be easy. Other states are working hard to gain the advantage. Fortunately in Arizona, we have the basic resources to succeed. We have great universities, vibrant business, opportunity for healthy growth and a natural climate and environment impossible to duplicate elsewhere. That is why the choices we make now must be wise. The gravest mistake of all would be to squander these resources and the opportunity to make a difference.

This effort by the Citizens Finance Review Commission is an essential step in developing for Arizona a vision that can become a reality. The important part of the work we offer to our fellow citizens is not so much the results — although we believe they can be of benefit to Arizona — but the fact that we did the work in the first place. It is an example of government for the people in the most pure sense. The time is at hand to take the difficult, long-lasting steps to modify our revenue structure.

Sincerely,

Bill Post and Tony Astorga
Co-chairmen

The Findings of the Commission

THEME ONE: *Economic Vitality.*

Focusing tax policy on economic vitality is one of the commission's four working principles in making reform recommendations. Guided by a general desire to improve the state's economy for the long term, the commission believes Arizona's revenue structure should:

- Contribute to economic vitality and a stable economic environment,
- Encourage new investment based upon reasonable analyses of benefits and expected total return to the state, and
- Keep Arizona competitive with other states.

A strong economy produces many obvious benefits. It increases tax revenues and reduces demand for public health and welfare services. While government is not directly responsible for economic growth, it can ensure that tax policy does not present unnecessary competitive barriers. A characteristic of sound tax policy is to be competitive and promote economic vitality and prosperity.[1] Put another way, and as economist Elliott Pollack has concluded through his research, a key goal of tax policy should be to do as little harm as possible to the growth potential of the economy.

Stimulating economic growth is one of many competing factors in developing tax policy. While policies that stimulate economic growth are among the goals of the commission, determining the actual effect of tax policy on economic growth has long been a controversial topic in economic theory, empirical research and economic policymaking. In addition, the amount of state taxes businesses pay is only a fraction of the amount they pay in federal taxes. Nonetheless, the state should specifically target a tax structure that encourages businesses to locate or expand in Arizona.[2]

As discussed below, the commission approved several recommendations directly targeting economic vitality. However, the overall thrust of the study is intended to raise the level of discussion about the relationship of taxation and economic vitality. Injecting the concept of "do no harm" to the economy into every discussion of taxation will raise the warning flag about the possible negative economic impact of new or increased taxation, as well as the unintended consequences that sometime occur when taxes are lowered without real analysis of future benefit.

Further, the commission's other Working Principles — equity, volatility and simplicity — support the goal of improving economic vitality for the long term. Equitable taxation draws revenues from as broad a base as possible, which helps to keep taxes low for individuals and businesses. Reducing volatility will avoid special, hastily enacted taxes or abrupt changes in tax structure, making it easier for individuals and businesses to plan for the future. A simpler structure makes it easier for taxpayers to comply with tax policy and makes it less expensive and simpler for government to enforce its policies. Better compliance and collection in turn contribute to a tax structure with broad-based and low taxes. Following all these principles will help keep taxes low and predictable for individuals and for businesses seeking economic growth in Arizona.

In general, taxes distort behavior[3] and can negatively impact economic growth. However, tax revenue also pays for basic services such as public safety and transportation that are essential to and positively impact economic growth. Historical debate has focused on the amount of good that taxes can do compared to the negative effects. Setting aside that debate, the commission agreed that Arizona's tax structure should be at

least reasonably competitive with other states. The commission further agreed that the state should try to attract and keep businesses that:

- Expand our knowledge-based workforce,
- Are capital intensive,
- Utilize skilled labor, and
- Pay above-average wages.

Attracting these kinds of businesses depends on a complex set of factors such as infrastructure and quality of life, but clearly taxation is one of those factors. A recent study for the Arizona Business Coalition looked specifically at the tax competitiveness of Phoenix for six high-wage industries vis-à-vis eight other high growth cities (San Diego, Denver, Tampa, Atlanta, Las Vegas, Austin, Dallas, Seattle).[4]

The results are still preliminary, but the study is the first of its kind to capture the effects of legislative changes to the Arizona tax code made within the last 10 years. The results of the study confirmed some beliefs of the commissioners and challenged others as outdated. In order to establish a comparable base, companies were constructed in selected industries to represent typical taxpayers. In general, the study's data showed that state and local combined business tax levels in Phoenix for selected high-wage companies are around the middle of the pack, but high for mature biotechnology companies, a group the state desires to attract. The report's data showed the moderating effect of accelerated depreciation and low residual values on business personal property tax burdens and estimated the impact on corporate income tax burdens for the targeted companies due to the set-off effect of available research and development income tax credits. Further, the report's data showed that household tax levels in Phoenix tend to be on the higher end of the spectrum, predominantly because of the relatively high transaction privilege tax burden.

The authors of the report noted that the results supported a long-standing belief that Arizona's businesses property is heavily taxed. The report also showed both the importance and impact of well-designed depreciation and tax credit strategies.

With the general goal of improving the state's attractiveness to business and to expand knowledge-based, capital-intensive businesses specifically, the commission makes the following recommendations:

1. THE STATE SHOULD MOVE TOWARD REDUCING OVERALL BUSINESS PROPERTY TAX BURDENS.

Property tax is a tax on the market value of privately owned property, which may include land, structures, machinery and other real property such as vehicles. Tax liability typically is calculated by multiplying the value of the property by the assessment ratio. Then the tax rate is applied per $100 of taxable property value. The tax rate usually consists of multiple tax rates of several overlapping jurisdictions, such as county, municipality, school district and special district. Because of this complexity, it is difficult to compare the property tax from one place to another.

The commission's property tax research team report entitled "Reducing the Assessment Ratio from 25 percent to 20 percent for Commercial and Industrial Primary Property Tax," cited a 2000 Minnesota Taxpayers Association study which reported that, compared to the largest urban area in each state, the tax on commercial and industrial properties was third highest in the nation.[5] The Business Coalition's report added that although the overall combined real property and business personal property tax burden on businesses is high, the effect of the business personal property tax portion is mitigated by recent legislation that allows accelerated depreciation of personal property and low residual values. For the high tech industries that were the target of the Business Coalition's

The practical effect of the high property tax burden is that few large-scale manufacturers are willing to locate in Arizona without some form of tax break.

report, the personal property tax makes up a significant portion of overall property tax burden. Thus, the positive effect of the accelerated depreciation and low residual value rules on overall property tax burden for these companies was real. Businesses that tend to have higher real property taxes and low business personal property taxes would not receive a corresponding benefit. The study's data also showed that despite the mitigating effect of the accounting rules, the overall tax burden on mature biotechnology companies is higher in Phoenix than in the eight competitor cities.

In general, the commission believes that the state's economic competitiveness would be improved by reducing the overall property tax burden on business.

2. THE STATE SHOULD REDUCE THE BUSINESS PERSONAL PROPERTY TAX ON LOCALLY ASSESSED BUSINESS PERSONAL PROPERTY.

The business personal property tax imposes an annual tax on the tangible personal property of a business. This tax conflicts with Arizona's goal of attracting high technology and research-oriented industries, both of which tend to produce higher-wage jobs. Both industries have a disproportionate share of their assets in tangible personal property. The commission recognized that this tax adds to the already high property taxes that capital-intensive businesses pay in Arizona and creates disincentives for the type of industries the state seeks to develop. The commission recommends a reduction in the locally assessed business personal property tax.

3. THE STATE SHOULD APPLY A UNIFORM ASSESSMENT RATIO ON ALL FUTURE VOTER-APPROVED PROPERTY TAX-FUNDED BONDS AND OVERRIDES.

The state's property tax assessment ratio system taxes most businesses at a rate that is 2.5 times the assessment ratio for most residential homeowners. By approving bonds and budget overrides, residents within a district have been able to shift some of their property tax burden to businesses within the district. The commission was sympathetic to the conundrum this situation creates for businesses, which are unable to vote, and was aware of the distorting effect the situation might have on the resident voter's decision to approve the bond or override.

For reasons related to bond covenants and related matters, it would be disastrous to retroactively change assessment ratios. But, the commission recommends that all future voter-approved property tax-funded bonds and overrides be applied on a uniform assessment ratio, whatever that ratio may be. The appeal is that voters still could approve bonds and overrides at their discretion, but would bear an equal share of the property tax burden they had approved.

While this recommendation addresses equitable taxation, it also could have a significant long-term effect on business property taxation. The use of multiple assessment ratios contributes significantly to Arizona's high ranking in comparative studies on property tax burdens. For example, while homeowner property ranked in the bottom half, industrial property ranked as high as third nationally in the comparison of property tax burdens published in 2000 by the Minnesota Taxpayers Association.[6]

The practical effect of the high property tax burden is that few large-scale manufacturers are willing to locate in Arizona without some form of tax break. While the equalizing effects of this proposal will take several years, it will eventually provide some reductions to the effective tax rates on business property, thereby improving Arizona's attractiveness as a location for property-intensive businesses.

