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Fiscal Impact of TPT Contracting Simplification: Less Revenue for State and Most Municipalities

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One of the priorities for Governor Jan Brewer is simplifying Arizona's complex transaction privilege tax system, including as it pertains to contracting, as most states tax contractors at the point of purchase. Because Arizona is a growth state, many communities heavily rely on revenue from contractors to pay for growth and general administrative expenses and prioritized capital projects.

Tax simplification is an important step to make the state eligible for added internet revenues. If Congress enacts enabling legislation the state will be expected to make uniform its tax base. It's also expected that the state will need to ease the administrative burden, so that on line retailers remit taxes to the Department of Revenue, and assist with tax calculation software if local tax rates differ between jurisdictions.

Another reason for simplifying tax collection relates to reducing business costs, so businesses, especially small businesses, use fewer resources to be in compliance. Changes like making the tax base uniform go a long-way here.

As with any statutory change, especially in tight fiscal times, an additional concern is whether a change reduces revenue, is revenue neutral or enhances revenue. In addition, as construction has historically been a large share of the Arizona economy, changes to that component will have distributional effects.

One of the key shortcomings with the current contracting transaction privilege tax system is noncompliance with contractors, meaning that they fail to pay the full amount due, currently assessed based on 65 percent of the contract. Finance divisions at the local level are not directly part of the inspection process, and it's normally too costly to do extensive audits, so at least for large projects they look for general compliance based on an estimated value. The Arizona Department of Revenue for program cities and towns is even farther divorced from the local construction projects. Thus, the system as designed requires occasional audits to monitor compliance, and is fairly inefficient relative to potential revenue, though historically a reasonably lucrative source of tax revenue for the state and municipalities due to the size of the construction sector in the Arizona economy.

The Arizona Department of Revenue estimates noncompliance at 31 percent.[1] Using a similar methodology, the Grand Canyon Institute arrives at 28 percent. The difference between the two lies with areas of noncompliance that are difficult to quantify.

The Transaction Privilege Tax Simplification Taskforce used a 41 percent materials cost assumption.[2] Again, the Grand Canyon Institute finds that to be a highly credible number, but based on the Economic Census arrived at 39 percent for our estimate.

Collectively, the Grand Canyon Institute estimates that changing to a point of sale for construction materials will reduce state sales tax revenue by $85 million. However, due to higher shared revenues, cities and counties would receive $40 million more. But receipts to the General Fund will decline by $125 million. However, though cities receive $15 million of the $40 million, their locally generated revenues are projected to decline by $25 million, leaving cities also with less revenue. Furthermore, point of sale for contracting materials, GCI expects to be fairly concentrated in larger cities. Consequently, declines in revenues would be proportionately larger in most cities and towns with the exception of the state's three largest cities: Phoenix, Tucson and Mesa. However, due to large areas of unincorporated areas near Tucson, Tucson may also see a net loss in revenue. GCI does want to caution that the estimated distribution among cities is speculative, as opposed to the much stronger data sources used elsewhere in the report. [3]

Given that the Joint Legislative Budget Committee projects the General Fund remaining stagnant at $9 billion through fiscal year 2016, and that state spending has fallen in real terms precipitously since 2007, there are serious questions whether the state can afford this kind of lost revenue, especially as one considers the possibility of another economic slowdown before the end of the decade. This change to construction sales tax is not a change that improves

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[1] "Transaction Privilege Tax Simplification Task Force Final Report" December 13, 2012, http://www.azgovernor.gov/TPT/documents/Materials/TPT_121312_TaskForceFinalReport.pdf, (accessed February 10, 2013)

[2] "Transaction Privilege Tax Simplification Task Force Final Report," p. 14.

[3] The author would like to express appreciation to the following individuals who were interviewed related to aspects of this report to better understand their expertise and perspective and to try and improve the accuracy of the report: Elaine Smith, Hans Olofsson Carter Froelich, Grady Gammage, Andrew McGuire, Kevin Artz, and Andrew Greenhill. They are not responsible for the content of the report.

economic growth, as there's no indication despite its complexity and inefficiencies that the current system has inhibited construction growth in the state.

The Good: Efficient Taxes, Steps to Unifying the Tax Base

Louisiana, Colorado, Alabama and Arizona stand out from the rest of the country in local reporting requirements in addition to state reporting requirements. [4] One goal of tax simplification is to reduce these reporting requirements, which can benefit businesses both inside and outside the state.

As noted in the TPT Simplification Task Force Final Report, the contracting tax is both complex and practically complex to enforce, requiring substantial audits far more than other areas of the TPT system.

Current Environment: Impact Fees and Construction Sales Tax

Impact fees are an ideal means of paying for growth, as construction is assessed to pay for costs associated with it. Two years ago SB1525 was passed by the legislature to provide uniformity with respect to the definition of impact fees. That change in definition roughly reduced most municipalities' impact fees by about 17 percent.[5] This resulted from a requirement to remove categories, such as general administrative, from impact fees. SB1525 also restricts service areas to prevent communities from expending monies on areas unrelated to growth such as Art Centers.[6]

Municipalities are now in the process of doing complex engineering analyses to determine exact amounts for impact fees. They will no longer be able to try and use comparables from other communities (e.g., if community X paid $10 million for firehouse, so will community Y), as has sometimes been the case, and must instead rely on licensed professionals. By August 1, 2014 new fees need to be in place that will restrict many of the costs of development formerly covered by impact fees. A developer-majority committee oversees this at the municipal level. Under SB1525, impact fees can cover expanded library space, but not the books to fill the library. They can include parks, but if the parks include substantial added amenities beyond

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[4] "Transaction Privilege Tax Simplification Task Force Final Report" , p. 3.
[5] Duncan Associates (2012), "National Impact Fee Survey," p. 6, http://www.impactfees.com/publications%20pdf/2012_survey.pdf, accessed February 25, 2013.
[6] Froelich, Carter (2012), "Arizona Enacts Sweeping Development Impact Fee Legislation," Arizona School of Real Estate and Business, January 26**,** http://www.asreb.com/skins/asreb/standard.aspx?elid=66&aid=284**,** accessed February 27, 2013.

open space, impact fees may not cover them. The net effect is likely to result in a further reduction of impact fees at least in some communities.[7]

Regardless of one's view on SB1525, its fiscal impact has been to curb revenue sources for cities that have already had to deal with the fiscal challenges from the economic slowdown since 2008. In addition, some growth communities such as Surprise and Queen Creek charge higher TPT rates on prime contracting than general retail. Communities engage in such policies since growth is such a key part of their local economies. SB1525 also curtails this practice.

