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FY 2022 Budget Agreement Revenue Assumptions

SUMMARY

The FY 2022 budget agreement relies on a conservative set of revenue assumptions that – in the face of historic General Fund performance – likely underestimates collections over the next four years.

After review, OSPB now believes that the dramatic over-performance in recent years is in part due to an underestimate of potential revenue gains from two major policy changes:

- Conformity in 2017 to the Tax Cuts & Jobs Act, which expanded the State's Income Tax base
- Adoption, also in 2017, of a Remote Sellers tax following the Supreme Court's decision in *Wayfair*

Together, these changes have increased the taxable share of Arizona's economy, effectively allowing the State to collect more revenue at the same rates (or approximately the same amount of revenue at lower rates). Additionally, economists generally agree that income taxes are the most distortionary and economically harmful of the major tax types (see, for example, the OECD's Tax Policy Reform and Economic Growth).

Therefore – in light of both continued dramatic over performance of State revenue collections relative to projections and the Proposition 208 income tax increases – the Executive believes a sustainable, ongoing tax reform that protects existing spending obligations, ensures structurally and cash balanced budgets over the three-year forecast period, and ensures the continued economic competitiveness of Arizona relative to surrounding states is prudent and necessary.

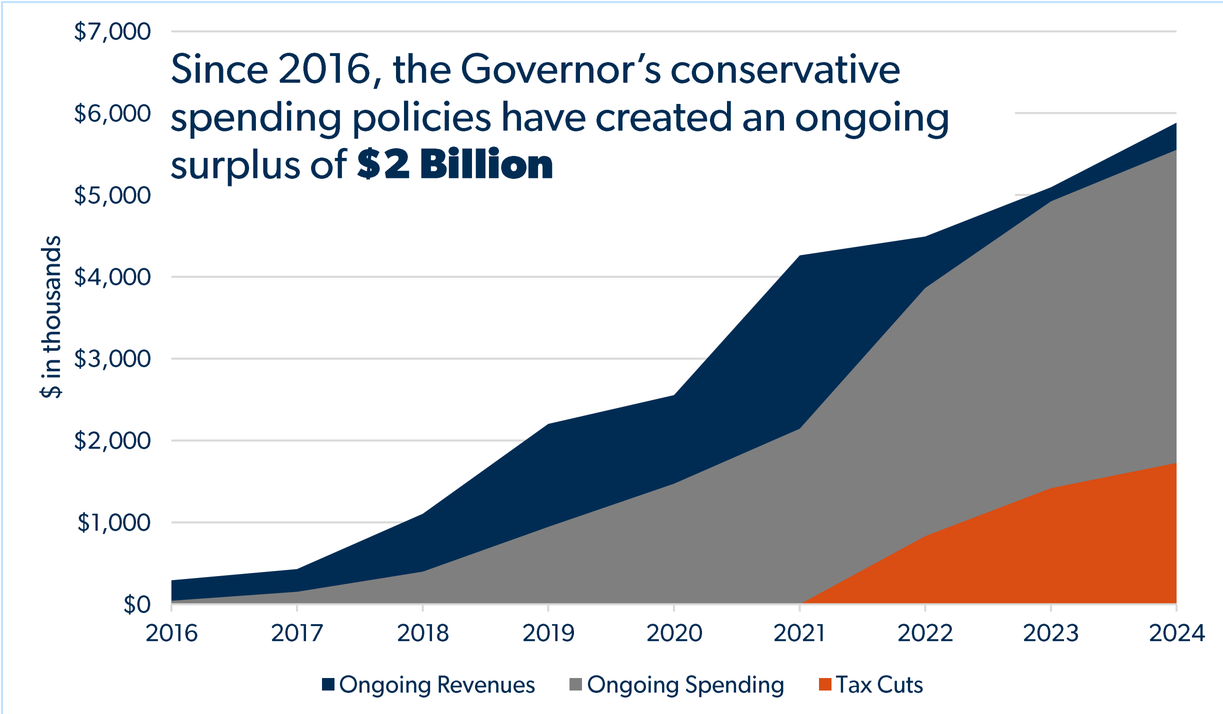
GENERAL REVENUE BACKGROUND

Revenues in FY 2021 have exceeded collections last year by more than **$2 *billion***. Due to the one-time rollover of Individual Income Tax payments, revenues in FY 2020 were down (2.3%) for the year – absent that rollover, however, we estimate revenues would have ***increased*** by approximately $400 million over the year despite the pandemic-related Recession. **All projections to date have been dwarfed by actuals**, as seen in the table below.

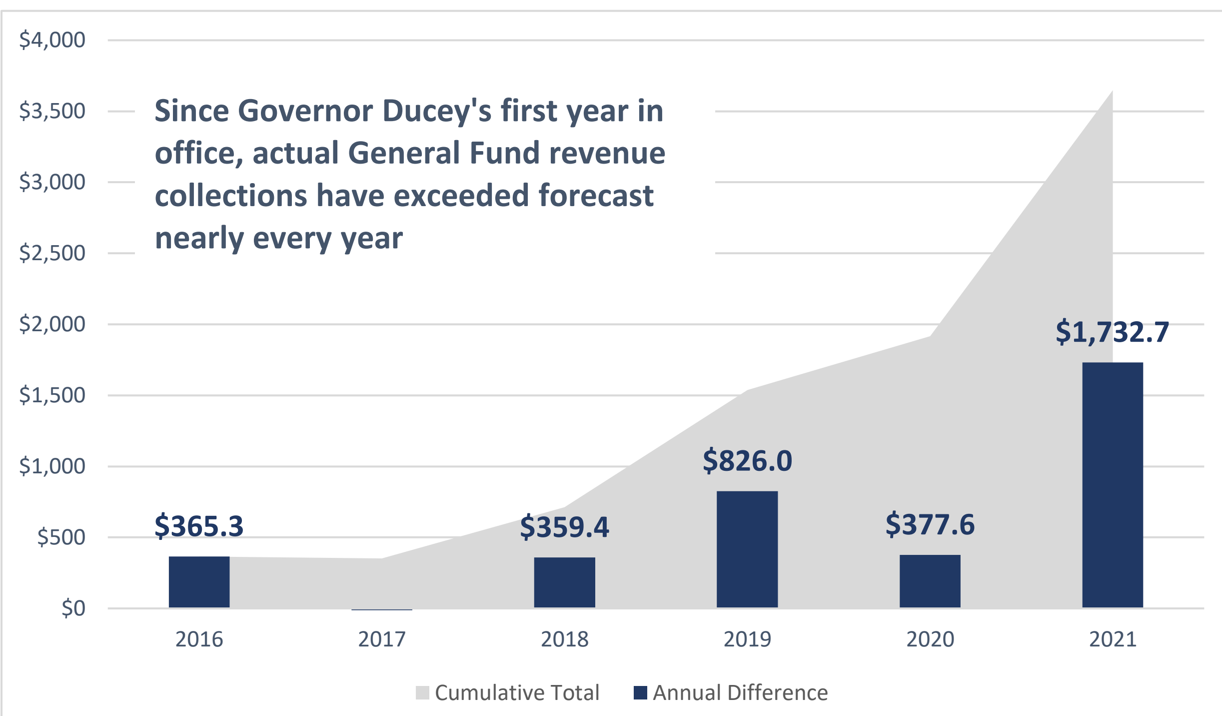
	2021 Enacted Budget		2021 JLBC Baseline		
	Projection	YTD Surplus	Projection	YTD Surplus	YTD Actuals
IIT	14.7%	+$664.1M	27.5%	+$83.1M	33.4%
CIT	(11.8%)	+$279.6M	6.9%	+$197.7M	45.7%
TPT	(0.1%)	+$695.4M	8.1%	+$234.3M	12.9%
General Fund	**3.8%**	**+$1,732.7M**	**14.8%**	**+$554.3M**	**22.6%**

