

INDICATOR INSIGHT

ECONOMICS ◀•▶ AN EXPERT'S INSIGHT ON THE ISSUE IN ARIZONA



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RETAIL SALES AND REVENUE COLLECTED FROM THE SALES TAX

The transaction privilege tax (TPT), often referred to as the sales tax, is a major source of revenue for state and local governments in Arizona. The TPT is applied to numerous categories, such as contracting and utilities. The analysis in this paper is limited to the retail category, which accounts for half of the TPT collected by state government, and the restaurant and bar category, which contributes one-tenth of the TPT revenue. Retail sales is alternatively defined as the retail category or as the combination of the retail and restaurant and bar categories.

The state government portion of the TPT has a tax rate of 5 percent. However, in the retail and restaurant and bar categories, the state distributes more than one-fourth of the revenue from this 5 percent tax to counties, cities and towns. An additional TPT tax of 0.6 percent, approved by voters in May 2001, is dedicated to education. From June 2010 through May 2013, an additional temporary tax of 1 percent was collected. County and city governments have the option of applying additional TPTs. Excluding the temporary sales tax, the overall TPT rate ranges across Arizona from less than 6 percent to more than 7 percent in unincorporated areas and from 7.6 percent to more than 10.7 percent in cities and towns.

In addition to these variations by locality in the tax rate, the tax base also varies by community. For example, food items to be consumed at home are not taxed by the state or by some local governments.

The tax base in the retail category is narrowly defined to apply primarily to goods purchased in stores. Few services are taxed and most online purchases, even of goods, are not taxed. Historically, this narrow tax base was not an issue since the bulk of consumer spending consisted of goods purchased in stores. Over time, however, services and online purchases have made up increasing shares of consumer spending. Thus, the traditional tax base of goods purchased in stores is shrinking relative to the size of the economy.

Retail Sales

The decline in taxable retail sales in Arizona from 1984 through 2012

is illustrated in Figure 1, measured as sales per \$1,000 of personal income. The fluctuations in the lines displayed in Figure 1 are due to the economic cycle. Even relative to personal income, retail sales fall during recessions and rise during recoveries. In addition to these fluctuations, each of the

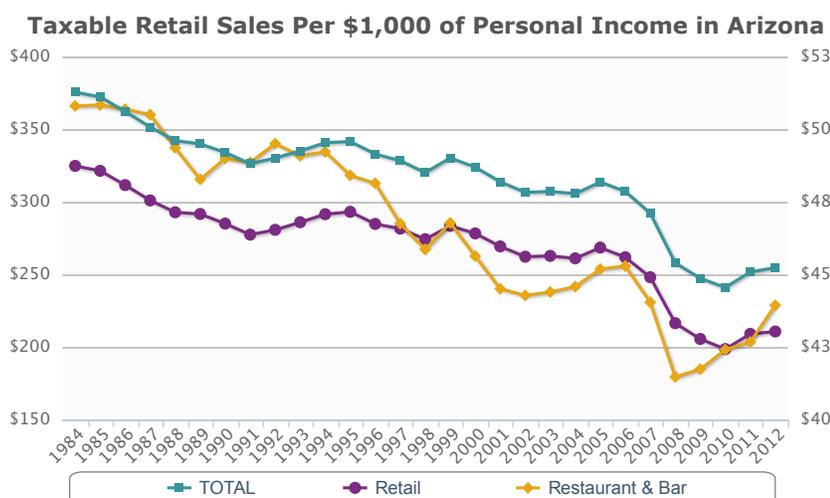


Figure 1 - Taxable Retail Sales Per \$1,000 of Personal Income in Arizona. Source: Arizona Department of Revenue (retail sales) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income). Note: Use left axis for the total and for retail; use the right axis for restaurant and bar.

Arizona Indicators is an online information resource and analysis tool that centralizes data about the state and its communities. Arizona Indicators presents interactive visualizations, clear data descriptions, and public opinion data in a broad range of content areas.

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lines, but especially the line for the retail category, shows a downward trend. The downtrend after 2007 is exaggerated by the length and severity of the recession that began at the end of 2007. Still, it is obvious that taxable retail sales relative to personal income have fallen significantly since the start of the series in 1984, with the annual declines interrupted only during economic recoveries.

Declines in retail sales relative to the size of the economy also have occurred nationally. The national retail sales data collected by the U.S. Census Bureau are not directly comparable to the taxable retail sales data reported by the Arizona Department of Revenue. To make the two series more comparable, gasoline stations have been excluded from the national data. Nationally, annual average retail sales relative to personal income were 6 percent lower in the 2002-09 economic cycle than in the 1992-2001 cycle; the decline was 12 percent in Arizona.

TPT Revenue

Retail sales are reported by calendar year, but government revenue is reported by fiscal year (July 1 through June 30). In this section, references to years are for fiscal years.