SB1525 also requires communities like these that had higher construction sales taxes than on retail to rebate that portion against impact fees. For instance, in Surprise the regular retail rate is 2.2 percent, but the prime contacting rate is 3.7 percent, then 1.5 percent is deemed discriminatory, and SB1525 requires that those proceeds be rebated against impact fees. The net effect is that these communities will be coming up with lower impact fees as a consequence.[8]

Right now cities are bound to include those rebates in their calculations of new impact fees, and they are on a very tight timetable to do so and complete it and have it in place by August 1, 2014. Consequently, it's critical If the legislature changes construction sales tax for localities to point of sale that they also immediately address this issue for localities, so that cities currently charging a discriminatory prime contracting rate aren't forced to include revenues they no longer will be receiving as a rebate on impact fees, which the current language of HB2657 does not address.[9]

Generally, impact fees pay for the immediate cost of development, and municipalities tend to use construction sales tax to pay for broader, more general capital projects or general operating expenses. These issues are enhanced since the passage of SB1525. Impact fees can't be used to cover general administration. Likewise, a new park in one neighborhood may create pressures to upgrade existing parks. Or growth may require added lanes to a road, but impact fees may cover only part of that expense. As construction has been a huge part of Arizona's economy historically, many communities rely a great deal on construction sales tax, especially during stronger economic times.

Changes to formulas under SB1525 may limit the ability of growth communities to meet all the costs tied to growth.

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[7] For a very thorough and critical review of SB1525, see McGuire, Andrew J. and Peter W. Culp (2011), "Understanding SB 1525 Arizona's Assault on Municipal Impact Fees," October 27, Gust Rosenthal and Squire Sanders, http://growthandinfrastructure.org/proceedings/2011_proceedings/culp_sb1525.pdf, accessed March 9, 2013

[8] See McGuire and Culp (2011).

[9] Andrew McGuire pointed out this current legal obligation as an omission in HB2657 as drafted.

Compliance with the Current Contracting Tax System

Every five years, the Census Bureau conducts an economic census that becomes the basis of estimating GDP. The last one with available data is from 2007. The Census only covers businesses with employees, so to the Census, the Grand Canyon Institute also includes the Non-Employee businesses statistics from the Census Bureau.

In doing so, the Grand Canyon Institute followed a similar methodology to the Arizona Department of Revenue. Arizona Department of Revenue numbers are used to determine the tax base for contracting/construction and this is divided by the construction portion of the economy as determined by the census.[10]

Table 1 Tax Base from Contracting Calendar Year 2007

	FY 2007	FY 2008	CY2007=AVG
contracting % DOR	$1,118,583,646	$1,006,520,211	$1,062,551,929
divide by .05	0.05	0.05	0.05
contracting base	22,371,672,920	$20,130,404,220	21,251,038,570
divide by .65	0.65	0.65	0.065
contracting business activity	$34,417,958,338	$30,969,852,646	**$32,693,905,492**

Source: Arizona Department of Revenue Annual Reports 2007, 2008.

Table 1 illustrates how the contracting base was calculated based on Arizona Department of Revenue tax data.

Table 2 illustrates how the Construction economic base for contracting was determined from Census data, and the tax base was divided by the census economic base to determine compliance.

[10] The Arizona Department of Revenue calculation is not published, but senior economist Elaine Smith explained the process by which the figure was developed, and the Grand Canyon Institute carefully evaluated the data sources in the process of replicating it, and found it to be sound. For instance, the value added via the Census is about 20 percent greater than what is used for construction for GDP. However, the reason for the difference relates to different definitions of value added. Relative to the contracting base, GCI determined the Economic Census definition of value added best fit relative to determining the potential contracting tax base. See Bureau of Economic Analysis (2006), "Gross Domestic Product by State Estimation Methodology," p. 4, http://www.bea.gov/regional/pdf/gsp/GDPState.pdf, accessed March 8, 2013.

There are a number of areas expressed in the TPT Simplification Taskforce Report related to businesses applying the contracting tax (65 percent of the retail tax) to items that do not qualify or misuse of tax exemption certificates at the retail level. Neither is quantified. The Grand Canyon Institute chose to add into the economic base the additional non-construction business activity done by construction firms as noted in the Census to try and capture these broader elements of noncompliance. The Arizona Department of Revenue's higher rate of noncompliance is likely due to estimating these impacts as larger. The Grand Canyon Institute uses 72 percent compliance in its estimates (see Table 2).

Table 2 Economic Census Contracting and Estimated Compliance

Employer Materials & Value Added[11]	$42,488,905,000
Non-Employer Receipts	$2,367,112,000
Total Construction	$44,856,017,000
Total Business Activity	$45,233,418,000
Arizona Tax Base	$32,693,905,492
Construction/Tax Base	0.729
Business Activity/Tax Base	0.723

Source: Economic Census 2007, NonEmployer Survey 2007, Arizona Department of Revenue Annual Reports 2007, 2008.

Note that a 1999 Study by Arthur Andersen done for the state found a significantly lower compliance rate, 58 percent. The Grand Canyon Institute was not able to review that study, but

[11] The Census normally sources by the location of the business, not the location of work done. This figure is, however, for the value of work done in Arizona. We assume all the work done by non-employer businesses is done in Arizona. Table 3 uses the value of work done by Arizona businesses, as that's the figure that is broken down in the Census. Table 2 uses an imputation of those figures to derive Arizona located work based values.

the Census reports that after the 1997 economic census the methodology of construction was changed to improve estimates.[12] Hence, the GCI doubts that is a reliable estimate.

