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Enhanced Revenue Enforcement Creates Fairness, Raises Millions in Revenue

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Executive Summary

In comparison to other states, Arizona has much leaner staffing in its Department of Revenue, even though the tax code for the income tax with its myriad of tax credits, deductions, exemptions, and other income treatment, and a transaction privilege tax with numerous goods and services subject to tax are both rather complex to administer. Compared to 2001, Arizona has less than half as many people in the department relative to the state's population, an enormous drop.

Other states don't show comparable declines and they currently have staffing levels frequently twice as high as Arizona. The number of corporate auditors has reportedly dropped to four as a result of 52 employees being laid off at the end of fiscal year 2016.

When it comes to state tax administration, certain things are both obvious and evident. First, without a vigorous tax enforcement presence, some people and businesses will underpay their share of state taxes. Second, when the state needs added revenue without raising taxes, investing in added enforcement staff results in a substantial return on investment of $4 to as much as $25 for every dollar spent, depending on the enforcement function funded.

The Department of Revenue can expect to increase state revenue by at least $70 million for FY2018 by increasing staffing for audit, collections, and licensing enforcement.

In one scenario examined, the Department of Revenue can expect to increase state revenue by at least $70 million in the first year and more so in subsequent years by increasing staffing for audit, collections, and licensing enforcement. Many Arizonans would like to find a means of funding priorities like education without raising taxes. Investments in the Department of Revenue would be the most logical first step.

Staffing in Arizona's Department of Revenue

Layoffs in the Dept. of Revenue have been dramatic. The total number of corporate auditors reportedly plummeted from 30 to 4. The Joint Legislative Budget Committee reported to a House subcommittee on Appropriations, "Total Enforcement staff has declined (42%) since FY 2015."

Arizona has reduced staffing in its Department of Revenue by almost 40% since 2001. In 2001, Arizona's Department of Revenue employed 1,023 FTE employees. After staying stable through 2008, it declined precipitously with the Great Recession in 2009 to only 644, gradually rebuilt staffing to 779 in 2012, and has again been plummeting from 756 in 2015 to 646 in 2016. These cuts have hit the Audit and Collection divisions particularly hard. For FY2017, a $7 million cut in what was able to be spent on payroll led to 52 more employees in the Department of Revenue being laid off in June 2016. The impact has been dramatic with the total number of corporate auditors reportedly plummeting from 30 to 4.[1] The Joint Legislative Budget Committee reported in its presentation to a House subcommittee on Appropriations, "Total Enforcement staff has declined (42%) since FY 2015."[2] Compared to 2005, total audit and collections enforcement staff has been cut 60%. See Table 1.

Table 1

Arizona Dept. of Revenue Staffing

Fiscal Year	Employees	Audit Division FTE filled	# of Corporate Auditors	Collections Division FTE filled	Agency Budget (millions)
2001	1023		21		
2002	998		19		
2003	1050		22		
2004	1044		35		
2005	1019	296		212.5	
2006	995				
2007	959				
2008	964				

[1] Randazzo, Ryan (2016), "Arizona lays off 52 in revenue department," Arizona Republic, June 30, http://www.azcentral.com/story/money/business/economy/2016/06/30/arizona-lays-off-52-revenue-deparment/86571172/ and Hansen, Ronald J. (2016), "Economist warns Legislature: Arizona could lose up to $100 million after laying off 26 auditors," Arizona Republic, October 5, http://www.azcentral.com/story/news/politics/legislature/2016/10/05/economist-warns-legislature-arizona-could-lose-up-100-million-after-laying-off-26-auditors/91621228/ (accessed Feb. 24, 2017).

[2] Joint Legislative Budget Committee (2017), "Department of Revenue," Health and Welfare Subcommittee of House Appropriations, February 7, http://www.azleg.gov/jlbc/18dorjlbcpres.pdf (accessed February 27, 2017).