The decrease in taxable retail sales relative to the size of the economy has important implications to state and local governments. The tax rate of the state portion of the TPT, which is shared with local governments, has remained steady at 5 percent since 1984, excluding the recent temporary rate increase. Thus, the narrowing of the base has led to lower tax collections for the general fund. Legislative actions that have exempted many types of activities from the TPT have contributed to the reduction in general fund TPT revenue seen in Figure 2. In contrast, many local governments have increased their TPT rate, offsetting the declining revenue shared by the state.

The decrease in TPT revenue since 1984 shown in Figure 2 is similar to the decrease in taxable retail sales illustrated in Figure 1. General fund revenue from other sources also has declined relative to personal income. On average, the large decreases in income tax rates since the mid-1990s have resulted in a lowering of income tax collections, though economic cycles and extremes in capital gains have caused large annual variations in income tax collections since the late 1990s. Even sharper decreases have occurred in other revenue.

Thus, at the same time that TPT revenue has fallen relative to personal income, the general fund has become increasingly dependent on the TPT due to the elimination of revenue sources, reductions in tax rates, and/or narrowing of tax bases. As seen in Figure 3, the portion of general fund revenue coming from the TPT has increased over the last four decades from less than 40 percent to around 50 percent. During the same period, the share from sources of revenue other than the TPT and income tax has dropped from more than 30 percent to 10 percent. The sharp drop in the TPT share in 1980 is due to the removal of the tax on food to be consumed at home; the increase in share in 1984 corresponds to a rate increase from 4 percent to 5 percent. The fluctuations in the TPT share since the late 1990s largely result from sharp variations in capital gains reported in income tax filings.

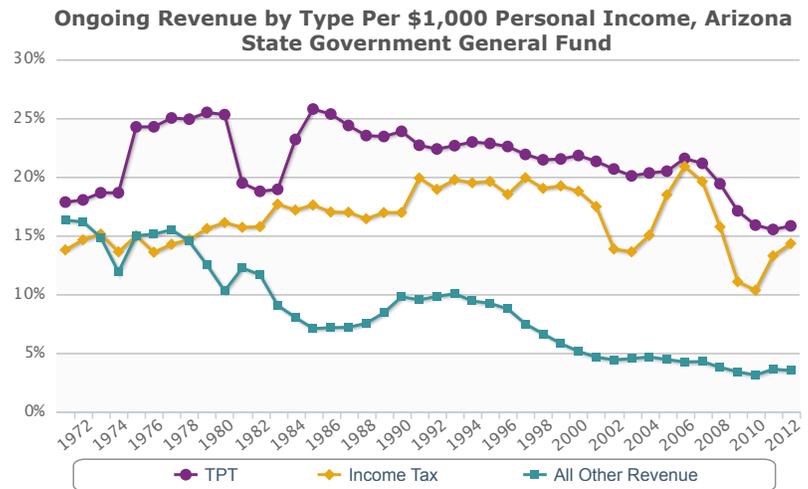


Figure 2 - Ongoing Revenue by Type Per \$1,000 of Personal Income, Arizona State Government General Fund. Source: Arizona Joint Legislative Budget Committee (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

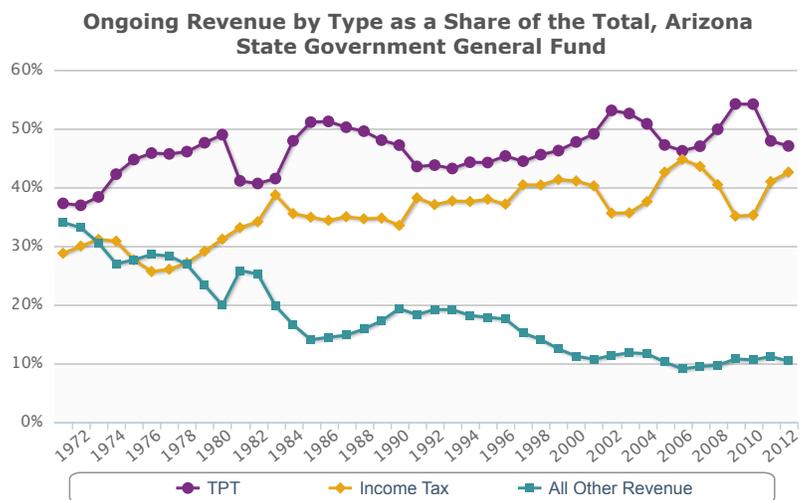


Figure 3 - Ongoing Revenue by Type as a Share of the Total, Arizona State Government General Fund. Source: Arizona Joint Legislative Budget Committee

Figures 2 and 3 focus on the state government general fund, while Figures 4 and 5 take a broader view of all own-source state and local government revenue (revenue received from the federal government is not included). These data, reported by the U.S. Census Bureau, only go through 2010. Figure 4 is comparable to Figure 2 in displaying revenue per \$1,000 of personal income. Since the tax reductions since the mid-1990s have been focused on state government general fund sources, the broader revenue data that includes other state government funds and local governments do not show nearly as much deterioration in revenue over time. Combined state and local government TPT collections have not decreased relative to personal income, except since 2007 due to the deep recession. Increases in local government TPT rates have offset the decreases in revenue resulting from the narrowing of the tax base.