That same study came up with a 41 percent material cost, which the Transaction Privilege Tax Simplification Taskforce used in their report. A fiscal analysis completed for similar legislation in 2006 by Jack Corey used a 37 percent material cost assumption, the same figure as had been used in 1999 by the Arizona Department of Revenue.[13]

The Grand Canyon Institute used data from the Economic Census and finds support for 37 percent as a material cost assumption. Table 3 provides the Grand Canyon Institute calculation. The economic census at the state level combines fuel costs with material. In determining the actual cost of materials, GCI deducted the cost of gasoline and diesel fuels used in construction as they are not part of the TPT and multiplied the material costs subject to TPT (95.7 percent of the total) to the original material share to arrive at our estimate.

Based on calculations for the United States and Arizona, GCI estimates that 39 is closer to the actual share for material costs subject to TPT and use tax, and thinks 41 percent is likely too high, meaning estimates using 41 percent will overstate revenue projections from a construction material-sourced tax.

Table 3 Material Costs in Contracting

	Arizona	United States
Employer Materials & Value Added	$43,229,659,000	1,339,930,848,000
Material Costs (inc. fuel)	$17,074,708,000	$561,754,672,000
Portion Material Costs	0.392	0.419
US Diesel and Gasoline	$24,288,913,000	$24,288,913,000
US Material Costs	$561,754,672.000	$561,754,672.000
% Material not Gas	0.957	0.957
Taxable Material Costs Share	**0.375**	**0.401**

Source: Economic Census 2007

[12] According to the Bureau of the Census, "In the 1987-1997 censuses, the value of construction work was collected to measure actual construction activity done during the year. Studies have shown that respondents were not able to accurately report these data. In 2002 and 2007, receipts, billings, or sales for construction work was collected. "

[13] Corey, Jack (2006), Fiscal Analysis SB1463, Arizona State Legislature, http://www.azleg.gov//FormatDocument.asp?inDoc=/legtext/47leg/2r/fiscal/sb1463.doc.htm&Session_ID=83, accessed March 8, 2013.

State Tax Change: $125 million less to General Fund, $40 million more to Municipalities

Next the prior estimates are applied to estimate revenue from material sourcing. However, material sourcing may come from out of state or in state. Based on the 2010 Washington State compliance study and tax information available at their Department's web site by industry code, GCI arrives at additional findings.[14] No other data source appears available to estimate construction use taxes or compliance.

1. Retail-based sales taxes have 99 percent compliance
2. 97 percent of materials for construction were sourced from in state firms
3. 3 percent of materials for construction came from out of state
4. Use tax compliance for out of state sales was 87 percent for construction, better than the 77 percent compliance overall for businesses and the use tax in Washington state. For Arizona, GCI assumes 85 percent compliance, if the tax is assessed at point of sale, as at the time Washington state was assessing the tax on contractors selling it to the final consumer.

Arizona's TPT system is rather complicated and includes a nonshared and distributional component. The change to a material sourced tax increases the distributional base to 40 percent (2 percent of the 5 percent tax) from 20 percent, and reduces the nonshared portion that goes to the General Fund exclusively. The distributional portion goes 25 percent to cities, 40.51 percent to counties and 34.49 percent to the state General Fund.

Rather than being revenue neutral, as suggested by Scenario #1 of the TPT Simplification Taskforce, collectively, GCI estimates the change will reduce revenues from contracting by $85 million. In addition, the GCI estimates the loss of revenues to the General Fund would equal $125 million instead of $60 million under Scenario #1. GCI sees cities gaining $15 million and counties gaining $25 million.

A quick way to evaluate the revenue effect is to compare compliance times the taxable portion. Since the TPT Simplification Task Force used 69 percent compliance and 41 percent for materials, they come up with a revenue neutral figure as 0.69 times 0.65 (the contracting rate)

[14] Valz, Erin (2010), "Department of Revenue Compliance Study," Washington State Dept. of Revenue, August 20, http://dor.wa.gov/Docs/Reports/Compliance_Study/compliance_study_2010.pdf, accessed February 22, 2013, and "Detailed Tax Data by Industry and Tax Classification," Washington State Department of Revenue, data from 2006 used to match the 2010 Compliance Study by NAICS code focused on Construction, http://dor.wa.gov/content/AboutUs/StatisticsAndReports/line_code_detail/default.aspx, accessed February 22, 2013.

is approximately equal to 1 times 0.41 (they assumed 100 percent compliance with the point of sales tax and also use tax). The Grand Canyon Institute estimates higher current compliance and lower materials, resulting in the revenue shortfall. The Grand Canyon Institute also believes it uses more realistic compliance numbers by breaking point of sales into in state and out of state sales with different compliance rates for each.

Table 4 Contracting as 65% of Contract v. Materials Sourced

	FY2012 Actual	FY2012 Materials Sourced	Difference
Potential Contracting	$ 20,391,742,201	$ 20,391,742,201	
In State %	100%	97%	
In State Compliance	72%	99%	
Out of State %		3%	
Use Tax Compliance		85%	
Realized Contracting	$14,682,054,385	$20,102,179,462	
Taxable Portion	65%	39%	
Taxable Amount	$9,543,335,350	$7,839,849,990	
tax rate	0.05	0.05	
Revenue	$477,164,635	$391,992,500	**$-85,172,135**
Distribution base	$95,432,927	$156,797,000	$61,364,073
Nonshared	$381,731,708	$235,195,500	$-146,536,208
Cities	$23,858,232	$39,199,250	**$15,341,018**
Counties	$38,659,879	$63,518,465	**$24,858,586**
State General Fund	$414,646,525	$289,274,785	**$-125,371,740**
Total	$477,164,635	$391,992,500	**$-85,172,135**

Based on Financial data from Arizona and Washington State Dept. of Revenue

State and Local Speculative Analysis of Cities: Less Revenue for Most

The Arizona League of Cities of Towns circulated calculations of the construction sales tax by municipality. To that we've shown each city's current share of construction sales tax revenues.

The first chart, Table 5, illustrates the current situation for FY2012 and includes both the local contracting TPT as well as the city's share of SSR (State Shared Revenue) from contracting. These represent total current revenues from construction, though in Table 6 and Table 8 GCI makes adjustments for $13 million in construction sales taxes that SB1525 requires be rebated against impact fees from those communities that charge a higher rate on construction than retail..