Arizona Dept. of Revenue Staffing

Fiscal Year	Employees	Audit Division FTE filled		# of Corporate Auditors	Collections Division FTE filled		Agency Budget (millions)
2009	644						
2010	648			40			
2011	711						
2012	779						
2013	738						
2014	703						
2015	756	201	187		148	162	$75.5
2016	646	212		30	120		$78.8
2017		114		4	88		$78.7
2018							$76.8 (proposed)

Source: Arizona Annual Workforce Reports through FY2016, Arizona Auditor General reviews in 2005 and 2015, JLBC Presentation to House Appropriations Subcommittee 2/7/17 for staffing FY2015-217, Executive Budget Proposal for FY2017 and FY018 for budget amounts, former auditor in Department of Revenue for 2010 auditors, *Arizona Republic* on 52 laid off for FY2017 and corporate auditor change. Note Auditor General and JLBC report same number of Audit plus Collection staff (349) for FY2015, but 14 staff are categorized differently.

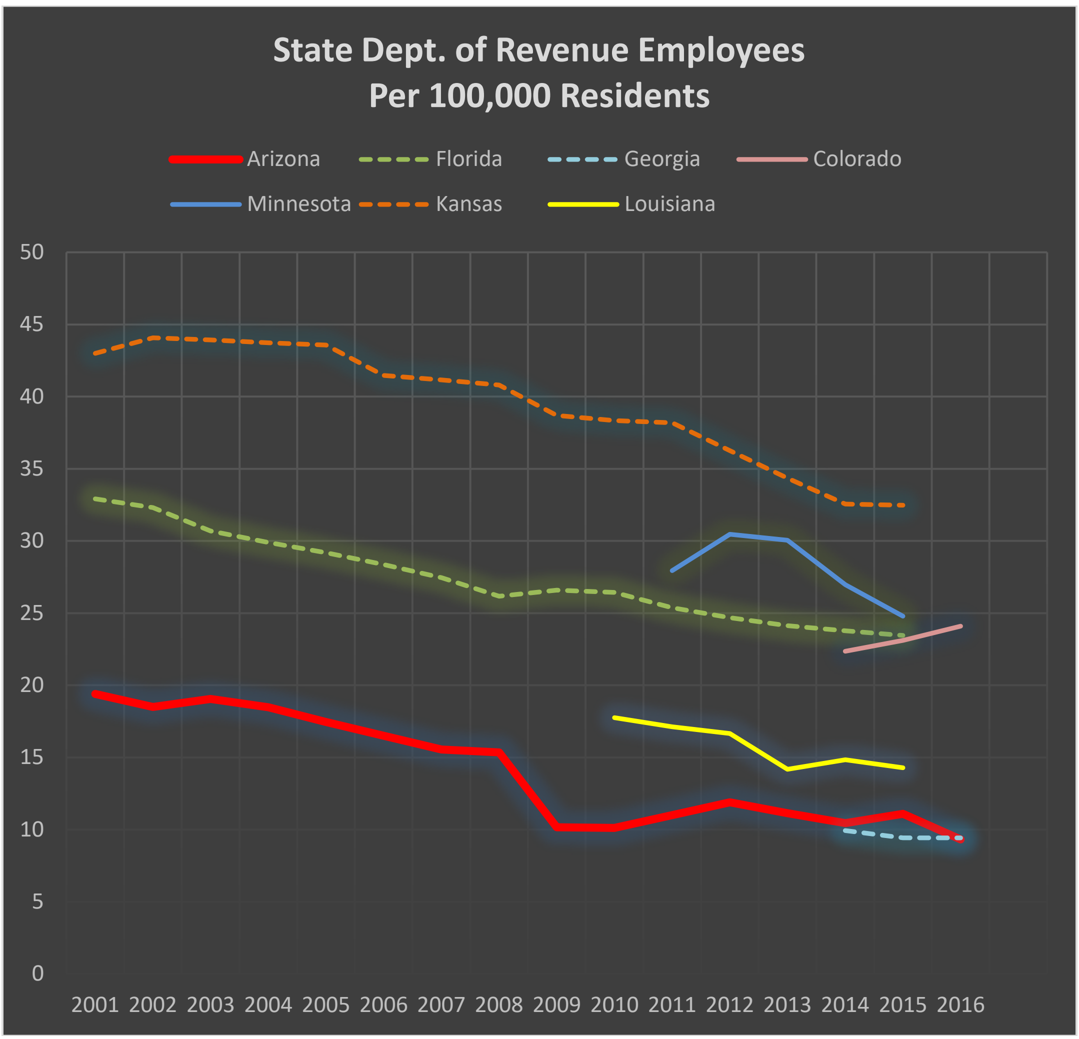
Many states like Arizona publish annual workforce reports regarding state employees. These reports include relevant staffing in Departments of Revenue. Using those documents and state populations, the relative staffing in these agencies can be compared across states. The six states selected each had at least three years of full-time equivalent (FTE) staffing data available and ranged from being about half the size of Arizona (Kansas) to three times the population of Arizona (Florida) with most states having fairly similar or slightly smaller populations. All the states are ranked on the lower to middle of total state employees per resident, with Florida having the lowest in the country. Arizona ranks 7th and Georgia 12th. Every state's tax system is different, so one should be careful in drawing direct comparisons. However, Arizona has a centralized and complex tax code. Its Transaction Privilege (Sales) Tax is centrally administered by the Department and includes differing portions for local government and the state. Corporate income taxes by their very nature are complex, and Arizona provides a multitude of tax credits that can be used for a number of years for both the individual and corporate tax code. Consequently, Arizona's staffing needs one would expect to be at least comparable to other states, even those on the lower scale of state employees per state resident.

