

## Risking the Future of Education in Arizona: How Prop. 126 Threatens the State Budget

Arizonans will vote this November on Proposition 126, a proposed constitutional amendment that would prohibit the state and local governments from ever imposing the sales tax on services. Proposition 126, if enacted, would jeopardize funding for education, healthcare and other state priorities because it would prevent Arizona from changing its sales tax law to adjust to our changing economy in which people are increasingly spending more of their income on services than goods.

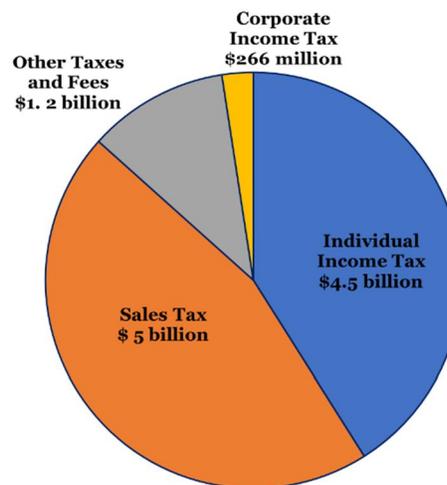
### Arizona's Sales Tax Base is Shrinking

Monies collected from sales taxes make up nearly half of all revenue to the state general fund. The state charges an additional 0.6% sales tax dedicated to education, in addition to the sales tax revenue which is distributed to the state general fund. This 0.6% sales tax generates over \$640 million annually with about \$500 million going to K-12 education. The remainder goes to universities and community colleges.

However, Arizona's sales tax base has been getting smaller and smaller. There are over 100 exemptions in Arizona law for which sales tax is not charged. Some of these exemptions are for basic needs like food and medicine, while others are special interest tax breaks for particular products like private jets and fine art. These exemptions ultimately reduce the size of the tax base. In 2017, sales tax exemptions excluded \$12.0 billion from sales tax collections, 40 percent for services that aren't taxed.

A 2014 study from the University of Arizona found that there was a "one-third reduction in the taxing capacity of the sales tax in just a little over two decades," with the trend worsening substantially since 2005. The study found several reasons for Arizona's eroding tax base including tax exemptions for services mixed with an aging population that spends more on those exempt services, and the increase in online purchases.<sup>1</sup>

### Arizona collects nearly half its revenues from the sales tax



Source: Joint Legislative Budget Committee, Fiscal Year 2018 Appropriations Report (2017)

<sup>1</sup> Alberta Charney, *Arizona's Eroding Sales Tax Base* (2014). <http://bit.ly/UASalesTaxBaseStudy>

### Services account for a growing percentage of all sales tax exemptions<sup>2</sup>

Year	Total Value of Sales Tax Exemptions	Percent of all Exemptions Given to Services
2003	\$6.0 billion	19 percent
2010	\$11.2 billion	30 percent
2017	\$12.0 billion	40 percent

## The Ongoing Shift to a Service-Based Economy will Continue to Shrink Our Sales Tax Collections

One of the most important long-term economic trends in the United States is the move from a

goods-based economy to a service-based economy. This shift has been long in the making and shows no signs of slowing down.<sup>3</sup>

One of the major factors driving this shift in recent years is the increase in online shopping. For example, shoppers used to go to a store and buy their movies on DVD, which they paid sales tax on. Today, many shoppers choose to get a Netflix subscription instead of buying something in a store – since Netflix operates as a cloud-based service, consumers do not pay sales taxes. Not only is the state losing sales tax revenue as fewer people buy physical DVDs, it begs a basic question of fairness: Why should one form of watching a movie be taxed while the other is not?