4. THE STATE SHOULD ALIGN THE TRANSACTION PRIVILEGE TAX TO MORE APPROPRIATELY MIRROR THE STATE'S ECONOMY BY EXPANDING THE TAX BASE.

Arizona taxes the sale of products, but generally excludes the sale of services. The decision to exclude services from the tax base was made in the 1930s, when the national economy was industry-based and the purchase of goods made up most of an average household's consumption. Today, our economy is more knowledge- and service-based, and the average household spending on services has increased in relation to spending on consumer goods. Yet, Arizona's transaction privilege tax policy remains guided by a decision made more than 70 years ago. As the state's economy continues to grow more service-oriented, the tax base shrinks or grows at an increasingly smaller rate. Policymakers will be forced to either increase the tax rate or expand the base. Longtime Arizona residents will recognize the slow but steady climb in the transaction privilege tax rate over the last 20 years.

The commission determined that the tax base should reflect the state's economy. To determine which services should be included in the tax base, the commission weighed the practicalities of administrative ease, competitive effects and likelihood that the consumer would attempt tax avoidance by purchasing the service in another state. Studying the experiences of other jurisdictions, the commission determined that certain services — often called "consumer" or "personal" services — should be included in the tax base. For a complete list of these services, see the research report "Expansion of Transaction Privilege Tax to Services" and, for a summary of estimated revenue value for some of the services, see "Value of Certain Service Taxes." Both are on the commission's website at www.azcfrc.az.gov.

In addition to adopting this general principle, the commission makes several specific recommendations of ways to pursue a broader transaction privilege tax. Related recommendations are discussed in the "Diversification" section as recommendation nos. 29 and 30 and in the "Equity" section as recommendation no. 33.

5. THE STATE SHOULD CAREFULLY EXAMINE THE EFFECTIVENESS OF THE POSSESSORY INTEREST TAX TO DETERMINE IF IT IS FUNCTIONING THE WAY IT WAS INTENDED, I.E., AN IN-LIEU PROPERTY TAX.

Possessory interest exemptions allow some private businesses to pay no property tax, while others — sometimes in the same industry on adjoining land — do pay the tax. Researchers pointed out that local jurisdictions predominantly use the property tax exemption for land owned by governments and sovereign entities (more often called the "possessory interest exemption") to build property-tax-free buildings that are then leased to private businesses. The result is that the other taxpayers in the district make up for the revenue lost to possessory interest exemptions.

Local jurisdictions support the use of possessory interest exemptions as an economic development tool. They collect an annual excise tax from these properties through the "Government Property Lease Excise Tax Program." However, the annual excise tax has been in effect only since 1996, and the commission questioned whether it has effectively raised revenue substantially equal to the amount lost to the possessory interest exemption. The commission recommended a careful examination of the Government Property Lease Excise Tax Program to determine whether it is capturing its intended taxpayers and tax revenue. The Governor should consider appointing a group of experienced professionals in this area in order to provide a current assessment of the value versus cost of these tools.

THEME TWO: *Long-term Planning.*

Prudent long-term planning is essential in managing revenue volatility. The commissioners concluded that state government fails to utilize some of the fiscal management tools used by private companies and demonstrates a relative lack of long-term fiscal planning, which is perhaps the most basic and crucial element of the financial health of a family, company or state.

The commission discovered that long-term fiscal planning, including five-year forecasts and commitments to three-year budgets — all commonplace in the private business world — are not necessarily welcome in the public arena.

Motivations for the lack of government appreciation for private business practices include:

- Term limits regularly drain the legislature of institutional knowledge,
- Newly elected public officials may be unwilling to follow the "dead hand" of a former legislative body,
- Turnover is cyclical among government administrators and employees,
- State government is decentralized to encourage efficiency, and
- Arizona's balanced-budget constitutional requirement necessitates the use of cost accounting rather than accrual accounting (nearly all business entities use accrual accounting).

An informal study by the Arizona Center for Public Policy showed that a number of agencies, the two State budget offices and the State Auditor General's office regularly collect retrospective information about revenue and expenditures at the program, agency and state levels of government. However, the reports do not contain prospective information that could assist policymakers in long-term planning.[7]

Examples of recent decisions that may have benefited from long-term planning:

- Allowing for permanent cuts to income-tax rates during temporary periods of high income-tax collection,
- Removing, during a strong economy, a nearly 70-year-old statewide property tax historically used as a budget-balancing tool,
- Allowing the budget stabilization fund, or "rainy day fund," to be funded less, rather than more, during healthy economic times, and
- Adding new school construction financing responsibilities to the state without providing a corresponding funding source.

While not all fiscal planning tools used in private business are transferable to a public arena, long-term planning, formulated appropriately and consistently and with considered leadership, can lend predictability to the revenue stream and minimize volatility inherent in changing revenue cycles.

6. THE STATE SHOULD ASSIGN SPECIFIC RESPONSIBILITY FOR LONG-TERM PLANNING TO A PARTICULAR AGENCY OR COMMITTEE.

Fundamentally, the state must address its fiscal data and analysis deficiency. Although the scope of our assignment did not include expenditure review, since revenues fund expenditures, long-term planning must include both. Improved expenditure projections and revenue forecasting are essential to sound fiscal decision-making and could reduce short-term revenue difficulties. The state should not embark on making any significant changes to the revenue structure without

Each proposed policy change should be scrutinized on the basis of its long-term costs and benefits, not simply its effect on the current budget cycle, as low initial utilization of new programs often distorts and understates long-term costs.

independent review and analysis. Each proposed policy change should be scrutinized on the basis of its long-term costs and benefits, not simply its effect on the current budget cycle, as low initial utilization of new programs often distorts and understates long-term costs. Advanced professional analysis will increase confidence in the planning effort and provide necessary insight into the long-term consequences of revenue decisions before they are made. Detailed research and analysis should drive tax policy, not the reverse.

The commission believes the fiscal practices described below used in other states and by private businesses would help state government efficiently manage revenues.

7. IN ADDITION TO ITS CURRENT PRACTICE OF COST ACCOUNTING, THE STATE SHOULD UTILIZE ACCRUAL ACCOUNTING ON A SELECTIVE BASIS TO PROVIDE THE STATE'S FINANCIAL POLICY-MAKERS WITH LONG-TERM PLANNING BUDGET DATA. THIS WILL:

- Allow better matching of long-term (three years or more) expenditures with long-term revenue bases,
- Provide better data to support the use of financing tools (bonding) for capital projects, and
- Reveal structural imbalances in the revenue and expenditure equation.

Accountants from the national firms Deloitte & Touche, KPMG and Ernst & Young collaboratively examined the state's accounting practices.[8] They studied why cash accounting methods are used, the pros and cons of using these methods and how to implement some accrual accounting methods. The accountants' report to the commission pointed out that most states with balanced-budget requirements use cash accounting, which reveals the cash flow of a state, but not necessarily its long-term fiscal health.

The report revealed that many states recognize the short-term fiscal distortions created by cash accounting and apply limited accrual accounting for long-term budget planning purposes. The accountants recognized the high administrative cost of teaching accrual accounting to each governmental agency and maintaining two sets of accounting books. Therefore, they suggested a form of sampling: conduct an accrual accounting of the revenues and expenditures of the 20 percent of the agencies that are allocated 80 percent of the funds. This would provide the data needed for policymakers to make informed long-term fiscal decisions and recognize trends that could lead to future fiscal problems.

8. THE STATE SHOULD CENTRALIZE INFORMATION ABOUT FEDERAL FUNDS IN AN EFFORT TO INCREASE THE FEDERAL GRANT DOLLARS IT RECEIVES.

The commission received a report, "Federal Funds Received in Arizona," by Tom Rex of Arizona State University, that showed Arizona consistently ranks low in the amount of federal grant dollars that states obtain.[9] In fiscal 2002, Arizona ranked 41st on a per-capita basis in the amount of federal grant money received. The Morrison Institute for Public Policy conducted a follow-up report, "Managing Arizona's Federal Funds," which surveyed how various states manage federal grant-writing: a decentralized, entrepreneurial method; a more centralized clearinghouse method; and a highly centralized, sole grant-writing source method.[10] Each method has strengths and weaknesses.

Arizona utilizes the decentralized method. Each agency is responsible for gathering and storing grant information, writing applications and creating programs eligible for new federal grant money. While this system is highly entrepreneurial, it yields a lack of coordination and can result in duplication of efforts.

Based on the results of the survey, the commission favors greater centralization and coordination of information about federal funds with the goal of increasing the amount of federal grant dollars Arizona receives, but rejects the model that centralizes decision-making authority for applying for federal funds.