Table 5 City and Town Current State and Local Contracting TPT Revenues FY2012

City/Town * = Non-Program City	Total Local TPT Contracting Revenues FY 2011/2012	% of total Local TPT Collection	Population	% of total population	Current SSR (contracting)
Apache Junction *	$710,748	0.42%	35,840	0.71%	$170,243
Avondale *	1,498,541	0.89%	76,238	1.52%	$362,136
Benson	385,570	0.23%	5,105	0.10%	$24,249
Bisbee	117,523	0.07%	5,575	0.11%	$26,482
Buckeye	2,899,220	1.72%	50,876	1.01%	$241,665
Bullhead City* (Estimate)	75,000	0.04%	39,540	0.79%	$187,818
Camp Verde	128,008	0.08%	10,873	0.22%	$51,648
Carefree	542,480	0.32%	3,363	0.07%	$15,974
Casa Grande	1,859,114	1.11%	48,571	0.97%	$230,716
Cave Creek	1,038,152	0.62%	5,015	0.10%	$23,822
Chandler *	10,902,378	6.48%	236,123	4.70%	$1,121,602
Chino Valley	187,286	0.11%	10,817	0.22%	$51,382
Clarkdale	266,314	0.16%	4,097	0.08%	$19,461
Clifton	66,610	0.04%	3,311	0.07%	$15,727
Colorado City	11,189	0.01%	4,821	0.10%	$22,900
Coolidge	761,373	0.45%	11,825	0.24%	$56,170
Cottonwood	398,676	0.24%	11,265	0.22%	$53,510
Dewey-Humboldt	39,337	0.02%	3,894	0.08%	$18,497
Douglas *	520,915	0.31%	17,378	0.35%	$82,547
Duncan	4,265	0.00%	696	0.01%	$3,306
Eagar	37,387	0.02%	4,885	0.10%	$23,204
El Mirage	238,369	0.14%	31,797	0.63%	$151,038
Eloy	247,079	0.15%	16,631	0.33%	$78,998
Flagstaff *	2,614,288	1.55%	65,870	1.31%	$312,887
Florence	1,456,062	0.87%	25,536	0.51%	$121,298
Fountain Hills	280,365	0.17%	22,489	0.45%	$106,824
Fredonia	47,888	0.03%	1,314	0.03%	$6,242

Gila Bend	278,086	0.17%	1,922	0.04%	$9,130
Gilbert	5,174,814	3.08%	208,453	4.15%	$990,167
Glendale *	4,656,476	2.77%	226,721	4.51%	$1,076,941
Globe	70,455	0.04%	7,532	0.15%	$35,778
Goodyear	4,755,592	2.83%	65,275	1.30%	$310,061
Guadalupe	95,806	0.06%	5,523	0.11%	$26,235
Hayden	116,563	0.07%	662	0.01%	$3,145
Holbrook	158,618	0.09%	5,053	0.10%	$24,002
Huachuca City	16,032	0.01%	1,853	0.04%	$8,802
Jerome	15,061	0.01%	444	0.01%	$2,109
Kearny	125,987	0.07%	1,950	0.04%	$9,263
Kingman	639,713	0.38%	28,068	0.56%	$133,325
Lake Havasu City	1,209,319	0.72%	52,527	1.05%	$249,507
Litchfield Park	563,330	0.33%	5,476	0.11%	$26,011
Mammoth	14,063	0.01%	1,426	0.03%	$6,774
Marana	5,827,796	3.47%	34,961	0.70%	$166,067
Maricopa	1,535,980	0.91%	43,482	0.87%	$206,543
Mesa *	9,972,117	5.93%	439,041	8.74%	$2,085,477
Miami	86,689	0.05%	1,837	0.04%	$8,726
Nogales * (Estimate)	100,000	0.06%	20,837	0.41%	$98,977
Oro Valley	2,098,812	1.25%	41,011	0.82%	$194,805
Page	127,505	0.08%	7,247	0.14%	$34,424
Paradise Valley	1,220,750	0.73%	12,820	0.26%	$60,896
Parker	60,367	0.04%	3,083	0.06%	$14,644
Patagonia	17,778	0.01%	913	0.02%	$4,337
Payson	390,389	0.23%	15,301	0.30%	$72,681
Peoria *	3,611,614	2.15%	154,065	3.07%	$731,820
Phoenix *	44,070,671	26.20%	1,445,632	28.78%	$6,866,858
Pima	41,612	0.02%	2,387	0.05%	$11,338
Pinetop-Lakeside	230,097	0.14%	4,282	0.09%	$20,340
Prescott *	1,956,902	1.16%	39,843	0.79%	$189,257
Prescott Valley	953,638	0.57%	38,822	0.77%	$184,407
Quartzsite	103,415	0.06%	3,677	0.07%	$17,466
Queen Creek	2,193,080	1.30%	26,361	0.52%	$125,217
Safford	188,644	0.11%	9,566	0.19%	$45,439
Sahuarita	2,175,680	1.29%	25,259	0.50%	$119,982
St. Johns	35,035	0.02%	3,480	0.07%	$16,530
San Luis	562,988	0.33%	25,505	0.51%	$121,151
Scottsdale *	12,900,000	7.67%	217,385	4.33%	$1,032,595

Sedona * (Estimate)	50,000	0.03%	10,031	0.20%	$47,648
Show Low	296,422	0.18%	10,660	0.21%	$50,636
Sierra Vista	1,028,675	0.61%	43,888	0.87%	$208,471
Snowflake	84,726	0.05%	5,590	0.11%	$26,553
Somerton *	153,168	0.09%	14,287	0.28%	$67,864
South Tucson	38,538	0.02%	5,652	0.11%	$26,847
Springerville	2,345	0.00%	1,961	0.04%	$9,315
Star Valley	16,510	0.01%	2,310	0.05%	$10,973
Superior	0	0.00%	2,837	0.06%	$13,476
Surprise	4,451,945	2.65%	117,517	2.34%	$558,214
Taylor	36,173	0.02%	4,112	0.08%	$19,532
Tempe *	6,831,000	4.06%	161,719	3.22%	$768,177
Thatcher	98,378	0.06%	4,865	0.10%	$23,109
Tolleson	870,317	0.52%	6,545	0.13%	$31,089
Tombstone	13,725	0.01%	1,380	0.03%	$6,555
Tucson *	14,545,456	8.65%	520,116	10.36%	$2,470,589
Tusayan (Estimate)	25,000	0.01%	558	0.01%	$2,651
Wellton	118,085	0.07%	2,882	0.06%	$13,690
Wickenburg	106,240	0.06%	6,363	0.13%	$30,225
Willcox * (Estimate)	100,000	0.06%	3,757	0.07%	$17,846
Williams	120,464	0.07%	3,023	0.06%	$14,359
Winkelman	6,184	0.00%	353	0.01%	$1,677
Winslow	236,690	0.14%	9,655	0.19%	$45,862
Youngtown	28,743	0.02%	6,156	0.12%	$29,241
Yuma	3,238,307	1.93%	93,064	1.85%	$442,061
Totals:	**$168,182,702**	100.00%	5,022,708	100%	$23,858,232