For the seven years following the Great Recession and immediately prior to the passage of the Tax Cuts & Jobs Act, and Arizona's conformity to the same, the General Fund averaged ongoing revenue growth of 5.9%. This figure is consistent with the long-run average growth rate – including historical Recessions – of about 5.5%. From FY 2018 and through FY 2021, however, the General Fund has enjoyed base ongoing growth rates of **over 7.7%** - again despite the pandemic and associated Recession. These growth rates are typically associated with **post-recession recoveries**, yet we observed this performance at the **end** of the last economic cycle and **during** the most recent recession.

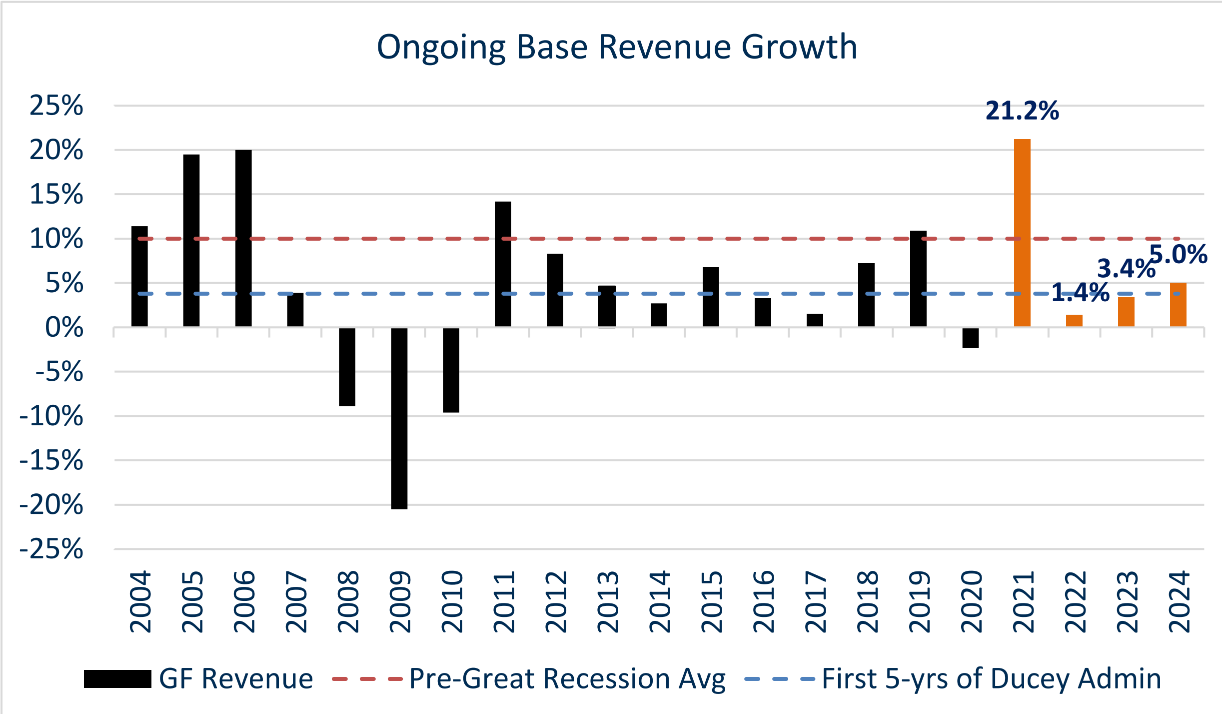
Based on an analysis produced by OSPB, the combination of consistent over performance by General Fund revenues with consistently conservative enacted budgets has created an ongoing surplus of approximately $2 billion this year, after inheriting a $300 million structural deficit at the end of FY 2015. If we do nothing on taxes, that surplus would grow to almost $4 billion over the next three years. This is illustrated graphically in the chart below.