9. THE STATE SHOULD INCREASE THE CURRENT LIMIT ON THE BUDGET STABILIZATION FUND (THE "RAINY DAY FUND") TO ITS ORIGINAL 15-PERCENT CAP AND TAKE MEASURES TO MAKE "RAIDS" ON THE FUND MORE DIFFICULT.

In 1990, the Arizona Legislature created a budget stabilization fund. The law required that payments be made to the fund during periods of rapid state income growth and money be paid out during economic downturns. The maximum the state could pay into the account was 15 percent of the general fund revenue for that year. During the economic boom of the 1990s, the limit on payments into the fund was reduced to 7 percent of the state general fund. Money in the fund was expended not to smooth fluctuations due to economic cycles, but to fund massive, unexpected alternative fuel vehicle tax credits. Even if the state had not dipped into the budget stabilization fund to pay for these credits, simulation studies by Arizona State University's Tom Rex[11] revealed that with the 7-percent cap, the fund would have been inadequate to carry the state through its economic downturn from fiscal years 2000 through 2002. The original 15-percent cap, however, would have been adequate.

A further study for the commission by University of Arizona Economics Professor Alberta Charney[12] suggests even a 15-percent cap might be too low because governmental expenses are likely to rise during fiscal downturns as unemployment, public health and welfare demands increase. All of the technical advisors agreed that as long as a budget stabilization fund is used to address only economic cycles, rather than contingent loss liabilities, it is one of the best ways to prepare for inevitable economic downturns. The commissioners concur and recommend returning to at least the original 15-percent cap.

Further, the commission recommends taking measures to protect the budget stabilization fund from raids due to unexpected costs or losses, such as the alternative fuels credits. Although it is tempting to use the funds for budget shortfalls due to forecasting errors or litigation losses, the result is that the public and the state do not absorb the full financial effect of the errors and are consequently less likely to be vigilant in the future.

10. THE STATE SHOULD UTILIZE CAPITAL FINANCING TOOLS (BONDING) FOR LONG-TERM CAPITAL ASSETS WITH DEBT SERVICE TIED TO SPECIFIC REVENUE STREAMS.

Short-term expenses that benefit current taxpayers should be funded by immediately available tax revenue, but long-term, capital investments should be funded through financing. A building, for instance, benefits both current and future taxpayers, so the costs associated with the building should be shared by future taxpayers. By financing such investments, the state matches the burden of the cost of the investment with the groups that benefit from it.

As a matter of course, businesses and individuals differentiate between short-term expenses and long-term investments. Individuals pay for groceries with immediately available funds, but finance the purchase of their homes. Businesses pay for wages with ready cash, but finance new building construction. The commission recommends the state follow this example and finance, through bonding, long-term capital assets. To continue to finance long-term assets with

current revenues would be the equivalent of purchasing a home or an office building solely with available cash, a situation only available to the wealthy.

The commission also recommends the debt service be tied to specific revenue streams. This not only assures the state carefully considers the cost of debt financing, but allows the state to match types of recurring expenses to appropriate stable, recurring types of revenue.

11. THE STATE SHOULD ESTABLISH HIGH-LEVEL TAX POLICY GUIDELINES TO BE USED TO TEST THE SOUNDNESS OF FUTURE PROPOSED TRANSACTION PRIVILEGE TAX EXEMPTIONS.

In public meetings throughout the state, the commissioners repeatedly heard that the tax base for the state's transaction privilege tax — more commonly known as sales tax — is riddled with exemptions. Some exemptions are good and effective, but others are unsupportable, antiquated or illogical. The commission's research team that examined the transaction privilege tax listed more than 200 exemptions within the tax base. Some of the exemptions are easily supported by public policy, while others are not. The conclusion of the research team was that the exemptions were granted in piecemeal fashion by different policymakers over the course of 70 years. The result is a mix of exemptions without uniform, long-term goals to guide future policymakers.

In addition to examining the current exemptions, the commission believes proposed tax exemptions should be scrutinized against uniform principles. In particular, the commissioners recommend that the legislature review each proposed tax exemption against certain guiding principles that reflect generally accepted public policy reasons why that exemption should be granted. Currently, the legislature generally receives only fiscal notes describing the estimated tax revenue loss of a proposed tax exemption. The commission proposes a second report that describes the alleged benefits of the exemption. This additional report would reveal the long-term cost-benefit analysis and assist policymakers with their decision about an exemption. In addition, the guiding principles would impose a certain long-term consistency to the tax exemptions that currently is lacking.

The commission's research group proposed a set of guiding principles to apply to future tax exemption reports. They are:

- Broad base and low rate. Basic economic theory indicates that the best tax system has as broad a base and as low a rate as possible.
- Economic efficiency. Distortion of the behavior of businesses and consumers should be minimized. Thus, the same good or service should not be taxed multiple times.
- Ease of Administration. Taxes should be easy for consumers to pay, vendors to collect and the state to monitor and enforce.
- Basic needs. Because the transaction privilege tax is inherently regressive, certain goods and services that fulfill basic needs should be exempt.
- Accountability. All exemptions should contain a clear and timely purpose, incorporate accountability measures and be subject to regular review. Exemptions created to achieve a policy goal (e.g., job creation) should be regularly evaluated to ensure the goal is being met, and to confirm the policy goal remains an objective of the state.

For more detail, please see "Guiding Principles in Evaluating Transaction Privilege Tax Exemptions" on the commission's website at www.azcfrc.az.gov.

12. THE STATE SHOULD NOT DEPEND ON GENERAL FUND REVENUES TO FINANCE NEW SCHOOL CONSTRUCTION, BUT INSTEAD SHOULD IMPLEMENT A PROCESS FOR NEW SCHOOL CONSTRUCTION USING LOCAL SCHOOL DISTRICT, COUNTY OR STATE PROPERTY TAXES.

In July 1994, the Arizona State Supreme Court held in Roosevelt v. Bishop that the state's statutory scheme for financing capital construction for public schools violated article XI, §1 of the Arizona Constitution (the general and uniform clause). In 1998, Arizona legislators enacted "Students FIRST" legislation that was signed into law and found adequate by the State Supreme Court as not violating the Arizona Constitution. Students FIRST established a centralized school capital funding system with limited bonding for the school districts, building adequacy standards, a mechanism for curing existing deficiencies, a building renewal formula and a new construction funding formula.

Students FIRST relieved the school districts of the requirement of funding capital needs of the school districts and placed the burden onto the state general fund. Stated differently, Students FIRST eliminated the traditional revenue stream that had been used to pay for capital construction – that is, local property tax – and placed the expense associated with that revenue stream onto the general fund. Under Students FIRST, school facility construction costs to the State are approximately $300 million per year including renewal costs.

The commission considered several proposals to eliminate the dependence on the general fund for the construction of schools. These proposals included implementing a statewide property tax, a county school construction assessment similar to the county equalization assessment and a local property tax.

Two proposals to implement a local property tax were considered. The first requires using a guaranteed yield formula to ensure that local property tax will result in fully equitable access to funding. Under this proposal, the state would create a system whereby a certain amount of local property tax would guarantee a certain yield to that district regardless of the value within the district. A dollar of property tax should result in a certain dollar amount per student within that district regardless of the property value within the district.

The second would be to create a capital facility construction funding formula and a capital qualifying tax rate that would be administered similarly to the way the current maintenance and operations expenses are funded. Under this proposal, the local school district would determine the amount of money needed by the district to pay for school facilities based on a formula. The formula would be based on student count, square footage and other factors. Then the school district would assess a local property tax of no more than the capital qualifying tax rate (capital QTR). The capital QTR would be set at the state level. Then the state would provide equalization assistance to those districts whose need exceeded what the levy would yield by the capital QTR tax rate.

The commission believes all the options studied are preferable to the current method of financing new school construction.

13. THE STATE SHOULD, WHERE POSSIBLE, PHASE IN MAJOR CHANGES – OR PHASE OUT CHANGES – TO THE TAX STRUCTURE OVER TIME.

Rapid changes in tax policy can create distortions that result in bad decisions by individuals and companies. Individuals and companies who change their behavior based on future tax benefits usually do so at some short-term expense. By frequently and abruptly

changing tax policy, policymakers undermine the taxpayers' confidence in their ability to realize promised benefits and render tax policy a useless way to affect public policy initiatives. In addition, tax changes can produce complex interactions and stimulate behavior that counteracts the intention of the tax change.

The alternative fuel tax credit cost is an example of an unintended result from tax policy change. Therefore, the commission recommends that major changes in tax policy be phased in gradually.

THEME THREE: *Money Management.*

Money management is a means of reducing volatility, one of the primary Working Principles for the commission. Poor money management and fiscal policies for the often-ignored "miscellaneous revenues" (all revenue except property tax, income tax and transaction privilege tax) can add up to significant revenue loss.