Figure 1 shows that Arizona has, in fact, one of the lowest staffing rates among the states identified. Per 100,000 residents Arizona has dropped from 19.4 in 2001 to 9.3 in 2016, a decline of more than half. By contrast during the same period Florida's staffing level dropped 30 percent and Kansas by one-fourth.

Taken as a ratio Arizona's estimated current staffing levels to these states is shown in Figure 2. Generally, most states have two to three times the Department of Revenue staffing level of Arizona with only Georgia being roughly comparable.

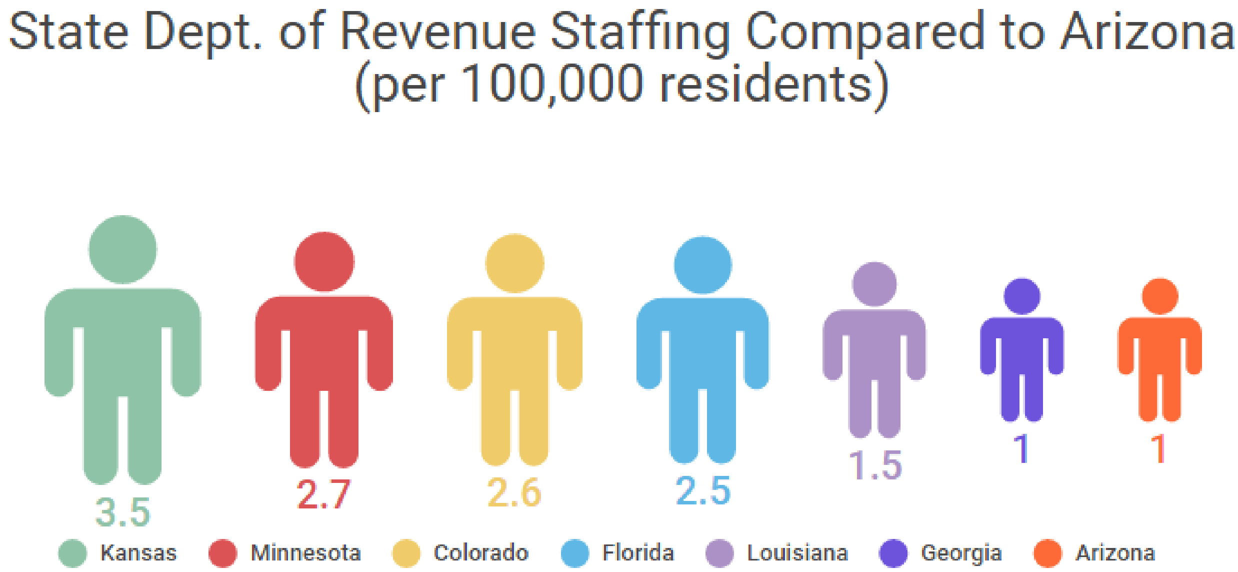
As the Arizona Auditor General stated in its 2005 Performance Audit, "Auditing is a critical function because the State depends on taxpayers to voluntarily report and remit taxes in a timely manner. Therefore, auditing is used to educate taxpayers and to discover and correct differences between taxpayer obligations and what they report and pay. Auditing also serves to encourage compliance with tax laws and helps instill confidence in the fairness of state government by reassuring taxpayers who comply that those who do not comply are at risk."[3]

Figure 1



[3] Auditor General (2005), "Department of Revenue: Performance Audit," August, Report 05-06, https://www.azauditor.gov/reports-publications/state-agencies/revenue-department/report/department-revenue-audit-division-2005 (accessed February 24, 2017).