Source: Arizona League of Cities and Towns and author's calculations

Table 6 shows the impact across all municipalities of a change to a material-sourced tax system and illustrates the net revenue change to cities and towns.

Table 6 Aggregate Impact on Cities and Towns of Material-Source Tax

	FY2012
Construction Local Tax Revenue	$168,182,702
Portion required to be rebated against impact fees (SB1525)	($13,328,700)
Current SSR Construction Portion	$23,858,232
Added SSR from Material-Sourced Tax	$15,341,018
Estimated Local Retail Material Sourced	$142,236,391

Net Change excluding SB1525	($10,605,292)
Percent Change	-5.5%
Net Change Including SB1525 mandated rebates	$2,723,408
Percent Change	1.5%

$168 million is the current local tax revenue generated by local construction taxes. $24 million represents the current state shared revenue cities and town receive based on construction alone. A change to a retail material sourced tax, the Grand Canyon Institute estimates based on using actual city ax rates will generate $142 million. Plus, the higher portion of state shared revenue bring is $15 million more. However, $157 million in new revenue falls short of the $168 million currently received, so cities and towns lose $11 million or 5.5 percent of total construction revenues with a change to a material-sourced tax. This comparison is the best one to use when comparing the overall policy change to how city and town revenues had been structured.

SB1525, however, disallows added revenue to municipalities if they charge a higher construction tax rate than retail. SB1525 required that the amount be rebated against impact fees. Thus, under this law which just went into effect on January 1, 2012, municipalities which charged a discriminatory rate on contracting have to rebate that amount against impact fees, so the added tax rate no longer produces added revenues. Using that as a base, reduces current construction revenues by $13 million (see Table 8 for the particular municipalities impacted) and leads to a small $3 million or 1.5 percent gain collectively for cities and towns.

Tables 7 and 8 are more speculative (they are located at the end of the text). All estimates to this point in the analysis have been firmly grounded in a well-developed methodology. Unfortunately, there's no publicly available data on the location of construction material suppliers. Large commercial builders don't' source from Home Depot or your local hardware store. However, we can use general principles of economics to speculate how material sourced taxing might be distributed. Generally, material suppliers would be expected to locate in regional centers with larger populations, as opposed to on the periphery where growth may be occurring, though there may be some suppliers in those areas. Hence, GCI expects there would be disproportionate supplier locations in Phoenix, Mesa and Tucson, and to a lesser degree small cities that are regional centers, Prescott and Flagstaff.

Based on economic theory, Table 7 illustrates a speculative distribution of material sourced-taxes, presuming a disproportionate distribution near population centers and key regional hubs. In fiscal year 2012, using the base amounts from Table 6, Table 7 shows their projected distribution among cities and towns. The distribution is significantly skewed toward larger municipalities, such that net gains are focused primarily on two of the three largest cities, Phoenix and Mesa, especially Phoenix.

Tucson is an unusual case. In the Phoenix-area, you can list a number of cities that border any given city. In Pima County only four other communities are incorporated besides Tucson, and, only one of which, South Tucson, actually borders Tucson. So Tucson is for the most part surrounded by unincorporated areas, and 36 percent of Pima County's population lives in unincorporated areas, most of it adjacent to Tucson.[15] Consequently, and based on conversations with Tucson officials, the Grand Canyon Institute speculates the impact to be lessened by these factors. The city estimates their net loss at $7 million, which may be more accurate than the $1 million loss speculated by GCI.[16]

In Table 7, Total TPT Contracting Revenues and Current SSR (contracting) refer to revenues cities are receiving now as also expressed in Table 5 and Table 6. The Increased SSR represents the distribution of the $15 million in additional state shared revenue that comes due to the rise in the distributional share of the tax under a materials sourced tax as also noted in those tables.

The remaining columns are speculative. The first is the hypothesized share of construction materials sales occurring at the locality. It's weighted in a manner that emphasizes relative population as well in some cases if a city is a regional center—which was applied to Flagstaff and Prescott. For the general weights, GCI presumes a city with four times the population of another will have twice the per capita construction materials, and a city with nine times the population of another will have three times the per capita construction materials.

GCI's analysis makes use of the local tax rates applied to contracting and retail in determining the expected revenue to be generated.

SB1525 disallows added revenue from discriminatory construction tax rates, which a number of communities have. However, to get a better picture of how cities are being squeezed financially, those mandatory rebates are not included in Table 7. Keep in mind that reduced impact fee revenue are not included in Table 7. Table 7 effectively is using a pre-SB1525 base.

Table 8 identifies the lost revenue due to the required rebate against impact fees in SB1525 and illustrates the impact of point of sale taxes on municipalities. For those municipalities that charge a higher tax on construction contracts than retail, the degree to which it is higher will be required to be rebated against impact fees, so there will be no added revenue. Table 8 uses SB1525 as a partial base. It illustrates net changes in revenue due to mandatory rebates of

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[15] Pangburn, Joe (2009), "Unincorporated Pima Communities Leave Millions of Shared Revenue on the Table," Inside Tucson Busines, September 11, http://www.insidetucsonbusiness.com/news/unincorporated-pima-county-communities-leave-millions-of-shared-revenue-on/article_4218a01a-2cda-56d3-931d-0f5ee677375a.html, accessed March 12, 2013.