The source of this surplus is clear: for going on six years, the General Fund has consistently outperformed expectations, with the one exception of FY 2017 (when revenues were in line with projections). This trend has only accelerated since FY 2018 – a fact consistent with the Conformity income tax and *Wayfair* sales tax expansions. The apparent slowdown last year can be entirely attributed to the pandemic. Cumulatively, the result is staggering.



Despite these extreme recent results, however, the Governor and Legislative leadership continue to believe that a cautious approach is warranted. On an ongoing basis, this budget agreement allows base revenue growth to slow to just 1.4% next year, growing to just 5.0% by FY 2024. To demonstrate how conservative these figures are, consider the table below, which displays long-run revenue growth over our most current projections.



We further believe that substantial evidence exists supporting the claim that these surpluses are due – at least in part – to recent tax base expansions that have effectively enabled all jurisdictions in Arizona to collect more revenue at existing rates.

Following the passage of the *2019 Tax Omnibus*, the Department of Revenue created new filing codes and reports intended specifically to capture **new** revenues associated with the new Remote Sellers law. Throughout this process, staff at the Department and the Governor's Office were cognizant that some taxpayers subject to the new law may have already been filing some taxes under current law, and steps were taken to account for this in the reporting design. To be clear:

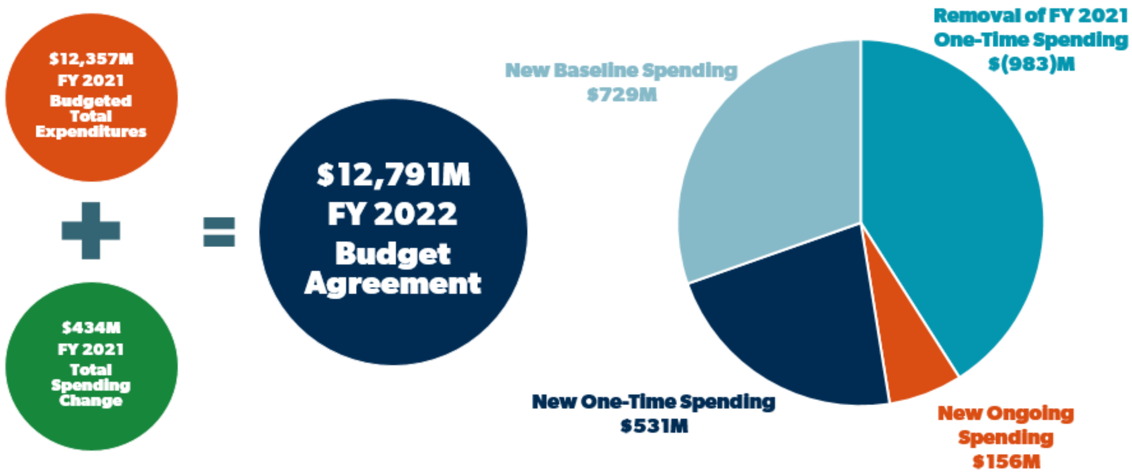
- Despite assertions otherwise, **neither Amazon nor Walmart was collecting sales tax on marketplace sales prior to 2020**
- Despite assertions otherwise, according to the Department of Revenue, **both Amazon and Walmart are separately reporting new and existing revenues under the correct filing codes**

Given that these two firms control nearly half of the e-commerce market in the United States, these two facts substantially undermine any claim that the State is either significantly over-counting its new *Wayfair* revenues, or that we were already collecting these revenues under another filing category.

Additionally, consider that over the 5 years preceding enactment of the *2019 Tax Omnibus*, annual TPT growth averaged 4.9%. **Excluding the new Remote Sellers category**, TPT growth since 2020 has averaged 4.4%. Since enactment and including the new Remote Sellers tax annualized growth has been 7.7% - leaving a gap of nearly 2.8% in surplus TPT growth that cannot be attributed to a "revenue shift" and occurred despite the global pandemic and its associated recession. Based on the most current data, and annualized, OSPB believes there is potentially $465 million in new, annualized, ongoing revenue attributable to *Wayfair* – or **approximately 400% more than JLBC forecast**.