Figure 2



The Department of Revenue ensures that each and every taxpayer, whether a person or business entity, pay their fair share of taxes. The lack of a vigorous audit, collection and licensing enforcement effort leads to evasion, fraudulent reporting and failure to discover errors many taxpayers make in filing and paying taxes. Based on return filings in 2003-2005, over 40% of individual tax returns had errors. In addition, Department of Revenue licensing enforcement staff annually found hundreds of businesses that were operating, but not paying state transaction privilege and/or corporate income taxes, and sometimes failing to remit personal income taxes withheld from employees. As a result of these types of situations, citizens and businesses who do remit their taxes are having to shoulder the burden of supporting essential government services or are being deprived of adequate state services due to insufficient tax revenues.

Enhanced Enforcement Increases Revenue

Over my nine plus years as Arizona's Revenue Director, we were asked multiple times to provide an enhanced tax enforcement plan to raise revenues when the economy slowed and money was needed to sustain funding for essential health, safety and education programs. Implementation of these enhanced enforcement programs raised revenues without the need to raise taxes from businesses and people already paying their fair share. Revenue also used amnesty programs (we were the first Department of Revenue in the country to implement such a program in 1982), which can be a good tool for short term revenue increases on a one-time basis. Amnesties are only valuable, however, if taxpayers believe they may be audited and subject to penalties and interest if they fail to pay their fair share of taxes. Without vigorous enforcement, voluntary compliance will decline and no toothless amnesty programs will be as effective as they could be, particularly if also done frequently or for a long period of time.

The amount of added revenues from new enforcement staff could be easily targeted to education or other programs.

Many Arizonans are concerned about the lack of adequate funding for essential state programs, particularly education. One approach to address the lack of funding would be to invest more in auditors, collectors and licensing enforcement staff at the Department of Revenue. Unfortunately enforcement staffing at Revenue, as noted, has significantly declined by 40% since FY2015 and 60% compared to FY2005, thereby contributing to the inadequacy of future resources to fund essential services and likely leading to lower levels of voluntary compliance. While some automation of some functions has undoubtedly occurred due to automating some functions, auditing efforts and licensing enforcement require field work by staff in most instances.

During the first four months of fiscal 2017, for example, likely a result of reduced enforcement staff, auditors and collectors at Revenue only collected about $94.5 million; including less than $2.6 million from corporate auditing that had produced nearly $34 million in the prior year.[4] If the same pace of audit and collections continues throughout the remainder of fiscal 2017, Revenue would only collect around $284 million in unpaid taxes from auditing and collecting activities. This compares to $390 million and $400 million in each of the prior two fiscal years, respectively. See Table 2.

Table 2

Fiscal Year	Net Audit + Collections (millions)	Percent of All Revenue	Lost Revenue relative to 2006-2008 (millions)
2006	$458	**3.4%**	
2007	$488	**3.4%**	
2008	$448	**3.2%**	
2009	$391	3.3%	
2010	$370	3.4%	
2011	$357	2.9%	**$53**
2012	$348	2.7%	**$88**
2013	$359	2.6%	**$96**
2014	$373	2.9%	**$64**
2015	$390	2.8%	**$72**
2016	$398	2.8%	**$82**

Source: Arizona Department of Revenue Annual Reports.

Decreased staffing appears to have diminished the state's ability to collect as net audit and collections were about 3.3% of all revenue collected in FY2006-2008 before major staffing reductions occurred. By FY2016 audit and collections only provided 2.8% of all

[4] Figures provided by Arizona Dept. of Revenue.

The Department of Revenue staff tracks how much enforcement revenue is raised by enforcement activity by month. Additional net monies resulting from new staffing would be easily identified.

revenue as shown in Table 2. Had the Department maintained a similar level of productivity in net Audits and Collections as it had from 2006-2008, in FY2016 the Department of Revenue would have collected an additional $82 million.

The amount of added revenues from new enforcement staff could be easily targeted to education or other programs as the Department of Revenue staff tracks how much enforcement revenue is raised by enforcement activity by month, and has done so for years. Additional net monies resulting from new staffing would be easily identified.

