

## What if Arizona eliminated sales tax exemptions?

Arizona relies heavily on transaction privilege and use taxes—often referred to as the sales tax—to provide revenue for government programs and services. In fact, sales tax is the largest component of the state’s General Fund, at 54%. As Arizona looks to recover from the effects of the Great Recession, attention has focused in part on items that are not subject to sales tax now and how that revenue might help plug a mid-year budget gap that ranges between \$1.4 and \$1.6 billion. The Governor’s Office of Strategic Planning and Budgeting has projected a deficit in excess of \$3 billion for next year<sup>1</sup>.

When discussing state revenue and sales tax, exemption is used to refer to two different things. The first is the large number of services in Arizona that are not taxed, and traditionally have never been taxed. The second are other things that at one time were taxed, but now no longer are. This assessment, provided to give a very broad view of the impacts, talks about both.

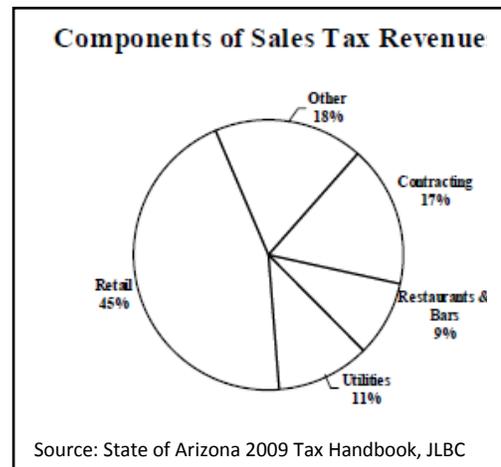
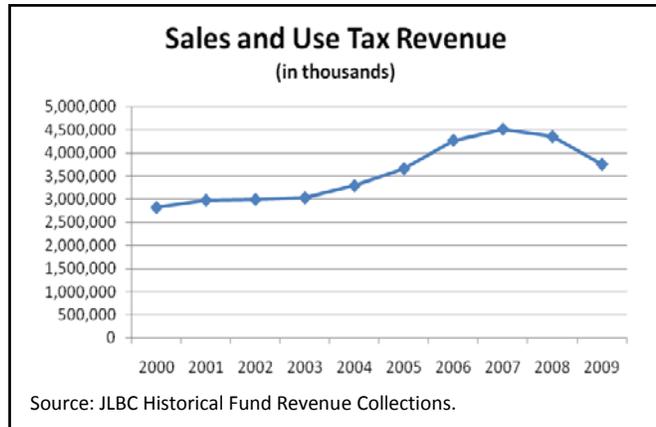
Sales tax exemptions cover a host of different things, from the obscure—hotel soap, to the significant—personal and professional services.

Eliminating these exemptions would be politically difficult and supporters of exemptions for services believe elimination would negatively impact small businesses and possibly the pace of the economic recovery. In fact, Arizonans who favor taxing services should expect a battle. In 2007, Michigan passed a law taxing several personal services, including wedding planning, personal trainers, and investment advice; as well as business services including consulting, logistics and design services. In response, state lawmakers faced a storm of protest and repealed the law shortly thereafter. However, removing sales tax exemptions would provide a significant cash infusion to the General Fund.

### The choices that got us here

Arizona’s tax structure is rooted in our agricultural and mining history and a goods-based economy. However, in 2007, services accounted for 60% of personal consumption nationally.<sup>2</sup>

Estimates are that Arizona has in excess of 200 sales tax exemptions. While this did not occur overnight, the majority of exemptions in place today have been implemented since 1980. The number of exemptions increased 450% between 1980 and 1999, to a total of 121.<sup>3</sup> In 2001, when the Arizona Transaction Privilege Tax Exemption Study Group



<sup>1</sup> <http://www.ospb.state.az.us/documents/2010/ArizonaBudgetStatus2010.pdf>

<sup>2</sup> Sales Taxation of Services Survey – 2007 Update. Federation of Tax Administrators. <http://www.taxadmin.org/fta/pub/services/services.html>

<sup>3</sup> *Five Shoes Waiting to Drop on Arizona’s Future*. Morrison Institute for Public Policy, ASU. 2001

convened, they identified 194 exemptions; and in 2003, when the Citizens' Finance Review Commission (CFRC) tallied exemptions, the number had risen to over 220.<sup>4</sup>

Many of these exemption choices were made when Arizona was in the midst of a growth and construction boom. While the exemptions created fewer revenue sources, the growing economy and the increase in the number of taxpayers overshadowed any negative impact. The Great Recession has changed all of this.

Since 2007, all revenue sources, including income and corporate taxes, have seen significant decreases. Sales tax is no different, with incoming revenue decreasing 31% between 2007 and 2010.<sup>5</sup>

The governor has suggested the legislature refer to the ballot a temporary sales tax increase of one cent. The discussion centers on increasing the value of the sales tax, but not extending the base of goods or services to apply it to.