GENERAL EXPENDITURE BACKGROUND

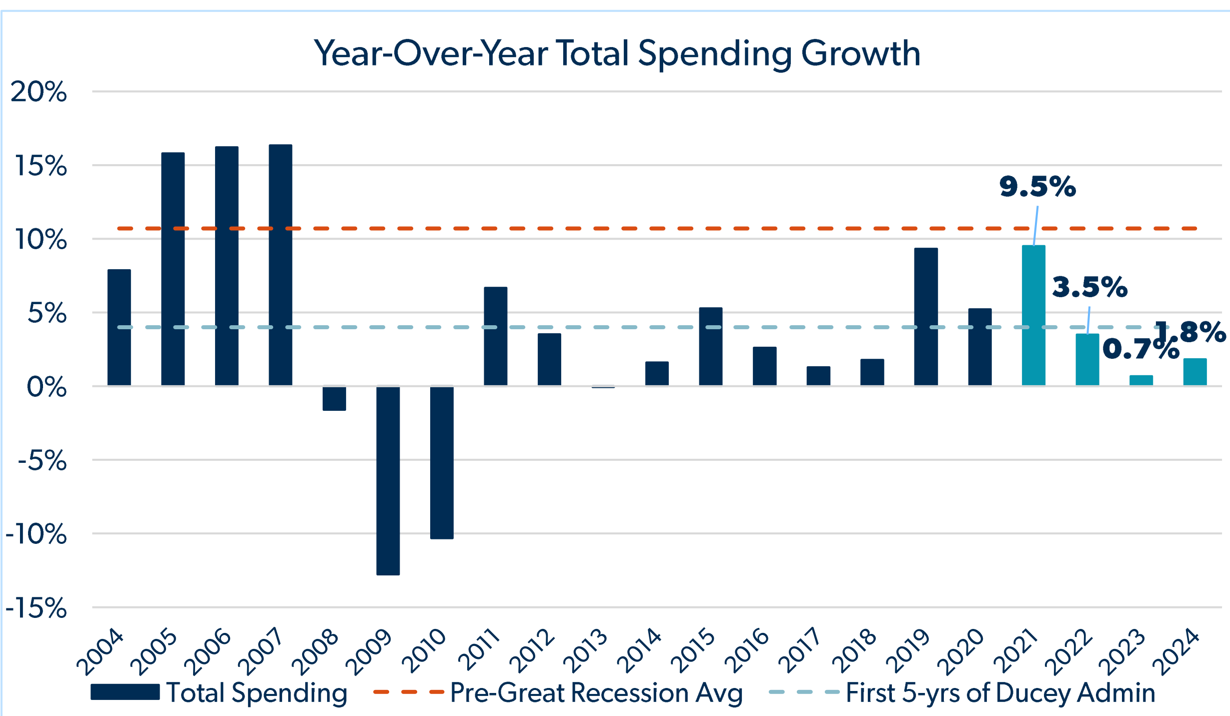
Despite these historically conservative revenue projections, and an historic tax reform, this budget is able to protect **all** of our baseline commitments (including the Governor and Legislature's '20x2020' plan which has increased average teacher salaries by 20% in Arizona) while strategically funding those new priorities that matter.