## Prop. 126 Will Push the Sales Tax Rate Higher

This trend will only deepen into the future, further eroding the sales tax base and state revenues. Legislation was considered but not enacted during the 2018 session which would stop the taxation of online goods and services. That legislation sought to define a significant portion of online transactions as services, exempting them from sales tax, which the Arizona League of Cities and Towns estimated would reduce state revenues by \$120 million annually. It is expected similar legislation will be introduced again in 2019. If more and more online transactions are defined as services, Proposition 126 will eliminate options to keep these transactions within the sales tax base.

One of the alternatives to make-up for the lost revenue from the shrinking sales tax base will be to raise the sales tax rate. Arizona already has the 11<sup>th</sup>

## Arizona has one of the most regressive tax systems in the country

State	Percent of income the bottom 20% pays in taxes	Percent of income the top 1% pays in taxes
1. Washington	16.8%	2.8%
2. Florida	12.9%	2.5%
3. Texas	12.5%	3.2%
4. South Dakota	11.3%	2.2%
5. Illinois	13.2%	5.9%
6. Pennsylvania	12.0%	5.5%
7. Tennessee	10.9%	3.4%
<b>8. Arizona</b>	<b>12.5%</b>	<b>5.7%</b>
9. Kansas	11.1%	5.1%
10. Indiana	12.0%	6.3%

Source: Institute on Taxation and Economic Policy, *Who Pays? 5th Edition (2015)*

<sup>2</sup> Arizona Department of Revenue, *Tax Expenditures Report* (2004, 2011, 2018). AZDOR sometimes changes and adds in tax categories. AZDOR began tracking financial service exemptions in 2010, therefore the 2003 exemptions do not include financial services. The FY2017 report remains in preliminary status and subject to future revisions.

<sup>3</sup> Center on Budget and Policy Priorities' Analysis, *U.S. Bureau of Economic Analysis – National Income and product Account Data* (2016.)

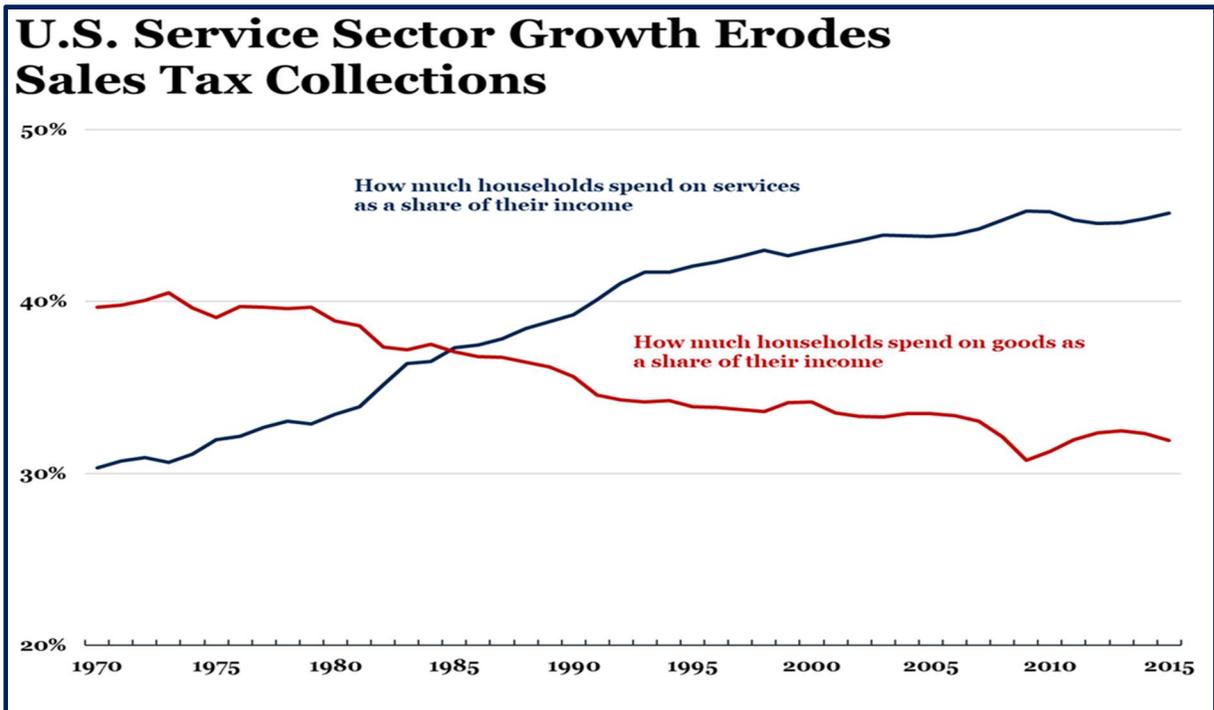
highest state plus local sales tax. In some communities the state plus local sales tax is already over 10 percent, creating negative impact for consumers and businesses. If Prop. 126 is enacted, state and local sales tax rates are likely to be pushed even higher over time.