The Department of Revenue has historically been very successful in finding and collecting unpaid state taxes, even though only a small percentage (less than 2%) of taxpayers are audited each year. Data from FY2006-FY2011 was obtained to illustrate in Table 3. In years past, licensing enforcement staff annually found hundreds of businesses failing to remit transaction privilege taxes owed and/or failing to file and pay corporate income taxes due. In addition, while efforts to collect known unpaid taxes has continued over the years, the accumulative accounts receivables (money billed but not received) increased from just over $450 million in 2007 to over $635 million at the end of fiscal 2013.[5] Clearly the opportunity to obtain added revenue without raising taxes exists through increased compliance efforts by the Department of Revenue.

Table 3

Percent of Taxpayers Audited (2006-2011)

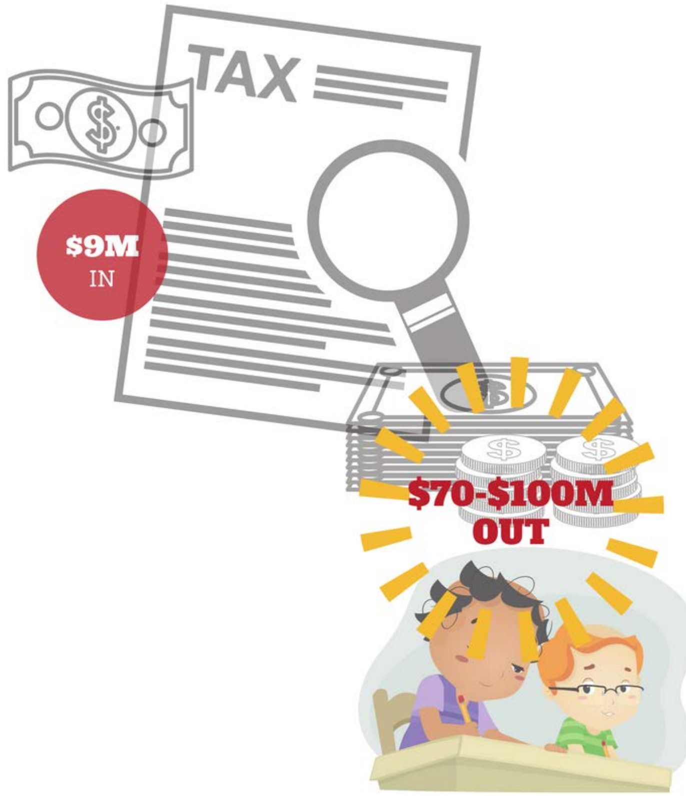
	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011
Corporate	0.79	0.81	0.59	0.72	0.53	0.35
Transaction Privilege Tax	5.13	4.24	3.57	2.78	1.36	2.64
Individual	1.93	1.77	1.66	1.20	1.24	1.87
Total	2.07	1.88	1.74	1.27	1.23	1.88

Source: Arizona Dept. of Revenue

Through comprehensive enforcement enhancement to ensure fairness in all areas of tax compliance, each dollar invested in added enforcement will return, on average, $10 to over $24 based on past experience. During my years as Director of the Department of Revenue, on average corporate auditors returned about $12 per dollar funded, individual income tax auditors returned about $4, and transaction privilege tax auditors $5.50. Licensing enforcement had the highest return on investment, raising an average of nearly

[5] From Arizona Department of Revenue.

$50 for every dollar invested in some years. Collection efforts were the second highest ROI, averaging about $26 returned per dollar expended. Latest information seen for fiscal year 2013 shows the value and return on investment for funding tax enforcement is still very high. Audit and licensing enforcement combined returned $11.65 in that fiscal year while Collections returned $24.21 per dollar spent. Further, information from 2011 (latest available) shows only 0.35% of corporations, 2.64% of transaction privilege licensees and 1.87% of individual income taxpayers are being audited, and those audit percentages have likely dropped as budget reductions have caused cuts in Revenue staffing. Clearly there is ample capacity to reinvigorate and even expand the audit and licensing enforcement programs.



One scenario to quickly enhance state revenues, would be to increase enforcement at the Department of Revenue as follows:

1. Add 40 corporate auditors plus 10 support staff.
2. Add 20 transaction privilege tax auditors plus 5 support staff.
3. Add 20 licensing enforcement staff plus 5 support personnel.
4. Add 40 collectors plus 10 support staff.