In the miscellaneous revenues category — fee collection, charges and interest — only Nevada and Tennessee accumulated less revenue per capita than Arizona in a national survey.[13] While the commission is not advocating adding new fees or charges simply to boost revenue, it is important to find where imbalances or opportunities for incremental revenue exist. With such an assessment, long-term cost-benefit can be carefully weighed. Further, any adjustments to miscellaneous revenue streams — including new ones — should be subject to a simple majority of the legislature rather than a two-thirds majority.

To accomplish this goal and to plug the gaps, the commission endorses the following ideas:

14. THE STATE SHOULD REMOVE THE CONSTITUTIONAL REQUIREMENT THAT RAISING TAX RATES REQUIRES TWO-THIRDS AFFIRMATIVE VOTE, REVERTING TO A SIMPLE MAJORITY REQUIREMENT.

Clearly, the two-thirds requirement for enacting new taxes was intended to make it difficult to raise taxes in Arizona, but the requirement will also greatly hinder efforts at comprehensive reform. The legislature has the significant responsibility for state fiscal management. Reducing the legislature's ability by narrowing its authority impairs its opportunity to perform one of the most important tasks for which the members were elected. For example, some recommendations by this commission would result in new or increased taxes for certain businesses, but these same changes could broaden the tax base and make it possible to keep tax rates low on business transactions overall. It's unlikely that the constitutional requirement was intended to inhibit changes such as the flattening and broadening of the transaction privilege tax. The two-thirds — or supermajority — requirement also applies to eliminating exemptions and makes it extremely difficult to create an equitable tax policy that reflects current conditions.

15. THE STATE SHOULD HIRE A CONSULTANT TO EXAMINE THE FAIRNESS AND EXTENT OF MISCELLANEOUS TAXES AND FEES IMPOSED BY THE STATE FOR SERVICES.

The state charges fees for industries it regulates and some of the services it provides. Based on comparative data of certain fees and a recent report of aggregate

Some recommendations by this commission would result in new or increased taxes for certain businesses, but these same changes could broaden the tax base and make it possible to keep tax rates low on business transactions overall.

fees collected for services of the states,[14] the commission believes that the fees charged do not accurately reflect the fair market value of the services provided or even cover the real cost of providing the services. Although some regulatory agencies cover their own costs through fees collected from the groups they regulate or serve, many do not. The result is that certain groups receive services subsidized by taxpayers. At a minimum, the users of the governmental services should pay a fee equal to the real cost of the service they receive.

Naturally, agencies that provide welfare services do not have the opportunity to charge user fees. At a public input meeting, a City of Phoenix official described the city's policy of addressing such user fees. The city divides the services it provides into two categories: welfare-oriented and business-oriented. Welfare-oriented services are charged at or below cost, but business-oriented services are charged at fair-market value. For example, residential water charges are kept low and subsidized by the Sky Harbor Airport fees. Some commissioners encouraged the use of "de minimus" user fees even in the context of the state's welfare services to minimize free-riding inefficiencies. The commissioners supported the need to examine the amount and fairness of fees and taxes charged to service recipients.

16. THE STATE SHOULD DECREASE REVENUE LOSS BY INCREASING SPENDING ON REVENUE ENFORCEMENT UNTIL COST-BENEFIT EQUILIBRIUM IS REACHED, AND BY IMPLEMENTING A SYSTEM THAT MAKES TAX AVOIDANCE MORE DIFFICULT.

Tax laws without sufficient enforcement opens the doors to evasion, which at its simplest represents lost revenue for the state. But it is important to weigh the revenue to be gained against the cost of the actions to enforce. The commissioners endorsed increased funding for auditing (by the departments of Revenue and Motor Vehicles and other agencies that collect fees and taxes) to the point where the marginal administrative costs are higher than the marginal benefit in revenue. The increased funding for enforcement should not be viewed as a means of expanding revenue or the tax laws, but rather to more broadly and fairly enforce existing laws. The commission also endorsed implementing systems to make tax avoidance more difficult.

17. THE STATE SHOULD REPLACE UNIT-BASED FEES AND TAXES WITH PERCENTAGE-BASED FEES AND TAXES.

Unit-based taxes, which fall in the category of miscellaneous revenues, are flat tax amounts applied to a unit of an item, rather than being based on a percentage of the value of an item. For example, Arizona's gasoline tax is 18 cents per gallon. The tobacco tax is 58 cents per pack. The alcohol tax is $3 per gallon of spirituous liquor, 84 cents per gallon for most wine and 16 cents per gallon for most beer. Because these taxes are applied at a fixed amount-per-unit price, the tax never keeps pace with inflation. The gasoline tax has not changed since 1991, and alcohol taxes have remained constant since 1984. Since their enactment, however, the cost of the programs for which these funds are earmarked has risen by inflation. Gasoline tax revenues fund road construction, which grows more costly as materials and labor costs increase. The inevitable long-term result is an imbalance between the source and the use of the funds.

There are two ways to address this imbalance: retain a flat fee for administrative ease, but add a predictable annual inflator, or replace the unit-based fees with a fee based on the cost of the item sold, which should automatically rise with the cost of inflation. The latter

is similar to a sales tax for the particular item. The majority of the commission favored percentage-based fees and taxes, but supported either measure to address the problem.

18. THE STATE AGENCIES SHOULD MAXIMIZE THE "TIME VALUE" OF MONEY BY INCREASING INTEREST EARNINGS THROUGH THE USE OF FREQUENT DEPOSITS, LONGER-TERM, HIGHER-INTEREST ACCOUNTS AND OTHER FISCAL MEASURES.

Each of these suggestions creates incremental additional revenue. Collectively, the state's gain could be significant. Implementation would need to occur at the individual agency level. But the entire state, including its elected officials, would need to adopt a philosophy that every dollar matters. For instance, for an agency to take advantage of longer-term, higher-interest accounts, the agency would need to schedule its major expenses throughout the year, which requires a certain level of predictability about the level of services it is expected to provide.

THEME FOUR: *Simplicity.*

Simplicity — another of the commission's four Working Principles — is one of the few propositions in tax policy that generates universal agreement.

A simpler tax system reduces taxpayer costs of compliance in terms of time, money and mental anguish. Simplicity reduces unintentional tax evasion and increases the likelihood that taxpayers will understand and see the tax system as fair.[15]

The key to tax simplification is to make fewer distinctions across economic activities and personal characteristics. Taxes should be imposed on a broad base at relatively low rates that do not vary by income source or expenditure type. Progressivity should be embodied in the rate structure and the tax base, not in the design of specific provisions. Universal exemptions, deductions or credits are much simpler than targeted ones.[16]

However, a simpler tax system also has costs. A simpler tax system reduces the ability of policymakers to achieve other goals of tax policy. Features of the tax code designed to increase tax equity, police intentional tax evasion or encourage a particular activity often increase complexity.[17]

Thus, tax complexity arises in large part as the result of a trade-off between simplicity and other goals. The analysis becomes whether particular tax provisions provide good value for the complexity they create. This depends on the magnitude and incidence of the costs and benefits of complexity, where the benefits include the extent to which complexity aids in achieving other policy goals.[18]

Given the goal of simplifying Arizona's tax policy, the commission made the following recommendations:

19. THE STATE SHOULD HAVE AS FEW CORPORATE AND PERSONAL INCOME TAX CREDITS AS POSSIBLE.

The state should review and phase elimination of all but the following corporate income tax credits:

- Research and development
- Enterprise zones
- Defense restructuring

- School site donation
- Technology training

The state should review and phase elimination of all but the following personal income tax credits:

- Clean elections credit
- Family tax credit
- Increased excise taxes paid (Prop. 310 offset) credit
- Property tax credit for low-income seniors
- Private school tuition tax credit
- Extracurricular activity public school tax credit

A simple tax system is straightforward with as few exceptions as possible. With this goal in mind, the commission asked for comprehensive studies of Arizona's corporate and income tax credits. The reports examine when each credit was enacted, the burden of administering the credit, its policy goal and any indicators of its efficacy in achieving the goal. The reports, "An Examination of Personal Income Tax Credits," and "An Examination of Corporate Income Tax Credits," are available on the commission's website at www.azcfrc.az.gov.

The reports revealed that until 1981, the state had no corporate income tax credits. The number of corporate income tax credits began rising quickly in 1996 and peaked in 1999. However, it appears most of the corporate tax credits are ineffective at promoting the anticipated behavior or outcome and some, like the alternative fuels credit, had unexpected, adverse outcomes. The five credits recommended for retention (see above) appear to be most effective based on several factors, including the number of claimants and the burden of administering the credit.