We accomplish this by targeting our spending to one-time, strategic investments that improve the long-term fiscal health of Arizona. Specifically, the budget invests (just from the General Fund and over the next two years):

- $200 million for future drought mitigation (FY 2021)
- Nearly $200 million for new school construction
- $300 million to reduce the State's unfunded pension liabilities (FY 2021)
- $507 million for reductions in debt at SFB, ADC, and the Lottery (FY 2021)
- $62 million in General Fund support for Unemployment Insurance Trust Fund (FY 2021)
- $430 million in Capital projects over two years

These one-time investments minimize long-term fiscal risk by not adding new ongoing liabilities.
To summarize, **this is a baseline budget**. Most ongoing spending reflects our commitment to fully funding past promises, while most new initiative spending is one-time in nature and focused on infrastructure and debt reduction. Despite this, the



four-year budget outlook remains conservative and sustainable – below even the five-year average under Gov. Ducey that has produced Arizona's largest and longest-running structural surplus.

LOCAL REVENUE IMPACTS

Finally, OSPB wanted to address questions of the implications of this reform on local revenues. It is true that the State – excluding education funding – shares approximately 11% of General Fund revenues with local governments (the 3rd highest percentage of any State Government in this country) – including 15% of Income Tax revenues with a two-year lag. However, the state shares approximately 25% of Transaction Privilege Tax revenues with local governments (including 10% to Arizona cities and towns) and additionally allows municipalities to levy their own municipal privilege taxes. Average local sales tax rates in Arizona are the 9th highest in the country. While the benefit of the Urban Revenue Sharing fund is clear (there are no local income taxes in Arizona), it is less clear what the benefit of the State's high overall revenue sharing rates are given the relatively high local sales tax rates and roughly average local property taxes.

When considering the implications of these reductions in revenue sharing, recall that other recent policy changes in State law which have *increased* local revenues largely pass without comment. The *2019 Tax Omnibus* passed with vocal support from the League of Arizona Cities and Towns, and unlike the State, no general commensurate offset was contemplated from local governments. During debate of that bill and its associated changes to municipal taxes, the League asserted that municipal revenue gains would be minimal – a contention the data now suggests was at least as incorrect as the State's own estimates.

Considering surplus revenue gains contemplated with the passage of Proposition 207, the Remote Sellers tax, and relief from DOR's local cost-sharing assessment, **we believe Arizona cities and towns stand to collect $1.3 billion more in cumulative net new revenue over the next six years even after this tax reform**.

City and Town Impacts From Select Tax Provisions ($ in millions)

	2021	2022	2023	2024	2025	2026
Budget Tax Cuts (URS)					($170.5)	($297.8)
Prop 207 State Shared	$2.6	$4.6	$6.6	$6.6	$6.6	$6.6
Prop 207 Local	$11.5	$20.0	$28.8	$28.8	$28.8	$28.8
Wayfair State Shared	$46.5	$47.4	$48.4	$49.3	$50.3	$51.3
Wayfair Local	$203.7	$207.7	$211.9	$216.1	$220.5	$224.9
DOR Assessment Relief		$11.3	$11.3	$11.3	$11.3	$11.3
Total	$264.3	$291.1	$307.0	$312.2	$147.0	$25.1
5-Year Cumulative Total	$264.3	$555.4	$862.4	$1,174.6	$1,321.6	$1,346.6

These assertions, again, are based on actual collections to date or static JLBC analyses. They do not account for other economic growth attributable to this budget or to economic harm induced by Proposition 208. Indeed, according to the League's own analysis of its revenue losses under this proposal, **Proposition 208 would reduce local revenues by $2.4 billion over ten years** – a loss that would be entirely mitigated by the plans proposed combined tax cap.

To summarize, since CY 2020:

- The State has created an entirely new revenue stream for local governments
- Voters have legalized and subjected to tax recreational marijuana
- Revenue growth at all levels has accelerated, fueled in part by federal passage of the Tax Cuts & Jobs Act
- Despite the extremely conservative revenue projections in the budget agreement, we anticipate the State, Counties, and Arizona Cities and Towns will all continue to exceed their baseline revenue projections
- By mitigating the harmful effects of Proposition 208, this tax package protects the status quo – at the small cost of, perhaps, 1.5% of total revenue per city on a static basis

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