### **To exempt or not to exempt**

Sales tax exemptions, including the taxing of services, come up regularly when Arizona finds itself in a deficit. Arguments for eliminating some or all exemptions point to increased stability as well as the potential to allow for a lower overall rate. Discussion of exemptions highlights the need to get out of the budget jam in the short term and then decide on how to reform Arizona's policies to create a coherent revenue system. CFRC produced a number of guiding principles for examining these exemptions. The Commission noted, "When the base is narrow, even minor fluctuations in relatively few industries can have a significant impact on state revenues. When the base is as broad as possible, weaknesses in one industry can more easily be offset by gains in others. A broader base also allows for a lower rate."<sup>6</sup> Currently, Arizona's statewide base rate is 5%, with an additional .6% added through voter initiative that bypasses the general fund and goes directly for K-12 expenditures.

A variety of economists and fiscal agencies, including the Arizona Department of Revenue and the Joint Legislative Budget Committee (JLBC), have attempted to quantify the revenues lost as a result of these exemptions. The Department of Revenue reviewed all the exemptions for transaction privilege and use taxes and estimated potential lost revenue in excess of \$9.5 billion<sup>7</sup>; the JLBC's estimate was over \$10 billion.<sup>8</sup>

These exemptions cover a host of goods, and numerous services. For example, a commercial lease tax exempted in 1993 was estimated to have cost the state \$93 million in revenue and the exemption for the wage and salary portion of the price of construction totaled an estimated \$640 million.<sup>9</sup>

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<sup>4</sup> Public Finance in Arizona, Volume III: Options for Managing the Arizona State Government General Fund. December, 2008 <http://wpcarey.asu.edu/seidman/reports/UnivEconomist/publicFinance-3.pdf>

<sup>5</sup> McPheters, Lee, Clearing the Wreckage of the "Great Recession" Will Take Years, [knowledge@w.p.carey.asu.edu](mailto:knowledge@w.p.carey.asu.edu)

<sup>6</sup> Citizens' Finance Review Commission. Guiding Principles in Evaluating Transaction Privilege Tax Exemptions. August 29, 2003. <http://www.azcfr.gov/documents/principles.pdf>

<sup>7</sup> The Revenue Impact of Arizona's Tax Expenditures FY 2008/2009. Arizona Department of Revenue. November, 16, 2009.

<sup>8</sup> State of Arizona 2009 Tax Handbook. JLBC. October 2, 2009

<sup>9</sup> Public Finance in Arizona, Volume III: Options for Managing the Arizona State Government General Fund. December, 2008 <http://wpcarey.asu.edu/seidman/reports/UnivEconomist/publicFinance-3.pdf>

However, there are a number of exempted items that one doesn't even think about, including health club memberships and feed for livestock and poultry. In addition to these, there are further exemptions that could generate some substantial revenue. For example:

- Articles incorporated into a manufactured product - \$1 billion
- Arizona lottery tickets – estimated lost revenue \$24.22million
- Seeds, seedlings, roots, bulbs, cuttings – estimated lost revenue \$1.97 million

Professional, administrative, and personal services form a large component of exemptions. It is estimated if all services were subject to sales tax, revenues would be in excess of \$2.1 billion.<sup>10</sup>

However, there are a number of arguments against taxing services. For example, taxing business to business services, such as accounting and legal, may result in higher costs passed down to the end-of-line consumers. Further, sales tax is viewed as a regressive tax, in that it impacts lower income individuals at a higher rate. Opponents of eliminating exemptions, especially those that currently exist for grocery and health care, argue this would put an even larger burden on the poor.

- However, in 2003, the CFRC issued a number of recommendations, three of which dealt directly with this issue. Specifically, they recommended the state:
  - Align the transaction privilege tax (TPT) to more appropriately mirror the state's economy.
  - Broaden the TPT base by including personal or consumer services.
  - Broaden the TPT base by including certain transactions that are currently exempt.<sup>11</sup>

Since the 1980s, the value of taxing personal and consumer services has been a key argument for providing increased revenue and stability to Arizona's overall fiscal system.

Broadening the sales tax base through focused elimination of exemptions would potentially generate millions in revenues needed to plug budget holes.



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<sup>10</sup> The Revenue Impact of Arizona's Tax Expenditures FY 2008/2009. Arizona Department of Revenue. November, 16, 2009.

<sup>10</sup> State of Arizona 2009 Tax Handbook. JLBC. October 2, 2009

<sup>11</sup> Public Finance in Arizona, Volume III: Options for Managing the Arizona State Government General Fund. December, 2008 <http://wpcarey.asu.edu/seidman/reports/UnivEconomist/publicFinance-3.pdf>