The commission noted that it generally is detrimental to the overall stability of a tax code to enact a credit and then remove it after taxpayers have expended time and money to take advantage of the credit. Therefore, if credits are eliminated, they should be eliminated in a way that is least disruptive. For example, they could be phased out over a long period of time (10 years or more), they could sunset at a certain date (10 years out or more) or other activities could be "grandfathered."

The commission adopted a similar analysis in reviewing the individual income tax credits. Of the more than 20 personal income tax credits, the commission's research revealed that many of the tax credits were either ineffective at producing the anticipated behavior or outcome or lacked accountability measures. At least eight credits were claimed by fewer than 10 filers in 2000. Still, the commission believed several individual income tax credits have policy considerations that outweigh the goal of simplicity. Most are income tax credits designed to provide tax relief and financial assistance to low-income and disabled people. These are:

- Family tax credit
- Credit for increased excise taxes paid (Prop. 310 offset)
- Property tax credit for low-income seniors

For further discussion, please see recommendation no. 32.

20. THE STATE SHOULD FOLLOW THE FEDERAL INCOME TAX RETURNS AS MUCH AS POSSIBLE.

Taxpayers pay at least two levels of income tax: federal and state. Simplicity dictates that the state income tax rules and regulations mirror those applied by the federal government. Currently, Arizona's tax code is "coupled" to the federal income tax code by its use of the federal adjusted gross income as the starting point for Arizona tax returns. Although the state suffers some loss of control by remaining coupled to federal income tax rules, the commission generally agreed to follow the federal income tax returns as much as

Arizona cities must move toward greater statewide uniformity of definitions of taxable transactions and tax rates. The rising popularity of the Streamlined Sales Tax Agreement in other states and in Congress underscores Arizona's urgent need to pursue greater uniformity.

possible. They did so for reasons of simplicity, both for the taxpayer in complying with tax laws and for the Department of Revenue in administering tax laws. The only exception to this general rule is that the commission rejected applying a state level alternative minimum income tax, which would have copied a controversial federal practice and complicated state income tax significantly.

21. THE CITIES AND STATE SHOULD PURSUE GREATER TRANSACTION PRIVILEGE TAX UNIFORMITY. THE COMMISSION RECOMMENDS TAKING NO FORMAL ACTION TO JOIN THE STREAMLINED SALES TAX AGREEMENT AT THIS TIME, BUT RATHER TO MONITOR ITS JOURNEY THROUGH CONGRESS.

It is universally acknowledged that Arizona's transaction privilege tax system is unusually cumbersome. The complexity arises from the state's desire to maintain as much local control as possible. Consequently, each city may have its own customized tax base, using its own definitions of taxable transactions and applying its own tax rates. This flexibility has served the localities well, allowing each city to build a sales tax revenue stream based on the peculiarities of the local economy. But this flexibility also has created an unusually large administrative hurdle to business expansion into new localities.

Arizona's system is so customized that proponents of the Streamlined Sales Tax Agreement, which requires states to create uniform tax bases throughout a state, say Arizona is one of three states that would undergo the most dramatic changes by enacting a uniform tax base.[19] The League of Arizona Cities and Towns estimates that some cities would lose as much as 25 percent of their transaction privilege tax revenue if they were to immediately conform to the state's tax base.

The effects of applying a uniform tax base (with uniform definitions of taxable transactions) would be so dramatic that the commission recommended the state not join the Streamlined Sales Tax Agreement at this time. The commission recognized that by not signing on to the agreement, Arizona would have little formal say in the development of the legislation, which is currently moving through Congress. However, it seemed presumptive and irresponsible to make such dramatic changes to Arizona's transaction privilege tax structure to conform to legislation still under negotiation. The commission also believes that the state should appoint an administrator to coordinate and influence the development of federal legislation.

The commission recognized, however, that with the growing number of Internet sales transactions eroding the state sales tax and transaction privilege tax bases, some form of national legislation (whether the Streamlined Sales Tax Agreement or its progeny) ultimately will be enacted to modernize current tax administration methods. Greater uniformity undoubtedly will be part of that legislation.

For reasons of simplicity alone, Arizona cities must move toward greater statewide uniformity of definitions of taxable transactions and tax rates. The rising popularity of the Streamlined Sales Tax Agreement in other states and in Congress underscores Arizona's urgent need to pursue greater uniformity.

A complete research paper, "Internet and Remote Sales Tax Collection: The Application of the Streamlined Sales Tax Statute in Arizona," is available on the commission's website at www.azcfrc.az.gov.

22. EACH TRANSACTION PRIVILEGE TAX EXEMPTION SHOULD INCLUDE A SUNSET PROVISION TO PERIODICALLY COMPARE THE PUBLIC POLICY SUPPORTING THE TAX EXEMPTION AGAINST THE EVOLVING STATE OF THE STATE.

The commission believed it is advisable to regularly review a transaction privilege tax exemption that continues in perpetuity. Each exemption exists for a specific public policy reason, even if not always immediately discernable. Public policy evolves along with the changing state economy, population and sociological concerns, yet Arizona's tax exemptions have not kept up.

For example, among the transaction privilege tax exemptions are a number that were designed to attract a certain business to the state. Although the target company may have rejected Arizona, the related exemption continues in state law. The statute, once enacted, applies the transaction privilege tax exemption not only to the new target business, but also to existing businesses. When the target business selected another state, the existing local businesses gained a windfall that continues today.

Even if the tax exemption is never utilized by an entity, its mere existence in state law imposes a "cost" by adding complexity to the tax system. With more than 220 exemptions, the task of reviewing the statutes and "cleaning house" is indeed daunting.

The commission recommended a sunset clause be applied to each exemption or group of exemptions. A sunset provision — whether applied to some or all — will impose a regular and periodic review of the exemptions, their efficacy and their relevance to current public policy goals. The commission was split between an automatic sunset provision that would require the legislature to affirmatively renew the exemption or, conversely, a requirement that the legislature study and affirmatively retire an exemption. A number of commissioners pointed out that an automatic termination requiring affirmative renewal may be more appropriate in light of Arizona's "supermajority vote" required to terminate a tax exemption.

Others noted that exemptions lose their value if an affirmative renewal is required. Taxpayers are not likely to rely on a tax exemption that is temporary.

A research report discussing all the exemptions and the application of a sunset clause is available on the commission's website at www.azcfrc.az.gov under the title "Organizing the Transaction Privilege Tax Exemptions: Our Process and an Explanation of Our Results."

23. THE STATE SHOULD NOT ADOPT A GROSS RECEIPTS OR EXPANDED FRANCHISE TAX AS A REPLACEMENT FOR CORPORATE INCOME TAX.

Arizona currently applies corporate income tax on a corporation's net income. Some states have rejected taxation of net income and have instead applied tax at the gross receipts (or gross sales) level. The belief of states that have opted to tax at the gross receipts level is that net income is a poor measure of actual earnings of a company because net income is distorted by certain accounting rules, particularly in the areas of depreciation, amortization and expense recognition.[20] Rather than taxing all corporations at the same tax rate on each corporation's individual income tax, the gross receipt states have established a variety of tax rates (based predominantly on individual industry margins) for different industries that are applied to gross receipts.

Taxation of sales, before any accounting effects, appealed to many commissioners. However, the commission recognized that adopting a gross receipts tax would require significant investment in conforming the new gross receipts tax to the current transaction privilege tax system (which is in itself a form of gross receipts tax). In light of the practical and legal challenge this presented, the commission felt it would be prudent to retain the simpler, flat-rate corporate tax system at this time.

The commission also considered but rejected replacing the corporate income tax with an expanded franchise tax. A franchise tax is a tax on net worth, rather than net income. It taxes businesses regardless of whether they have income or sales. Consequently, the franchise tax level in states that apply it tend to be low and tend to be in addition to, rather than in lieu of, a corporation income tax.

24. THE STATE SHOULD PHASE OUT THE HOMEOWNER'S REBATE.

At the commission's public input meetings, individuals who had recently moved to Arizona time and again noted how low their residential property tax is compared to the level of property tax they had been paying prior to relocating. What became clear was that the public is not aware that part of the reason home property tax is low is because it is subsidized by business owners and the state itself. The state subsidy is through the homeowner's rebate, a reduction of every residential homeowner's primary property tax bill by 35 percent (up to a dollar limit of $500). Originally designed to provide some assistance to low-wage households, it is a subsidy enjoyed by all homeowners, irrespective of wealth, and is largely unknown by the public that benefits from it. In technical terms, it lacks "transparency" or "visibility." In addition, the homeowners' rebate adds one more layer of complexity to a property tax system the commission endeavors to simplify.

The commission recommended phasing out the homeowners' rebate because it has become an invisible public benefit that is not well understood by the public, that creates an administrative burden on the county assessors and complicates an already complicated property tax system.