The support staff is essential to ensure auditors, licensing staff and collectors are able to focus on enforcement and not clerical duties. Licensing staff and collectors will have the biggest return on investment in the short term as the training curve is not as great as for auditors. It is important to expand corporate and transaction privilege tax enforcement to provide the incentive for businesses to voluntarily report and pay timely and correctly. The effectiveness of the Individual income tax audit function at the state level is almost totally dependent on federal income tax audits, plus it has a lower return on investment. Adding staff for this function may not be as beneficial as funding other enforcement functions.

The Department of Revenue would need to put more current figures together for both costs and benefits from such an enhanced compliance program, but an estimate of the value added from enforcement expansion can be reasonably made. The added revenue is based on FY2013 Return on Investment data from the Department of Revenue. A review

Department of Administration personnel information suggests audit staff salaries average less than $40,000 and collection staff less than $35,000. Support staff are presumed to average $28,000 for this analysis. Employee related expense is estimated at 35% and other operating expense is estimated at 20% of salary for audit and licensing staff, and 15% for other staff. Based on experience the impacts are estimated as follows, at a minimum.

1. Added revenue from audit and licensing enforcement, $48 million first year and $69 million in subsequent years. Annual cost would be about $6 million, for an initial return of $8 for each dollar appropriated, and over $11 in future years.
2. New collectors and support staff should increase revenue by at least $47 million the first year and $62 million in the next year. The added annual cost would be about $2.6 million, for an initial return on investment of over $18 for each dollar invested and growing to the mid $20's in subsequent years.

Overall, added revenues would be at least $95 million in the first year and $131 million in subsequent years. There will be a 5% adjustment for double counting when collections obtains revenue resulting from audits, so net new revenue would be about $90 million in year 1 and about $125 million in subsequent years. It should also be noted that a small portion of the added revenue (20% or less) would be shared with cities and counties by law, but the bulk of the revenue gain would be deposited in the State General Fund. This means about $70 million would net to the General Fund the first year and at least $100 million in following years. The breakdown is shown in Table 4. Note in Table 4 that the net to the General Fund is that total revenue gains to the state less the cost of the additional staff. Local government receives about 20% of any added revenue.

To reach these levels, the hiring process must begin as soon as possible. Thus, for this fiscal year, the legislature needs to pass a supplemental appropriation to the Department of Revenue of $1.5 M to begin the recruitment and hiring process. Then the gains for the following fiscal years can realized. Even in FY2017, the new staff will bring in more revenue than the amount of the supplemental appropriation.

Table 4

150 Additional Hires for Department of Revenue Scenario

Fiscal Year	Cost to add 150 Staff	Added Staff Audit and Licensing	Added Staff Collections	Revenue Gains from Added Staff	Portion to General Fund	Portion to Local Government
2017[6]	$1.5 M	100	50	$ 5 M	$ 4 M	$ 1 M
2018	$8.6 M	100	50	$ 90 M	$ 70 M	$20 M
2019 on	$9 M	100	50	$125 M	$100 M	$25 M

[6] Cost and Revenue estimates for FY2017 are approximate and would depend on how quickly staff was hired.

Conclusion

One scenario of added hiring was demonstrated here. Obviously, there are other levels of increased funding to enhance enforcement available to policy makers. The net increase in revenue could be even greater if policy makers realize that there is ample capacity for expanding enforcement to ensure fairness and equity while collecting even higher amounts of unpaid tax dollars to support essential government services.

If policy makers in the Legislature desire to obtain the added $70 million or more revenue from enforcement dollars, they should fund the Department with a supplemental appropriation as quickly as possible. This will ensure new staff is hired and trained so added revenues from non-filers and underreporting taxpayers can begin to be raised early in fiscal 2018.

Elliott Hibbs, a member of the Grand Canyon Institute Board of Directors, has over 38 years of highly successful government service, over 28 of which have been in Arizona, where he was appointed by four different governors for high level positions requiring Senate confirmation. He served as Director of the Department of Revenue and Director of the Department of Administration, among many other roles within and outside of government.

Dave Wells holds a doctorate in Political Economy and Public Policy and is the Research Director for the Grand Canyon Institute, a centrist fiscal policy think tank founded in 2011. He can be reached at DWells@azgci.org or contact the Grand Canyon Institute at (602) 595-1025.