Increasing the sales tax rate disproportionately impacts low and middle-class Arizonans because they pay a greater percentage of their income on sales tax than do those who earn more. Arizona's increasing reliance on the sales tax to fund state government and continued hikes to the sales tax rate are reasons why Arizona has the 8<sup>th</sup> most regressive tax system in the nation, meaning we take a much greater share of income from low- and middle-income families than from wealthy families. Proposition 126 will make an already regressive tax system worse.

## Proposition 126 will eliminate options to fund state priorities

The declining revenue from the shrinking sales tax base is compounded by hundreds of millions of dollars in tax cuts made at the State Capitol between 1990 and 2017, mostly to the personal and corporate income taxes. These cuts resulted in reducing state general fund revenues by \$4.4 billion when adjusted for inflation.



Source: Center on Budget and Policy Priorities, Analysis of U.S. Bureau of Economic Analysis National Income and Product Account Data (2016)

Declining revenues hurt Arizona's ability to keep up with the needs of a fast-growing population. Arizona's public schools have over \$800 million less in annual funding than a decade ago, state funding for universities dropped 47 percent between 2008 and 2017, lawmakers eliminated state funding for community colleges, funding for state child care

subsidies evaporated, and almost every state agency operates with less funding today than a decade ago.

Arizona has a significant revenue problem and removing options is a bad idea. Proposition 126 will only make it more difficult to restore all of the state funding that has been cut and left unrestored over the past decade. The Arizona Constitution already requires a two-thirds vote from both chambers of the legislature and the governor's signature to raise revenue through new taxes. It is not surprising that there have been no new sales taxes imposed on services since this constitutional provision was enacted by voters in 1992. Adding an additional constitutional barrier to tax reform means that when Arizona experiences the next economic downturn, lawmakers will have fewer alternatives for balancing the budget and will be more likely to make large destructive cuts to important priorities.

## **Proposition 126 Will Hurt Our Neighborhoods and Schools**

A broad sales tax base is necessary to maintain good neighborhoods and build thriving communities. Cities and towns receive much of their revenue from the sales tax and are hurt when the tax base is too narrow. Reduced revenues for cities and towns could result in critical cuts to police, fire, street repairs and other city services. Cities could be forced to raise their local sales tax rates, which are added onto the state sales tax rate.



In addition to the revenue which goes into our state's general fund, our neighborhood public schools also depend on the additional 0.6% sales tax which goes into the dedicated Classroom Site Fund to pay teachers, reduce class sizes, and provide resources for struggling teachers. As the sales tax base shrinks, schools will receive less money from the Classroom Site Fund making it more difficult to provide our students with the quality education they need to succeed in college and careers.

Proposition 126 will keep Arizona's economy tied to the past instead of enabling us to be innovative and able to adapt to shifts in the economy. Rather than taking options off the table, Arizona should strive for a more flexible sales tax code which will ensure that we will have the revenue needed to educate and train a skilled workforce, provide quality infrastructure and bring better paying jobs and economic growth to our state.