25. THE STATE SHOULD NOT REINSTATE THE "THROWBACK RULE" IN THE CORPORATE INCOME TAX CALCULATION. THE THROWBACK RULE ESSENTIALLY REQUIRES CORPORATIONS TO INCLUDE AS ARIZONA SALES THOSE SALES MADE TO PLACES THAT DO NOT TAX THE SALES.

The throwback rule of corporate income tax would allow Arizona to tax corporate income that is not taxed by another state. "Nowhere income," as the income that is not taxed at the state income level is colloquially called, is "thrown back" to Arizona and made subject to Arizona corporate income tax. Arizona had a throwback statute until 1998, when it was repealed.

To understand the throwback rule, one has to understand how a corporation's income tax liability to a state is calculated. In Arizona, a corporation's income that is subject to Arizona tax is a weighted mixture of the relative value of:

- The corporation's real property located in Arizona,
- Employee payroll that is paid in Arizona, and
- The sales made in Arizona, all as a percentage of the corporation's total real property, payroll and sales.

To calculate the amount of sales made in Arizona, one would only count the sales that are delivered or sold in Arizona, not those that are sent from Arizona. This is referred to as the "destination rule."

The destination rule creates at least two broad categories[21] of sales that will never enter into the calculation of a corporation's income tax: sales to destinations that do not have an income tax and sales to the United States government. To these "nowhere sales," a state throwback rule would apply tax based on the state of origin, rather than the state of destination. For example, if an Arizona manufacturer were selling umbrellas to a company in Nevada, under the destination rule, the Arizona manufacturer would include the value of those umbrella sales in its calculation of its income taxes due to the state of Nevada. Because Nevada does not have a corporate income tax, the

Simplifying the Arizona tax structure will at minimum require uniform application of taxes statewide and an intensive review that will eliminate many existing exemptions. Cities cannot continue to have their own customized tax base.

umbrella sales never become part of an income tax calculation, unless Arizona applies a throwback rule and includes the umbrella sales that originated in Arizona as part of the Arizona income tax liability calculation.

The throwback rule appealed to the commission's sense of equitable corporation income tax treatment between those who have nowhere income and those corporations that do not. Ultimately the commission decided against reinstating a throwback rule in light of the additional administrative burden that would be placed on taxpayers to track and allocate nowhere income relative to the small additional revenue it would produce for the state.[22]

26. THE STATE SHOULD CONTINUE TO IMPOSE THE ESTATE TAX ON THE AMOUNT THAT IS EQUAL TO THE STATE TAX CREDIT PROVIDED FOR IN THE FEDERAL TAX CODE EVEN THOUGH THAT CREDIT IS SCHEDULED TO BE PHASED OUT. THE STATE SHOULD NOT "DECOUPLE."

Arizona's estate tax is "coupled" to the federal estate tax credit. This means the amount of estate tax applied to an estate in Arizona is equal to the amount of the federal estate tax credit. This is a common practice in the states. It is elegant in its simplicity for both the taxpayer and the state to administer. The problem that has prompted many states to "decouple" and establish an independent estate tax rate is that the federal estate tax credit is being phased out. As the federal estate tax credit falls, so do the state's coupled estate taxes. One common way states have managed their decoupling is to fix the estate tax rate at the rate of the federal estate tax credit in 1996, just before the phase-out commenced.

The commission considered seriously the fact that the state's estate tax revenue will decline if the state continues to stay coupled to the federal estate tax credit. Although the revenue levels year-to-year are volatile, they have sometimes been quite significant.

Ultimately, the commission decided to remain coupled to the federal estate tax credit for reasons of simplicity. Any change would require all Arizonans with an estate tax plan to revisit those tax plans with trusts and estate lawyers. Further, the trusts and estate experts monitoring federal action on the federal estate tax credit advised the commissioners that the federal government (and consequently the states) will be forced to take further action on estate tax matters because the phase out will end by 2011 and return to pre-1996 rates. The commission decided that long-term predictability and stability in the estate tax law trumped concerns by the commissioners over the potential revenue loss. Thus, they decided it is better to remain coupled with the federal estate tax credit.

27. THE STATE SHOULD NOT ADOPT A REAL ESTATE TRANSFER TAX.

A real estate transfer tax is a tax on the sale of real property. One quality of a real estate transfer tax that appealed to the commissioners is its somewhat counter-cyclical nature. As the last economic cycle has shown, real estate transactions are affected more dramatically by mortgage rates than general economic cycles. As a result, real estate transfer tax revenue was, for the 36 other states that have adopted a real estate transfer tax, counter cyclical in this last economic downturn. This quality makes real estate transaction taxes unique and helps the diversification of the state's revenue streams.

However, the commission decided not to recommend adopting a real estate transfer tax at this time for a variety of reasons, including the added administrative burden of collecting and paying a new tax, concern over the effect it might have on the real estate development industry, the impact on the construction industry, disagreement about whether to apply the tax on commercial and residential transfers of real property and concern about rate creep and the effect it might have on accessibility to home ownership.

THEME FIVE: *Diversification.*

Achieving lower volatility is one of the commission's four Working Principles. Greater diversification will help attain that goal. Unpredictability of revenue streams plagues private business as well as state government. Historical studies show Arizona's economic cycles closely mirror those of the national economy. The result is that the state's funding commitments, particularly to necessary long-term investments, are jeopardized. Promised wage increases to government workers are revoked; administrative costs rise as programs are started, stopped and then restarted; and productivity is lost when uncertainty exists. A "rainy day fund" helps smooth over some of the cycles, but another remedy is to diversify the revenue base.

In a fiscal sense, diversification means having as broad a tax base as possible within administrative limits. In an ideal world, the state's revenue streams would include revenues that are counter-cyclical (revenues would increase even as the economy soured). Although the commission was unable to find counter-cyclical revenue streams, it discovered that some are less volatile than others and are affected by different external factors. A diversified revenue base that emphasizes the least-volatile sources would reduce the inevitable volatility of the state's revenue streams. With the need for a broader, more diverse tax base in mind, the commission made the following recommendations:

28. ARIZONA SHOULD RE-ENACT THE OPTION OF A STATE PROPERTY TAX, APPLIED ON A UNIFORM ASSESSMENT RATIO.

Until 1996, the state's revenue streams included transaction privilege, income and property tax, the "three-legged stool" of taxation. The state property tax was revoked in 1996, eliminating the most stable source of revenue for the general fund. Furthermore, property tax collections tend to grow along with increases in the value of real estate, a trend that is expected to continue in a growth state like Arizona. It is irresponsible to ignore the most stable and predictable revenue stream, as property tax is less subject to swings in the economy than income and sales taxes. Reinstituting the state property tax will help stabilize the budget during economic downturns. The commission recommended that Arizona re-enact the state property tax, leaving the determination of the actual rate (which may in some years be zero) to public officials. The commission also recommended applying the state property tax on a uniform assessment ratio to create uniformity throughout the property tax base between residential and business property taxpayers.

29. THE STATE SHOULD BROADEN THE TRANSACTION PRIVILEGE TAX BASE BY INCLUDING "PERSONAL" SERVICES OR "CONSUMER" SERVICES.

Broadening the base for the transaction privilege tax generally infuses more diversity and stability into the revenue stream that currently makes up nearly half of the state's general fund. A broader base also allows the state to reduce or at least maintain the transaction privilege tax rate. This rate is expected to continue its steady climb as greater demands are placed on the tax revenue and the base continues to shrink because it only taxes the sale of products in an ever-increasing service-oriented economy.

After much discussion, the commission recommended adding to the tax base "personal" services, also called "consumer" services. These services:

While some exemptions exist for sound policy reasons and are repeated in many other jurisdictions, a number of exemptions seem to be ineffective, inexplicable or unique to Arizona's tax code.

- Are consumed by the ultimate end user,
- Are usually the type of services that consumers are not likely to try to obtain in lower tax districts to avoid taxation, and
- Generally have an obvious site of the transaction. Examples include dry cleaning, personal grooming services, automobile tune-ups, dating services and massages. Additional examples of "personal services" that could be included in the tax base can be found in the appendix to the research report "Expansion of Transaction Privilege Tax to Services" on the commission's website at www.azcfrc.az.gov.

Other categories of services are "professional" services and "business-to-business" services. The principle reason the commission did not recommend adding professional services to the tax base was the complexity of allocating the site of a professional service. The commission did not add business-to-business services because of the risk of double taxation. For a complete list of these services, see the research report "Expansion of Transaction Privilege Tax to Services" and, for a summary of estimated revenue value for some of the services, see "Value of Certain Service Taxes" both on the commission's website at www.azcfrc.az.gov.