[16] Reported via interview with Andrew Greenhill, Assistant to the City Manager, Tucson.

construction taxes against impact fee for some communities post-SB1525, but it does not include reduced impact fees overall due to the more stringent criteria for calculating impact fees. Table 8 shows that SB1525 has reduced revenues significantly in those communities that had higher construction tax rates than for retail, a.k.a. discriminatory construction tax rates. These communities alone have lost $13 million in construction tax revenue that is required to be rebated against impact fees. When that adjustment is added, the net effect is that changing to material-based sourcing leads to a modest $3 million gain. This gain is entirely the result of the greater state-shared revenue, as the locally generated sales taxes from construction are $12 million short. This is summarized in Table 6.

However, as with Table 7, Table 8 shows that most communities do not see revenue gains, but experience losses. Phoenix and Mesa have significant gains, but almost all of the rest of the state falls short.

Conclusion

Collecting taxes at point of sale is both simpler and provides far greater compliance than the current contracting-based assessments. Unfortunately, tax simplification as designed for contracting comes at a significant cost. State base revenues decline by $85 million (plus a decline in Prop. 301 monies) with the state General Fund taking an even larger hit at $125 million. In addition, though cities would gain $15 million in state share, locally generated tax is projected to decline by $12 million, meaning cities come out ahead by $3 million, but GCI speculates that this will be concentrated in large areas like Phoenix, and the vast majority of cities and towns will suffer losses.

These losses are compounded if one considers how SB1525 has already reduced local finances. If one uses a pre-SB1525 world as the base, then municipalities end up $11 million short. That adjusts the requirement that discriminatory construction tax rates can no longer be used to enhance municipal revenue, but does not adjust for lower impact fees overall as a consequence of SB1525, so this understates revenue losses. As noted earlier, almost every municipality in Arizona suffers lost revenue, especially those that had higher construction tax rates relative to retail. The only ones that show gains are Phoenix and Mesa.

Fiscal issues are particularly striking in light of JLBC forecasts that the current $9 general fund is projected to only increase through FY2016 by $100 million, due to added business tax deductions coming on line in the next few years. A change to a materials-sourced tax would wipe out even that small nominal increase. At a 2.5 percent annual inflation, the General Fund needs to grow $235 million annually, so Arizona is falling short, which is particularly disconcerting should there be another economic slowdown before the decade ends.

As a report issued last month by Grand Canyon fellow Tom Rex noted, the state's past tax policies have reduced the General Fund by $3.1 billion without having a significant impact on economic growth.[17] From a fiscal standpoint, as it relates to contracting, this tax change will not bring added growth, and while the simplification and greater compliance it offers are strengths, the price tag of $125 million to the General Fund, which in stronger economic times would be double that, raise serious concerns regarding whether Arizona can afford it. Likewise, the structural changes to the local-based construction revenues would significantly shift recipients so that most localities end up net losers.

Fortunately, contracting reform does not appear to be a requirement to meet the internet sales requirements for Congressional legislation, so it need not be an obstacle to other parts of sales tax simplification, such as uniform tax bases at the local level.

Table 7 Speculative Distribution of Construction Materials Tax

City/Town * = Non-Program City	Total Local TPT Contracting Revenues FY 2011/2012	Current SSR (contracting)	Increase from SSR with Materials Tax	Speculative. Construction Material I Share	Speculative Supplier Local Revenue	Speculative Difference to Current Revenue	Percent Change
Apache Junction *	$710,748	$170,243	$109,467	0.22%	$342,596	(258,685)	-29%
Avondale *	1,498,541	$362,136	$232,856	0.67%	$1,207,826	(57,858)	-3%
Benson	385,570	$24,249	$15,592	0.01%	$20,929	(349,049)	-85%
Bisbee	117,523	$26,482	$17,028	0.01%	$23,884	(76,611)	-53%
Buckeye	2,899,220	$241,665	$155,392	0.37%	$790,129	(1,953,699)	-62%
Bullhead City* (Estimate)	75,000	$187,818	$120,768	0.25%	$360,904	406,673	155%
Camp Verde	128,008	$51,648	$33,210	0.04%	$78,064	(16,734)	-9%

[17] Rex, Tom (2013), "The Effects of Tax Reductions In Arizona: Significantly Reduced Government Revenue and No Apparent Impact on Economic Growth," Grand Canyon Institute, February 18.

Carefree	542,480	$15,974	$10,272	0.01%	$13,428	(518,780)	-93%
Casa Grande	1,859,114	$230,716	$148,352	0.34%	$491,363	(1,219,399)	-58%
Cave Creek	1,038,152	$23,822	$15,317	0.01%	$24,453	(998,381)	-94%
Chandler *	10,902,378	$1,121,602	$721,198	3.66%	$3,950,080	(6,231,100)	-52%
Chino Valley	187,286	$51,382	$33,039	0.04%	$77,462	(76,785)	-32%
Clarkdale	266,314	$19,461	$12,514	0.01%	$18,056	(235,744)	-82%
Clifton	66,610	$15,727	$10,113	0.01%	$13,118	(43,379)	-53%
Colorado City	11,189	$22,900	$14,725	0.01%	$15,365	18,901	55%
Coolidge	761,373	$56,170	$36,117	0.04%	$88,538	(636,717)	-78%
Cottonwood	398,676	$53,510	$34,407	0.04%	$82,324	(281,945)	-62%
Dewey-Humboldt	39,337	$18,497	$11,894	0.01%	$11,154	(16,289)	-28%
Douglas *	520,915	$82,547	$53,078	0.07%	$147,219	(320,617)	-53%
Duncan	4,265	$3,306	$2,126	0.00%	$843	(1,296)	-17%
Eagar	37,387	$23,204	$14,920	0.01%	$23,509	1,042	2%
El Mirage	238,369	$151,038	$97,119	0.18%	$390,398	249,148	64%
Eloy	247,079	$78,998	$50,797	0.07%	$147,675	(48,608)	-15%
Flagstaff *	2,614,288	$312,887	$201,189	0.81%	$1,001,638	(1,411,461)	-48%
Florence	1,456,062	$121,298	$77,995	0.13%	$187,312	(1,190,754)	-75%
Fountain Hills	280,365	$106,824	$68,689	0.11%	$201,250	(10,426)	-3%
Fredonia	47,888	$6,242	$4,013	0.00%	$4,373	(39,502)	-73%
Gila Bend	278,086	$9,130	$5,870	0.00%	$5,802	(266,414)	-93%
Gilbert	5,174,814	$990,167	$636,685	3.04%	$3,276,504	(1,261,626)	-20%
Glendale *	4,656,476	$1,076,941	$692,481	3.45%	$7,185,265	3,221,270	56%
Globe	70,455	$35,778	$23,005	0.02%	$30,006	(17,444)	-16%