In Figure 5, state and local government revenue per \$1,000 of personal income in Arizona is compared to the national average. This shows Arizona's heavy dependence on the sales tax relative to other states, with the Arizona figure at least 37 percent higher than the national average in every year except 2010 – the drop in the line after 2007 reflects the longer and deeper recession in Arizona. In contrast, Arizona collects much less than the national average from other revenue sources. The sharp drop in the income tax line in Figure 5 after 2007 is not only due to the recession and a decline in capital gains; a significant tax reduction was implemented during this period.

The narrowing of the TPT base affects all governments in Arizona – governments will be increasingly unable to fund current programs. The severity of the narrowing base is amplified by the heavy dependence on the TPT relative to other revenue sources. The issue is most pronounced in the state government general fund, which is especially reliant on the TPT.

The primary solution is to expand the TPT base to include some services and purchases made electronically. If the base was widened in this way, TPT collections would keep pace with the economy.

Without broadening the TPT base, the issue can be minimized by substantial changes to the revenue system that result in the TPT providing a much lesser share of the revenue. This could be accomplished by lowering the TPT rate while increasing rates and/or bases of other revenue sources.

Broadening the TPT base would have the added benefit of reducing the cyclical nature of TPT revenue. More generally, any reworking of the revenue system needs to include the reduction in the cyclical nature of government revenue as a primary goal. Cyclical nature has become a serious issue with the state government general fund since the late 1990s. The numerous changes to the tax code affecting the general fund since the mid-1990s have resulted in heavy dependence on just two revenue sources – the TPT and the income tax have provided about 90 percent of general fund revenue since the mid-2000s, compared to 67 percent in the early 1970s. Revenues from the TPT and from the income tax are highly cyclical.

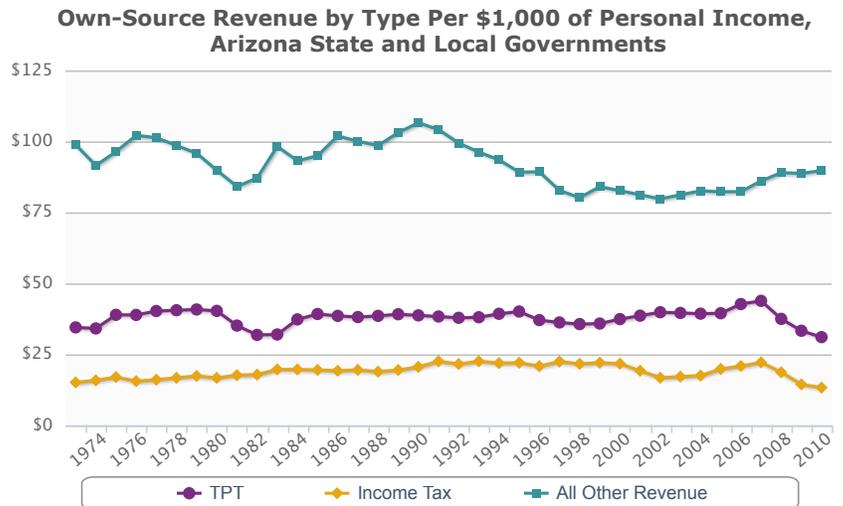


Figure 4 - Own-Source Revenue by Type Per \$1,000 of Personal Income, Arizona State and Local Governments. Sources: U.S. Department of Commerce, Census Bureau (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

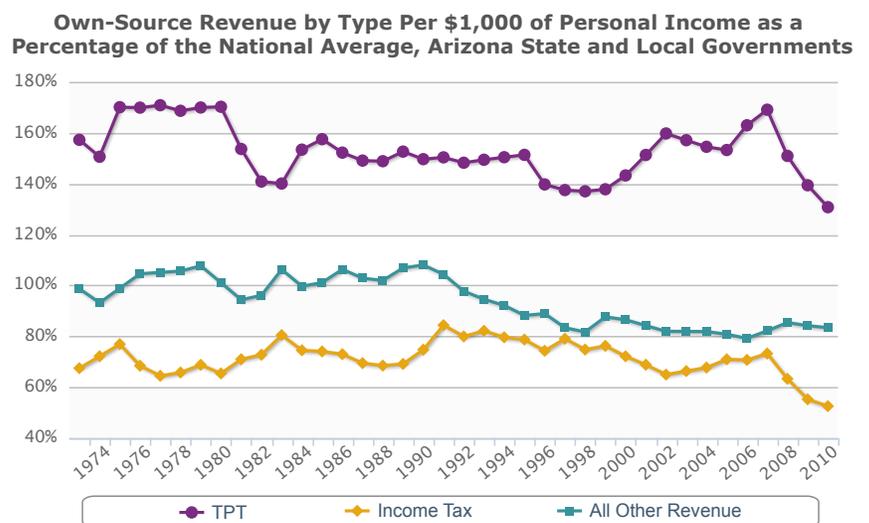


Figure 5 - Own-Source Revenue by Type Per \$1,000 of Personal Income as a Percentage of the National Average, Arizona State and Local Governments. Source: U.S. Department of Commerce, Census Bureau (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income).