30. THE STATE SHOULD BROADEN THE TRANSACTION PRIVILEGE TAX BASE BY INCLUDING CERTAIN TRANSACTIONS THAT CURRENTLY ARE TAX EXEMPT. A PRIVATE/PUBLIC REVIEW TEAM SHOULD BE ESTABLISHED TO EXAMINE WHETHER TO RETAIN EACH OF THE MORE THAN 200 STATUTORY EXEMPTIONS.

The state should scrutinize its statutory exemptions that carve out special treatment for specified transactions. The commission's research committee for transaction privilege tax, which was constituted entirely of private citizens, reviewed the more than 200 exemptions and categorized them according to the policy reasons for their existence. The research committee's spreadsheet, which includes statutory language, a plain English translation, the year of enactment/revision and the estimated revenue lost (when available), can be found on the CFRC website at www.azcfrc.az.gov.

The research committee concluded that while some exemptions exist for sound policy reasons and are repeated in many other jurisdictions, a number of exemptions seem to be ineffective, inexplicable or unique to Arizona's tax code. The research committee provided a short list to begin the review of the exemptions. A public/private team should thoroughly review these exemptions and all others and retire those that neither meet generally accepted reasons for tax exemptions nor provide clear evidence of efficacy.

THEME SIX: *Equity.*

Equity and fairness are at the heart of tax policy and are among the Working Principles for the commission. Political leaders pay homage to these ideals in virtually every sphere of lawmaking and regulation. Citizens, moreover, are keenly sensitive to arguments about fairness in almost every policy debate.[23]

In tax parlance, equity exists on two levels: horizontal and vertical. Essentially, "horizontal equity" refers to the treatment of equals, while "vertical equity" refers to adjustments made among non-equals.[24]

Horizontal equity dictates that those with equal status — whether measured by ability to pay or some other

appropriate scale — should be treated the same. They should pay the same amount of tax and receive the same amount of benefits, regardless of their income source. For example, horizontal equity encourages the same tax treatment for the teacher who earns $25,000 a year in wage income and the retiree who earns $25,000 a year from dividend and interest income.

Vertical equity generally requires that those with less ability to pay be treated favorably relative to those with greater ability. Some refer to vertical equity as "progressivity." The justification for vertical equity is explained in a number of ways. One commissioner provided justification based on the notion that wealthier citizens have a greater stake in the preservation of laws and societal order and would, therefore, pay a greater share to maintain such tools of order as law enforcement, the court system and infrastructure.

Equity, both horizontal and vertical, became one of four guiding principles the commission used to establish recommendations. Based on the concept of equity, the commission made the following recommendations:

31. THE STATE SHOULD WITHHOLD INCOME TAX FROM NON-RESIDENTS.

To achieve horizontal equity, Arizona should begin to withhold income taxes from non-residents. For withholding purposes, residents and non-residents should be considered equals. Twenty-eight other states already apply some withholding on non-resident income, usually in the form of:

- Withholding on non-wage income,
- Withholding on distribution income from partnerships, limited liability companies or corporations, or
- Withholding on real estate sold in the state.

The commission's recommendation does not expand a non-resident's current tax liability; rather, it establishes a method the commission believed will increase enforcement of the laws governing non-residents, who might otherwise never file Arizona tax returns despite legal obligations to do so. A detailed description of all the variations of the 28 states' non-resident withholding laws, along with relevant exemptions and "de minimus" rules, is provided as an exhibit to the "Non-resident Withholding Taxes" report on the commission's website at www.azcfrc.az.gov.

32. THE STATE SHOULD RETAIN CERTAIN LOW-INCOME TAX CREDITS, INCLUDING THE FAMILY TAX CREDIT, THE INCREASED EXCISE TAXES PAID CREDIT (PROP. 301 OFFSET) AND THE PROPERTY TAX CREDIT FOR LOW-INCOME SENIORS.

The state should increase the progressivity of its tax code by reducing the income tax burden on those in the lowest income-tax bracket. Thus, despite a general desire to retire most income tax credits in an effort to simplify the tax code, the commission recommended that the state retain, among others, the three income tax credits that provide direct economic relief to the state's low-income citizens. One commissioner sought to retain the income tax credit for those making donations to groups dedicated to the working poor, but the commission recommended retaining only the three credits that directly aid low-income citizens. For more information about these credits, see "An Analysis of Personal Income Tax Credits" on the commission's website at www.azcfrc.az.gov.

33. IN CONJUNCTION WITH ELIMINATING CERTAIN EXEMPTIONS AND BROADENING THE TRANSACTION PRIVILEGE TAX BASE, THE STATE SHOULD LOWER THE RATE ACCORDINGLY.

Tax experts suggest the best tax is one that is as broad as possible and as low as possible. A low tax rate minimizes changes in behavior that arise out of tax

avoidance. If the state were to increase the breadth of the transaction privilege tax base by including certain personal services, the tax rate itself could be lowered to create a revenue neutral result. The commission supports the idea of a one-time adjustment to the state transaction privilege tax rate in conjunction with the expansion of the tax base.

34. THE STATE SHOULD ELIMINATE THE 1-PERCENT CONSTITUTIONAL CAP ON RESIDENTIAL PROPERTY TAX.

The 1-percent constitutional cap on residential property tax affects almost all other reforms this commission and others have considered. The cap acts as an artificial ceiling on primary property tax and is enjoyed only by residential property owners. Spending in excess of the cap is subsidized by the state general fund. The cap has frustrated state tax-policy administrators who recognize the "disconnect" it creates between the spending decisions of local government and the residents' decisions to fund local government spending. This is particularly true for residents in districts that already have hit the 1-percent cap and know they will not have to pay for any further spending.[25] Instead, the additional expenses are absorbed by business taxpayers and the state general fund.

Some commissioners recommended replacing the 1-percent cap with an income tax credit or rebate for some of the property taxes paid by low-income residents. The appeal of the suggestion is that it creates a targeted subsidy for property owners at greatest risk of losing their residence if the 1-percent cap is lifted.

35. THE STATE SHOULD REVIEW THE EFFECTIVENESS OF PRIVATE SCHOOL TUITION TAX CREDITS AND THE EXTRACURRICULAR PUBLIC SCHOOL TAX CREDIT.

The commission's debate over the reduction of the private school tuition tax credit and the extracurricular public school tax credit was intense. Those who supported the private school tuition and extracurricular public school tax credits pointed to the increased funding they have provided to both private and public schools. Detractors pointed to the abuses of the credits (for example, the tuition credits by grandparents who contribute funds designated for their grandchildren, or neighbors conducting similar specific allocations by "swapping" donations solely for the benefit of each other's children). Some suggested reducing the credit to something less than the current 100 percent of the donation or converting the credit to a deduction. Because of the magnitude and potential consequences of changing or eliminating these credits, the commission recommended the state further investigate all options in this area.

36. THE STATE SHOULD NOT ADOPT A SINGLE FLAT TAX RATE FOR PERSONAL INCOME TAX PURPOSES.

Arizona's personal income tax rates become moderately higher as the taxpayer's adjusted gross income rises. The commissioners considered applying a flat tax rate, rather than a graduated progressive income tax rate, on personal income tax, but retaining all other standard deductions and exemptions. The appeal of a flat tax is its simplicity and greater incentive to earn more income than exists under a progressive tax system.

The commission noted that retaining standard deductions in a flat tax regime allowed the state income tax to retain some moderate progressivity at the very lowest income brackets, but the system quickly lost its progressivity as income rose. Ultimately, the commission rejected the flat tax because figures from the Department of Revenue showed that to remain revenue neutral, the flat tax rate would have to be near 3.54 percent, raising the tax rate on all individuals who earn adjusted gross income of less than $100,000 per year and lowering the tax rate on all individuals who earned $100,000 or more per year. The commission could not support lowering the taxes on the wealthiest in the state at the expense of the poorest in the state.

WHERE YOU CAN FIND OTHER INFORMATION:

All of the Citizens Finance Review Commission studies are posted on our website at www.azcfrc.az.gov under our "Research Reports."