Goodyear	4,755,592	$310,061	$199,372	0.53%	$956,902	(3,599,318)	-71%
Guadalupe	95,806	$26,235	$16,869	0.01%	$37,682	(41,255)	-34%
Hayden	116,563	$3,145	$2,022	0.00%	$1,173	(113,368)	-95%
Holbrook	158,618	$24,002	$15,434	0.01%	$24,732	(118,453)	-65%
Huachuca City	16,032	$8,802	$5,660	0.00%	$2,746	(7,626)	-31%
Jerome	15,061	$2,109	$1,356	0.00%	$752	(12,953)	-75%
Kearny	125,987	$9,263	$5,956	0.00%	$5,929	(114,102)	-84%
Kingman	639,713	$133,325	$85,729	0.15%	$215,851	(338,133)	-44%
Lake Havasu City	1,209,319	$249,507	$160,435	0.38%	$552,600	(496,284)	-34%
Litchfield Park	563,330	$26,011	$16,726	0.01%	$26,041	(520,563)	-88%
Mammoth	14,063	$6,774	$4,355	0.00%	$2,472	(7,236)	-35%
Marana	5,827,796	$166,067	$106,783	0.21%	$300,063	(5,420,950)	-90%
Maricopa	1,535,980	$206,543	$132,808	0.29%	$416,199	(986,972)	-57%
Mesa *	9,972,117	$2,085,477	$1,340,977	9.29%	$11,684,303	3,053,163	25%
Miami	86,689	$8,726	$5,611	0.00%	$4,518	(76,561)	-80%
Nogales * (Estimate)	100,000	$98,977	$63,643	0.10%	$138,067	101,710	51%
Oro Valley	2,098,812	$194,805	$125,261	0.27%	$381,231	(1,592,320)	-69%
Page	127,505	$34,424	$22,135	0.02%	$42,478	(62,892)	-39%
Paradise Valley	1,220,750	$60,896	$39,157	0.05%	$83,287	(1,098,306)	-86%
Parker	60,367	$14,644	$9,417	0.01%	$7,858	(43,093)	-57%
Patagonia	17,778	$4,337	$2,789	0.00%	$1,899	(13,090)	-59%
Payson	390,389	$72,681	$46,734	0.06%	$92,092	(251,562)	-54%
Peoria *	3,611,614	$731,820	$470,566	1.93%	$2,498,249	(642,800)	-15%
Phoenix *	44,070,671	$6,866,858	$4,415,440	55.50%	$79,785,465	40,130,234	79%

Pima	41,612	$11,338	$7,291	0.00%	$5,353	(28,968)	-55%
Pinetop-Lakeside	230,097	$20,340	$13,079	0.01%	$16,077	(200,941)	-80%
Prescott *	1,956,902	$189,257	$121,694	0.38%	$547,591	(1,287,617)	-60%
Prescott Valley	953,638	$184,407	$118,575	0.24%	$409,053	(426,009)	-37%
Quartzsite	103,415	$17,466	$11,231	0.01%	$12,793	(79,391)	-66%
Queen Creek	2,193,080	$125,217	$80,515	0.14%	$221,020	(1,891,544)	-82%
Safford	188,644	$45,439	$29,218	0.03%	$53,684	(105,743)	-45%
Sahuarita	2,175,680	$119,982	$77,149	0.13%	$184,273	(1,914,258)	-83%
St. Johns	35,035	$16,530	$10,629	0.01%	$14,135	(10,271)	-20%
San Luis	562,988	$121,151	$77,901	0.13%	$373,943	(111,144)	-16%
Scottsdale *	12,900,000	$1,032,595	$663,966	3.24%	$3,838,269	(8,397,765)	-60%
Sedona * (Estimate)	50,000	$47,648	$30,638	0.03%	$69,174	49,812	51%
Show Low	296,422	$50,636	$32,559	0.04%	$50,521	(213,342)	-61%
Sierra Vista	1,028,675	$208,471	$134,049	0.29%	$369,287	(525,340)	-42%
Snowflake	84,726	$26,553	$17,074	0.01%	$19,185	(48,468)	-44%
Somerton *	153,168	$67,864	$43,637	0.05%	$129,340	19,809	9%
South Tucson	38,538	$26,847	$17,263	0.01%	$24,381	3,106	5%
Springerville	2,345	$9,315	$5,990	0.00%	$5,979	9,624	83%
Star Valley	16,510	$10,973	$7,056	0.00%	$5,096	(4,358)	-16%
Superior	0	$13,476	$8,665	0.00%	$6,936	15,601	116%
Surprise	4,451,945	$558,214	$358,936	1.29%	$2,034,140	(2,058,869)	-41%
Taylor	36,173	$19,532	$12,559	0.01%	$12,104	(11,510)	-21%
Tempe *	6,831,000	$768,177	$493,944	2.08%	$2,985,236	(3,351,820)	-44%
Thatcher	98,378	$23,109	$14,859	0.01%	$19,470	(64,048)	-53%

