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PRELIMINARY EXAMINATION OF ARIZONA'S GOVERNMENTAL REVENUE SYSTEM

May 2003

Prepared for the Citizens Finance Review Commission

by

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SUMMARY

Arizona’s fiscal system compares poorly against the characteristics of a well-functioning fiscal system, contributing to the cyclical and structural fiscal deficits that have received considerable attention in recent months. Generally accepted guiding principles of a fiscal system are listed below in order from broadest considerations to more micro concepts:

1. **Accountability:** Link revenues and expenditures so that sufficient revenues are available. (While critical to a well-functioning fiscal system, sufficiency of revenues is beyond the scope of this report, which concentrates on the design of the revenue system.)
2. **Stability:** Minimize annual fluctuations in revenues over the economic cycle through use of an adequately funded Budget Stabilization Fund and multiple revenue sources.
3. **Responsiveness:** Ensure that revenue collections keep pace with growth in the state’s economy over the long-term.
4. **Predictability:** Avoid ad hoc changes to the revenue system.
5. **Efficiency:** Minimize impacts on economic behavior by using broad-based revenue sources with low marginal tax rates; match revenue collections to public benefits to the extent possible.
6. **Competitiveness:** Promote economic vitality and prosperity.
7. **Exportability:** Tax nonresidents as well as residents.
8. **Neutrality:** Minimize differential treatment of like economic activities.
9. **Horizontal Equity:** Treat people of equal means similarly.
10. **Vertical Equity:** Minimize regressivity of the overall tax structure.
11. **Simplicity:** Minimize compliance and administrative costs.

Based on a literature review and analyses of Arizona tax rates and other revenue data relative to other states, a qualitative assessment of Arizona’s current revenue system compared to generally accepted guiding principles is presented below. The revenue systems of most states compare unfavorably to such a “best-practices” revenue system. (This assessment can be applied to state government’s general fund and to the combined finances of state and local governments in Arizona.)

| Guiding Principle | Evaluation | Comments |
|------------------------------|-------------------|--|
| Stability and Predictability | Poor | Highly cyclical revenues, multiple changes to tax code, poor use of rainy day fund, overemphasis on sales tax, little use of more stable revenue sources |
| Responsiveness | OK | Overemphasis on sales tax, whose collections lag behind economic growth due to out-of-date code |
| Efficiency | Poor | Heavy reliance on certain taxes, some with high tax rates |
| Competitiveness | Poor | Heavy taxation of businesses, particularly on the property tax |
| Exportability | Good | Some of the tax burden is borne by nonresidents |
| Neutrality | Poor | Multiple tax credits and exemptions |
| Horizontal Equity | Poor | Credits and exemptions are a negative |
| Vertical Equity | Poor | Heavy and increasing reliance on regressive taxes |
| Simplicity | Poor | Considerable complexity to tax code of each of the major taxes |

No fiscal system can be designed to excel in all criteria since some of the guiding principles partially conflict with others. However, a much-improved system could be created by applying generally accepted best principles of fiscal policy to Arizona's fiscal system. A system that achieves an OK-to-good evaluation against each of the guiding principles is feasible to create.

To realize a best-practices fiscal system in Arizona, two key actions are necessary. First, the Budget Stabilization Fund must be strengthened by increasing the amount that can be placed into the fund and by making transfers to and from the fund strictly formula driven, not subject to appropriation. Implementing this change only would greatly enhance stability and predictability of revenue flows. Cyclical deficits could be eliminated.

Second, the revenue system must be considered as a whole, not as a set of unrelated components. The ideal system would look essentially the same regardless of the desired amount of revenues to be collected (within a reasonable revenue range). Total revenues could be raised or lowered by adjusting tax rates and user fees.

In order to achieve a best-practices revenue system in Arizona, the current mix of revenue sources must be modified. Some tax bases need to be broadened and some tax rates need to be increased while other tax rates should be decreased. No recommendation is being made that overall revenue should be either increased or decreased from the existing level.

A preliminary list of the most significant revenue system changes to consider follows, again based on the literature review and analyses of tax rates and other revenue data. Adopting all of these actions would raise the evaluation of the overall revenue system on all of the guiding principles. However, any individual action may produce negative effects as well as benefits. For example, an increase in the reliance on the personal income tax adopted in isolation could decrease stability. However, by reducing reliance on the also-cyclical sales tax and by increasing reliance on other more stable sources, such as the property tax and user fees, an overall gain in stability would result.

- **General Sales Tax:** (1) Broaden the base by taxing most services, Internet sales and grocery items, enhancing the revenue system's stability, responsiveness, and predictability. (2) Limit the use of exemptions, improving neutrality, horizontal equity, and simplicity. (3) Reduce reliance on the sales tax by substantially lowering the high tax rate, promoting efficiency, competitiveness, and vertical equity.
- **Property Tax:** (1) Reinstate the property tax for the state general fund, boosting stability, responsiveness, and predictability. (2) Lower high business property tax rates, strengthening efficiency, competitiveness, and horizontal equity. (3) Greatly simplify the complex property tax code.
- **Personal Income Tax:** (1) Increase reliance by raising the low tax rates, furthering responsiveness and vertical equity. (2) Limit the use of credits and exemptions, advancing neutrality and horizontal equity. (3) Enhance progressivity (vertical equity) by adjusting tax rates and brackets.
- **Corporate Income Tax:** Restructure to improve neutrality, horizontal equity, and simplicity, perhaps by income apportionment or replacing the corporate income tax with a business franchise tax.

- **Other Taxes:** (1) Increase the share of revenues coming from other existing tax sources to augment stability and efficiency. Arizona collects little from some selective sales taxes and certain license taxes, especially the vehicle license tax. Indexing these tax rates to inflation will improve responsiveness. (2) Implement new tax sources to forward stability, responsiveness, efficiency, and vertical equity. A real estate transfer tax is used in most states.
- **Nontax Revenues:** Increase the share of revenues coming from nontax sources such as user fees and federal funds to promote stability, efficiency, and exportability.