TRANSACTION PRIVILEGE TAX

- Expansion of Transaction Privilege Tax to Services
- Streamlined Sales Tax Statute in Arizona
- Observation Report
- Guiding Principles
- Transaction Privilege Tax on Interstate Telecommunications
- Real Estate Transfer Tax
- Suggested List of Exemptions for Elimination
- Value of Certain Service Taxes

PROPERTY TAX

- Reinstate a State Property Tax
- Eliminate the Homeowner's Rebate
- Applying a Uniform Qualifying Tax Rate over the Entire State
- Eliminate or Reduce the Business Personal Property Tax
- Eliminate the 1% Residential Property Tax Cap
- An Examination of Possessory Interest Exemptions
- Effects of Eliminating the Distinction Between Full Cash and Net Limited Property Value on Property Tax
- Applying a Single Assessment Ratio for Voter-Approved Bonds and Overrides
- Reducing the Assessment Ratio from 25% to 20% for the Commercial and Industrial Primary Property Taxes

INCOME TAX

- Possible Reforms to Arizona Individual Income Tax
- Implications of "Throwback" Rule to Corporate Income Tax
- Single Sales Factor Apportionment
- Nonresident Withholding Taxes
- Examination of Personal Income Tax Credits
- Examination of Corporate Income Tax Credits
- Minimum Income Tax on C-corps., S-corps and Limited Liability Companies
- Minimum (Annual) Tax on Partnerships, Limited Liability Companies and S-Corporations
- Analysis of Alternative Minimum Tax for Corporate Income Tax
- Analysis of Arizona Estate Tax

OTHER

- Miscellaneous Revenues Report
- Budget Stabilization Fund: Cap Size and Issues
- Federal Funds Received in Arizona
- Managing Arizona's Federal Funds
- Application of a Flat Tax Rate for Individual Income Tax
- Gross Receipts or Franchise Tax as an Alternative to Income Taxes on Business
- Report on Financing School Capital Construction

In addition to these research reports, the CFRC website includes a number of the written materials from presentations made by others to the commission. These are located under the commissioners' reading materials on our website.

Appendix

Among the various proposals the commission analyzed, there were some that ultimately did not receive the recommendation of the commission. There were seven such proposals. Each commissioner may have had his or her own reasons to agree or disagree with the individual proposals. We do not attempt to record all those reasons here, but provide some context for the discussions.

1. IN CONJUNCTION WITH THE PROPOSALS TO ELIMINATE MANY OF THE CORPORATE AND INDIVIDUAL INCOME TAX CREDITS, THE STATE SHOULD MAKE A CORRESPONDING DROP IN THE INCOME TAX RATES.

The proposal arose from a feeling that by eliminating most of the corporate and individual tax credits, the net effect would be a modest tax revenue increase from the increase in income tax burden for some corporations and individuals. The proposal attempted to spread the benefit of that modest revenue gain over all income taxpayers by lowering overall rates. The commissioners who did not support the proposal pointed out that tax rates did not go up when the credits were originally introduced, so any benefit received by the individuals and corporations who took advantage of the tax credits was a windfall. They also were concerned about the permanency of a rate cut and the inability to accurately measure what the rate cut should be considering the volatility of the revenue loss from year-to-year due to credits.

2. AS A WAY TO REDUCE OVERALL BUSINESS PROPERTY TAX, DECREASE THE ASSESSMENT RATIO ON BUSINESS PROPERTY.

Although the commission agreed that businesses bear a larger portion of the property tax burden relative to residential homeowners primarily through the uneven assessment ratio, the commission stopped short of supporting a decrease in the business property assessment ratio. Instead, the commission proposed repealing certain rebates, caps and selectively applying a uniform assessment ratio prospectively as a way to move property tax burdens to greater equilibrium. Commissioners who questioned a blanket decrease in the assessment ratio noted a number of exemptions for businesses and special classifications for some types of for-profit entities would also need to be examined for elimination.

3. THE STATE SHOULD ADOPT THE 100 PERCENT SALES FACTOR FOR INCOME TAX ON A VOLUNTARY BASIS.

The thorough research report written on the topic received much praise and much debate among the commissioners. Although the proposal had some strong support within the commission, many questioned the decision to make the income tax rule voluntary (allowing corporate taxpayers to change the method of calculating their tax burden from year-to-year) and the efficacy of the tax change at creating the desired effect of stimulating businesses to move more jobs to Arizona. Still others supported the concept, but withheld support for the proposal because they would have preferred application of the 100 percent sales factor rule only to selected industries, particularly the industries that already have most of their sales outside of Arizona and could locate their businesses anywhere.

4. THE STATE SHOULD NOT APPLY A UNIFORM QUALIFIED TAX RATE ("QTR") THROUGHOUT THE STATE.

This proposal failed to receive sufficient support to either apply or not apply a uniform qualified tax rate across the state. However, the rejection of this proposal was not a statement in support of a unified QTR. Overall, the commissioners showed little interest in changing the current application of the qualified tax rate.

5. THE STATE SHOULD MAINTAIN THE USE OF LIMITED PROPERTY VALUES AND FAIR MARKET VALUES FOR RESIDENTIAL PROPERTY TAX.

This proposal did not receive enough support to qualify as a recommendation, but its corollary proposal to change the dual valuation system for residential property tax did not receive sufficient support either. After the Maricopa County assessor estimated that limited property values in recent years are 90 to 97 percent of fair market values, the commission did not have sufficient support among itself to support continuation of the dual valuation system as an inflationary protective measure or to do away with the dual system.

6. IF THE STATE EXPANDS THE TRANSACTION PRIVILEGE TAX BASE BY APPLYING THE TAX TO CERTAIN PERSONAL SERVICES, TO ALL AUTOMOBILE SALES AND TO REAL ESTATE TRANSFERS, AND THEN DROPS THE OVERALL RATE CORRESPONDINGLY, THE REDUCTION OF THE TAX RATE SHOULD BE SUSPENDED AND THE INCREASE IN TAX REVENUES ASSOCIATED WITH BROADENING THE BASE SHOULD BE PUT INTO THE BUDGET STABILIZATION FUND UNTIL THAT FUND REACHES 15 PERCENT OF THE GENERAL FUND.

The proposal did not receive sufficient support among the commission to become a recommendation, predominantly because of its compound nature.

Footnotes

1 "Preliminary Examination of Arizona's Governmental Tax System" by Tom Rex of the Center for Business Research at Arizona State University, prepared for the Citizens Finance Review Commission, published May 2003.

2 "Optimizing Arizona's Tax Structure," by Elliott D. Pollack, published August 2003, prepared for the Citizens Finance Review Commission.

3 "Preliminary Examination of Arizona's Governmental Tax System" by Tom Rex of the Center for Business Research at Arizona State University, prepared for the Citizens Finance Review Commission, published May 2003.

4 "Comparative State and Local Tax Analysis – Presentation of Preliminary Findings" by the Maguire Company and KPMG, LLP presented to the Citizens Finance Review Commission on December 15, 2003. The results of this study are still preliminary and based on reasoned assumptions about hypothetical taxpayers. In the next phase, the study will compare its preliminary results to results from surveys of taxpayers and conclude with a peer-review process.

5 "50-State Property Tax Comparison Study for Payable Year 2000" by the Minnesota Taxpayers Association in cooperation with the National Taxpayers Conference, published January 2001.

6 Id.

7 Upon the request of the commission, the Arizona Center for Public Policy examined how Arizona employs long-term fiscal planning regimens within the legislative and executive branches. The Arizona Center for Public Policy concluded that a number of relevant reports regarding revenues and expenditures are already statutorily required, but these reports do not appear to provide prospective information, like multi-year expenditure forecasts.

8 A copy of the summary of their presentation is available on our website under the commission's reading materials at www.azcfrc.az.gov.

9 The research report, "Federal Funds Received in Arizona," by Tom Rex is available on the CFRC website at www.azcfrc.az.gov.

10 The research report, "Managing Arizona's Federal Funds," by the Morrison Institute for Public Policy is available on the CFRC website at www.azcfrc.az.gov.

11 "Public Finance in Arizona," published in January 2003 by the ASU Center for Business Research.

12 "Budget Stabilization Fund: Capsize and Other Issues," available on the commission's website at www.azcfrc.az.gov.

13 See Governing Magazine's "2003 State and Local Sourcebook." Arizona ranked last in fees collected from state and local governments combined.

14 Id.

15 William G. Gale, The Brookings Institution, Tax Simplification: Issues and Options, Testimony to U.S. House Committee on Ways and Means, July 17, 2001.

16 Id.

17 Id.

18 Id.

19 Testimony of members of the CFRC Transaction Privilege Tax Team at the September 25, 2003, commission meeting.

20 Investment bankers, for instance, often place greater value on a company's earnings before income tax, depreciation and amortization (referred to as "EBITDA") compared to its net income.

21 Other categories of nowhere sales exist, including sales into a state in which there is insufficient nexxus for the state to require the out-of-state company to file an income tax return in the state.

22 In 1998, the Arizona Department of Revenue estimated the throw back rule accounted for approximately $5.0 million of corporation income tax.

23 "And Equal (Tax) Justice for All?" by C. Eugene Steuerle, originally published in Tax Justice: The Ongoing Debate (2002, Urban Institute Press), edited by Joseph J. Thorndike and Dennis J. Ventry, Jr.

24 Id.

25 Residents of Pima County note the residential property tax in Pima County is at the 1-percent constitutional cap in part due to the cost of services provided by the county to unincorporated parts of the county. In contrast, Maricopa County has proportionately higher incorporated towns that are responsible for providing the public services at a local level.

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