Tolleson	870,317	$31,089	$19,991	0.02%	$30,382	(819,945)	-91%
Tombstone	13,725	$6,555	$4,215	0.00%	$2,941	(6,569)	-32%
Tucson *	14,545,456	$2,470,589	$1,588,607	8.38%	$12,052,732	(904,117)	-5%
Tusayan (Estimate)	25,000	$2,651	$1,704	0.00%	$605	(22,691)	-82%
Wellton	118,085	$13,690	$8,803	0.00%	$8,877	(100,405)	-76%
Wickenburg	106,240	$30,225	$19,435	0.02%	$25,628	(61,177)	-45%
Willcox * (Estimate)	100,000	$17,846	$11,475	0.01%	$15,856	(72,669)	-62%
Williams	120,464	$14,359	$9,233	0.01%	$11,444	(99,787)	-74%
Winkelman	6,184	$1,677	$1,078	0.00%	$533	(4,573)	-58%
Winslow	236,690	$45,862	$29,490	0.03%	$65,322	(141,879)	-50%
Youngtown	28,743	$29,241	$18,802	0.02%	$33,256	23,316	40%
Yuma	3,238,307	$442,061	$284,248	0.91%	$1,107,717	(1,846,342)	-50%
Totals:	$168,182,702	$23,858,232	15,341,018	100.00%	$142,236,391	(10,605,292)	-6%

Source: Arizona League of Cities and Towns and author's calculations

Table 8 Speculative Impact of Materials-Based Sourcing Partially Net of SB1525

City/Town * = Non-Program City	**Additional construction tax revenue required to be rebated to impact fees (SB1525)**	**Speculated Materials Source Difference based on revenue neutral discriminatory construction taxes** (excludes reduced impact fees)	**Percent change in total construction revenues**
Apache Junction *	$0	($258,685)	-29%
Avondale *	$0	($57,858)	-3%
Benson	($144,589)	($204,460)	-77%
Bisbee	$0	($76,611)	-53%

Buckeye	$0	($1,953,699)	-62%
Bullhead City* (Estimate)	$0	$406,673	155%
Camp Verde	$0	($16,734)	-9%
Carefree	($135,620)	($383,160)	-91%
Casa Grande	($929,557)	($289,842)	-25%
Cave Creek	($415,261)	($583,121)	-90%
Chandler *	$0	($6,231,100)	-52%
Chino Valley	$0	($76,785)	-32%
Clarkdale	($66,579)	($169,166)	-77%
Clifton	$0	($43,379)	-53%
Colorado City	$0	$18,901	55%
Coolidge	($190,343)	($446,374)	-71%
Cottonwood	($99,669)	($182,276)	-52%
Dewey-Humbo ldt	$0	($16,289)	-28%
Douglas *	$0	($320,617)	-53%
Duncan	$0	($1,296)	-17%
Eagar	$0	$1,042	2%
El Mirage	$0	$249,148	64%
Eloy	($82,360)	$33,752	14%
Flagstaff *	$0	($1,411,461)	-48%
Florence	($728,031)	($462,723)	-54%
Fountain Hills	$0	($10,426)	-3%
Fredonia	$0	($39,502)	-73%
Gila Bend	$0	($266,414)	-93%
Gilbert	$0	($1,261,626)	-20%
Glendale *	$0	$3,221,270	56%
Globe	$0	($17,444)	-16%
Goodyear	($1,358,741)	($2,240,578)	-60%
Guadalupe	$0	($41,255)	-34%
Hayden	$0	($113,368)	-95%
Holbrook	$0	($118,453)	-65%
Huachuca City	$0	($7,626)	-31%
Jerome	$0	($12,953)	-66%
Kearny	($31,497)	($82,605)	-80%
Kingman	$0	($338,133)	-44%
Lake Havasu City	$0	($496,284)	-34%
Litchfield Park	($234,721)	($285,842)	-81%

Mammoth	$0	($7,236)	-35%
Marana	($2,913,898)	($2,507,052)	-81%
Maricopa	($658,277)	($328,695)	-30%
Mesa *	$0	$3,053,163	25%
Miami	$0	($76,561)	-80%
Nogales * (Estimate)	$0	$101,710	51%
Oro Valley	($1,049,406)	($542,914)	-44%
Page	$0	($62,892)	-39%
Paradise Valley	$0	($1,098,306)	-86%
Parker	$0	($43,093)	-57%
Patagonia	$0	($13,090)	-59%
Payson	$0	($251,562)	-54%
Peoria *	$0	($642,800)	-15%
Phoenix *	$0	$40,130,234	79%
Pima	($13,871)	($15,097)	-39%
Pinetop-Lakeside	$0	($200,941)	-80%
Prescott *	$0	($1,287,617)	-60%
Prescott Valley	$0	($426,009)	-37%
Quartzsite	($29,547)	($49,844)	-55%
Queen Creek	($1,032,038)	($859,507)	-67%
Safford	$0	($105,743)	-45%
Sahuarita	($1,087,840)	($826,418)	-68%
St. Johns	$0	($10,271)	-20%
San Luis	$0	($111,144)	-16%
Scottsdale *	$0	($8,397,765)	-60%
Sedona * (Estimate)	$0	$49,812	51%
Show Low	$0	($213,342)	-61%
Sierra Vista	($293,907)	($231,432)	-25%
Snowflake	$0	($48,468)	-44%
Somerton *	$0	$19,809	7%
South Tucson	$0	$3,106	5%
Springerville	$0	$9,624	83%
Star Valley	$0	($4,358)	-16%
Superior	$0	$15,601	116%
Surprise	($1,804,843)	($254,026)	-8%
Taylor	$0	($11,510)	-21%

Tempe *	$0	($3,351,820)	-44%
Thatcher	($28,108)	($35,940)	-38%
Tolleson	$0	($819,945)	-91%
Tombstone	$0	($6,569)	-32%
Tucson *	$0	($904,117)	-5%
Tusayan (Estimate)	$0	($22,691)	-82%
Wellton	$0	($100,405)	-76%
Wickenburg	$0	($61,177)	-45%
Willcox * (Estimate)	$0	($72,669)	-62%
Williams	$0	($99,787)	-74%
Winkelman	$0	($4,573)	-58%
Winslow	$0	($141,879)	-50%
Youngtown	$0	$23,316	40%
Yuma	$0	($1,846,342)	-50%
Totals:	($13,328,700)	$2,723,408	2%

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The Grand Canyon Institute, a 501(c)3 nonprofit organization, is a centrist think-thank led by a bipartisan group of former state lawmakers, economists, community leaders, and academicians. The Grand Canyon Institute serves as an independent voice reflecting a pragmatic approach to addressing economic, fiscal, budgetary and taxation issues confronting Arizona.

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